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U.S. INCOME

S Corporations: Corporate Tax Issues

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This Portfolio revises and supersedes previous versions of 731-3rd T.M., *S Corporations: Corporate Tax Issues*.

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S Corporations: Corporate Tax Issues

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *S Corporations: Corporate Tax Issues*, No. 731-3rd, reviews the special corporate-level issues of the S corporation.

In general, the S corporation operates as a pass-through entity and, as such, its shareholders are able to avoid federal double-taxation on S corporation earnings. This Portfolio examines the limited circumstances in which the S corporation itself is taxed, including the passive income and built-in gains taxes. The Portfolio presents a comprehensive discussion of the distribution mechanics unique to the S corporation but critical to its single-tax regime. The Portfolio discusses corporate asset acquisition and disposition transactions, including reorganizations. The Portfolio closes with the tax consequences affecting an S corporation with international operations.

This Portfolio provides the practitioner with analysis of the taxation of S corporations and their shareholders. In addition, the Portfolio explains the relationship of the S corporation provisions with other areas of the tax laws and illustrates the advantages and difficulties of a corporation operating in S corporation form.

For additional discussion of S Corporations, see 730 T.M., *S Corporations: Formation and Termination*, and 732 T.M., *S Corporations: Shareholder Tax Issues*.

This Portfolio may be cited as Lamorena, and Sobol, 731-3rd T.M., *S Corporations: Corporate Tax Issues*.

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DETAILED ANALYSIS

I. Taxation of the S Corporation

A. General

1. S Corporation Exempt from Income Tax

Subchapter S treats the S corporation as a pass-through entity similar to a partnership. Items of income and loss pass through separately to shareholders, and, generally, the S corporation is not subject to any corporate-level tax on those items. Section 1363[1] provides that, if a valid S corporation election is in effect for the entire year, the S corporation normally is not subject to any taxes imposed under Chapter 1 of the Internal Revenue Code (the Code). This means the S corporation is not subject to the corporate income tax (§11), the accumulated earnings tax (§531), or the personal holding company tax (§541).[2]

The S corporation may be subject to income tax in the following, limited situations:

- An excess net passive income tax is imposed by §1375 if the S corporation has accumulated earnings and profits (E&P) and gross receipts more than 25% of which are passive investment income. See I.B.3., below.
- The built-in gains tax (applicable generally for C corporations converting to S corporation status after 1986) is imposed by §1374 upon the taxable disposition of an appreciated asset within the first 5 years after the election of S status. See I.C., below.
- If investment credit property is disposed of prematurely and a tax credit was allowed prior to the corporation's S election, investment tax credit recapture may apply.[3]

Comment: Section 164 imposes a $10,000 limit ($5,000 for married individuals filing separately) on the amount of state and local taxes an individual can deduct for federal income tax purposes in taxable years beginning after December 31, 2017, and before January 1, 2026.[4] In response to the federal limitation, many states have enacted or proposed legislation to lessen the impact of the limitation by shifting the tax on a pass-through entity owner to the pass-through entity. The pass-through entity deducts state and local income taxes as a business expense at the federal level, followed by a deduction for the tax paid by the entity in the owners' distributive share of income. The shareholders generally claim a credit on their state tax returns for the amount of taxes paid by the pass-through associated with the income allocated to them. For coverage of these entity-level taxes, see 1560 T.M.S., *State Taxation of Limited Liability Companies and Partnerships,* at 1560.03.B.4.

Although the S corporation generally is not subject to tax under Chapter 1 of the Code, it is still subject to all taxes imposed by other chapters of the Code, including employment and excise taxes.

2. Application of Subchapters C and K

The S corporation is a hybrid entity subject to special rules borrowed from subchapters C and K. Familiarity with the regular corporate and partnership rules is most helpful, if not essential, when dealing with S corporation taxation. For example, in S corporation issues relating to the passthrough of profit and loss, many of the partnership rules provide useful analogies.

Although S corporation income is treated in many respects similarly to partnership income for tax purposes, §1371(a) provides that the C corporation rules also apply to S corporations. Under §1371(a), these rules do not apply when the result would be inconsistent with the purpose of treating the S corporation as a pass-through entity. This provision leaves open to question which subchapter C rules apply to an S corporation.[5]

The application of the subchapter C rules for reorganizations, redemptions, and liquidations to S corporations is discussed in more detail in I.G., below.

3. Computation of Taxable Income

Even though the S corporation is a passthrough entity, the taxable income of an S corporation is generally computed in the same manner as an individual's taxable income.[6]

The following special rules for computing income apply under §1363(b):

- the income and loss items referenced in §1366(a)(1)(A) are to be separately stated;
- none of the deductions under §703(a)(2) are allowed:
  - o personal exemptions (§151);
  - o taxes of foreign countries and U.S. possessions (§164 and §901);

[1] Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended, and to the regulations promulgated thereunder.

[2] Reg. §1.1363-1(a)(1).

[3] *See* §50. Section 46 defines the amount of the investment credit as equal to the sum of the rehabilitation credit (§47), the energy credit (§48), the qualifying advanced coal project credit (§48A), the qualifying gasification project credit (§48B), the qualifying advanced energy project credit (§48C), the advanced manufacturing investment credit (§48E), and the former qualifying therapeutic discovery project credit project credit for qualified investments made in tax years beginning in 2009 or 2010 (former §48D). See 730 T.M., *S Corporations: Formation and Termination,* for a discussion of investment credit recapture and S election terminations, and see 583 T.M., *Cost Segregation and the Former Investment Tax Credit,* for a general discussion of investment credit recapture.

[4] §164(b)(6), effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

[5] For tax years beginning before 1997, former §1371(a)(2) treated the S corporation as an individual with respect to its stock ownership in another corporation. The 1996 Small Business Job Protection Act, Pub. L. No. 104-188, §1310, deleted this provision to help clarify that §332, §337, and §338 may be applied in appropriate circumstances. *See* H.R. Rep. No. 104-737, at 226 (1996). The 1996 repeal did not change the general rule governing the computation of income of an S corporation (e.g., an S corporation and its shareholders may not claim a dividend received deduction).

[6] §1363(b). *See also* Reg. §1.1363-1(b).

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o charitable contributions (§170);

o net operating losses (§172);

o additional itemized deductions, e.g., medical expenses (§211–§224); and

o depletion for oil and gas wells (§611).

• the corporate preference reduction rules under §291 apply if the S corporation was a C corporation for any of the three immediately preceding years, preventing corporations from avoiding the preference reduction rules by electing S status.[7]

Because S corporation taxable income is computed in the same manner as for an individual, the dividends received deduction under §243 and the other corporate deductions provided in subchapter B of Chapter 1 of the Code are not available to the S corporation.[8] The election under §248 to deduct some organizational expenditures currently and amortize any remaining organizational expenses over 180 months is specifically allowed.[9]

Several provisions principally designed to curb tax shelter activity apply to S corporations but not to regular corporations. These provisions include:

• §183, which limits deductions attributable to activities not engaged in for profit;

• §280A, which disallows the deduction of certain expenses incurred in connection with the business use of a home and the rental of a vacation home;

• §464, which provides that certain taxpayers involved in the business of farming cannot deduct amounts paid for feed, seed, fertilizer, etc., before such items are used; and

• §469, which limits the deductibility of S corporation items depending on the level of participation the shareholder has in the S corporation's trade or business.[10]

4. Earnings and Profits

An S corporation, unlike a C corporation, generally does not generate earnings and profits (E&P). Any E&P carried over from prior C corporation years remain unadjusted for the duration of S status;[11] however, accumulated E&P can be acquired by an S corporation in certain corporate transactions under §381.

To the extent an S corporation's distributions exceed its accumulated adjustments account (AAA), distributions are treated as coming out of accumulated E&P (if any) and are taxed as dividends to shareholders. Accumulated E&P are adjusted downward for such distributions.[12] In addition, proper adjustments to E&P are made for redemptions and certain reorganizations.[13] For a complete discussion of the distribution rules, see II., below.

Accumulated E&P are also important in determining if excess net passive income will be taxed under §1375 and if S status will terminate after three consecutive years of excessive passive income under §1362(d)(3). For a complete discussion of the passive income rules, see I.B., below.

If investment credit property is disposed of, and the S corporation is subject to recapture tax, the corporation's E&P are adjusted for the tax under §50(a).[14]

Comment: Because §1371(c) precludes adjustments to accumulated E&P during S corporation existence, it is not clear what adjustment needs to be made for federal and state tax deficiencies assessed against the S corporation for any prior C corporation years. Under §1368(e)(1)(A), the AAA cannot be adjusted for such federal tax deficiencies. It would seem appropriate for payments of such deficiencies to come out of and reduce accumulated E&P; however, this appears to be prohibited by §1371(c)(2), which only allows an E&P adjustment in select cases (none of which deals with tax deficiencies). A counter argument to this §1371 prohibition against adjustment is that the adjustment relates to tax activity in C status. As a result, the accumulated E&P should be adjusted to reflect a federal or state tax deficiency assessed against the S corporation for any prior C corporation years because the adjustment is attributable to a C period, and not an S period. While this is an equitable argument perhaps not supported by the statute, in effect, the correct policy position would be to reduce accumulated E&P for federal or state tax deficiency attributable to a C period, which would correspondingly reduce the amount that could be treated as a dividend in the future.

5. Carrybacks and Carryforwards

a. Net Operating Losses (NOLs)

Because a NOL generated by an S corporation passes through to its shareholders, it cannot be used as a carryback or carryover by the corporation itself.[15] Such a NOL is treated as an ordinary loss by the shareholders. As such, the loss is deductible by the shareholders, subject to any loss limitation provisions applicable at the shareholder level.[16]

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[7] §1363(b). See *Vainisi v. Commissioner*, 599 F.3d 567 (7th Cir. 2010), where the Seventh Circuit held that a bank, which was a qualified subchapter S subsidiary (a QSub), was allowed to deduct 100% of the interest expense incurred in connection with the purchase of certain qualified tax-exempt obligations after the three-year period of §1363(b)(4).

[8] §1363(b); Reg. §1.1363-1(b).

[9] §1363(b)(3).

[10] Corporations engaged in the trade or business of farming are generally required to use the accrual method of accounting rather than the cash method if the three-year average annual gross receipts exceed a base statutory amount of $25 million (indexed for inflation); however, §447(c)(1) specifically exempts S corporations from this requirement. *See* §447 (reference to §448(c)). For inflation-adjusted amounts, see Tables, Charts & Lists, *Gross Receipts Test Limit by Year under §448(c).*

[11] §1371(c)(1).

[12] §1371(c)(3).

[13] §1371(c)(2).

[14] §1371(d)(3). Under §46, the investment credit includes the rehabilitation credit, the energy credit, the qualifying advanced coal project credit, the qualifying gasification project credit, the qualifying advanced energy project credit, the advanced manufacturing investment credit, and the clean electricity investment credit. Note that the investment credit previously also included the qualifying therapeutic discovery project credit under former §48D; however, former §48D was repealed by the Consolidated Appropriations Act of 2018, Pub. L. No. 115-141, Div. U., §401(d)(3)(A).

[15] §1371(b)(2). Loss items can only be used at the shareholder level to the extent of a shareholder's basis in stock and debt. §1366(d)(1). In addition, the use of losses may be limited by the passive loss rules (§469), the at-risk rules (§465) and/or the excess business loss rules (§461(l)).

[16] *See* §172. For a detailed discussion, see 539 T.M., *Net Operating Losses — Concepts and Computations. See also* §461(l).

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b. Other Carryover Items

In general, no carryforward or carryback items arising in a taxable year for which a corporation is a C corporation can be carried to a taxable year in which the corporation is an S corporation.[17] This rule applies even though the denial of subchapter C carryover items arguably could trigger the tax benefit rule under §111.

In *Rosenberg v. Commissioner*,[18] the taxpayers attempted to invoke the tax benefit rule under §111 by effectively recharacterizing C corporation NOL carryforwards as an income exclusion from gross sales. The Tax Court held that §1371(b)(1) expressly prohibits such carryforwards and, therefore, the statute could not be circumvented via the tax benefit rule.[19]

However, under §1374(b), the amount of recognized built-in gain subject to tax under §1374 may be reduced by NOL, capital loss, business credit or minimum tax credit carryovers from C corporation years.[20]

Note: An S corporation year is treated as an elapsed year for purposes of determining the number of years these items can be carried back or forward.[21] Therefore, in contemplating an S election or termination, consideration should be given to any carryover items that may expire as a result of a change in status.

> *Example:* XYZ, a C corporation, sustains a net capital loss of $10,000 in its calendar year ending December 31, Year One that may not be carried back. Effective January 1, Year Two, XYZ elects S status and has $25,000 of net capital gain income, all of which is taxable to the shareholders. At the end of Year Two, the S election is terminated. The $10,000 net capital loss from Year One may not be used as a carryover against the capital gain recognized in Year Two while XYZ is an S corporation, but it may be carried forward, undiminished, as a deduction for Year Three when XYZ is a C corporation. However, Year Two is counted in determining the total period under §1212(a)(1) over which the loss may be carried.[22]

While the potential carryovers and carrybacks affected by this rule have not been identified by the IRS, a potential list could include:

- capital losses under §1212(a);
- NOLs under §172;
- excess charitable contributions under §170(d)(2);
- excess contributions to qualified pensions under §404(a)(1)(E);
- excess contributions to stock-bonus and profit sharing plans under §404(a)(3);
- percentage depletion deductions for independent producers under §613A(d)(1); and
- various credits including the foreign tax credit under §904(c) and §907(f).[23]

Consistent with flow-through treatment of S corporations, any items subject to potential carryover are passed through to shareholders with carryover status determined at the shareholder level.[24]

In *St. Charles Inv. Co. v. Commissioner*,[25] the Tenth Circuit, reversing the Tax Court, held that passive activity losses (PALs) could be carried forward from a C corporation year to an S corporation year pursuant to §469(b) and §469(f)(2), and that the suspended PALs associated with the activities disposed of in the year of the S election were fully deductible pursuant to §469(g)(1)(A). The court determined that restrictions on carryforwards from a C year to an S year are not enumerated in §469 and have no effect on the operation of §469(b). The court also determined that, under §469(f)(2), the rules of §469 continued to apply to the corporation's suspended PALs, as if it had continued in its C status, pursuant to §469(f)(2). Therefore, the corporation could fully deduct suspended PALs associated with activities when those activities that were disposed of pursuant to §469(g)(1)(A).

When a third-party creditor forgives an S corporation's indebtedness, cancellation of indebtedness income arises. To the extent the income is excluded, tax attributes under §108(b)(2) are reduced.[26] NOLs (and NOL carryovers) are one of the tax attributes that can be reduced under §108(b)(2) to avoid cancellation of indebtedness income. Because §1371(b)(1) prohibits carryforwards or carrybacks arising from a C corporation taxable year to be carried over to an S corporation year, it would seem that this rule could foreclose the use of subchapter C NOLs as a tax attribute available for reduction under §108 to avoid cancellation of indebtedness income. Section 108(d)(7)(B) specifically provides that losses suspended at the shareholder level by the basis limitation of §1366(d)(1) are treated

[17] §1371(b)(1). Even under the former subchapter S rules, there was an implicit rule that prohibited carrybacks from a subchapter C year to a subchapter S year. *Mitchell v. Commissioner*, T.C. Memo 1990-617.

[18] 96 T.C. 451 (1991).

[19] The Tax Court also held that even if §1371(b)(1) did not prohibit the application of the tax benefit rule, the tax benefit rule would not apply to taxpayer's case.

[20] §1374(b)(2), §1374(b)(3).

[21] §1371(b)(3).

[22] Note that, with respect to NOLs, losses arising in tax years ending after 2017, generally cannot be carried back but may be carried forward indefinitely. Farming losses may be carried back two years. *See* §172(b)(1). Losses arising prior to 2018 could generally be carried back two years and forward 20 years. For a detailed discussion, see 539 T.M., *Net Operating Losses — Concepts and Computations*. For C corporations with NOLs arising in tax years ending after 2017, the fact that an S year counts in terms of a carryforward limitation will have little significance.

[23] The rules for carryover of excess charitable contributions are modified for tax years beginning after 2025 to conform to the 1% floor on contributions before an amount is deductible by a corporation under §170(b)(2)(A), and the 0.5% floor for individuals making deductible contributions under §170(b)(1)(l), both as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70426(a), §70425(a). However, no deduction is available at the S corporation level, and only shareholders may take a carryover deduction, if any is available, using the individual limitations under §170(b)(1). For a discussion of this limitation, see 521 T.M., *Charitable Contributions: Income Tax Aspects*, at IX.B.

[24] §1371(b)(2).

[25] 232 F.3d 773 (10th Cir. 2000), *rev'g* 110 T.C. 46 (1998).

[26] §108(b). See also Reg. §1.108-7(d), T.D. 9469, 74 Fed. Reg. 56,109 (Oct. 30, 2009), which provides guidance on how an S corporation reduces its tax attributes under §108(b) for taxable years in which it has cancellation of debt income that is excluded from gross income under §108(a).

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as NOLs for purposes of tax attribute reduction under §108(b)(2).[27]

The exclusion of income arising from the discharge of indebtedness and corresponding reductions in tax attributes (including losses which are not allowed by reason of any shareholder's basis limitation) are to be made at the corporate level.[28]

6. *Controlled Group Membership*

To prevent taxpayers from setting up multiple corporations and taking advantage of certain benefits such as graduated tax rates and exemptions for alternative minimum and environmental taxes, the controlled group limitation rules were enacted.[29] Under pre-2018 §1561, component members of a controlled group were limited in their ability to use these benefits. Because there is a flat tax on corporations and the alternative minimum tax on corporations was repealed, current §1561 only provides a limitation on the accumulated earnings credit.[30] The term controlled group is defined in §1563 and usually refers to parent-subsidiary groups or brother-sister controlled groups. Component members include certain corporations linked by stock ownership (usually at least 80% of the value) and other enumerated excluded and included corporations.

Three terms of art are generally used in the controlled group rules. First, a corporation may be a member of a controlled group;[31] however, under §1561(a)(1), only component members are considered for purposes of allocating the tax benefit. In addition, §1563(b)(2) identifies certain corporations as excluded corporations, which cannot be component members.[32] Nothing precludes an S corporation from being a *member* of a controlled group, as described in §1563, but an S corporation cannot be considered a *component member* of a controlled group unless it is subject to the built-in gains tax under §1374 and, presumably, the tax under §1375.[33]

An S corporation that is an excluded member remains a member for purposes of those Code provisions that apply merely based on controlled group membership (and not provisions that apply based on component member status). Similarly, an S corporation can be treated along with other corporations as a single corporation under §52 principles for purposes of determining whether another corporation is an applicable corporation within the meaning of §59(k), even though an S corporation itself cannot be treated as an applicable corporation.

Under §1361(b)(3), an S corporation parent can own up to 100% of a C corporation subsidiary. The S corporation's unfettered ability to own corporate subsidiaries means that the controlled group rules can be relevant in the S corporation context.

7. *Elections at the Corporate Level*

Generally, any elections affecting the computation of items derived from an S corporation are to be made by the corporation.[34] Corporate-level elections affect general accounting methods, involuntary conversion treatment under §1033, depreciation methods, inventory valuation methods, and selection of fiscal year. On the other hand, two elections in the Code are made at the S shareholder level:[35]

- §617, relating to the deduction and recapture of certain mining exploration expenditures; and
- §901, relating to foreign taxes paid during the year.

To minimize exposure to the alternative minimum tax, each shareholder may also elect to amortize the shareholder's allocable share of qualified expenditures under §59(e) over a 10-year period beginning with the taxable year in which the qualified expenditures are made.[36]

B. Passive Income

1. *General*

S corporations that do not have accumulated E&P are not subject to passive income limitations;[37] however, S corporations with accumulated E&P are subject to passive income limitations. S corporations with accumulated E&P need to monitor their passive income for two reasons:

- if passive income for a taxable year exceeds 25% of gross receipts for the year, a corporate level tax on excess net passive income may be imposed under §1375(a); and
- if the 25% limit is exceeded for three consecutive tax years, the corporation's S status will terminate at the beginning of the next tax year under §1362(d)(3).

The purpose of the passive income rules is not entirely clear. In explaining the passive income test, the 1982 Subchapter S Revision Act[38] (SSRA) Senate Finance Committee Report states:

> The passive income test (as modified) is retained for corporations with accumulated earnings and profits to prevent the conversion of a regular corporation's operating company into a holding company whose income is not subject to a corporate level tax, with-

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[27] The 1993 Revenue Reconciliation Act, Pub. L. No. 103-66, §13150, amended §108(d)(7)(B) to provide that this section does not apply to any discharge of qualified real property business debt described in §108(a)(1)(D). In general, qualified real property business debt, defined in §108(c)(3), is debt incurred in connection with real property used in a trade or business. The amount excluded from gross income under §108(a)(1)(D) is applied to reduce the basis of depreciable real property. The provision is effective for discharges after December 31, 1992, in taxable years ending after such date.

[28] §108(d)(7)(A).

[29] *See* S. Rep. No. 88-830, at 150 (1964).

[30] *See* §1561(a), as amended by Pub. L. No. 115-97, §12001(b)(16), effective for tax years beginning after 2017, and §13001(b)(6)(A), effective for transfers made after December 31, 2017.

[31] §1563(b)(1)(A). *See also* Reg. §1.1563-1(a)(1)(ii), T.D. 9522, 76 Fed. Reg. 19,907 (Apr. 11, 2011) (clarifying which corporations would be included in controlled group of corporations).

[32] Note that in Prop. Reg. §1.1563-1(a)(1)(ii) the IRS clarified that a corporation that satisfies the controlled group rules for stock ownership and qualification would be a member of such group, without regard to its status as a component member.

[33] Reg. §1.1563-1(b)(2)(ii)(C). *See also* former Reg. §1.1563-1T(b)(2)(ii)(c), T.D. 9304, 71 Fed. Reg. 76,904 (Dec. 22, 2006) (clarifying that "only to the extent that a particular tax (and thus a particular tax benefit item to which section 1561(a)) applies to an S corporation is that type of corporation treated as a component member of the group").

[34] §1363(c); Reg. §1.1363-1(c)(1).

[35] §1363(c)(2); Reg. §1.1363-1(c)(2).

[36] §59(e)(4)(C); Reg. §1.1363-1(c)(2)(ii).

[37] §1362(d)(3), §1375. This rule contrasts with former §1372(e)(5), under which a subchapter S corporation with or without subchapter C [accumulated] E&P could terminate its subchapter S status if more than 20% of its gross receipts came from passive income sources.

[38] Pub. L. No. 97-354.

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out the imposition of any shareholder tax on accumulated corporate earnings as would occur if the corporation was liquidated. However, to reduce the likelihood of a termination of election, the bill, rather than terminating the election, would impose a corporate level tax in certain circumstances where the test is not met.[39]

Comment: The total combined tax (i.e., the tax on passive income assessed against the S corporation itself and the tax on S corporation earnings imposed at the individual shareholder level) will usually be greater than the tax that would have been assessed had the corporation been a C corporation and distributed its earnings to its shareholders as a dividend.

Thus, it seems that the passive income rules are aimed at regular corporations converting their operations into personal holding companies and electing S status without shareholders having to pay a second tax on these earnings.

Comment: An S corporation can acquire accumulated E&P in certain acquisitions to which §381 applies.[40] In these cases, the passive income rules will need to be closely monitored after the §381 transaction.

2. Definitions

The terms accumulated earnings and profits, gross receipts, and passive investment income have the same meaning under the passive income tax rules as they do under the S corporation termination rules.[41]

a. Accumulated Earnings and Profits

A corporation has accumulated E&P if it had *any* E&P in a prior existence as a subchapter C corporation and those amounts have not been distributed.

The regulations define the term subchapter C earnings and profits (now referred to in the Code as accumulated earnings and profits) as the E&P of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an election under §1362(a) (or under §1372 of prior law) is not in effect. Accumulated E&P is modified as required by §1371(c).[42]

C corporations electing S status may not be entirely aware of the amount of their accumulated E&P. There is no de-minimis amount of E&P that an S corporation can have before §1375 can apply; the excess passive income tax can apply even if the S corporation has only $1 of E&P. Thus, an S corporation must make a good faith effort to determine its E&P when it wishes to avoid the excess passive income tax by distributing all its E&P.

Comment: The passive income tax can be waived by the IRS under §1375(d) if the S corporation demonstrates good faith in concluding it did not have accumulated E&P and it distributes any remaining E&P within a reasonable time of discovery or agrees to amend returns and make a deemed dividend election.[43]

An S corporation with E&P also risks termination of S status if passive investment income exceeds 25% of gross receipts for three successive years, even if no passive investment income tax is imposed on the S corporation in one or more of those years, for example, due to the taxable income limitation in §1375(b)(1)(B) discussed below.[44] An inadvertent termination can be waived by the IRS National Office under §1362(f) if certain conditions are met. Generally, requests for such waivers receive favorable rulings (see I.B.3., below); however, obtaining a waiver for an inadvertent termination due to excess passive income could prove to be more of a problem if the taxpayer actually pays the passive income tax during the three-years before the termination. The issue will be proving inadvertency where the taxpayer demonstrates awareness of the passive income rules.

For a detailed discussion regarding the computation of E&P, see 762 T.M., *Earnings and Profits.*

b. Gross Receipts

The term gross receipts is not specifically defined in either §1362(d)(3) or §1375. The pre-SSRA regulations, however, state that the term gross receipts is not synonymous with gross income.[45] Reg. §1.1362-2(c)(4)(i) states that the term gross receipts generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. These total receipts are not reduced by returns, allowances, costs or deductions. Furthermore, gross receipts include the amount received or accrued from the sale or exchange of any kind of property including §1231 property and income on investment property and for services rendered by the corporation.[46]

Comment: The inclusion of the amount received from the sale or exchange of property makes sense. The special rules for capital assets found in Reg. §1.1362-2(c)(4)(ii) and described

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[39] S. Rep. No. 97-640, at 6 (1982).

[40] §381 applies to liquidations of subsidiaries under §332 and to reorganizations under §368(a)(1)(A), §368(a)(1)(C), §368(a)(1)(D), §368(a)(1)(F), and §368(a)(1)(G).

[41] Reg. §1.1375-1(b)(4) The term subchapter C earnings and profits with respect to S corporations which were once C corporations was replaced by the term accumulated earnings and profits in §1375(d) by the 2005 Gulf Opportunity Zone Act, Pub. L. No. 109-135, §412(qq), to conform the terminology in §1375(d) to the terminology in §1375(a), as amended by the 1996 Small Business Job Protection Act, Pub. L. No. 104-188, §1311(b). Because of other changes made by the 1996 Act, an S corporation generally does not have accumulated earnings and profits after 1996 other than those from a period when the S election was not in effect. The S corporation regulations have not been amended to reflect the change in terminology; they continue to refer to subchapter C earnings and profits.

[42] Reg. §1.1362-2(c)(3). In general, no adjustment is made to earnings and profits while the corporation is an S corporation. §1371(c)(1). Exceptions are allowed for operating distributions under §1368(c)(2), and for redemptions, liquidations, and reorganizations. Again, the S corporation regulations have not been amended to reflect the change in terminology from subchapter C earnings and profits to accumulated earnings and profits; they continue to refer to subchapter C earnings and profits. *See* §1362(d)(3), as amended by the 1996 Small Business Job Protection Act, Pub. L. No. 104-188, §1311(b).

[43] *See* PLR 201935006. But see PLR 200830008 where it appears the taxpayer was not required to distribute any accumulated earnings and profits to obtain the inadvertent termination relief.

[44] §1362(d)(3)(A).

[45] Pre-SSRA Reg. §1.1372-4(b)(5)(iv).

[46] *See* Reg. §1.1362-2(c)(6) *Exs.* 1 (amount of money and face amount of note (or issue price if different) received in sale or exchange of depreciable property used in a trade or business included in gross receipts), 6 (dividend income on stock held for investment included in gross receipts), 7 (interest on accounts receivable arising from sales of inventory included in gross receipts), 8 (interest received in ordinary course of lending business included in gross receipts).

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below cannot apply to depreciable property used in a trade or business because property used in a trade or business is excluded from the definition of the term capital asset provided in §1221.[47] Similarly, if the S corporation manufactured and sold goods treated as inventory within the meaning of §1221(a)(1), gross receipts would include total sales includible for the taxable year under the corporation's method of accounting. There is no offset for cost of goods sold or any other deductions relating to the generation of this income for purposes of determining the amount included in gross receipts. In effect, including total sales in the computation of gross receipts dilutes the ratio of passive income to gross receipts, minimizing the possibility that a corporation actively engaged in a trade or business will be disqualified. For example, if a corporation: (i) sells for $1,000,000 inventory items that, because of unfavorable business conditions, had a cost of over $1,000,000, and (ii) has $1,000 of dividend income, it is engaged in a trade or business, does not have passive income in excess of 25% of gross receipts (taking into account only the $1,000,000 sales proceeds and not the cost of the property sold), and should not be disqualified under the S corporation rules. If the test were instead phrased in terms of gross income, the corporation would not qualify since its only gross income is $1,000 of dividends.

With respect to capital gain, the term gross receipts generally includes only the capital gain net income from dispositions of capital assets (as defined in §1221) other than stock and securities.[48] The term capital gain net income is defined in §1222(9), and thus losses are taken into account in determining gross receipts for this purpose. This rule generally prevents the churning of capital assets to generate gross receipts.[49] Gross receipts from the sale or exchange of stock or securities are taken into account only to the extent of the gains therefrom.[50]

Comment: Assuming a planning objective is to generate more gross receipts to avoid a passive income problem, consider first disposing of any asset other than a capital asset. Gross receipts include all receipts from such assets. Next, the sale of stock or securities generates gross receipts — without also generating passive investment income to the extent there is gain (with no reduction for any losses).

The regulations also provide an example illustrating amounts received in sales involving financing, which are includible in gross receipts.[51] In summary, these amounts are:

- money in the face amount of a note (or issue price if different) received by an accrual method corporation on the sale of §1231 properties;
- cash down payment in the face amount of notes (or issue price if different) received on the sale of a capital asset, but only to the extent of capital gain net income (losses are taken into account and would reduce gross receipts); and
- cash down payment and the amount of notes (or issue price if different) received on the sale of stock and securities, but only to the extent of gain on the sale (losses would not be netted against the gains).

In addition, Reg. §1.1362-2(c)(4)(iii) specifically provides that gross receipts do not include amounts received from:[52]

- a loan;
- a repayment of a loan;
- a contribution of capital;
- the issuance by the corporation of its own stock; and
- amounts received in nontaxable sales or exchanges, except to the extent that the corporation recognizes gain on the sale or exchange.

The amount received for an option to purchase property held by a former subchapter S corporation, where such amount was to be applied toward the purchase price upon exercise of the option, was found to constitute gross receipts for purposes of former §1372(e)(5).[53]

In Rev. Rul. 69-192, the IRS concluded that the gross receipts of an accrual basis insurance agency include the total premiums due when it bills its clients, since it is extending credit and not merely acting as an agent for the insurance company.[54]

In Rev. Rul. 71-455, a former subchapter S corporation participated in a joint venture with another entity. The IRS ruled that the corporation should include in its gross receipts its distributive share of the joint venture gross receipts rather than its distributive share of the ordinary loss of such venture. The IRS based its conclusion on the partnership rules under §702(a) and §702(b), and Reg. §1.702-1(a). In general, those rules provide that the character of income and loss items flowing through to the partners is retained at the partner level. Based on the IRS private letter rulings in this area, this rule applies to S corporation investments in all types of partnerships. The IRS extended the rationale of Rev. Rul. 71-455 to S corporations

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[47] §1221(a)(2), §1231(b).

[48] §1362(d)(3)(B)(i); Reg. §1.1362-2(c)(4)(ii)(A).

[49] In *Joseph Gann, Inc. v. Commissioner*, 701 F.2d 3 (1st Cir. 1983), *aff'g per curiam*, T.C. Memo 1982-104, *cert. denied*, 464 U.S. 821 (1986), the first-in, first-out (FIFO) method under Reg. §1.1012-1(c)(1) for determining basis was used to calculate gross receipts when the basis of shares of stock sold could not be specifically identified. *See also Hall v. Commissioner*, 92 T.C. 1027 (1989) (same).

[50] §1362(d)(3)(B)(ii). For taxable years beginning before May 26, 2007, amounts received by an S corporation in a liquidation which were treated under §331 as payments in exchange for stock owned by the S corporation were not treated as gross receipts from the sale of stock or securities where the S corporation owned more than 50% of each class of stock of the liquidating corporation. Pre-2007 Small Business and Work Opportunity Act (SBWOTA) §1362(d)(3)(C)(iv); Reg. §1.1362-2(c)(4)(ii)(B)(2). Since gains from the sale or exchange of stock or securities are no longer considered passive, the provision is no longer needed. The 2007 SBWOTA, §8231(a), eliminated gains from sales or exchanges of stock or securities as an item of passive investment income.

[51] Reg. §1.1362-2(c)(6) *Ex.* 1.

[52] Reg. §1.1362-2(c)(4)(ii)(B)(2) provides that gross receipts do not include amounts described in former §1362(d)(3)(C)(iv), relating to the treatment of certain liquidations. The 2007 SBWOTA, §8231(a), deleted former §1362(d)(3)(C)(iv), effective for taxable years beginning after May 25, 2007.

[53] *Branch v. United States*, 67-2 USTC ¶ 9636 (N.D. Ga. 1967).

[54] In PLR 8403017, the IRS ruled that gross premiums received from the sale of insurance contracts by a reinsurance and insurance agency, when the contracts are binding on the date of sale, constitute gross receipts for purposes of former §1372. Similarly, in PLR 9017046, an S corporation was permitted to include its credit and consignment sales in its gross receipts because it had, in effect, entered into two separate contracts — one with the purchaser and one with its packers.

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which were limited partners in limited partnerships, including publicly traded partnerships.[55]

In PLR 200928024, the IRS ruled that the taxpayer's distributive share of gross receipts attributable to the publicly traded limited partnership's purchasing, gathering, transporting, storage, and resale of crude oil and refined petroleum products does not constitute passive investment income under §1362(d)(3) and §1375(a).

Note: Under §7704(a), certain publicly traded partnerships are treated as corporations for federal income tax purposes. However, under §7704(c), certain publicly traded partnerships are not treated as corporations if they can meet a 90% gross income requirement from certain qualifying income, e.g., mineral or natural resource income. Thus, if an S corporation has a passive income problem, investing in a publicly traded partnership in the mineral or natural resource business could generate additional gross receipts and increase the denominator for purposes of the 25% gross-receipts-from-passive-income threshold.[56]

Like-kind exchanges of oil well prospecting and drilling supplies among American oil companies seeking oil in Tunisia were not considered gross receipts from sources outside the United States for purposes of the former gross receipts test. In *Helis v. Usry*,[57] the court relied on former Reg. §1.1372-4(b)(5)(iv), which provided that gross receipts do not include amounts received in nontaxable sales or exchanges except to the extent that gain is recognized; looking then to pre-2018 §1031(a),[58] the court found that no gain was to be recognized on the exchange of drilling supplies because such supplies were like-kind property used in a trade or business.

For taxable years beginning before May 26, 2007, the Code specified that the passive investment income of options or commodities dealers does not include any gain or loss incurred in the normal course of a trade or business from trading in any §1256 contract or property related to the contract.[59] Though that provision was stricken from the Code for subsequent years, this exception for commodity future contracts has long been the IRS's position.[60]

Commodity futures contracts are not stocks or securities for purposes of the §1091 wash sale provisions,[61] or for any purpose of any other section of the Code using these terms. A commodity future is an executory contract which the investor enters into and, in most cases, closes out through a commodity clearing association or corporation. The closing process involves: (i) the assignment by the contract holder of their rights and obligations under the contract or, alternatively, and (ii) either the receipt of payment for the rights assigned or payment to the clearing corporation for its assumption of the holder's obligations. In the former case, gain is realized; in the latter there is a loss. The gross receipts referred to in Rev. Rul. 72-457 are amounts received from the closing out of a futures contract undiminished by the corporation's costs (interest or other allocable costs) and commissions. Rev. Rul. 79-294 seemed to further clarify this area in ruling that gross receipts from the closing out of commodity futures contracts are not netted against losses from closing such contracts.[62] It appears, however, that this ruling has been changed by statute. Under §1362(d)(3)(B)(i) (or §1362(d)(3)(C) for taxable years beginning before May 26, 2007), gross receipts from the sale of capital assets (other than stock or securities) are netted against losses because gross receipts includes capital gain net income.

c. Passive Investment Income

Passive investment income is defined to include gross receipts derived from royalties, rents, dividends,[63] interest, and annuities[64] It does not include interest on deferred payment

[55] See PLR 9034058, in which the IRS found that a food and drug manufacturing business that transferred its business to a partnership in exchange for a 99% limited partnership interest was entitled to include in its gross receipts its distributable share of the partnership's gross receipts. Also, the IRS concluded that the character of the S corporation partner's gross receipts would be the same as the partnership's. In PLR 8950053, relying on Rev. Rul. 71-455, the IRS ruled that an S corporation's distributive share of a partnership's gross receipts as a general partner counts as the corporation's gross receipts for passive income purposes.

[56] See §7704(b) for definition of a publicly traded partnership and §7704(c)(2) for those publicly traded partnerships that are excepted from association status. *See also* PLR 200539009 (S corporation's distributive shares of publicly traded partnership's gross receipts attributable to natural resource income under §7704(c) and §7704(d) do not constitute passive investment income under §1362(d)(3)(C)) and PLR 9144024 (S corporation entitled to include gross receipts from publicly traded partnership, nature of income held not be passive). For a discussion of private letter rulings related to qualifying income of publicly traded partnerships, *see* Keator, *"Hydraulically Fracturing" Section 7704(d)(1)(E) — Stimulating Novel Sources of "Qualifying Income" for MLPs*, 28 Tax Mgmt. Real Est. J. 223 (Aug. 7, 2013) (discussing recent trend in IRS letter rulings of expanding categories of acceptable qualifying income, particularly with respect to activities related to oil and natural gas exploration and development). *See also* 723 T.M., *Publicly Traded Partnerships*, Worksheet 18.

[57] 464 F.2d 330 (5th Cir. 1972).

[58] Nonrecognition treatment of like-kind exchanges completed after December 31, 2017, are limited to the exchange of real property held for productive use in a trade or business or for investment. *See* §1031. A transition rule applied for exchanges of formerly eligible property if the property was either disposed of or received on or before December 31, 2017. Pub. L. No. 115-97, §13303(c) (non-code provision).

[59] Former §1362(d)(3)(D), stricken by 2007 SBWOTA, §8231(a).

[60] Rev. Rul. 72-457, (income derived by S corporation from buying and selling commodity futures is not passive investment income). *See also* PLR 8238048 and PLR 7929016.

[61] Rev. Rul. 71-568, (commodity future contracts held not to be stock or securities for purposes of §1091).

[62] The Tax Court, in *N.M. Timber Co. v. Commissioner*, 84 T.C. 1290 (1985), however, rejected this position and held that former §1372(e)(5)(C), which includes in gross receipts the gains from the sales or exchanges of stocks and securities, did not apply to offsetting commodities futures contract transactions.

[63] Reg. §1.1362-2(c)(5)(ii)(C) provides that the term dividends includes dividends as defined in §316, amounts to be included in gross income under §551 (relating to foreign personal holding company income taxed to U.S. shareholders) for its effective years (the 2004 American Jobs Creation Act, Pub. L. No. 108-357, §413(a)(1), repealed the provisions for foreign personal holding companies effective for taxable years of foreign corporations beginning after 2004, and for taxable years of U.S. shareholders with or within which such taxable years or foreign corporations end), and consent dividends as provided in §565. Dividends received by an S corporation from a C corporation in which the S corporation has an 80% or greater ownership stake are not treated as passive investment income for purposes of §1362 to the extent they are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. §1362(d)(3)(C)(iv).

[64] §1362(d)(3)(C)(i). For taxable years beginning before May 26, 2007, this list included gross receipts from sales or exchanges of stock or securities, but only to the extent such a sale or exchange resulted in a gain. Pre-SBWOTA §1362(d)(3)(C)(i); Reg. §1.1362-2(c)(5)(i). In addition, for taxable years beginning before May 26, 2007, in the case of commodities or options dealers, passive investment income was determined by not taking into account any gain or loss, in the ordinary course of the activity of dealing in §1256 contracts, from any §1256 contract or property related to such a contract. Former §1362(d)(3)(D); Reg. §1.1362-2(c)(5)(iii)(A).

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sales of property held for sale to customers or the performance of services in the ordinary course of a trade or business of selling the property or performing the services.[65] Nor does it include gross receipts derived in the ordinary course of a trade or business of lending or financing; dealing in property; purchasing or discounting of accounts receivable; notes or installment obligations; or servicing mortgages.[66] Under Reg. §1.1362-2(c)(5)(iii)(C), passive investment income also does not include amounts included in the gross income of a patron of a cooperative (within the meaning of §1381(a), without regard to paragraph §1381(a)(2)(A) or §1381(a)(2)(C) of §1381(a)) by reason of any payment or allocation to the patron based on patronage occurring in the case of a trade or business of the patron.[67]

Comment: The preamble to the original §1362 proposed regulations requested comments from the public regarding whether the IRS can adopt a trade or business standard in their final regulations in lieu of the strict passive definition.[68] The final regulations adopt this standard for most categories of passive income, but fail to adopt a broad, across-the-board trade or business standard. It is worth noting, however, that the regulations provide that passive investment income will not include income which is identified by the IRS by regulations, revenue ruling or revenue procedure as income derived in the ordinary course of a trade or business.[69] Often, a determination regarding the classification of income as passive is difficult to make and turns upon the facts in each particular case. Many such cases and rulings are discussed below. Also discussed are several of the numerous private letter rulings the IRS has issued for guidance on what constitutes passive investment income.

(1) Rental Income

Rents do not constitute passive income if the corporation provides significant services or incurs substantial costs in the rental business.[70]

Note: None of the other categories of passive income enjoy a similar exception. The IRS has rejected application of the significant services rule to other passive income categories.[71]

The regulations define rents as "amounts received for the use of, or right to use, property (whether real or personal) of the corporation."[72] The rules further provide:

> Rents does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial cost in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business, is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).[73]

Rents appear to include certain deferred payments for the use of property or services, which are imputed as rental income under §467. However, rents do not include produced film rents as defined under §543(a)(5).[74] In addition, Reg. §1.1362-2(c)(5)(ii)(B)(4) provides that rents do not include compensation for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing or production of real or tangible personal property of the same type.

Reg. §1.1362-2(c)(6) provides no example involving a rent payment. The determination of whether sufficient significant services exist to treat payments as non-rents for S corporation passive income purposes is a factual matter. The IRS has shown a willingness to issue published as well as private rulings in this area. Some of the more significant rulings are summarized below. Cases are also discussed below. While there has been substantial litigation in this area, in general, the IRS seems to prevail in these cases.

Comment: A private letter ruling is advisable in this area. A ruling could provide the assurance that no passive income exposure exists with respect to payments characterized as rents for business purposes. Mustering the necessary facts is essential to obtaining a favorable ruling. If necessary, S corporations might want to consider offering additional services to their tenants when practical from a business perspective.

(a) Favorable Rulings Not Constituting Rents

The IRS has generally taken a fairly liberal approach in defining rents. In the following published rulings, the IRS has held that amounts received by former subchapter S corporations were not rents within the meaning of the former gross receipts test. Not all of the IRS rulings can be reconciled with case law in this area.

In Rev. Rul. 61-112, the IRS ruled that amounts received by a corporation from farms which it owns and leases to individuals under a share-farming arrangement were not rents when the corporation participated to a material degree in the produc-

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[65] §1362(d)(3)(C)(ii); Reg. §1.1362-2(c)(5)(ii)(D)(2).

[66] §1362(d)(3)(C)(iii); Reg. §1.1362-2(c)(5)(iii)(B). *See also Estate of Kaiser v. Commissioner*, T.C. Memo 1997-88 (insurance premiums paid directly to underwriters may not be included in gross receipts and deducted in cost of sales by insurance company that marketed policies and performed various services related to policies).

[67] Former §1362(d)(3)(D); Reg. §1.1362-2(c)(5)(iii)(A).

[68] PS-260-82, 1989-1 C.B. 1026.

[69] Reg. §1.1362-2(c)(5)(ii)(G).

[70] Reg. §1.1362-2(c)(5)(ii)(B)(2). *See also White's Ferry, Inc. v. Commissioner*, T.C. Memo 1993-639 (although terms lease and rent were used, agreements constituted joint operating agreements under which taxpayer exercised substantial and continuing management control over business operations and such control is inconsistent with lessor-lessee relationship, therefore, amounts received were not rent and no passive investment income tax was due).

[71] *See, e.g.*, PLR 8328037 (franchise payments are royalty income despite the fact that significant services may be provided).

[72] Reg. §1.1362-2(c)(5)(ii)(B)(1).

[73] Reg. §1.1362-2(c)(5)(ii)(B)(2). See *Crouch v. United States*, 509 F. Supp. 727 (D. Kan. 1981), *aff'd*, 692 F.2d 97 (10th Cir. 1982), for a description of services considered to be customarily rendered to the tenants of an apartment building, including employment of a full-time maintenance man to handle day-to-day repairs.

[74] Reg. §1.1362-2(c)(5)(ii)(B)(3).

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tion of farm commodities through physical work or management decisions, or a combination of both.[75]

In Rev. Rul. 64-232, the IRS ruled that amounts received from leasing glassware, silverware, tables, chairs, and electronic equipment were not rents where the corporation performed delivery and pickup functions with respect to the items and washed, polished, repaired, and stored them prior to their lease to a customer. Similarly, in PLR 8926039, the IRS ruled that payments received for rental of office furniture were not passive investment income where the S corporation provided pickup and delivery, maintenance and repair, and space planning and interior design.

In Rev. Rul. 65-40, the IRS ruled that amounts received for the short-term leasing of motor vehicles were not rents where the lessor furnished such maintenance as gas and oil, tire repair and changing, cleaning and polishing, oil changing and lubrication, and engine and body repair.

In Rev. Rul. 65-83,[76] the IRS set forth examples of payments for the use of personal property which did not constitute rents because significant services were rendered by the corporation in connection with such payments. The kinds of personal property used in the examples were construction barricades, golf carts, cranes, and dress suits. Citing Rev. Rul. 65-83, the IRS ruled in PLR 9148013 that an S corporation did not have passive investment income from leasing relocatable modular offices where the corporation provided significant services in connection with the rentals, including planning, design and manufacture, site preparation, delivery and installation, and removal.[77]

In Rev. Rul. 65-91, the IRS ruled that the following situations involving the provision of storage space for personal property did not constitute rents: (i) fees for the storage of grain because of the services that are performed in inspecting and turning the grain in order to prevent spoilage and infestations; (ii) payment received for the handling and storage within a refrigerated warehouse where the owner of the warehouse supplies the necessary labor for moving the goods in and out of the warehouse and is responsible for providing housekeeping services, refrigeration, maintenance, and other necessary services; and (iii) amounts received from the operation of a parking lot where the vehicles are parked by attendants.

In Rev. Rul. 70-110, the IRS ruled that demurrage, which is the exchange made by a transportation company or shipper for unreasonable detention of its shipping containers (railroad cars, ships, air cargo pallets, etc.), was not rent or any other kind of passive investment income.

In Rev. Rul. 70-206, the IRS ruled that payments received for making television sets available to hospital patients and for required services, including unlocking and locking and adjusting and repairing the sets, are not rents.

In Rev. Rul. 75-349, the IRS ruled that a former subchapter S corporation that distributed feature length motion pictures to exhibitors for a share of box office receipts and that performed support work, prepared advertising, furnished advance personnel, inspected theaters, and delivered and picked up films, or that itself rented theaters to exhibit the films and retained all the box office receipts, did not receive rents or other passive investment income.

In Rev. Rul. 76-48, the IRS ruled that amounts received for the use of tennis and handball courts by players who were provided with locker room and parking facilities, lesson fees with no additional charge made for the use of the court, and sales of sport items by a shop on the premises, were not rents.

In Rev. Rul. 76-469,[78] the IRS ruled that amounts received as part of a business of leasing motor vehicles under long-term leases were not rents where the lessor provided maintenance, repair, and other significant services to the lessee. Further, an open-end contract may be construed as a conditional sale rather than a lease. In that case, payments received under the contract are not passive investment income.

In Rev. Rul. 81-197,[79] the IRS ruled (in Situation 2) that the chartering of aircraft to provide transportation where the aircraft owner retains possession, command, and control of the aircraft was not a lease arrangement but rather the furnishing of transportation services. Amounts received by the payee company were compensation for services rendered, not rents. Possession, command, and control of the aircraft were not lost by the user's designation of the time and place of arrival since the pilot was an employee of the payee company and therefore had "primary authority for the safety and actual operation of the aircraft."

In Rev. Rul. 83-139, the IRS found (in Situation 1) that fixed monthly income received by a trailer park owner who provided insubstantial services for the convenience of tenants were rentals and not net earnings from self-employment. The services provided were city sewage and electrical connections, roadway access, maintenance, and a laundry facility. In Situation 2, the IRS found significant services were provided, e.g., provision of a recreation hall, auditorium, and library; therefore, the monthly payments did not constitute rents but were includible in self-employment income.[80]

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[75] In PLR 9003056 and PLR 8927039, the IRS ruled that crop sharing arrangements did not constitute passive income because the S corporation participated in the decision-making process (e.g., what crops to plant, when to harvest and how to market). *See also* PLR 9514005 (rental income received by S corporation from farm land was not passive investment income where company's shareholders were actively involved in tenant's farming operations as advisers, unofficial managers, and laborers).

[76] *See also* PLR 9532004 (income from leasing personal property is not passive investment income because significant services are provided and substantial costs incurred even though lessees of property were responsible for maintenance, payment of all taxes and fees, and obtaining damage and liability insurance).

[77] *See also* PLR 199937037 and PLR 9501016.

[78] See also PLR 8926044, in which contracts for the use of cars owned by the taxpayer were determined to be conditional sales contracts where the customer bore all of the risk of loss during the term of a contract, the customer could either purchase the car at the end of the contract term or pay any difference between a negotiated value and the actual value of the car, and the taxpayer did not claim depreciation deductions on cars subject to a contract.

[79] See also GCM 39169, which uses the same rationale used in Rev. Rul. 81-197 (Situation 2).

[80] See PLR 9003039 where the IRS ruled that facts were similar to Situation 2 of Rev. Rul. 83-139 and, thus, the payments were not rents since significant services were provided. In PLR 9003039, the operator of a mobile home park used predominately by retired residents provided, among other services, sewerage, garbage service, lawn and grounds service, assistance to tenants who wished to resell their home, a resident manager, and a shelter house which had a kitchen, elaborate recreation area, and handicap access. *See also* PLR 9234011, PLR 9121043, PLR 9045057, PLR 9018050. *But see Bobo v.*

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In addition to these published rulings and related private rulings, the IRS has issued many other private letter rulings on what constitutes rents, frequently focusing on whether there are significant services. A sample of these rulings is as follows:

- In PLR 201812003, the IRS ruled that rental income received by S corporation under certain farm leases was not passive investment income where the S corporation fully participated in the farms' management and the leases split expenses between the S corporation and the tenant.

- In PLR 201722019, the IRS ruled that rental income received by S corporation under a sharecropping lease and a rental property lease arrangement were not passive investment income where the S corporation provided and maintained insurance on all improvements and fixtures, paid expenses associated with the repair, maintenance, and replacement of irrigation drainage pumps, and paid the insurance, water reclamation tax, water rights fees, water coalition dues, and property taxes.

- In PLR 201725022, the IRS ruled that rental income received by a C corporation intending to elect to be treated as an S corporation was not passive investment income where the corporation developed, managed, maintained, and repaired commercial real estate concentrating in medical office suites and clinics. Services included drafting and negotiating leases, renewals, and other agreements with the assistance of an independent leasing agent; maintaining or repairing the heat and air conditioning systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup; daily walk-through inspections to report on water breaks, lighting outage, vandalism, damage to building exteriors and interiors; sweeping sidewalks and parking lots; resurfacing the parking lot; periodic pest and vermin control; and emergency response and property access for public safety.

- In PLR 201232023, the IRS ruled that rental income received by an S corporation were not passive investment income where the shareholders and officers of the S corporation inspected, maintained, and repaired the building, including roofs, canopies, external walls, windows, floors, foundations, guttering and downspouts, plumbing, painting, and internal light fixtures; inspected, maintained, and repaired all common areas, including the parking lots, sidewalks, curbs, and external light fixtures; maintained the property grounds, including landscaping, garbage removal, and snow and ice removal; and negotiated leases, renewals, and other agreements with tenants, collected rents, monitored compliance with lease terms, addressed complaints and requests of tenants, advertised commercial space, and solicited new tenants.

- In PLR 201125011, the IRS ruled that an S corporation provided substantial services when it, maintained and repaired the building, including the roofs, external walls, windows, floors, foundations, guttering and downspouts, plumbing, sidewalks, curbs, drainage ditches, air conditioning and heating units, security and fire alarm systems, provided waste disposal, and performed safety inspections. The S corporation also negotiated leases, collected rents, monitored compliance with lease terms, and addressed tenant complaints and requests.

- In PLR 201118011, the IRS ruled that an S corporation provided substantial services such as property inspection, common area maintenance and repair, including carpeting and painting; janitorial and cleaning services; maintenance and repair of building structural components, including roofs and facades; upkeep and repair of building systems (heating, air conditioning, plumbing, water and sewer, electrical and lighting); parking lot maintenance; landscape maintenance; snow removal; trash collection; pest control; providing security personnel; and the approval and supervision of capital improvements through its employees and those of independent contractors in connection with the rental of real property.

(b) Unfavorable Rulings Constituting Rents

In Rev. Rul. 65-91, the IRS ruled that the amounts received by the operator of a cotton warehouse were rents where the owner of the stored goods was entitled to a specific space for a specific time and provided for its own loading, unloading, and other handling and protective services required for its goods.

In Situation 1 of Rev. Rul. 81-197, the IRS ruled that amounts received under a lease for the use of an aircraft in which the lessee provides its pilot, fuel, oil, and maintenance constituted rents for the use of property. In this situation the lessor transferred complete "possession, command and control" of the aircraft to the lessee. The fact that the lessee was reimbursed by the lessor for maintaining the aircraft did not constitute significant services furnished in connection with the rental payments so as to preclude characterizing the payments as rent.

In Situation 1 of Rev. Rul. 83-139, the IRS found that fixed monthly income received by a trailer park owner who provided insubstantial services for the convenience of tenants were rentals and not net earnings from self-employment. The services provided were city sewage and electrical connections, roadway access, maintenance, and a laundry facility. In Situation 2, the IRS found significant services were provided, e.g., recreation hall, auditorium, and library; therefore, the monthly payments did not constitute rents but were includible in self-employment income.

(c) Favorable Cases Not Constituting Rents

In *Nigh v. Commissioner*,[81] the Tax Court found that an S corporation's income from its barge operations was not passive income in the form of rents. The IRS contended that since the company used an outside manager to operate its barges, it was really a lease arrangement with rental proceeds to the S corporation. However, the court concluded that the arrangement was

Commissioner, 70 T.C. 706 (1978), *acq.*, 1983-2 C.B. 1 (payments were rentals where owners of a mobile home park provided a number of services including sewerage maintenance, trash collection, grounds maintenance, and a laundry facility).

[81] T.C. Memo 1990-349.

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an agency relationship and that the activities of the managing agent were attributable to the S corporation itself.

In *Lausmann v. Commissioner*,[82] a former subchapter S corporation leased a veneer dryer (equipment for drying out freshly cut lumber) to a related corporation. Employees of the related corporation operated the dryer, but were supervised by a foreman employed by the subchapter S corporation. The foreman was completely responsible for all decisions concerning the veneer drying process. The court held that, because of the foreman's oversight of the veneer drying process, the subchapter S corporation had performed significant services in connection with the leasing of the veneer dryer so that the income therefrom did not constitute rents.

(d) Unfavorable Cases Constituting Rents

In *Feingold v. Commissioner*,[83] the court held that payments received for use of bungalows and recreational areas constituted rents in that services furnished were not comparable to a hotel or motel and thus did not meet the requirements of the regulations pertaining to significant services.

In *Stover v. Commissioner*,[84] the court held that amounts received for the rental of lots in a mobile home community constituted rents because the services furnished by the corporation (the providing of utility hookups to the mobile home owners) did not constitute significant services rendered to the occupant under the regulations.

In *Bramlette Building Corp. v. Commissioner*,[85] the Fifth Circuit affirmed the decision of the Tax Court which held that payments received from tenants constituted rents where the services rendered by the taxpayer to its tenants through maids, porters, elevator operators, and a maintenance engineer were incidental and did not come within the exception pertaining to significant services. The court also held that the leasing of space to the operators of a barbershop, a drugstore, and a lunch counter did not constitute the rendering of services to the other tenants.

In *Winn v. Commissioner*,[86] income from the bareboat charter of river barges was held to be rents. Activities rendered in connection with the charters, consisting of maintenance of seaworthiness, general repair and maintenance of barges, dockage when not in use, delivery of barges to sites where needed, management decisions, and cross-charter arrangements were held not to constitute significant services so as to avoid classification of the income as rents.

In *City Markets, Inc. v. Commissioner*,[87] a corporation owned and maintained a farmer's market which took up an entire city block, and derived all of its income from leasing parts of those buildings. The written lease agreements imposed no obligations on the corporation other than to afford the tenant "quiet, peaceful and uninterrupted possession" and to make "those repairs due to structural defects." The corporation employed two full-time maintenance men whose activities consisted of cleaning and sweeping and maintaining the five public restrooms, the sidewalks and alleys around the buildings, and some parts of the interior of the buildings, repairing the parking area pavement, spraying garbage cans, unblocking sewer lines, repairing electrical, heating and air conditioning equipment, making roof repairs, and replacing broken windows. They also kept automobiles from blocking the entrances to the building and on occasion took telephone messages for tenants. The court held that these activities did not constitute significant services for the purpose of avoiding the classification of income as rents.[88]

In *McIlhinney v. Commissioner*,[89] a corporation which owned and operated an enclosed shopping mall was responsible for maintaining the common areas in good repair and for keeping the common areas reasonably free of snow, ice, refuse and other obstructions. It was required to maintain the lights in the parking area and keep the parking area lit during the hours of darkness when the mall was open for business. It was also responsible for the maintenance and repair of the exterior and all structural portions of the premises and the maintenance of plumbing, water lines, and electrical wiring to the point where these items entered the interior of the building. It employed a full-time staff of ten, including four maintenance men, plus part-time carpenters and carpenter helpers. The court held that the services rendered by the corporation were no different than those normally required to maintain similar premises in good rental condition and therefore, the income received constituted rents.

In *Kennedy v. Commissioner*,[90] the court held that income received pursuant to a typical sharecropping arrangement constituted rents.

In *Van Etten v. Commissioner*,[91] the court held that an amount received by a subchapter S corporation engaged in property development constituted rent. The court rejected the taxpayer's argument that since part of the rent could have been applied against the purchase price of the property, such amount should be treated as earnest money, which was later forfeited, rather than as rent.

In *Thompson v. Commissioner*,[92] a corporation's subchapter S election was terminated because more than 20% of the income was from rental of videocassettes. Significant services were not rendered by the corporation. The court rejected the corporation's argument that the lease became a sale when the lessee retained rental tapes as a bargaining tool to enforce the rental agreement.

In *Lillis v. Commissioner*,[93] the Tax Court rejected the taxpayer's argument that advertising, cleaning, repairing, and maintenance were services significant enough to foreclose the court's finding that the taxpayer's income constituted rents.

In *Sanborn v. Commissioner*,[94] the Tax Court found that interest received in a sale-leaseback arrangement could not be

[82] T.C. Memo 1978-420.

[83] 49 T.C. 461 (1968).

[84] 781 F.2d 137 (8th Cir. 1986).

[85] 52 T.C. 200 (1969), *aff'd*, 424 F.2d 751 (5th Cir. 1970).

[86] 67 T.C. 499 (1976), *aff'd in part and rev'd in part*, 595 F.2d 1060 (5th Cir. 1979).

[87] 433 F.2d 1240 (6th Cir. 1970), *aff'g* T.C. Memo 1969-202.

[88] *See also H&L Reid, Inc. v. United States*, 375 F. Supp. 1099 (E.D. Mich. 1973).

[89] T.C. Memo 1979-473.

[90] T.C. Memo 1974-149.

[91] T.C. Memo 1977-400, *aff'd*, 623 F.2d 622 (9th Cir. 1980).

[92] 73 T.C. 878 (1980).

[93] T.C. Memo 1983-142, *aff'd*, 740 F.2d 974 (9th Cir. 1984).

[94] T.C. Memo 1983-579.

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offset against the corporation's rental payments to the buyer-lessor, thereby generating significant passive income.

(2) Royalties

The term royalties under the regulations means all royalties, including mineral, oil and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises and other like property. The regulations further provide that these royalty amounts cannot be reduced by the costs of the rights under which the royalties are received, nor can they be reduced by any amounts deductible in computing taxable income.[95] This rule assures that the royalty amounts included in passive income are roughly equivalent to gross receipts. The term royalties does not include royalties derived in the ordinary course of a trade or business of licensing property. Royalties received by a corporation are so derived if, based on all facts and circumstances, the corporation either: (i) created the property, or (ii) performed significant services or incurred substantial costs with respect to the development or marketing of the property.[96] Compare PLR 8328037, where franchise payments were treated as royalty income. The IRS did not accept the taxpayer's contention that franchise payments should be excluded as passive income if significant services were provided.

In addition, the regulations provide for a number of specific exceptions to the definition of royalties, including exceptions for copyright royalties; mineral, oil or gas royalties; amounts received upon disposal of timber under §631(b) and disposal of coal or domestic iron ore with a retained economic interest under §631(c);[97] and active business computer software royalties.[98]

For these purposes, copyright royalties are defined under §543(a)(4) and mineral, oil and gas royalties are defined under §543(a)(3). Under Reg. §1.543-1(b)(12)(iv), a personal holding company rule, copyright royalties means compensation for the use of, or the right to use, works copyrighted under Title 17 of the United States Code, or similar laws of treaty countries. Mineral, oil, or gas royalties are not personal holding income if the aggregate amount of such royalties constitutes 50% or more of the gross income of the corporation for the taxable year and the corporation's total §162 deductions are at least 15% of the corporation's gross income.[99]

Another exception to the treatment as passive royalties relates to active business computer software royalties as defined under §543(d) (without regard to paragraph §543(d)(5)).[100] Again, the rules do not treat such royalties as tainted under the passive income rules if these same payments are not be treated as personal holding income. Under the personal holding company rules, such royalties are generally not treated as personal holding company income if: (i) the royalties are received by a company actively engaged in the computer software business, (ii) the royalties constitute at least 50% of the corporation's gross income and (iii) the §162, §174, §174A, and §195 deductions relating to the royalties are at least 25% of gross income.[101]

In GCM 39580 (Nov. 24, 1986), the IRS Office of Chief Counsel distinguished among four types of income which a corporation (T) received for licensing and maintaining computer programs and determined that only one of these constituted royalty income. The corporation marketed three programs, one of which (Program B) it owned and the other two of which (Programs C and D) were owned by other businesses. T sold nonexclusive, nontransferable rights to use the programs under proprietary agreements between the customers and the programs' owner. T received payments for perpetual marketing agreements for Program B, as well as percentages of the fees paid for use of Programs C and D and various charges for maintenance and repair services on all three programs. The Chief Counsel concluded that only the perpetual agreements for Program B generated royalty income since the other payments were for the services provided in marketing other businesses' properties. The maintenance and repair fees also were not royalties, according to the GCM, except for those amounts paid for corrections or improvements to the software.

Comment: The regulations do not adopt, for royalties, the ongoing significant services concept that is applicable to rents. The exceptions adopted in the rules relating to copyright royalties, mineral, oil, and gas royalties, and active business computer software royalties apply a trade or business standard for most royalty payments under the passive income rules which reference historic services and costs incurred in development or marketing of the property.

In *United States v. 525 Company*,[102] the Fifth Circuit held under former §1372(e)(5) that reserved oil payments were not receipts from royalties and, therefore, the corporation's subchapter S status had not terminated. The court found nothing to indicate that Congress intended to include oil payments within the terms royalties or mineral, oil or gas royalties. Relying on the Treasury's long-standing and consistent administrative interpretation that oil payments were not included within the term royalties, the court stated that the Treasury's position in the regulations under former §1372(e)(5), characterizing oil payments as royalties, could not be justified.

In *Swank & Son, Inc. v. United States*,[103] a district court rejected the IRS argument that a "bonus paid for the execution of an oil and gas lease" constituted a royalty within the meaning of pre-SSRA §1372(e)(5), stating that the terms bonus and royalty had definite meanings in the oil and gas industry and that they did not mean the same thing. The court in *Opine Timber Co., Inc. v. Commissioner*,[104] held that delay rentals under an oil lease (payments made to the lessor by a lessee who elects not to drill in a given year or years) are rent. The term royalty does not, however, include amounts received upon the disposal

[95] Reg. §1.1362-2(c)(5)(ii)(A)(1).

[96] Reg. §1.1362-2(c)(5)(ii)(A)(2). *See* PLR 200726030 (royalties not passive where taxpayer provided substantial services and incurred substantial costs in creating, developing, and marketing product).

[97] *See* 610 T.M., *Timber Transactions*.

[98] Reg. §1.1362-2(c)(5)(ii)(A)(3).

[99] Reg. §1.543-1(b)(11).

[100] Reg. §1.1362-2(c)(5)(ii)(A)(3).

[101] §543(d), *amended by* the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70302(b)(8). In PLR 8952072, the IRS ruled that amounts received by an S corporation with subchapter C (since renamed accumulated) E&P met the definition of active computer software royalties under §543(d) and, therefore, did not constitute passive investment income under §1362(d)(3)(C)(i).

[102] 342 F.2d 759 (5th Cir. 1965), *aff'g* 230 F. Supp. 803 (N.D. Tex. 1964).

[103] 362 F. Supp. 897 (D. Mont. 1973), *aff'd per curiam*, 522 F.2d 981 (9th Cir. 1975).

[104] 64 T.C. 700 (1975).

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of timber or coal with a retained economic interest with respect to which the special rules of §631(b) or §631(c) apply.[105]

In Rev. Rul. 71-407, the IRS stated without explanation that amounts received by a professional football team for broadcast rights to its games are not passive investment income.

Comment: Authorities pre-dating the current regulations are still relevant to the extent that these authorities provide guidance on issues not resolved in the regulations.

(3) Interest

The term interest as used in §1362(d)(3)(C) means any amount received for the use of money.[106] Because the test is in terms of gross receipts, interest expense may not be used to reduce interest income.[107]

Comment: The use of the term gross receipts to define passive income means that tax-exempt income is taken into account. As a result, in an S corporation context, tax-exempt income can be subject to the passive investment income tax, even though those amounts would not be subject to regular tax.

Tax-exempt interest and amounts treated as interest under §483, §1272, §1274, and §7872 will be treated as interest for purposes of the passive investment income rules.[108] The regulations also provide that amounts received as interest on obligations acquired from the sale of property described in §1221(a)(1) or the performance of services in the ordinary course of a trade or business of selling the property or performing the services do not constitute passive investment income.[109]

Furthermore, Reg. §1.1362-2(c)(5)(iii)(B)(1) provides that passive income does not include gross receipts that are directly derived in the ordinary course of a trade or business of:

- lending or financing;
- dealing in property;
- purchasing or discounting accounts receivable, notes, or installment obligations; or
- servicing mortgages.

For this purpose, gross receipts directly derived in the ordinary course of business would not include gain (as well as interest income) with respect to loans originated in a lending business, or interest income (as well as gain) from debt obligations of a dealer in such obligations. For instance, the IRS ruled in PLR 199938035 that the interest income derived from interests in loans held by a partnership holding interests in bank loans would be gross receipts directly derived in the ordinary course of a trade or business pursuant to Reg. §1.1362-2(c)(5)(iii)(B)(1), and would not be considered passive investment income under §1362(d)(3)(C). In PLR 200327029, the IRS ruled that interest income derived from lending activities conducted by a corporation also in the business of commercial property rental were receipts derived in the course of a trade or business and not passive investment income under §1362(d)(3)(C).

Comment: Thus, under the regulations, mortgage bankers, for example, should not have passive interest income if the interest is earned in the ordinary course of buying and selling mortgages as a trade or business.

Moreover, §1362(d)(3)(C)(v) provides that in the case of a bank (as defined in §581) or a depository institution holding company (as defined in §3(w)(1) of the Federal Deposit Insurance Act), passive investment income does not include interest income earned by such bank or holding company or dividends on assets required to be held by such bank or holding company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank or participation certificates issued by a Federal Intermediate Credit Bank.

The regulations do provide, however, that interest earned from the investment of idle funds in short-term securities does not constitute gross receipts directly derived in the ordinary course of business.[110] Similarly, a dealer's income or gain from an item of property is not directly derived in the ordinary course of its trade or business under the regulations if the dealer held the property for investment at any time before the income or gain is recognized.

In *Thompson v. Commissioner*,[111] a former subchapter S corporation purchased tax refund claims from taxpayers filing Forms 1040 and 1040A. The corporation would pay a taxpayer an amount equal to two-thirds of the refund due to the taxpayer in exchange for the right to receive any refund made by the IRS. The court held that the discount income the corporation derived on the receipt of the refund checks does not constitute interest within the meaning of pre-SSRA §1372(e)(5) and that the corporation's subchapter S election remained in effect.

In *Burbage v. Commissioner*,[112] the Tax Court held that a former subchapter S corporation had terminated as a result of excess passive income because of interest received on loans. The court rejected the taxpayer's contention that because the receipts were booked as other interest, and that the interest rate was extremely high, the income was really attributable to services.[113]

(4) Dividends

In general, dividends are treated as passive income for purposes of the passive income tax rules. Although dividends would flow through to the individual shareholders and be taxable to them at a 20% rate,[114] if subject to the passive income tax, dividends received by S corporations are taxed at the S corporation level at a 21% rate under §1375.[115]

Passive income does not include dividends received by an S corporation from a C corporation in which the S corporation has an 80% or greater ownership interest to the extent that the

[105] Reg. §1.1362-2(c)(5)(ii)(A)(3).

[106] Reg. §1.1362-2(c)(5)(ii)(D)(1).

[107] *See Llewellyn v. Commissioner*, 70 T.C. 370 (1978).

[108] Reg. §1.1362-2(c)(5)(ii)(D)(1).

[109] Reg. §1.1362-2(c)(5)(ii)(D)(2).

[110] Reg. §1.1362-2(c)(5)(iii)(B)(2).

[111] 73 T.C. 878 (1980).

[112] 82 T.C. 546 (1984).

[113] In PLR 8515056, the IRS ruled that the interest an S corporation received as a real estate developer on installment notes held on the sale of lots was not passive investment income.

[114] An additional 3.8% tax may be levied against the dividend income of certain individuals under §1411 (net investment income tax).

[115] §1375 provides the tax shall be computed by multiplying the excess net passive income by the highest rate of tax specified in §11(b). For tax years prior to 2018, the highest rate was 35%. *See* pre-2018 §11(b).

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dividends are attributable to the E&P of the C corporation derived from the active conduct of a trade or business.[116] Regulations provide that E&P of a C corporation derived from the active conduct of a trade or business are the E&P of the corporation derived from activities that would not produce passive investment income under §1362(d)(3) if the C corporation were an S corporation.[117]

The regulations provide a safe harbor that may be used to determine the amount of the active E&P of a dividend-paying corporation 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 E&P are produced.[118]

> *Example:* X, an S corporation, owns 85% of the one class of stock of Y, a C corporation. On December 31, Year One, Y declares a dividend of $100 ($85 to X), which is equal to Y's current E&P. In Year One, Y has total gross receipts of $1,000, $ 200 of which would be passive investment income if Y were an S corporation. One-fifth ($200/$1,000) of Y's gross receipts for Year One is attributable to activities that would produce passive investment income. Accordingly, 1/5 of the $100 of E&P is passive, and $17 (1/5 of $85) of the dividend is passive investment income.[119]

If less than 10% of the C corporation's E&P for a taxable year are derived from activities that would produce passive investment income, all E&P produced by the corporation during the taxable year are considered active E&P.[120]

Also, under the regulations, a C corporation may treat a portion of its E&P accumulated by the corporation before the time an S corporation acquires 80% of its stock under §1504(a)(2) as active E&P. The rules allow pre-acquisition E&P to be treated as active in the same proportion as the C corporation's active E&P for the three taxable years ending before the time when the S corporation became an 80% or more owner bear to the C corporation's total E&P for those three taxable years.[121]

(5) Annuities

The regulations provide that the term annuities means the entire amount received as an annuity under an annuity, endowment, or a life insurance contract, even if only part of such amount would be included in gross income under §72.[122] Since life insurance and financed buy-out agreements tend to be widely used in small, closely held corporations, the death of a shareholder could lead to a possible passive income tax or termination of S corporation status if the proceeds under the policy are made as annuity payments. However, lump-sum life insurance proceeds would not seem to be affected by the annuity taint.

Comment: When a key-person life insurance policy is used to fund a buy-sell agreement, an S corporation with accumulated E&P should be careful to assure a lump-sum payment is elected when the proceeds become payable; otherwise, it is possible the payments could become subject to annuity treatment and expose the corporation to the passive income tax.

(6) Sale of Stock or Securities

While gains from the sale or exchange of stock or securities are included in gross receipts, such gains are not treated as passive investment income.[123] Because gains from the sale or exchange of stock or securities increase the amount of an S corporation's gross receipts but not the amount of its passive investment income for purposes of determining the amount by which an S corporation's passive investment income exceeds 25% of gross receipts, the 2007 amendment is a taxpayer friendly rule in that an S corporation can increase the amount of its gross receipts without a corresponding increase to its passive investment income.

The term stock or securities is defined very broadly to include shares or certificates of stock, stock rights or warrants, or an interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation); an interest as a limited partner in a partnership; certificates of interest or participation in a profit-sharing agreement, or in any oil, gas, or other mineral property or lease; collateral trust certificates, voting trust certificates; bonds; debentures; certificates of indebtedness; notes; car trust certificates; bills of exchange; or any government obligations.[124]

Under the originally proposed regulations, any interest in a partnership was treated as a security and, therefore, any gain on the sale or other disposition of a partnership interest was included in both gross receipts and passive investment income. Commentators, however, suggested that this rule was inappropriate because it treated S corporations more harshly if they conducted a business through a partnership by causing all of the gain on the disposition of the partnership interest to be passive investment income. In contrast, if an S corporation that conducts a business directly disposes of its business, only gain which is realized on the sale of any stock or securities is passive investment income. In response to such comments, the final regulations generally treat only an interest as a limited partner in a partnership as a security and generally adopt a look through approach for interests as a general partner. In recognition of the fact that applying the look through approach could be burdensome to some S corporations, the final regulations provide that

[116] §1362(d)(3)(C)(iv). *See* CCA 201030024 (S corporation that (i) had E&P at time of its S corporation election; (ii) wholly owned domestic C corporation that was common parent of consolidated group that, in turn, wholly and indirectly owned domestic subsidiaries and CFCs; and (iii) reported its dividends from domestic subsidiaries and CFCs, fell within §1362(d)(3)(C)(iv) exclusion to passive investment income treatment).

[117] Reg. §1.1362-8(a). The regulations make no distinction that the corporation from which the dividend is received be a domestic corporation, thus this rule should also apply to dividends from controlled foreign corporations.

[118] Reg. §1.1362-8(b)(5).

[119] Reg. §1.1362-8(d) *Ex.* 1.

[120] Reg. §1.1362-8(b)(3).

[121] Reg. §1.1362-8(b)(4).

[122] Reg. §1.1362-2(c)(5)(ii)(E).

[123] §1362(d)(3)(C). For taxable years beginning before May 26, 2007, gross receipts from sales or exchanges of stock or securities (but only to the extent of gains therefrom and not offset by losses) constituted passive investment income. *See* Pre-2007 SBWOTA §1362(d)(3)(C), Reg. §1.1362-2(c)(4)(ii)(B). This prior rule did not apply to gains from the sale of stock or securities if the S corporation was a dealer in stocks and securities. Reg. §1.1362-2(c)(5)(iii)(B)(1)(ii), §1.1362-2(6) *Ex.* 6.

[124] Reg. §1.1362-2(c)(4)(ii)(B)(3).

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an S corporation may choose to treat a general partner interest as a security.[125]

Accordingly, under Reg. §1.1362-2(c)(4)(ii)(B)(4), if an S corporation disposes of a general partner interest, the gain on the disposition is treated as gain from the sale of stock or securities to the extent of the amount the S corporation would have received as a distributive share of gain from the sale of stock or securities held by the partnership if all of the stock and securities held by the partnership had been sold by the partnership at fair market value at the time the S corporation disposes of the general partner interest. The S corporation's distributive share of gain from the sale of stock or securities held by the partnership is not reduced to reflect any loss that would be recognized from the sale of stock or securities held by the partnership. The regulations further provide that, in the case of tiered partnerships, the rules set forth in the regulations are applied by looking through each tier.[126]

Comment: The regulations do not address the treatment of gains from the sale of a limited liability company interest. Limited liability company interests are similar to limited partnership interests, i.e., in cases where the limited liability company has more than one member and has not elected to be treated as an association or corporation for federal income tax purposes;[127] however, certain limited liability company members may also perform managerial functions as a general partner would in a limited or general partnership. As a practical matter, these managing limited liability company members should be treated like general partners while the more passive limited liability company members would be treated as limited partners for purposes of this rule.

Reg. §1.1362-2(c)(5)(iii)(A) provides that in the case of options or commodities dealers, passive investment income does not include gains or losses from any §1256 contract or property related to the contract, as long as such gain or loss is incurred in the normal course of a trade or business activity. For this purpose, the terms options dealer, commodities dealer, and §1256 contract have the same meaning as in former §1362(d)(3)(D)(ii).

The regulations also provide that gross receipts do not include amounts received on nontaxable sales or exchanges except to the extent that gain is recognized by the corporation, or amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.[128]

3. Passive Income Tax

a. Computing the Tax

A passive income tax at the highest corporate tax rate is imposed under §1375 on excess net passive income for those S corporations with accumulated E&P and gross receipts more than 25% of which are passive investment income. Excess net passive income is computed under a formula in which: (i) the passive investment income in excess of 25% of gross receipts for the taxable year is divided by the corporation's passive investment income for the taxable year; and (ii) the net passive income (less deductions) is multiplied by this percentage to arrive at excess net passive income.[129] Passive investment income for purposes of this computation is determined under §1362(d)(3), discussed at I.B., above.

Comment: The passive income tax is imposed at the "highest rate of tax specified in §11(b)."[130] For tax years beginning after 2017, the corporate tax rate under §11(b) is a flat 21% for all C corporations.[131] The accumulated earnings tax rate under §531 and the personal holding tax rate under §541 is 20%. For tax years beginning before 2018, the graduated rates on the first $100,000 of corporate taxable income were presumably not available, and a flat 35% rate was applied to excess net passive income.[132]

Comment: The regulations make clear that no passive income tax is imposed on an S corporation with passive investment income in excess of 25% of gross receipts unless there is accumulated E&P at the close of the corporation's year.[133] Therefore, if accumulated E&P is distributed before the close of a taxable year, the passive income tax can be avoided.[134]

Recognized built-in gains or losses as defined in §1374 are not included in passive investment income.[135] Prior to the 1986 TRA, for any capital gain subject to both the capital and passive income taxes, the capital gain tax was proportionately reduced by the amount of the excess net passive income attributable to such gain.[136] Now, the built-in gains tax controls. This means where such gain is potentially subject to both the passive

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[125] T.D. 8449, 57 Fed. Reg. 55,445 (Nov. 25, 1992).

[126] Reg. §1.1362-2(c)(4)(ii)(B)(4), §1.1362-2(c)(5) *Ex.* 4. The IRS has sometimes followed the aggregate theory of partnership taxation under the passive income rules prior to the finalization of the regulations. For example, in PLR 8852021, the IRS ruled that an S corporation holding a limited partnership interest would have passive investment income only to the extent that its distributive share of the partnership income was attributable to royalties, rents, and dividend or interest income. *See also Magneson v. Commissioner*, 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985) (general partner found to hold property received in a like-kind exchange for investment even though he immediately contributed such property to his partnership); *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972); *George Edward Quick Trust v. Commissioner*, 444 F.2d 90 (8th Cir. 1971) (income in respect of a decedent (IRD) includes the value of a partnership interest to the extent that value is attributable to partnership property that would have been IRD if held by an individual decedent). However, in PLR 7922083, the IRS ruled that the receipts from the sale of limited partnership interests, to the extent of gains therefrom, constituted passive investment income.

[127] Reg. §301.7701-2(a), Reg. §301.7701-3. *See also* Reg. §1.761-1(b); *TIFD III-E v. Commissioner*, 459 F.3d 220 (2d Cir. 2012) (concluding that banks' interests in limited liability company was not "bona fide equity participation," but instead "overwhelmingly in the nature of a secured lender's interest").

[128] Reg. §1.1362-2(c)(4)(iii).

[129] §1375(b); Reg. §1.1375-1(b).

[130] §1375(a) (flush language).

[131] §11(b).

[132] *See* pre-2018 §11(b)(2).

[133] Reg. §1.1375-1(a). The term subchapter C earnings and profits with respect to S corporations which were once C corporations was replaced by the term accumulated earnings and profits in §1375(d) by the 2005 Gulf Opportunity Zone Act, Pub. L. No. 109-135, §412(qq), to conform the terminology in §1375(d) to the terminology in §1375(a), as amended by the 1996 Small Business Job Protection Act, Pub. L. No. 104-188, §1311(b). Because of other changes made by the 1996 Act, an S corporation generally does not have accumulated earnings and profits after 1996 other than those from a period when the S election was not in effect. The S corporation regulations have not been amended to reflect the change in terminology; they continue to refer to subchapter C earnings and profits.

[134] *See, e.g.*, Reg. §1.1368-1(f)(3) (deemed dividend election).

[135] §1375(b)(4).

[136] Reg. §1.1375-1(c)(2).

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income and the built-in gains taxes, the gain is simply taxed under the built-in gains tax.

Excess net passive income is limited to taxable income of the corporation as determined under §63(a) without regard to net operating loss (NOL) deductions or special corporate deductions under §241–§249 (other than §248 organizational expenditures).[137]

Comment: This means that, in certain cases where the corporation has no taxable income as determined above, no passive income tax can be imposed because there is no excess net passive income to tax. If excess net passive income is so limited, the passive income tax is completely avoided; unlike the built-in gains tax (at least through the recognition period), the excess passive income tax is not suspended until such time as the corporation has adequate taxable income.

Net passive income is determined under §1375(b)(2) by reducing passive investment income by any allowable deductions that are directly connected with the production of the income. However, net passive investment income cannot be reduced by the NOL deductions[138] or by any special corporate deductions.[139] Under the regulations, to be directly connected with the production of income, a deduction must have "proximate and primary relationship to the income."[140] The regulations point out that expenses, depreciation, and similar items attributable solely to such income qualify for deduction. If an item is only partially attributable to the passive investment income, the deduction is allocated between the two types of income using any reasonable method.[141]

Example: For the taxable year, XYZ Corporation has gross receipts (GR) of $1,000,000, passive investment income of $400,000, expenses directly connected with the passive investment income of $100,000, and taxable income of $100,000. The excess net passive income is computed as follows:

Step 1: Determine amount of passive investment income over 25% of gross receipts:

Passive Investment Income (PII)	$400,000
– 25% Gross Receipts (1,000,000 × 25%)	– 250,000
	$150,000

Step 2: Determine net passive income:

PII	$400,000
– Directly Connected Expenses	– 100,000
Net Passive Income (NPI)	$300,000

Step 3: Determine excess net passive income:

$$\text{Excess NPI} = \text{NPI} \times \frac{\text{PII} - (.25 \times \text{GR})}{\text{PII}}$$

$$\$112{,}500 = 300{,}000 \times \frac{400{,}000 - (.25 \times 1{,}000{,}000)}{400{,}000}$$

Step 4: Determine if limitation on excess net passive income applies:

Excess NPI	$112,500
Taxable Income	100,000
Limitation (lesser of Excess NPI or Taxable Income)	$100,000

Step 5: Compute tax:

Excess NPI (lesser of Step 3 or Step 4)	$100,000
× Maximum Corporate Tax Rate	× 21%
Tax	$21,000

If a passive income tax is imposed, only the credit for certain uses of gasoline and other special fuels are allowed as a credit against the tax.[142] All other credits are disallowed. Since the passive income tax is a corporate-level tax, however, this limitation does not greatly affect the availability of credits to shareholders because most credits are claimed at the shareholder level.

If a passive income tax is incurred, §1366(f)(3) requires each item of passive income to be reduced by its pro rata share of the tax, before the income is passed through to the shareholders.[143] This reduction is necessary because the passive income tax is a corporate-level tax, and the amount of income that can be passed through to shareholders will decrease after it is paid in the same way that the tax on C corporations decreases the amount of earnings available for distribution to the C corporation's shareholders. The reduction for the passive income tax is computed as follows:[144]

[137] §1375(b)(1)(B).
[138] *See* §172.
[139] *See* §241–§249.
[140] Reg. §1.1375-1(b)(3)(i).
[141] Reg. §1.1375-1(b)(3)(ii).
[142] §1375(c); Reg. §1.1375-1(c)(1). *See* §34.
[143] *See also* Reg. §1.1375-1(e).
[144] Reg. §1.1366-4(c).

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$$\frac{\text{net amount of passive investment income item}}{\text{total net passive investment income for that taxable year}} \times \text{passive income tax}$$

Comment: Section 1366(f)(3)(B) refers to total passive investment income as the denominator in the fraction above, rather than net passive investment income. One commentator to the proposed regulations under §1366 requested clarification on whether the §1375 tax is based on gross or net passive investment income. In the preamble to T.D. 8852,[145] the IRS responded that, under §1375, excess passive investment income is allocated to items of passive investment income based on the net passive investment income of the corporation, and asserted that allocation of the tax imposed on the excess passive investment income should be similarly allocated, as reflected in the regulations

b. Waivers

The passive income tax can be waived by the IRS if the S corporation can show it had determined, in good faith, that the corporation had no accumulated E&P at the close of the taxable year and that any newly discovered E&P was distributed within a reasonable time.[146] The S corporation has the burden of establishing that under the relevant facts and circumstances the IRS should waive the tax. For example, if an S corporation established that in good faith and using due diligence it determined that it had no accumulated E&P, but subsequently on IRS audit accumulated E&P was determined to in fact exist, then an IRS waiver of the passive income tax would be appropriate if the E&P is distributed within a reasonable period of time after the audit.[147]

Under the regulations, a request for waiver of the tax must be made in writing to the IRS.[148] The request must contain all relevant facts establishing that the requirements for waiver have been met, including: (i) how and when the S corporation, in good faith and using due diligence, determined that it had no accumulated E&P at the close of the taxable year; (ii) how and when the accumulated E&P was discovered; and (iii) any steps taken to distribute the accumulated E&P. If the accumulated E&P has not been fully distributed, the request must provide a timetable for its distribution and an explanation for why the timetable is reasonable. All accumulated E&P must be distributed by the date on which the waiver is effective.[149]

4. Passive Income Terminations

If an S corporation has accumulated E&P at the close of each of three consecutive taxable years, and the corporation has passive investment income exceeding 25% of its gross receipts for each of those years, its S corporation status automatically terminates under §1362(d)(3) with the beginning of its next taxable year.[150] The IRS will consider reinstating the S election under §1362(f), however, if the S corporation can demonstrate that its status terminated inadvertently because, for example, there was a good faith underestimation of accumulated E&P, and if within a reasonable period of discovering the error the accumulated E&P is distributed.[151] In addition, the IRS may require the corporation to file amended corporate returns to pay any §1375 taxes due, and may require the shareholders to file amended shareholder returns to reflect the distribution of accumulated E&P as taxable dividends. Interest for any underpaid taxes by the taxpayers could also be due.[152]

Comment: Distributing the corporation's accumulated E&P is generally essential to obtaining a favorable ruling. Merely removing the property generating the passive income, by, for example, distributing it to the shareholders may not be enough.

5. Planning for the Passive Income Tax

a. Distributing E&P

Existing S corporations with passive income can avoid the passive income tax and termination exposure by distributing their accumulated E&P as a taxable dividend to shareholders. Because the passive income tax and termination rules look to accumulated E&P at the close of the taxable year,[153] distribu-

[145] 64 Fed. Reg. 71,641, 71643 (Dec. 22, 1999).

[146] §1375(d); Reg. §1.1375-1(d)(1). The term subchapter C earnings and profits with respect to S corporations which were once C corporations was replaced by the term accumulated earnings and profits in §1375(d) by the 2005 Gulf Opportunity Zone Act, Pub. L. No. 109-135, §412(qq), to conform the terminology in §1375(d) to the terminology in §1375(a), as amended by the 1996 Small Business Job Protection Act, Pub. L. No. 104-188, §1311(b). Because of other changes made by the 1996 Act, an S corporation generally does not have accumulated earnings and profits after 1996 other than those from a period when the S election was not in effect. The S corporation regulations have not been amended to reflect the change in terminology; they continue to refer to subchapter C earnings and profits.

[147] Reg. §1.1375-1(d)(1).

[148] *See* PLR 9024023 and PLR 9108017 (granting waiver of S termination due to redetermination of subchapter C earnings and profits); PLR 201248001 and PLR 201320008 (waiver of S termination conditioned on election to distribute accumulated earnings and profits pursuant to Reg. §1.1368-1(f)(3)). *See also* CCA 200937029 (waiver of tax on excess passive investment income under §1375(d) and relief for inadvertent termination of S corporation election under §1362(f) are separate determinations under jurisdiction of different IRS offices; grant of waiver does not waive §1362(d)(3) termination).

[149] Reg. §1.1375-1(d)(2).

[150] *See* Reg. §1.1362-2(c)(1). Consequently, gross receipts and passive income should be carefully examined every third year, and to the extent possible, passive income should be shifted between the third year and the next taxable year.

[151] *See, e.g.,* PLR 201414013 (S corporation with excess passive income terminated S status was granted relief upon making a deemed dividend election on open year amended return), PLR 200808004 (S corporation that received passive investment income in form of rental income on lease of real property associated with business sale qualified for §1362(f) relief), PLR 9411029 (S corporation that relied on tax adviser's advice qualified for relief); PLR 9046019 (S corporation remanufacturer of aircraft engine parts whose business declined over a period of years qualified for inadvertent termination relief); PLR 9039021 (S corporation status reinstated for corporation with undeveloped land with installment sale income, including interest). *See also* PLR 8721029. But see PLR 200830008 where it appears the taxpayer was not required to distribute the accumulated earnings and profits to obtain termination relief.

[152] *See* PLR 9024023.

[153] §1362(d)(3)(A)(i)(I) and §1375(a)(1); Reg. §1.1375-1(a). *See also* PLR 9747035 (for purposes of applying §1375(a), accumulated E&P is measured following liquidating distribution and accumulated E&P at close of year will have been reduced by taking into account liquidating distribution under §312); PLR 9752038 (§331, not §301 or §1368, governs liquidation of S corporation

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tions made during the tax year can eliminate passive income problems, as long as at the close of the year accumulated E&P have been completely eliminated.

To make distributions of accumulated E&P, the S corporation can elect under §1368(e)(3), with the consent of all shareholders receiving distributions during the year, to treat distributions as being made first out of the S corporation's accumulated E&P (rather than out of its current year's earnings). With this election, the corporation bypasses its AAA balance, which normally must be depleted before distributions are treated as made out of E&P.[154] If this election is made, it applies to all distributions during the year until accumulated E&P has been fully distributed.[155] Because the election cannot be made on a selective basis, all distributions during the year could be taxed as dividends.

Comment: Liquidating a corporation by distributing all of its property to shareholders should eliminate any accumulated E&P at the close of the liquidating tax year. Thus, the passive income tax should not be a problem in an S corporation's last year.[156]

If an S corporation decides to strip out its accumulated E&P, a comparison of the corporate-level tax on excess net passive income with the shareholder-level tax on the dividend distribution is necessary to determine whether to make the required distribution in year one, two, or three. If the corporation has a relatively small amount of excess net passive income and substantial E&P, generally it will be advantageous to defer the dividend distribution until year three, assuming a constant tax rate.

Comment: While dividends are taxable at 20%[157] at the individual shareholder level, corporations with small amounts of accumulated E&P relative to excess net passive income will have more incentive to pay out any remaining accumulated E&P to avoid having to manage a passive income tax problem at the corporate level.

In some instances, the IRS has permitted taxpayers to revoke their §1368(e)(3) election. In PLR 9312027, for example, a broker-dealer taxpayer with margin interest income was allowed to revoke the election when final regulations were issued under §1362 that revised the definition of passive investment income to exclude margin interest.[158] The IRS also noted in the ruling that the revocation would cause the normal ordering rules for distributions under §1368 to apply.[159] The IRS also permitted the taxpayer to revoke its §1368(e)(3) election in PLR 9341010. However, the IRS specified that the taxpayer could not, as the taxpayer had alternatively suggested, treat its prior distribution as if it had never occurred because a recontribution of the distribution occurred in a later year.

b. Monitoring Passive and Taxable Income

When the tax costs or economic considerations associated with distributing accumulated E&P are too high, the focus switches to controlling the S corporation's income and/or gross receipts. These monitoring techniques require either increasing active gross receipts, deferring passive income, or reducing (eliminating) taxable income.

While, in some cases, it may not be possible to avoid the corporate-level tax, it may still be possible to avoid termination. Because termination of the S election only occurs when excess net passive income is earned for three consecutive years, termination may be avoided by increasing active business receipts or deferring passive gross receipts in every third year so that the consecutive three-year test is not met. According to Rev. Rul. 75-188, sales of corporate assets could generate active receipts. The ruling concluded that proceeds from the sale of real estate used in a trade or business are not passive investment income.[160]

If all of the shareholders of the S corporation are also performing services as employees, reasonably increasing compensation may reduce or eliminate taxable income. This will result, however, in additional employment tax costs.[161]

A more long-term, but potentially expensive, solution would involve acquiring the assets of a business that generates sufficient active trade or business receipts to exceed three times the gross receipts from passive investment income. If outright asset ownership is not feasible, authority indicates that partnership investments may be a viable alternative. In Rev. Rul. 71-455, the IRS ruled that an S corporation general partner in a partnership could use its share of the active receipts rather than its distributive share of the partnership's net loss to compute passive investment income. Furthermore, in PLR 8804015, the IRS ruled that an S corporation limited partner could treat its distributive share of active receipts as nonpassive income.[162]

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and, for purposes of applying §1375(a), accumulated E&P is reduced by liquidating distribution). The term subchapter C earnings and profits with respect to S corporations which were once C corporations was replaced by the term accumulated earnings and profits in §1375(d) by the 2005 Gulf Opportunity Zone Act (2005 GOZA, Pub. L. No. 109-135, §412(qq), to conform the terminology in §1375(d) to the terminology in §1375(a), as amended by the 1996 Small Business Job Protection Act, Pub. L. No. 104-188, §1311(b). Because of other changes made by the 1996 Act, an S corporation generally does not have accumulated earnings and profits after 1996 other than those from a period when the S election was not in effect. The S corporation regulations have not been amended to reflect the change in terminology; they continue to refer to subchapter C earnings and profits.

[154] *See* §1368(c)(1). For further discussion of the election to distribute E&P first, see II.C.5., below.

[155] §1368(e)(3)(A).

[156] *See* PLR 9747035 (corporation's final taxable year closes after liquidating distribution).

[157] An additional 3.8% tax may be levied on the dividend income of certain individuals under §1411 (net investment income tax).

[158] *See* Reg. §1.1362-2(c)(5)(iii)(B).

[159] For a discussion of S corporation distributions, see II., below.

[160] This solution must be evaluated in light of potential corporate exposure to the capital gains tax and the built-in gains tax.

[161] In the case of FICA taxes, although the wage base is capped as to the Old-Age, Survivors and Disability Insurance (OASDI) component of the tax, the wage base is not capped as to the hospital insurance component of the tax. §3101. Thus, the hospital tax component applies to the entire amount of wages paid to an employee. For a detailed discussion of the OASDI wage base, see 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation.*

[162] The IRS later confirmed that a publicly traded partnership's gross receipts passed through to an S corporation partner are considered active income for purposes of the passive income tax. *See* PLR 200928024, PLR 200327004, PLR 200309021, PLR 200240043, PLR 199935015, PLR 199935014, PLR 199935013.

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C. *Built-in Gains Tax*

1. *General*

S corporations are subject to several corporate-level taxes, including a tax on any appreciated assets held on the day a C corporation converts to S status. If the S corporation has never operated in C status nor acquired assets from a C corporation, this built-in gains tax does not apply.[163]

The built-in gains tax was added in conjunction with the 1986 TRA repeal of the *General Utilities* doctrine, which applies to liquidating and nonliquidating distributions made after December 31, 1986.[164] The rationale for the tax is important to understand. In the post-*General Utilities* environment, Congress was concerned that shareholders of closely held C corporations could circumvent a corporate-level tax by converting to S status, waiting three years (to avoid the capital gains tax of pre-1986 TRA §1374), and liquidating the corporation or selling appreciated assets and then distributing the proceeds. In such a situation, only one level of tax would have been imposed because the distributee shareholders could have increased the basis of their stock under §1367(a) by the amount of gain recognized by the corporation (and passed through to the shareholders), thus making the distribution of the sale or liquidation proceeds tax free. If the corporation had remained in C status, however, a corporate-level tax would have been assessed on the sale or liquidation, along with a shareholder-level tax when the proceeds were distributed, either as a dividend in a nonliquidating context or as capital gain in a liquidation transaction. Therefore, to prevent circumvention of the two-tier tax, §1374 was added to the Code to impose a corporate-level tax on the built-in gain (as defined in §1374(d)(2)) recognized by former C corporations during a statutorily prescribed recognition period. The recognition period is defined to generally include the 5-year period starting with the first day of the first tax year the corporation is an S corporation.[165]

> *Example:* B, a calendar year C corporation, converted to S status on January 1 of taxable Year Three. Under §1374(d)(7), B's recognition period is five years. Thus the last day of B's recognition period is December 31 of taxable Year Seven.

While the built-in gains tax is intended to prevent avoidance of the two-tier C corporation tax, it often has more adverse consequences than if the gain were recognized in C status. This disadvantage results from the immediate corporate-level tax imposed on built-in gains. When income is recognized by a C corporation, it is subject to corporate tax. Because the C corporation generally can control the timing of double taxation by delaying distributions, the shareholders do not incur a shareholder-level of tax until they receive or accrue the dividends. In contrast, when the S corporation is subject to the built-in gains tax, the gain is recognized and taxed to the corporation, and is also (after reduction for corporate taxes paid) passed through and taxed to the shareholder.

Comment: Exposure to the built-in gains tax is a significant factor that must be considered in deciding whether to convert from C to S status. In many situations, proper planning can help to reduce the tax. In any event, the electing corporation must assess its potential exposure to the built-in gains tax versus the tax burden of remaining in C status.

For tax years beginning before January 1, 2018, another disparity between S and C treatment is that the built-in gains tax is imposed at the highest corporate rate. Under pre-2018 §11(b) the double tax on C corporations (except for personal service corporations) may have been imposed at the lower graduated rates of §11(b). However, for tax years beginning after 2017, the corporate tax rate is a flat 21%, thus eliminating any benefit of the graduated rates under §11(b).[166]

2. *Assets Subject to the Built-in Gains Tax*

Any asset carried over from C status may be subject to the built-in gains tax. The §1374 definition of asset is extremely broad. In addition to assets such as furniture and equipment, land, etc., or appreciated investments such as securities, other valuable rights such as goodwill or unrecognized income items are potential built-in gains tax items (even if not appearing on the balance sheet).

The regulations, in general, impose a corporate-level tax on the sale or exchange during the recognition period of assets held by a former C corporation on the first day of the recogni-

[163] The built-in gains tax is only applicable to C corporations that made or make an S election after 1986. If an election was made before 1987, the S corporation was taxed under pre-1986 TRA §1374. A much less comprehensive tax, pre-1986 TRA §1374 applied only to capital gain assets and only in the first three tax years of the S corporation when certain conditions were present. C corporations that elected S status during the period between January 1, 1987, and December 31, 1988, may have qualified for special transitional relief provided by the 1986 TRA. If certain criteria were met, the S corporation was subject to former §1374 (the capital gains tax) on long-term capital gain assets but was subject to current §1374 (the built-in gains tax) on its short-term and ordinary income assets. The transition rules were not elective if a corporation was otherwise eligible. Any corporation that qualified for transitional relief during 1987 and 1988, but made its S corporation election after 1988, is subject to the built-in gains tax. *See* Reg. §1.1374-8(b) (applicable to any transaction described in §1374(d)(8) that occurs on or after December 27, 1994), §1.1374-10(c) (applicable for taxable years beginning after December 22, 2004), T.D. 9236, 70 Fed. Reg. 75,730 (Dec. 19, 2005) (overturning result in *Colo. Gas Compression Inc. v. Comr*, 116 T.C. 1 (2001)).

[164] *See General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1935).

[165] §1374(d)(7). Pre-2015 §1374(d)(7) provided that the recognition period was a 10-year period for tax years beginning before 2009. In addition, a special seven taxable year recognition period applied for tax years beginning in 2009 and 2010, and a special five-year recognition period applied for tax years beginning in 2011 through 2014 (thus, note that a five-year recognition period applies for all tax years beginning after 2010). T.D. 8579, 59 Fed. Reg. 66,458 (Dec. 27, 1994) (adopting Reg. §1.1374-1(d)), which defines recognition period) confirms that the reference to a 10-year period in pre-2015 §1374(d)(7)(A) generally means a 10-calendar-year period (120 months). Section 1374(d)(7), as amended, simply replaced the 10-year period with a 5-year period. Therefore, the 5-year period under §1374(d)(7), as amended, presumably means a five-calendar-year period (60 months). Similarly, the special five-year recognition period for tax years beginning in 2011 through 2014 was determined by reference to the 5th year and 5-year period and, thus, no built-in gains tax was imposed on corporations that completed five calendar years as an S corporation. Pre-2015 §1374(d)(7)(B)(ii), pre-2015 §1374(d)(7)(C). However, the special seven-year recognition period for tax years beginning in 2009 and 2010 was determined by reference to the 7th *taxable* year (emphasis added). Pre-2015 §1374(d)(7)(B)(i). Thus, for any tax year beginning in 2009 or 2010, no built-in gains tax was imposed on a corporation that completed seven taxable years as an S corporation. In other words, it appears that a short S year was taken into account for purposes of the special rule applicable to 2009 and 2010. *See* §7701(a)(23).

[166] *See* §11(b).

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tion period to the extent that the income or gain realized from the subsequent sale or exchange of those assets reflects unrealized appreciation (i.e., built-in gain) in the corporation on the conversion date.[167] In addition, an S corporation's items of income and deduction are also generally treated as recognized built-in gain or loss under the regulations if the item would have been taken into account before the recognition period by a taxpayer using the accrual method of accounting.[168]

However, unless the income item is completely disposed of or sold during the recognition period, the regulations provide that built-in gain includes all amounts received for such item, not just the fair market value of the item at the time of conversion.[169] This is in contrast to the treatment of sales or exchanges of built-in gain assets where only gain inherent in the asset at the time of conversion is considered built-in gain. This rule was promulgated due to the valuation problems and potential for abuse in the area of receivables and payables.[170]

> *Example:* P is a calendar year, cash basis C corporation that elects to become an S corporation on January 1, Year 1. On January 1, Year 1, P has $50,000 of accounts receivable outstanding for services rendered prior to that date which have a fair market value of $40,000 and an adjusted basis of $0. If P collects $50,000 in accounts receivable in Year 1, such receipts constitute recognized built-in gain taxable to P because they would have been included in P's gross income prior to the recognition period under the accrual method of accounting. However, if P had sold all of the accounts receivable for $45,000 on March 15, Year 1, in a transaction treated as a sale or exchange for federal income tax purposes, P would have recognized built-in gain of only $40,000 on the disposition, the fair market value in excess of basis on January 1, Year 1.

The regulations apply the same test to built-in deduction items. An item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period by a taxpayer utilizing the accrual method of accounting. Thus, accrual concepts, such as the all events test and economic performance requirement, will apply in determining whether an item constitutes a built-in deduction. However, the final regulations expressly provide that in determining whether an item would have been allowed as a deduction by an accrual taxpayer, §461(h)(2)(C) and Reg. §1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, rebates, insurance contracts, warranty contracts, taxes and similar liabilities) do not apply.[171]

> *Example:* P is a calendar year cash basis taxpayer C corporation. In Year 1, a lawsuit is filed against P seeking damages in the amount of $1 million. P elects to become an S corporation on January 1, Year 2. In Year 2, P loses the lawsuit and damages are assessed in the amount of $400,000. P pays the damages and properly claims a deduction for that amount. Assuming P would not have been allowed a deduction prior to the beginning of the recognition period if it used the accrual method of accounting, the $400,000 deduction is not considered built-in loss.[172]

Under the originally proposed regulations, items deductible under the accrual method but for the application of §267(a)(2) or §404(a)(5) (which defer, respectively: (i) the deduction of unpaid items owed to related cash basis taxpayers, and (ii) the deduction of deferred compensation) would not have been treated as built-in deduction items. In response to criticism of this aspect of the proposed regulations, the IRS partially modified its position in the final regulations by extending recognized built-in loss treatment to amounts properly deducted under §267(a)(2) and §404(a)(5) during the recognition period if certain conditions are satisfied.[173] An amount deducted during the recognition period under §267(a)(2) is considered recognized built-in loss to the extent that: (i) all events have occurred to establish the fact of liability and the exact amount of the liability can be determined as of the beginning of the recognition period, and (ii) either the amount is paid within the first two and one-half months of the recognition period, or is paid to an individual owning less than 5% of the corporation's stock, measured by voting power and by value and applying the §267 attribution rules.[174] Any amount deducted during the recognition period under §404(a)(5) is considered built-in loss to the extent: (i) all events have occurred that establish the fact of the liability to pay the amount and the exact amount of the liability, and (ii) the amount is not paid to a related party to which §267(a)(2) applies.[175]

Comment: The IRS stated in the preamble to the final regulations that the additional limitations for amounts deducted under §267(a)(2) were promulgated because of the difficulty in determining whether amounts paid to related parties are attributable to services performed before or after the beginning of the recognition period.

The regulations also provide that prepaid income received by an accrual basis corporation that properly elects to defer the accrual of such income under Rev. Proc. 71-21[176] is not treated

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[167] *See* Reg. §1.1374-4(a).

[168] Reg. §1.1374-4(b).

[169] *See* Reg. §1.1374-4(b)(3) *Ex.* 1.

[170] *See* Reg. §1.1374-4(b)(3) *Ex.* 1.

[171] Reg. §1.1374-4(b)(2). In T.D. 8579, 59 Fed. Reg. 66,458 (Dec. 27, 1994), relating to final regulations under §1374, the IRS noted that it had eliminated an exception to the accrual method rule for §469 because losses suspended before the recognition period under §469 cannot be used in the recognition period under §1371(b)(1). In *St. Charles v. Commissioner*, 232 F.3d 773 (10th Cir. 2000), the court held that suspended PALs may be carried forward pursuant to §469(b) and §469(f)(2), and that the suspended PALs associated with the activities disposed of in the year of the S election were fully deductible pursuant to §469(g)(1)(A). The court determined that restrictions on carryforwards from a C year to an S year are not enumerated in §469 and have no effect on the operation of §469(b). The court also determined that under §469(f)(2), the rules of §469 continue to apply to St. Charles's suspended PALs as if it had continued in its C status pursuant to §469(f)(2). Therefore, St. Charles could fully deduct suspended PALs associated with activities when those activities that were disposed of pursuant to §469(g)(1)(A). Given the statement in the preamble to the final regulations, it would appear that the suspended PALs from C corporation years may also be available to offset built in gain under §1374 as a built-in deduction item.

[172] Reg. §1.1374-4(b)(3) *Ex.* 2.

[173] Reg. §1.1374-4(c).

[174] Reg. §1.1374-4(c)(1).

[175] Reg. §1.1374-4(c)(2).

[176] The regulations have not been amended to reflect that Rev. Proc. 71-21 was modified and superseded by Rev. Proc. 2004-34. *See also* §451(c). Regu-

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as a built-in gain asset since the prepaid income does not accrue before the conversion.[177]

In addition, the regulations give guidance as to how certain other assets are handled for §1374 purposes. For example, Reg. §1.1374-4(a)(3) *Ex.* 1 states that a working mineral interest owned on the date of conversion will be considered subject to the built-in gains tax on sale or disposition, but income from extracted minerals will not be subject to the built-in gains tax if no extraction takes place before conversion.[178]

Other examples of built-in gain or loss assets, income items, and deductions discussed in the regulations include:

- §481 adjustments due to a change of accounting method effective before the beginning of the second year of the recognition period;[179]
- deemed distributions of income during the recognition period due to a prior termination or disqualification of a DISC under §995(b)(2) before the recognition period;[180]
- any item of income properly taken into account during the first year of the recognition period as discharge of indebtedness income is recognized built-in gain if the item arises from a debt owed by an S corporation at the beginning of the recognition period,[181] and any bad debt deduction under §166 is treated as a built-in deduction if it arises from a debt owed to the S corporation at the beginning of the recognition period;[182]
- income properly taken into account under the completed contract method of accounting under Reg. §1.460-4(d) where performance of the contract began before the recognition period is built-in gain if the item would have been included in gross income before the recognition period under the percentage of completion method under Reg. §1.460-4(b), and any similar item of deduction is recognized built-in loss if the item would have been allowed as a deduction against gross income before the beginning of the recognition period under the percentage of completion method;[183] and
- installment sales.[184]

Although the §1374 definition of asset is broad, it is not clear how wasting assets, such as favorable leaseholds, mineral deposits, and licensing arrangements are to be treated for built-in gain purposes. If the fair market value of these assets exceeds basis on the date of conversion to S corporation status, there is a potential for recognition of built-in gain upon the disposition of the asset, for example, upon the sale of a favorable lease arrangement. While theoretically the wasting of an asset could be viewed as a disposition, thus requiring either ratable built-in gain recognition over the remaining lease term or a depletion of the asset, the wasting would also appear to constitute a depreciation of the asset, giving rise to a corresponding deduction.[185]

The IRS has clarified its view of the application of §1374 to certain timber, coal, and domestic iron ore production. In Rev. Rul. 2001-50, the IRS ruled that income recognized by an S corporation during the §1374(d)(7) income recognition period pursuant to §631(a), §631(b) or §631(c) constitutes normal operating business income and not built-in gains under §1374. The IRS noted that the receipt of normal operating business income in the nature of rents and royalties is not subject to tax under §1374. The IRS concluded that there is no indication that Congress intended the capital gain tax rate benefits provided by §631 to cause normal operating business income from the cutting of timber or the extraction of minerals to be subject to tax under §1374. The IRS noted that Example 1 of Reg. §1.1374-4(a)(3), as well as Rev. Rul. 72-515, supports this view. The IRS also explained that §631(c) is designed to favor domestic production of iron ore and sales of coal and iron ore to unrelated parties. The IRS observed that applying §1374 to income taxed under §631(c) could have the anomalous effect of taxing sales of domestic iron ore more heavily than sales of foreign production and taxing sales of coal and iron to unrelated parties more heavily than sales to related parties.[186]

An option to acquire property held on the date of a C corporation's conversion is an asset subject to the built-in gains tax. However, the amount of the built-in gain should be measured based on the FMV of the option versus its basis on the date of the conversion and not the difference between FMV and basis on the date of sale of the option.[187]

Congress made it clear that while income recognition items are subject to the built-in gains tax, built-in deduction items will serve to reduce a corporation's built-in gains tax exposure.[188] According to the TAMRA Committee Reports:

> As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in loss items would include otherwise deductible compensation paid after the conver-

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lations issued under §451(c) generally follow, and therefore render Rev. Proc. 2004-34 obsolete. *See* Reg. §1.451-8, T.D. 9941, 86 Fed. Reg. 810 (Jan. 6, 2021). A taxpayer may generally apply the final regulations to tax years beginning after 2017, provided that the taxpayer consistently applies the regulations in their entirety to all subsequent tax years.

[177] Reg. §1.1374-4(b)(3) *Ex.* 4.

[178] Rev. Rul. 2001-50, (harvesting of timber from forest asset held at time of conversion to S corporation status did not trigger the recognition of built-in gain); *see also* PLR 201006004 (citing Rev. Rul. 2001-50, IRS ruled that amounts received by S corporation during recognition period that were treated as gain from sale of coal under §631(c) will not be subject to built-in gains tax).

[179] Reg. §1.1374-4(d). *See* V.D.2., below.

[180] Reg. §1.1374-4(e).

[181] Reg. §1.1374-4(f).

[182] Reg. §1.1374-4(f).

[183] Reg. §1.1374-4(g).

[184] Reg. §1.1374-4(h). *See* I.C.4.b.(1), below.

[185] See Notice 2003-65, in which the IRS proposed two alternative methods to determining built-in gains for purposes of §382: the 1374 approach and the 338 approach (which includes a wasting asset concept). Because the 1374 approach outlined in the notice does not include a wasting asset concept (whereas the 338 approach does), it would seem that a wasting asset concept is not appropriate for determining built-in gains under §1374 as well. Notice 2018-30 modified Notice 2003-65 to provide that both approaches to identifying built-in items for purposes of §382 are to be determined without regard to bonus depreciation under §168(k).

[186] Rev. Proc. 2001-51, issued in connection with Rev. Rul. 2001-50, removes the application of §1374 to certain timber, coal, and domestic iron ore productions from the list of no ruling areas.

[187] *See* §1374(d)(1).

[188] §1374(d)(5)(B).

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sion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services.[189]

In light of this language, C corporations making an S election should attempt to identify possible built-in deduction items at the date of conversion. Items that are treated as recognized built-in losses include, in addition to accrued compensation, other accounts payable that arose during C corporation years and give rise to deductions during the S corporation years.

Comment: Where a cash method C corporation that is about to elect S status has substantial receivables, the corporation should consider declaring, before the end of its final C corporation year, a reasonable bonus payable in the next year to its shareholders for services actually rendered by them during the final C corporation year. The bonus declaration should be properly documented in the corporate minutes. Most importantly, to ensure treatment of the bonus as a built-in deduction, it should be paid within 2½ months of the first day of that next year, which will be the first year of the recognition period, to comply with the special rules of Reg. §1.1374-4(c) concerning the application of §267(a)(2) and §404(a)(5). Taxpayers should be aware, however, that the IRS may try to limit deductions attributable to accrued bonuses by declaring such amounts deferred compensation under §404(a)(5) subject to the limitations imposed by Reg. §1.1374-4(c)(2).[190]

Note: Because the TAMRA Committee Report specifically refers to compensation deductions by personal service corporations,[191] to the extent compensation is paid to a greater-than-10%-shareholder more than 2½ months after the conversion and is related to the receivables generating the built-in gain, such compensation should still be a built-in loss regardless of when it is paid. However, in taking such positions, taxpayers should consider attaching Form 8275-R, *Regulation Disclosure Statement*, to Form 1120-S to disclose a position contrary to IRS regulations.

3. Computing Built-in Gain

Any gain or income item recognized in the recognition period will potentially be subject to the built-in gains tax to the extent the item was owned on the date of conversion from C to S status. In general, the term recognition period means the five-year period[192] beginning on the first day of the S corporation's first tax year.

Comment: The capital gains tax under pre-1986 TRA §1374 had a recognition period of three tax years. In contrast, the built-in gains tax generally does not define recognition period in terms of tax years, but in terms of a 5-year period. Therefore, the recognition period generally lasts five full years (60 months), regardless of intervening short tax years.[193] Similarly, for tax years beginning before 2009, the recognition period was the "10-year period" beginning on the first day of the S corporation's first tax year and, therefore, lasted 10 full calendar years (120 months).[194] For tax years beginning in 2009 and 2010, the recognition period was defined by reference to the 7th *taxable* year (emphasis added) and, therefore, short S years were taken into account in determining the recognition period.[195]

In PLR 9801015, the IRS ruled that an election to treat subsidiaries as qualified subchapter S subsidiaries did not result in the recognition of built-in gain to either the parent or subsidiaries because the deemed liquidation of the subsidiaries under §332 is a nonrecognition transaction. In order to trigger built-in gain, the gain must be recognized during the recognition period.

Several important limitations minimize the gain that is taxed at the corporate level. These limitations are discussed below.

a. Net Unrealized Built-in Gain

The total amount of gain subject to the built-in gains tax cannot exceed the corporation's net unrealized built-in gain. Net unrealized built-in gain (NUBIG) is defined as the amount by which the fair market value of all assets of the S corporation (determined on the first day of its first tax year as an S corporation) exceeds the aggregate adjusted bases of such assets at that time.[196] Thus, NUBIG reflects the aggregate economic appreciation and depreciation in the electing corporation's underlying assets, including income and deduction items that are recognized in S status.

Before the regulations were issued, many practitioners were concerned that an appraisal of each asset was necessary to determine NUBIG. Since such appraisals can be very costly, the cost of an appraisal had to be weighed against tax savings. Instead of valuing each individual asset and aggregating these amounts for all of the corporation's assets, the regulations adopt the position taken in the proposed regulations to determine NUBIG by providing that a corporation's NUBIG is equal to:

- Step One — the amount realized by a converting corporation on a hypothetical sale of all of its assets on the first day of the recognition period to an unrelated party which assumed all of the corporation's liabilities, *decreased by*
- Step Two — any liability that would otherwise be included in the amount realized as calculated in (1) above that is deductible for tax purposes when paid, (e.g., accounts payable, salaries payable, etc., of a cash basis taxpayer) *decreased by*

[189] H.R. Rep. No. 100-795, at 63–64 (1988). *See* the Worksheets, below.

[190] However, the legislative history suggests that Treasury may have overstepped its bounds in Reg. §1.1374-4(c)(2). For a discussion of deferred compensation under §404(a)(5), see 385 T.M., *Deferred Compensation Arrangements.*

[191] Reg. §1.441-3(c)(1), T.D. 8996, 67 Fed. Reg. 35,009 (May 17, 2002).

[192] §1374(d)(7), as amended by Pub. L. No. 114-113, Div. Q, § 127(a) (making five-year recognition period permanent). *See also* pre-2015 §1374(d)(7)(C). For taxable years beginning before 2012, the recognition period was 10 years. Pre-2015 §1374(d)(7)(A). However, no built-in gains tax was imposed in taxable years beginning in 2011 if five years of the recognition period preceded such taxable year, and no tax was imposed in taxable years beginning in 2010 or 2009 if the seventh taxable year in the corporation's recognition period preceded such taxable year. *See* Pre-2015 §1374(d)(7)(B).

[193] §1374(d)(7), as amended by Pub. L. No. 114-113, Div. Q, §127(a); pre-2015 §1374(d)(7)(B)(ii); pre-2015 §1374(d)(7)(C).

[194] Pre-2015 §1374(d)(7)(A).

[195] Pre-2015 §1374(d)(7)(B)(i).

[196] §1374(d)(1).

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• Step Three — the aggregate adjusted bases of the corporation's assets on the first day of the recognition period, *increased or decreased by*

• Step Four — any §481 adjustments of the corporation on the first day of the recognition period, *and increased by*

• Step Five — any recognized built-in loss that would not be allowed under §382, §383, or §384.[197]

Example: P, a calendar year, cash basis C corporation elects to become an S corporation on January 1, Year 7 with assets and liabilities as follows:

Assets	**Basis**	**Fair Market Value**
Factory	$900,000	$500,000
Accounts Receivable	0	300,000
Goodwill	0	250,000
Total Assets	900,000	1,050,000
Liabilities		
Mortgage Payable		$200,000
Accounts Payable		100,000
Total Liabilities		$300,000

In addition, P also must include $60,000 in taxable income in Year 7, and Year 8 pursuant to §481.

P's NUBIG is determined as follows:

Amount realized on hypothetical sale		$1,050,000
Deductions allowed	(100,000)	
Bases of property	(900,000)	(1,000,000)
		$50,000
Section 481 adjustment	120,000	
NUBIG		$170,000

Comment: If the face amount of the receivables were $350,000 on the first day of the recognition period and the corporation succeeded in collecting all the receivables, the amount of recognized built-in gain on collection of the receivables would be limited to $220,000 (the NUBIG limitation increased by $50,000 for the increased value in receivables).[198] On the other hand, if the factory had an adjusted basis of $500,000 and a fair market value of $900,000 on January 1, Year 7, the amount of NUBIG would be $970,000. In that case, if the face amount of the receivables were $350,000 on the first day of the recognition period and P succeeded in collecting all of that amount, then the entire amount collected would be treated as recognized built-in gain under Reg. §1.1374-4(b)(1) because that amount would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer. However, if P sold the receivables for $325,000 on February 1, Year 7, the amount of recognized built-in gain would be $300,000 because the difference between the amount realized on the sale of the receivable and the fair market value of the receivable on January 1, Year 7 would not have been taken into account by an accrual method taxpayer, i.e., the additional $25,000 is considered to be appreciation in the value of the receivables after the S corporation election is made.[199] If P's subchapter S election were effective January 1, Year 21, then none of the amount collected on the receivables in Year 7 would be treated as recognized built-in gain since the collection and recognition of income was not within the recognition period.[200] In addition, the result would be the same in those cases if the receivables were sold, including in an installment sale.[201]

(1) Anti-Stuffing Rule

Because loss assets owned at the conversion date reduce a C corporation's exposure to the built-in gains tax, shareholders planning to convert to S status have an incentive to transfer loss assets to the corporation before conversion, thereby reducing the corporation's NUBIG at the conversion date. However, in Announcement 86-128, the IRS stated that it would issue regulations providing that the contribution of loss assets to a corporation in contemplation of an S election would not reduce the corporation's NUBIG in situations in which avoidance of the built-in gains tax motivated the contribution (the so-called anti-stuffing rule).

The IRS added that contributions of loss property within two years before the earlier of the date of conversion or the date of filing of an S election are presumed to have such a tax avoidance motive absent the showing of a clear and substantial relationship between the loss property and the current or future business of the corporation. This position was reflected later in the TAMRA committee reports: "It is expected that Treasury shall also prevent the avoidance of [the built-in gains tax] through contributions of property with built-in loss to a corporation before it becomes an S corporation."[202]

Reg. §1.1374-9 adopts this anti-stuffing rule, providing generally that if an asset is acquired before or during the recognition period and the principal purpose of the acquisition is to avoid a tax under §1374, then any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded. No mention is made in the regulations of any presumption of tax avoidance for contributions of loss property within two years before the earlier of date of filing of an S corporation election or date of conversion.

Comment: Whenever a pre-S election contribution of built-in loss assets is contemplated, a clear and substantial rela-

[197] Reg. §1.1374-3(a)(1)–§1.1374-3(a)(5). *See* discussion of Reg. §1.1374-3(b), §1.1374-3(c), and Reg. §1.1374-10(a) at I.C.5.c., below.

[198] Reg. §1.1374-3(c) *Exs.* 1, 2.

[199] Reg. §1.1374-4(b)(3) *Ex.* 1.

[200] §1374(a); §1374(d)(7)(A).

[201] §1374(d)(7)(B).

[202] H.R. Rep. No. 100-795, at 65 (1988).

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tionship between the loss property and the corporation's business activities should be documented.

(2) Effect of Liabilities

Generally, only asset, income, and deduction items are taken into account in determining NUBIG. It is unclear, however, whether liabilities in excess of the FMV of the asset are ignored for built-in gains tax purposes. Section 7701(g) states that, in determining gain or loss or deemed gain or loss with respect to any property, the FMV is treated as not less than the nonrecourse indebtedness to which the property is subject. If this provision is applied to an S corporation in the calculation of net unrealized built-in gain, a nonrecourse liability in excess of an asset's FMV can increase the net unrealized built-in gain.[203]

(3) Accounting Method Changes

Accounting method changes (e.g., a change from the cash to the accrual method) frequently involve a §481 adjustment, which requires inclusion of the adjustment over one or more years after the change. If a C corporation adopts a method change generating a §481 adjustment, and the corporation elects S status, the adjustment is subject to the built-in gains tax.[204] If there are built-in gain items, the §481 adjustments are taken into account annually, as recognized, under §1374(d)(5)(A) and included in the NUBIG computation at conversion to S status.

Reg. §1.1374-4(d) adopts this reasoning, providing that §481 adjustments attributable to a C corporation year are taken into account by the S corporation as either built-in gain or loss during the recognition period if the adjustments relate to items attributable to periods before the beginning of the recognition period under the principles for determining built-in gain or loss in the regulations.[205]

(4) Valuing Inventory When Computing NUBIG

As discussed above, a converting S corporation's NUBIG includes the amount that would be realized by the S corporation on a hypothetical sale of all of its assets to an unrelated party assuming all of the liabilities, subject to certain adjustments.

Reg. §1.1374-7(a) provides (i) that the value of an S corporation's inventory on the first day of the recognition period is determined by reference to a sale of the entire business to a buyer that expects to continue the business and (ii) that neither the buyer nor seller are under any compulsion to buy or sell and both are deemed to have knowledge of all relevant facts. In other words, the IRS adopts a non-distress, non-liquidating, bulk sale approach that should result in a value ranging between replacement value and retail price.

For S elections effective before December 17, 1994, a corporation was not bound to follow the valuation method set forth in Reg. §1.1374-7(a). There are authorities suggesting that inventory valuation based on replacement value or liquidation value may be appropriate alternatives in certain situations. For example, Rev. Proc. 2003-51[206] states that replacement cost can be used for valuing retail and wholesale inventories and raw material inventories of manufacturers. The revenue procedure suggests use of the comparative sales method or the income method for determining the value of finished goods inventory of manufacturers and for work in process.[207]

In the preamble to the proposed regulations,[208] the IRS stated that it was considering the use of a safe harbor under which taxpayers could determine recognized built-in gain from inventory under §1374 as follows:

> An S corporation's recognized built-in gain from inventory is equal to the gross profit (that is, gross receipts, less cost of goods sold and direct selling expenses) from one inventory turn after the first day of the recognition period multiplied by a designated percentage (for costs that add value to the inventory but were not taken into account in determining the inventory's gross profit). Thus, recognized built-in gain from inventory for the first year of the recognition period is equal to the inventory's gross profit for that year divided by the number of inventory turns in that year multiplied by the designated percentage. The number of inventory turns in the first year of the recognition period is equal to the cost of goods sold for that year divided by that year's opening FIFO value. In the case of LIFO taxpayers, no gross profits from inventory would be treated as recognized built-in gain until the taxpayer invades LIFO layers in existence on the first day of the recognition period.

In the proposed regulations, the IRS requested comments from the public concerning the usefulness of a safe harbor rule,

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[203] *See* §336(b).

[204] *See Argo Sales Co. v. Commissioner*, 105 T.C. 86 (1995) (holding that, even though Reg. §1.1374-4(d) was not in effect for years at issue, taxpayer's §481(a) adjustments were items of income attributable to periods before first year for which corporation was S corporation and were properly treated as recognized built-in gain); *MMC Corp. v. Commissioner*, T.C. Memo 2007-354, *aff'd*, 551 F.3d 1218 (10th Cir. 2009) (holding that income reported by corporation, consisting of §481 adjustments was taxable as built-in gain under §1374(d)(5) and that S election does not avoid corporate tax on gains attributable to periods when corporation was C corporation); *Rondy, Inc. v. Commissioner*, T.C. Memo 1995-372. *See also* H.R. Rep. No. 100-795, at 63 (1988). Although §481 adjustments are not specifically referenced in the §1374 tax discussion, they are referenced in the same report (at page 46) where the §382 built-in gain rules are explained. See S. Rep. No. 100-445, at 48 (1988), for a reference to §481 adjustments as built-in gain under §382.

[205] *See also* PLR 9106009 (family farm corporation was required to change to accrual method, and suspense account established to account for §481 adjustment resulting from accounting method change would be subject to built-in gains tax to extent of any reduction or recapture).

[206] *Superseding* Rev. Proc. 77-21, (valuation of inventories in a bulk purchase of assets). *See also* GCM 36124 (Dec. 27, 1974).

[207] Judicial authorities, on the other hand, support using the method adopted in the final regulations for valuing wholesale and retail inventories. In *Knapp King-Size Corp. v. United States*, 527 F.2d 1392 (Ct. Cl. 1975), and *Zeropack Co. v. Commissioner*, T.C. Memo 1983-652, involving taxpayers that sought to place high values on their inventories, replacement cost was specifically rejected in valuing wholesale and retail inventories, in favor of a net realizable value-type approach. In arriving at an appropriate value, the courts started with retail value, then deducted disposition and handling costs. Profit was then estimated and a judgment made on allocating the profit between buyer and seller. The profit element allocated to the buyer was further applied against the retail price to arrive at the inventory's value. *Cf. Jack Daniels Distillery v. United States*, 379 F.2d 569 (Ct. Cl. 1967) (valuation method for inventory considered irreplaceable); *Berg v. United States*, 167 F. Supp. 756 (D. Wis. 1958) (valuation of manufacturer's inventory on liquidation). See also CO-80-87, 57 Fed. Reg. 57,971 (Dec. 8, 1992), which indicates that the IRS was considering whether Rev. Proc. 77-12 should be modified to (i) provide further guidance on valuing inventory for purposes of §336, §338, §1060, and §1374 and (ii) incorporate the principles of *Knapp*, *Zeropack*, and other relevant precedent.

[208] CO-80-87, 57 Fed. Reg. 57,971 (Dec. 8, 1992).

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the specific safe harbor suggested in the preamble, and any alternative safe harbor that would be relatively simple to administer and would be consistent with the rule for valuing inventory contained in the proposed regulations. However, the preamble to the final regulations states that because no positive comments were received concerning the rule in the preamble, and no alternatives were suggested, no revenue procedure will be issued.

If a corporation owns inventory or goods in process on the date of conversion to S status and later finishes production or sells the inventory through its own marketing efforts, the corporation has an incentive to maximize the portion of overall gain attributable to the post-conversion activity. The IRS, however, will attempt to maximize the portion of the gain attributable to the corporation's pre-conversion activity. Thus, rules similar to the intercompany pricing rules of §482 may be relevant in determining the amount of built-in gain, although the IRS's posture may be different from the posture it adopts when applying §482 to a domestic manufacturer that has foreign affiliates performing finishing and/or marketing activities.

In *Reliable Steel Fabricators, Inc. v. Commissioner*,[209] the Tax Court held that, for purposes of determining the taxpayer's recognized built-in gain, work-in-process is valued at a discount from retail. In determining what a willing buyer would pay a willing seller for its work-in-process, the fair market value was lower than full retail price but higher than cost (because a willing buyer would not forgo all profit inherent in the inventory and a willing seller would not forgo all profit inherent in the work-in-process).

For any corporation subject to the inventory capitalization rules of §263A, the corporation's beginning inventory for the first tax year beginning after December 31, 1986, includes additional capitalized costs. If a corporation affected by §263A elects S status after December 31, 1986, the additional capitalized costs are added to basis before computing built-in gain. Therefore, built-in gain on the inventory should be reduced by these capitalized costs.

b. Dispositions

The S corporation incurs a built-in gains tax only upon the disposition of an asset or the recognition of a built-in income item. Even in cases in which a disposition occurs, the corporation can avoid the assessment of a built-in gains tax if it can demonstrate that the asset was not held on the date of conversion to S status or that a portion of the gain is attributable to post-conversion appreciation.

The term disposition includes, not only sales or exchanges, but other recognition events that dispose of the right to claim or receive income. It includes the collection of accounts receivable by a cash-method corporation and the completion of a long-term contract by a corporation using the completed contract method of accounting.[210] However, dispositions do not include the leasing or licensing of an asset to a third party because the underlying asset itself has not been disposed of.[211] Similarly, the granting of an option on built-in gain property would not be treated as a disposition of the underlying property. However, if the option is deep in the money and substantially certain to be exercised, a disposition of the built-in gain property could be triggered.

The disposition of inventory is determined based upon the inventory method used by the taxpayer.[212] Thus, taxpayers using the FIFO method of inventory will likely recognize built-in gain with respect to inventory sales in the first year while taxpayers using the LIFO method of inventory should only recognize built-in gain with respect to inventory if the taxpayer sustains a decrement in its LIFO layers after conversion.

(1) Partnership Interests

If an S corporation holds an interest in a partnership at the date of conversion from C to S status, will the disposition of underlying partnership property trigger the built-in gains tax to the S corporation partner? Technically, the S corporation has not disposed of its asset — the partnership interest — but the gain incurred at the partnership level does flow through and is ultimately taxable to the S corporation's shareholders.

The TAMRA committee reports instructed Treasury to write regulations to address built-in gains tax avoidance techniques. The committee reports specifically referenced the use of §704(c) to ensure that pre-contribution gain recognized by a partnership on the disposition of an underlying asset is allocated to the partner that contributed the appreciated property.[213] This reference in the committee reports suggests that Congress expected the IRS to apply an aggregate approach to built-in gains tax of tainted assets disposed of by partnerships, if used as a tax avoidance technique.

The IRS took this congressional cue and adopted the aggregate approach in the final version of the built-in gains tax regulations. In fact, one of the more complex areas of the regulations deals with S corporations that either own partnership interests on the first day of the recognition period and/or transfer property held on the first day of the recognition period to a partnership in a §1374(d)(6) transaction, e.g., a §721 transfer to a partnership. The regulations adopt the aggregate theory approach and provide a look-through rule requiring a partnership's gain or loss on the sale of assets during the recognition period to be treated as if such gain or loss had been directly incurred by the S corporation, limited by the S corporation's built-in gain or built-in loss in its partnership interest.[214] Additionally, the regulations provide an anti-stuffing rule in case a partnership is formed or availed of to reduce the built-in gains tax.[215]

If the S corporation disposes of its partnership interest during the recognition period, Reg. §1.1374-4(i)(3) adjusts the amount treated as recognized built-in gain or loss to account for amounts treated as recognized built-in gain or loss under the

[209] T.C. Memo 1995-293.

[210] §1374(d)(5); H.R. Rep. No. 100-795, at 63 (1988); Announcement 86-128. See also *Leou v. Commissioner*, T.C. Memo 1994-393, where the Tax Court held that the collection of accounts receivable by an S corporation, after converting from C corporation status, amounts to the disposition of a built-in gain asset.

[211] PLR 200240002 (income received from copyright license agreements entered into after a company's conversion to an S corporation status will not constitute recognized built-in gain).

[212] Reg. §1.1374-7(b).

[213] S. Rep. No. 100-445, at 67 (1988); H.R. Rep. No. 100-795, at 65 (1988).

[214] Reg. §1.1374-4(i).

[215] *See* Reg. §1.1374-9, T.D. 8579, 59 Fed. Reg. 66,458 (Dec. 27, 1994).

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look-through rules. This rule can add a great deal of complexity because it appears to require a partnership to appraise its assets every time one of its partners converts from C corporation status to S corporation status.

The regulations ameliorate some of the harsh results of the look-through rule described above by limiting the amount of an S corporation's attributable share of a partnership's recognized built-in gains or losses to the S corporation's built-in gain or loss in its partnership interest. Reg. §1.1374-4(i)(2)(i) states that an S corporation's partnership recognized built-in gain for any taxable year (the S corporation's net recognized built-in gain for year including partnership items over net recognized built-in gain without partnership items) may not exceed the excess, if any, of the S corporation's recognized built-in gain limitation, as described above, over its partnership recognized built-in gain for prior years. However, the limitation does not apply if a partnership is formed or availed of for the principal purpose of avoiding the built-in gains tax. The same calculation is also used in determining an S corporation's partnership recognized built-in loss for any taxable year, i.e., the excess of the S corporation's partnership recognized built-in loss for prior taxable proceeds.[216]

Under Reg. §1.1374-4(i)(4), the recognized built-in gain or recognized built-in loss limitation of an S corporation with a partnership interest is generally defined as the gain or loss that the S corporation could recognize if it sold its partnership interest at fair market value on the first day of the recognition period.

The regulations utilize a four-step approach to determine the effect on a corporation's net recognized built-in gain from its distributive share of partnership items, as follows:

- apply §1374(d) to the S corporation's distributive share of partnership items (income, gain, loss or deduction) pursuant to subchapter K to determine the extent to which such items would have been treated as recognized built-in gain or loss if such partnership items had been taken into account directly by the S corporation (partnership 1374 items);
- determine the S corporation's net recognized built-in gain without partnership 1374 items;
- determine the S corporation's net recognized built-in gain with partnership 1374 items; and
- if the amount computed under Step 3 exceeds the amount computed under Step 2, the excess is the S corporation's partnership recognized built-in gain, and when added to the amount computed under Step 2, is the S corporation's recognized built-in gain.[217]

If an S corporation sells or exchanges its partnership interest, recognized built-in gain will be the excess, if any, of the S corporation's recognized built-in gain or loss limitation over its partnership recognized built-in gain or loss during the recognition period.[218] The regulations also provide for the recognition of a built-in loss on the disposition of a partnership interest.

[216] Reg. §1.1374-4(i)(2)(ii).
[217] Reg. §1.1374-4(i)(1).
[218] Reg. §1.1374-4(i)(3).

Reg. §1.1374-4(i)(4)(i) defines an S corporation's recognized built-in gain or loss limitation as the amount equal to:

- the amount realized from a hypothetical sale of the corporation's partnership interest at fair market to an unrelated third party on the first day of the recognition period, *decreased by*
- the S corporation's adjusted basis in its partnership interest and any assets contributed to the partnership during the recognition period, *increased or decreased by*
- the S corporation's allocable share of the partnership's §481(a) adjustments.

If the above calculation is a positive amount, the S corporation has a recognized built-in gain limitation equal to that amount and a recognized built-in loss limitation of zero. The opposite holds true if the calculation is negative.[219]

The regulations include an exception for small business interests held by an S corporation. The look-through rules will not apply if the S corporation owns a less-than-10% partnership interest with a value of less than $100,000, unless the partnership is formed for a principal purpose of avoiding built-in gains tax under §1374.[220] The small interest exception generally applies for a taxable year if the S corporation's interest in the partnership represents less than 10% of the partnership's profits and capital at all times during the taxable year and prior taxable years in the recognition period and, as of the beginning of the recognition period, has a value of less than $100,000.

Solely for purposes of §1374, the regulations provide that an S corporation's §704(c) gain or loss with respect to any asset contributed to a partnership is not reduced during the recognition period, except for recognized built-in gain or loss with respect to that asset under Reg. §1.1374-4.[221]

Finally, the regulations provide that if on the first day of the recognition period an S corporation holds an interest in a partnership that holds an asset that the partnership distributes to its S corporation partner, a later sale of such asset by the S corporation during the recognition period is treated as if the S corporation held the asset on the first day of the recognition period and gain or loss is treated accordingly.[222]

The following examples illustrate the rules stated above:

> *Example 1:* X is a C corporation that elects to become an S corporation on January 1, Year 1. On that date, X owns a 50% interest in partnership P with a recognized built-in gain limitation of $100,000 (basis in the partnership of $300,000 and fair market value of $400,000) and a recog-

[219] Reg. §1.1374-4(i)(4)(ii).
[220] Reg. §1.1374-4(i)(5)(i), §1.1374-4(i)(5)(iii). In CCA 201324013, the Office of Chief Counsel noted it was likely that a taxpayer's transfer of property subject to §1374 to a partnership in a transaction structured to qualify for nonrecognition under the debt-financed distribution exception of Reg. §1.707-5(b) was permanent exclusion of income by deferring recognition of gain until after the end of the recognition period; however, IRS concluded that the anti-abuse rule of Reg. §1.752-2(j) should be applied to disregard the S corporation's indemnity obligation and treat a distribution within the two-year period of contribution as a disguised sale under §707(a)(2)(B) because none of the facts and circumstances indicate that the S corporation could rebut the presumption of Reg. §1.707-3(b)(1).
[221] Reg. §1.1374-4(i)(6).
[222] Reg. §1.1374-4(i)(7).

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nized built-in loss limitation of $0. P owns (among other assets) Blackacre with a basis of $50,000 and a value of $200,000. In Year 1, P sells Blackacre for $200,000 and recognizes a gain of $150,000 of which $75,000 is included in X's distributive share and treated as a partnership §1374 item. X's net recognized built-in gain for Year 1 computed without partnership §1374 items is $35,000 and with partnership §1374 items is $110,000. Thus, X has a partnership recognized built-in gain of $75,000 except as limited under Reg. §1.1374-4(i)(2)(i). Because X's recognized built-in gain limitation is $100,000, X's partnership recognized built-in gain of $75,000 is not limited and X's net recognized built-in gain for the year is $110,000 ($35,000 + $75,000). However, if X had a recognized built-in gain limitation of $50,000 instead of $100,000 (for example basis in the partner's interest of $350,000), X's partnership recognized built-in gain would have been limited to $50,000 and X's net recognized built-in gain would be $85,000 ($35,000 + $50,000).

Note: If P sells Blackacre for $210,000 and recognizes a gain of $160,000, X's $80,000 distributive share would be presumed to be recognized built-in gain and treated as a partnership §1374 item, but this presumption would be rebutted if X established that X's gain would have been only $75,000 if Blackacre had been sold on the first day of the recognition period. In such a case, only X's $75,000 distributive share of the $150,000 gain would be treated as a partnership §1374 item.[223]

Example 2: X is a C corporation that elects to become an S corporation on January 1, Year 1. X owns a 50% interest in partnership P with a recognized built-in gain limitation of $0 and a recognized built-in loss limitation of $25,000.

In Year 1, P's partnership §1374 items are:

- ordinary income of $25,000, and
- capital gain of $75,000.

X itself has:

- recognized built-in ordinary income of $40,000, and
- recognized built-in capital loss of $90,000.

X's net recognized built-in gain for Year 1 computed without partnership §1374 items is $40,000 and with partnership §1374 items is $65,000 ($40,000 + $25,000). Thus, X's partnership recognized built-in gain is $25,000 for the year except as limited under Reg. §1.1374-4(i)(2)(ii). Because X's recognized built-in gain limitation is $0, X's partnership recognized built-in gain of $25,000 is limited to $0 and X's net recognized built-in gain for the year is $40,000.[224]

Example 3: Y is a C corporation which elects to become an S corporation on January 1, Year 1. Y owns a 50% interest in partnership P with a recognized built-in gain limitation of $60,000 and a recognized built-in loss limitation of $0.

In Year 1, P's partnership §1374 items are:

- ordinary income of $25,000, and
- capital loss of $90,000.

Y itself has:

- recognized built-in ordinary income of $40,000, and
- recognized built-in capital gain of $75,000.

Y's net recognized built-in gain for Year 1 computed without partnership §1374 items is $115,000 ($40,000 + $75,000) and with partnership §1374 items is $65,000 ($40,000 + $25,000). Thus, Y's partnership recognized built-in loss is $50,000 for the year except as limited by Reg. §1.1374-4(i)(2)(ii). Because Y's recognized built-in loss limitation is $0, Y's partnership recognized built-in loss of $50,000 is limited to $0 and Y's net recognized built-in gain is $115,000.[225]

Example 4: X is a C corporation that elects to become an S corporation on January 1, Year 1. On that date, X owns a 50% interest in partnership P with a recognized built-in gain limitation of $200,000 and a recognized built-in loss limitation of $0. P owns (among other assets) Blackacre with a basis of $20,000 and a value of $140,000. In Year 1, P sells Blackacre for $140,000 and recognizes a gain of $120,000 of which $60,000 is included in X's distributive share and treated as a partnership §1374 item. X's net recognized built-in gain for Year 1 computed without partnership §1374 item is $95,000 and with partnership §1374 items is $155,000. Thus, X has a partnership recognized built-in gain of $60,000. In Year 3, X sells its entire interest in P for $350,000 and recognizes a gain of $250,000. Under Reg. §1.1374-4(i)(3), X's recognized built-in gain on the sale is limited by its recognized built-in gain limitation to $140,000 ($200,000 – $60,000).[226]

Reg. §1.1374-10(b)(1) contains a special effective date for partnership interests owned by S corporations. If a corporation transfers an asset to a partnership in a transaction to which §721(a) applies and the transfer is made either in contemplation of an S corporation election or during the recognition period, §1374 applies on the disposition of the asset by the partnership as if no transfer of the asset had occurred. This provision is effective as of January 1, 1987, the effective date of §1374, unless the recognition period with respect to the contributed asset is pursuant to an S election or a §1374(d)(8) transaction occurring on or after December 27, 1994.[227]

(2) Inventory

Since built-in gain is generally limited to gain on assets owned on the conversion date, a corporation with substantial inventory could have difficulty identifying which inventory items are disposed of. Reg. §1.1374-7 eases this burden by

[223] Reg. §1.1374-4(i)(8) *Ex.* 1.
[224] Reg. §1.1374-4(i)(8) *Ex.* 5.
[225] Reg. §1.1374-4(i)(8) *Ex.* 6.
[226] Reg. §1.1374-4(i)(8) *Ex.* 7.
[227] Reg. §1.1374-10(b)(1).

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providing that taxpayers must use their inventory accounting method to make this determination. Thus, for example, a corporation using the LIFO method would not be subject to built-in gains tax on its sale of inventory during the recognition period, except to the extent that it suffered a decrement in its LIFO inventory as it existed at the conversion date. On the other hand, a corporation using the FIFO method would always be subject to the built-in gains tax as inventory is sold during the recognition period after conversion to S status.

Reg. §1.1374-7(b) requires that the same inventory method that a corporation uses for tax purposes must be used to identify whether inventory that is disposed of by the corporation during the recognition period is inventory held on the first day of that period.

The regulations also state that if a corporation changes its method of accounting for inventory to the LIFO method and the principal purpose of such change is to avoid taxes under §1374, the corporation must use the FIFO method to take dispositions of inventory into account.[228]

The fact that LIFO inventory will only be taxed under §1374 if there is a decrement in the S corporation's inventory reserve to a lower level than the inventory held at the date of conversion prompted Congress to enact the LIFO recapture tax in 1987. Generally, §1363(d) mandates that a C corporation that converts to S corporation status and has used the LIFO method of inventory recapture such benefit for its last taxable C corporation year. Notwithstanding the recapture, there may still be built-in gain since the basis increase as a result of the recapture may not increase the basis of the inventory to fair market value. See I.F., below, which discusses the LIFO recapture tax in more detail.

4. *Recognizing Built-in Gains and Losses*

a. *Net Recognized Built-in Gain*

The term net recognized built-in gain is defined as the lesser of the amount that would be the taxable income of the S corporation if only recognized built-in gains and losses were taken into account, or the corporation's taxable income for the tax year (the so-called taxable income limitation).[229]

Recognized built-in gain is defined as the gain recognized within the five-year (seven-year for tax years beginning in 2009 or 2010 and 10-year for tax years beginning before 2009) post-conversion period, where the asset was held by the corporation on the date of the conversion, but only to the extent of the excess of fair market value over basis of such asset as of the date of conversion.[230] The tax is not imposed to the extent that the corporation can establish either that the asset was not owned on the conversion date or that the gain recognized exceeded the gain inherent in the asset as of the date of conversion.

Income items that are properly taken into account during the recognition period but are attributable to periods before the corporation became an S corporation are treated as recognized built-in gains for the year in which they are taken into account.[231] Payments received on installment obligations or accounts receivable relating to transactions that occurred before the S election and transactions that occurred during the recognition period are considered recognized built-in gains.[232] Similarly, completion of a long-term contract can create a recognized built-in gain.[233]

The IRS has clarified its view of the application of §1374 to certain timber, coal, and domestic iron ore production. If natural resources are mined or harvested after the effective date of an S corporation election, the income generated from the sale of timber, coal or iron ore will not constitute built-in gain income even though the underlying property was held at the time the S corporation election went into effect. In Rev. Rul. 2001-50, the IRS ruled that income recognized by an S corporation during the recognition period pursuant to §631(a), §631(b) or §631(c) constitutes normal operating business income, and not built-in gains under §1374. The IRS noted that the receipt of normal operating business income in the nature of rents and royalties is not subject to tax under §1374. The IRS concluded that there is no indication that Congress intended the capital gain tax rate benefits provided by §631 to cause normal operating business income from the cutting of timber or the extraction of minerals to be subject to tax under §1374. The IRS noted that Example 1 of Reg. §1.1374-4(a)(3), as well as Rev. Rul. 72-515, support this view. The IRS also explained that §631(c) is designed to favor domestic production of iron ore and sales of coal and iron ore to unrelated parties. The IRS observed that applying §1374 to income taxed under §631(c) could have the anomalous effect of taxing sales of domestic iron ore more heavily than sales of foreign production and taxing sales of coal and iron to unrelated parties more heavily than sales to related parties.

Rev. Proc. 2001-51, issued in connection with Rev. Rul. 2001-50, removes the application of §1374 to certain timber, coal, and domestic iron ore productions from the list of no ruling areas.[234]

The term recognized built-in loss is defined as any loss recognized during the applicable recognition period on the disposition of any asset to the extent that the S corporation can show that it owned the asset when the S election became effective and that the asset's basis exceeded its fair market value at that time.[235] The term also includes deduction items that are properly taken into account during the recognition period but that are attributable to periods before the S election was effec-

[228] Reg. §1.1374-7(b).

[229] §1374(d)(2).

[230] §1374(d)(3).

[231] §1374(d)(5)(A); Reg. §1.1374-4(b)(1). *See also* PLR 9430026.

[232] Reg. §1.1374-4(h).

[233] Reg. §1.1374-4(g).

[234] Rev. Rul. 2001-50 and Rev. Proc. 2001-51 confirm earlier thinking reflected in a series of private letter rulings before the IRS suspended rulings in this area. For example, in PLR 9430026, IRS ruled that income from a corporation's sale of logs cut from timber owned by the corporation would not generate recognized built-in gain, provided the timber was cut after the corporation's conversion into S corporation. Conversely, if the timber were cut before the recognition period and held as inventory, income from the sale of the logs during the recognition period would constitute recognized built-in gain. Note, however, that the IRS reached its conclusion without extensive analysis, failing to address what would seem to be the determinative issue of whether the fair market value of the timber, both cut and uncut, exceeded its adjusted basis at the date of conversion. By concluding as it did, the IRS effectively treated the uncut timber as if, at the date of conversion, it was not an asset of the corporation or its fair market value did not exceed its adjusted basis. *See also* PLR 9719032, PLR 9520044, PLR 9519024, PLR 9827020, PLR 9825018, PLR 199911035 (income from cutting timber does not generate recognized built-in gain provided it is cut during the recognition period).

[235] §1374(d)(4).

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tive.[236] Thus, accounts payable that arose during a cash method corporation's C year will give rise to deductions that are treated as recognized built-in losses during S corporation years.

b. Recognition

One of the key elements to triggering the built-in gains tax is the recognition of built-in gain.[237] The tax is only applied on the net *recognized* build in gain. Accordingly, recognition of built-in gains should be incurred in years in which built-in losses also can be recognized. These built-in losses can offset built-in gains to reduce or eliminate the corporate tax. There is no provision for the carryover of excess built-in losses to another taxable year. Consequently, excess losses will be lost as to future gains. While excess losses cannot offset gains in later years, they do still act as a limiter on the amount of future recognized built-in gains subject to tax because of their inclusion in the NUBIG limitation.

Not all dispositions of assets will be recognition events.[238] Under Reg. §1.1374-4(a)(1), §1374(d)(3) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for federal income tax purposes.[239] For example, a charitable contribution of property subject to built-in gains tax should not trigger a corporate-level tax because there is no gain recognized in this transaction. Similarly, leasing or licensing built-in gains property will not be a disposition event unless the lease is treated as a sale transaction.[240]

[236] §1374(d)(5)(B); Reg. §1.1374-4(b)(2). *See also* PLR 200925005 (certain salary expenses and other outstanding costs related to production of outstanding accounts receivable at time of S corporation election will qualify as §1374 built-in losses).

[237] §1374(d)(3).

[238] *See, e.g.*, TAM 9727001 (timber dispositions under any form of contract in which S corporation retains economic interest are treated as §631(b) timber dispositions). In TAM 9727001, the National Office concluded that Congress did not intend to impose a §1374 built-in gains tax in those cases where §631(b) applies to extend the favorable capital gains benefit to these transactions. The National Office also noted that a timber lessor through its retained economic interest in timber property is in a situation similar to the owner of the working interest in the oil and gas property in Example 1 of Reg. §1.1374-4(a)(3) in that they both look to the development of the property through extraction or severance for income and a return of invested capital. Thus, timber lease income will not trigger §1374 treatment whether or not §631(b) is applicable. For a discussion of §631(b), see 610 T.M., *Timber Transactions*. *See also* PLR 199911035 (income from cutting timber does not generate recognized built-in gain provided it is cut during recognition period), PLR 9827020, PLR 9825018, PLR 9802005 (income from timber contract and other sale of logs cut during recognition period not subject to tax under §1374), PLR 9739046 (taxpayer does not hold timber until it is cut and, therefore, is not liable for built-in gains tax), PLR 9729017 (qualified subchapter S subsidiaries' timber income not subject to §1374), PLR 9726015 (gain under §631(a) is not subject to §1374), PLR 9719032, PLR 9520044, PLR 9519024.

[239] *See, e.g.*, PLR 201722008 (ruling S corporation will not recognize built in gain or loss under §1374 when it converts its preferred interests in pass-through limited liability company to common interests, where: (1) fair market value of preferred interests will equal fair market value of the common interests to be received in conversion; (2) there will be no shift in the capital ownership of Y; and (3) the recapitalization will not result in deemed distribution in excess of basis as a result of any change in any member's share of Y's liabilities).

[240] See Rev. Rul. 55-540, for guidance on factors for determining sale or lease treatment. *See also* Reg. §1.861-18 (classifying transactions involving computer programs producing gain from sale or exchange, rent or royalty income from lease or license, or compensation, for limited purposes identified in Reg. §1.861-18(a)(1)).

(1) Installment Sales

Under pre-1986 TRA §1374, an S corporation was able to dispose of an asset on the installment basis and not incur a capital gains tax at the corporate level, as long as the payments on the installment note were received after the third tax year. In order to eliminate the use of this technique to avoid the new built-in gains tax, the IRS adopted a different rule in the regulations relating to the interaction of installment sales and §384 and §1374.[241]

S corporations may still sell assets on the installment method and defer assessment of the built-in gains tax; however, the regulations make it much more difficult to completely avoid the tax. Under the rules, if a taxpayer sells an asset either prior to or during the recognition period and recognizes income (either during or after the recognition period) from the sale under the installment method, the income will, when recognized, be taxed under §1374 to the extent it would have been so taxed in prior years if the selling company had elected out of the installment method.[242]

As a result, gain will not be recognized until the installment note is collected; however, when gain is recognized, the tax will be computed by reference to the taxable income of the corporation for all years beginning in the year of sale, through the end of the recognition period. The regulations follow Notice 90-27.[243]

In the case of an installment sale before the recognition period, all of the remaining unreported income as of the first day of the recognition period is treated as net recognized built-in gain in the first year of the recognition period.[244] As stated above, sales of built-in gain assets on the installment method during the recognition period can result in gain for installment payments received after the recognition period.

> *Example:* P corporation elects S corporation status as of January 1, Year 1. On that date P owns Asset 1 with an adjusted basis of $120,000 and a fair market value of $200,000. In Year 1, P sells Asset 1 in exchange for a note with interest payable annually at a market rate and the principal due in Year 6. Assume that if the $80,000 gain was reported in the year of sale, P would have included $40,000 in net recognized built-in gain for taxable years through Year 6 after considering P's income and gain from other sources, and applying its taxable income limitation, recognized built-in gain carryover and net unrealized built-in gain limitation.[245] Therefore, P has built-in gain of $40,000 from the installment sale in Year 6 even though the recognition period has ended.
>
> *Note:* If, instead, P corporation sold Asset 1 during Year 6, and received payment in Year 7, then no built-in gains

[241] Reg. §1.1374-4(h).

[242] Reg. §1.1374-4(h)(1), §1.1374-4(h)(2).

[243] This notice applies to installment sales occurring after March 26, 1990, with an exception for sales made pursuant to binding contracts on that date. For installment sales before this date, it appears that built-in gain could have been deferred beyond the built-in gain recognition period, thereby completely avoiding the tax.

[244] Reg. §1.1374-4(h)(2).

[245] *See* I.C.5.c., below.

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tax would be imposed because the sale would be outside the five-year recognition period.[246]

Comment: Before the regulation's release in final form, the notion of taxing built-in gains after the recognition period ended was quite controversial because the rule is not supported by the statute. However, given the final regulation's effective date (for S corporation elections on or after December 27, 1994), this controversial rule did not have an immediate impact.

When a corporation disposes of property that is subject to the built-in gains tax and recognizes the gain under the installment method, it is possible that an interest charge under §453A(c) could be imposed at the corporate level (in addition to interest charged at the shareholder level as would normally be the case). The rationale is that both a corporate- and shareholder-level tax are deferred and therefore two interest charges are due the IRS.

(2) Nonrecognition Transactions

Nonrecognition transactions such as a reorganization or a like-kind exchange can help defer the built-in gains tax, although they do not eliminate any potential exposure. Property acquired in a like-kind exchange whose basis is determined, in whole or in part, by reference to the basis of an asset that was held by the corporation when it became an S corporation is treated as being held by the corporation at the time of conversion.[247] In determining recognized built-in gain or loss, the fair market value and adjusted basis at the conversion to S status of the asset disposed of is used. In effect, the property received in the exchange takes a substituted built-in gain, and the tax on the built-in gain is imposed when the corporation disposes of the like-kind property (if such property is disposed of during the recognition period associated with the original property).

Example: XYZ Corporation makes an S election to be effective on January 1, Year 1. XYZ owns a rental apartment building with a fair market value of $100 and a basis of $60, and has no other built-in gains or losses. Three years later, the building is worth $150 and has an adjusted basis of $30. X exchanges the building in a like-kind exchange for another building. If XYZ disposes of the second building in a taxable transaction during the recognition period, the built-in gain will be determined by reference to the fair market value and adjusted basis of the first building as of January 1, Year 1.

This substituted basis rule does not lengthen the recognition period for the corporation, which remains at five years from the date of conversion to S status except with respect to net recognized built-in gain for taxable years before 2011.[248]

An S corporation can also acquire assets from a C corporation in a tax-free reorganization. In that case, a built-in gains tax is imposed on the assets acquired using rules similar to those applicable to a corporation converting to S status. There are, however, three very important special rules. First, the recognition period begins as of the date of the acquisition. Second, the tax applies to all S corporations that are subject to §1374, even if they have never been C corporations.[249] Third, recognized built-in losses associated with the acquired C corporation cannot be utilized to reduce recognized built-in gains associated with the acquiring S corporation's assets nor can the acquiring S corporation's recognized built-in losses be used to offset recognized built-in gains associated with the acquired C corporation's assets.[250]

In Announcement 86-128,[251] the IRS stated that if a C corporation or former C corporation transfers property to an S corporation via a tax-free merger, the property is subject to the built-in gains tax, notwithstanding that the transferee corporation has always been an S corporation. According to this announcement, similar rules will apply if an S corporation subject to the built-in gains tax transfers property to another S corporation in a nonrecognition transaction. If the transferor S corporation is subject to the built-in gains tax, the assets transferred will continue to be subject to the tax upon transfer, and the recognition period for the assets will be reduced by the portion of the period that expired before the transfer. Reg. §1.1374-8 adopts this approach.[252]

If an S corporation acquires assets from a C corporation during the recognition period in a transaction where the basis of such assets is determined by reference to the C corporation's basis (a §1374(d)(8) transaction), the regulations provide that separate calculations of tax must be made for each such §1374(d)(8) asset transaction.[253] For example, loss carryforwards acquired in one §1374(d)(8) transaction can only offset net recognized built-in gain attributable to assets acquired in

[246] §1374(a); §1374(d)(7).

[247] §1374(d)(6). Nonrecognition treatment of like-kind exchanges completed after December 31, 2017, is limited to the exchange of real property held for productive use in a trade or business or for investment. *See* §1031. A transition rule applied for exchanges of formerly eligible property if the property was either disposed of or received on or before December 31, 2017. Pub. L. No. 115-97, §13303(c) (non-code division).

[248] *See* §1374(d)(7); pre-2015 §1374(d)(7).

[249] §1374(d)(8). *See also* PLR 9801056 (corporation elected S status and stock it owned in C corporation at time of election had built-in gain; subsequent liquidation of C corporation into S corporation under §332 did not result in S recognizing any built-in gains tax under §1374; instead, §1374 tax imposed on any net recognized built-in gain attributable to assets acquired in liquidation during 10-year recognition period provided for in §1374(d)(8)); PLR 9801015 (same result where S corporation made QSSS elections for its subsidiaries). *But see* PLR 200250023 (in a §368(a)(1)(A) reorganization in which the target, an S corporation, merged into a disregarded entity, a qualified REIT subsidiary, followed by a transfer of the target's built-in gain assets and liabilities to a partnership whose sole general partner is the disregarded entity, as long as the target met the requirements to be treated as an S corporation at the date of conversion from a C corporation, the built-in gains are not triggered by the reorganization and continue to be deferred during the 10-year recognition period under §1374(d)(7)).

[250] Reg. §1.1374-8(c).

[251] See also *United States v. Tucker*, 217 F.3d 960 (8th Cir. 2000), in which, contrary to its position of applying TRA amended §1374 to pre-TRA S corporations in Announcement 86-128, the IRS argued that pre-TRA and TAMRA §1374 applies to S corporations formed prior to December 31, 1986. The court stated that the IRS failed to establish which version of §1374 applied therefore, it failed to prove actual tax loss.

[252] T.D. 8579, 59 Fed. Reg. 66,458 (Dec. 27, 1994) (citing H.R. Rep. No. 100-795, at 63 (1988), which states that "each acquisition of assets from a C corporation is subject to a separate determination of the amount of net built-in gain").

[253] Reg. §1.1374-8(c). Commentators to the proposed regulations had argued that restrictions on acquisitions should be similar to those applicable to C corporations, but the final regulations retained the separate determination rule.

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the same transaction. They cannot be used to offset recognized built-in gain from another §1374(d)(8) transaction or from assets held on the first day of the recognition period by the converting corporation.

Reg. §1.1374-8(d) also requires that the S corporation's taxable income limitation be allocated among these separate §1374(d)(8) transactions based on the ratio of each determination to the total of all such determinations.

Another potential issue in the context of S corporation acquisitions of C corporation assets in nonrecognition transactions is the possible doubling up of built-in gains subject to the built-in gains tax. For example, if a C corporation owns another corporation, and the C corporation parent makes an S corporation election, the newly electing S corporation's NUBIG will include the built-in gain inherent in the subsidiary's stock (if no election to treat such subsidiary as a qualified subchapter S subsidiary is made effective the same date as the S election). If the subsidiary is later liquidated into the S corporation parent in a liquidation to which §332 and §337(a) apply, the built-in gain in the subsidiary's assets carries over to the parent and would be includible in the parent's NUBIG which already reflects the built-in gain in the subsidiary's stock. To mitigate this problem, the IRS issued regulations that allow for a downward adjustment of the S corporation's NUBIG for the built-in gain in the subsidiary's stock, at the same time the NUBIG is increased for the built-in gain in the assets acquired in the §332 liquidation.[254] The regulations provide that if (i) §1374(d)(8) applies to an S corporation's acquisition of assets, (ii) some or all of the stock of the corporation from which the assets were acquired is taken into account in computing NUBIG for a pool of assets, and (iii) some or all of such stock is redeemed or cancelled in the carryover basis transaction, then the NUBIG is adjusted to eliminate the effect any built-in gain or built-in loss in the redeemed or canceled stock (unless a §165 loss is claimed on the stock) has on the initial computation of NUBIG for that pool of assets.[255] However, the adjustment to NUBIG is limited in two respects: (i) the NUBIG is only adjusted to reflect the amount of built-in gain or built-in loss inherent in the stock that has not resulted in recognized built-in gain or recognized built-in loss at any time during the recognition period; and (ii) adjustments that are duplicative of other adjustments to the NUBIG for a pool of assets are not allowed.[256] The regulations also provide that any adjustment to NUBIG under the regulations only affects computations of the amount subject to tax under §1374 for taxable years ending on or after the date of the liquidation or reorganization.[257]

When an S corporation subject to the built-in gains tax merges into a C corporation, the built-in gains tax is not triggered. Instead, the C corporation holding the former S assets is subject to normal subchapter C taxation when it disposes of the assets. Further, if a C corporation acquires an S corporation and, effective on the acquisition date, makes an S election for itself and a qualified subchapter S subsidiary election under §1361(b)(3) for the acquired corporation, the acquired corporation will be deemed to liquidate into the acquiring corporation on that effective date and there is no period between the termination of the acquired corporation's S election and its deemed liquidation.[258]

If an S corporation makes a qualified subchapter S subsidiary (QSub) election under §1361(b)(3), Reg. §1.1361-4(b), which addresses the timing of the subsidiary's deemed liquidation, is significant in determining whether the QSub election will result in a separate §1374(d)(8) transaction.[259]

Comment: Where an S corporation acquires an unrelated C corporation's assets in a tax-free transaction, it appears that the acquiring company's NOLs and business credit carryovers may not be available to offset the recognized built-in gain on disposition of the acquired corporation's assets within five years of the acquisition, because of the limitations under §384. Carryovers of the target corporation are allowed to be used against recognized built-in gains with respect to the acquired assets.[260] See III., below, for a more complete discussion.

5. Calculating the Built-in Gains Tax

The amount of tax paid by an S corporation during the recognition period is the highest rate of tax specified in §11(b).[261] This tax is assessed on the lesser of the corporation's net recognized built-in gain or taxable income.[262]

The regulations outline a four-step process in computing tax on built-in gains:

- Step One — The corporation must determine its net recognized built-in gain for the current tax year pursuant to §1374(d)(2) and Reg. §1.1374-2.

- Step Two — The net recognized built-in gain is reduced by the amount of any NOLs and capital loss carryforwards allowed under §1374(b)(2) and Reg. §1.1374-5.

- Step Three — The S corporation computes its tentative tax using the appropriate rate of tax determined under §1374(b)(1) to the amount determined in Step 2.

- Step Four — The S corporation computes its final tax by reducing tentative tax calculated in Step 3 (but not below zero) by any credit allowed under §1374(b)(3) and Reg. §1.1374-6.[263]

Section 1374(c)(2) provides that, for any taxable year, the net recognized built-in gain may not exceed the amount determined by subtracting the amount of the corporation's net rec-

[254] Reg. §1.1374-3(b), §1.1374-3(c), §1.1374-10(a).

[255] Reg. §1.1374-3(b)(1).

[256] Reg. §1.1374-3(b)(2).

[257] Reg. §1.1374-3(b)(3).

[258] Reg. §1.1361-4(b)(3)(ii). *See* PLR 200252085.

[259] For example, under Reg. §1.1361-4(b)(3)(ii), if a QSub election is made effective on the day of acquisition, the acquired S corporation generally is deemed to liquidate into the acquiring corporation as of the beginning of the day of acquisition. Reg. §1.1361-4(b)(3)(ii) clarifies that there is no period during which an acquired S corporation is a C corporation if the QSub election is made effective as of the time of the acquisition. There is no §1374(d)(8) transaction when an S corporation acquires assets from another S corporation if the acquired S corporation has no C corporation history and therefore the S corporation does not get a carryover basis from a C corporation.

[260] §1374(b)(2).

[261] §1374(b)(1). The corporate alternative minimum tax (CAMT), effective for taxable years beginning after 2022, does not apply to S corporations. *See* §55(b)(2), §59(k)(1)(A), added and amended by Pub. L. No. 117-169, §10101. For further discussion, see 752 T.M., *Corporate Alternative Minimum Tax,* at IX.

[262] §1374(d)(2)(A).

[263] Reg. §1.1374-1(a).

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ognized built-in gain in all previous years in the recognition period from the corporation's net unrealized built-in gain on the first day of the recognition period. Thus, net unrealized built-in gain operates as an overall limit on the amount of net recognized built-in gain subject to the built-in gains tax.

The regulations incorporate the net unrealized built-in gain limitation with the definition of net realized built-in gain and define a corporation's net recognized built-in gain for any taxable year as the least of the: (i) pre-limitation amount; (ii) taxable income limitation; or (iii) net unrealized built-in gain limitation.[264]

a. Pre-Limitation Amount

Pre-limitation amount is defined as the corporation's taxable income determined by using the rules applicable to C corporations and considering only the corporation's recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover.[265]

The formulation generally corresponds to the definition described above but the words "determined by using the rules applicable to C corporations" have been added. It is not clear how the phrase determined by using the rules applicable to C corporations should be interpreted since C corporations are subject to various rules not applicable to S corporations. However, the regulations make clear that the S corporation must use its accounting method (e.g., the cash method if using the cash method and not the accrual method) as if it were a C corporation, in determining the pre-limitation amount.[266]

If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for the year, the regulations provide that the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount.[267]

b. Taxable Income

Taxable income as defined under §1375(b)(1)(B) is determined as under §63(a), but without the dividends received or NOL deductions. Essentially this rule requires the S corporation to compute its taxable income as if it were a C corporation. Reg. §1.1374-2 defines the taxable income limitation as the corporation's taxable income determined by using rules applicable to C corporations as modified by §1375(b)(1)(B). Section 1375(b)(1)(B) disallows the use of certain deductions, e.g., NOLs under §172, in the calculation of an S corporation's net passive income. Again, it is not clear exactly how far the S corporation must go in making this computation. Under Reg. §1.1374-2(d), the S corporation must use its own method of accounting in determining the taxable income limitation even if, as a C corporation, its taxable income would have been required to be computed using the accrual method.

[264] Reg. §1.1374-2(a).
[265] Reg. §1.1374-2(a)(1).
[266] Reg. §1.1374-2(d).
[267] Reg. §1.1374-2(b).

c. Net Unrealized Built-in Gain Limitation

As discussed in I.C.4.a., above, a corporation's net unrealized built-in gain at the time of its conversion to S status operates as an overall limit on the amount of net recognized built-in gain subject to §1374.

The regulations provide that if an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds the taxable income limitation (defined as recognized built-in gain carryover) is included in the pre-limitation amount for the succeeding taxable year and consists of a ratable share of each item of income, gain, loss, and deduction excluded from net recognized built-in gain for the year the carryover arose.[268]

> *Example:* A C corporation converts to S corporation status as of January 1, Year 2. On December 31, Year 1, the corporation has a pre-limitation amount of $80 and a taxable income limitation of $60. Thus, in Year 2, only $60 would be subject to built-in gains tax and there would be a carryover of $20. If the corporation had no taxable income in Year 3 (determined without regard to the carryover amount) the corporation would not be subject to any built-in tax in Year 3 because the carryover would not increase taxable income, only the pre-limitation amount. From a policy perspective, this is the correct result since the taxable income limitation is intended to be a measure of the corporation's ability to pay any built-in tax, thus it would be inappropriate to add any carryover amount to taxable income.

Because taxable income limits the amount of built-in gain that is subject to tax, a corporation can reduce its tax by limiting its taxable income. However, any built-in gain in excess of the taxable income limitation is suspended and is treated as recognized built-in gain in the succeeding tax year.[269]

Comment: Gain is only suspended for built-in gains tax purposes. For all other purposes, the gain passes through to the shareholders under normal rules. Thus, gains could be taxed at the shareholder level before being taxed at the corporate level.

> *Example:* XYZ corporation elects S status on January 1, Year 1. It owns an apartment building with a $100 fair market value and a $60 basis and no loss assets or other built-in gain assets. On July 1, Year 1, when its basis in the building is $50, the building is sold for $100. During Year 1, XYZ Corporation incurs $30 in deduction items from operations. Because XYZ's net income for the year, $20 ($50 less $30), is less than the $40 built-in gain recognized on the building, only $20 of the built-in gain is subject to tax. The remaining $20 is suspended to the next taxable

[268] Reg. §1.1374-2(c).
[269] §1374(d)(2)(B). For S elections made before March 30, 1988, the recognized built-in gain in excess of taxable income was not subject to the suspense account approach and simply disappeared. This presented an important planning opportunity to any corporation under this rule. Proper management of taxable income through the remainder of the recognition period could virtually eliminate any exposure to the built-in gains tax.

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year and will be subject to tax as soon as XYZ corporation has adequate taxable income.

The suspense account ordinarily allows the S corporation the advantage of deferring, but not necessarily avoiding, the built-in gains tax. However, the taxable income limitation relieves the corporation of the tax if the gain can be suspended beyond the 5-year recognition period.

Upon liquidation of the S corporation within the recognition period, the suspense account is triggered to the extent of taxable income generated as a result of the liquidation. Any amount of the suspended and current built-in gain in excess of taxable income in the liquidation year is not subject to the built-in gains tax.

Comment: What happens if an S corporation with a suspense account converts to a C corporation? It seems clear that because the corporation is reentering the two-tier tax system, any previously suspended built-in gains would disappear as any future income would be subject to the double-tax regime.

Since an S corporation is not subject to the built-in gains tax if it recognizes net losses from its other assets and operations during the taxable year, it may be desirable to defer dispositions of built-in gain assets to years when the corporation anticipates losses. Alternatively, the corporation could defer income or accelerate loss items into years in which built-in gain assets will be sold.

d. Carryover Utilization

The amount of recognized built-in gain subject to tax under §1374 may not be reduced by net operating loss (NOL) carryovers from other S corporation years, but it may be reduced by net operating and capital loss carryovers from C corporation years.[270] The only tax credits currently allowable to reduce a built-in gains tax are §39 business credits carried forward from C corporation years of the corporation and the §34 gasoline and special fuels credit.[271]

Credit carryforwards from C corporations that merge into S corporations subject to built-in gains tax are not available to offset the tax on built-in gain from the acquiring S corporation's disposition of its built-in gain assets, but those credit carryforwards are available to reduce a §1374 tax imposed on dispositions of assets which the S corporation acquired in the merger.[272] Presumably, any subchapter C attributes would also be first limited by §382, §383, and (possibly) §384, before they would be available to offset any built-in gains in the assets of the acquired C corporation. The application of §382 will occur in the context of any ownership change and not just in the context of acquisition transactions. Similarly, any limitations imposed under §172, with regard to NOLs, and §1211 and §1212, with regard to capital losses, should apply to utilizing these losses against built-in gains.

As to loss carryforwards, the regulations make it clear that if §382, §383(b), or §384 would have applied to limit the use of a C corporation's NOL and capital loss carryovers on the first day of the recognition period, then §382, §383(b), or §384 also apply to limit their use as deductions against an S corporation's net recognized built-in gain.[273]

> *Example:* P, a C corporation, undergoes an ownership change under §382(g) on January 1, Year 1. Assume that on that date, P had NOL carryforwards of $300,000, net unrealized built-in gain under §382(h)(3)(A) of $0, and an annual §382 limitation under §382(b)(1) of $40,000. P elects S corporation status as of January 1, Year 2. On that date P has NOL carryforwards remaining of $260,000 (having used $40,000 of its pre-change NOLs in the preceding tax years) and a §1374 net unrealized built-in gain of $250,000. If P has a net recognized built-in gain of $75,000 in Year 2 it may use $40,000 of its NOL carryforwards as a deduction against its $75,000 net recognized built-in gain, because P's §382 limitation is $40,000.

Comment: Although these carryforwards are allowed to offset recognized built-in gain, they do not reduce the income passed through to the shareholder because §1374(b)(2) states that an NOL can be used as a deduction only for the purposes of this section.

The §1374 regulations[274] eliminated an exception in the proposed §1374 regulations prohibiting the use of §469 suspended passive losses against built-in gains because §1371(b)(1) achieves the same result by barring the use of subchapter C attributes in a taxable year for which the corporation is an S corporation. However, in *St. Charles Inv. Co. v. Commissioner*,[275] the Tenth Circuit held that §1371(b)(1) did not preclude an S corporation's deduction of suspended passive activity losses (PALs) that were incurred when the S corporation was a closely held C corporation. The court determined that restrictions on carryforwards from a C year to an S year are not enumerated in §469 and have no effect on the operation of §469(b). The court also determined that under §469(f)(2), the rules of §469 continue to apply to the S corporation's suspended PALs as if it had continued in its C status pursuant to §469(f)(2). Therefore, the S corporation could fully deduct suspended PALs associated with activities when those activities that were disposed of pursuant to §469(g)(1)(A).

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[270] §1374(b)(2). These items are only available to offset built-in gain items and in themselves do not create built-in loss items to be taken into account in computing net recognized built-in gain under §1374(d)(2).

[271] §1374(b)(3) (§53 allowance has been removed for tax years beginning after 2021). The regulations are in accord and only allow credits under §34 (special fuels credit), §39 (business credit carryforwards), and §53 (minimum tax credits) to reduce taxes imposed by §1374. No other credits are allowed. Additionally, the amount of §39 and §53 credits are subject to certain limitations under §38(c) and §53(c), as modified. Reg. §1.1374-6.

[272] Reg. §1.1374-8(c).

[273] Reg. §1.1374-5(b) *Ex*. It is noteworthy that Reg. §1.1374-5(b) requires that the §382 limitation apply on the first day of the recognition period in order for such limitation to apply to the use of the NOL carryforwards as deductions against the corporation's net recognized built-in gain. Thus, where a C corporation becomes an S corporation and thereafter undergoes a §382 ownership change, its NOL carryforwards from its C corporation years may be allowed as deductions against its net recognized built-in gain without regard to the §382 limitation. This rule might provide an ability to coordinate the timing of an ownership change and S election in order to avoid the application of the limitation under Reg. §1.1374-5(b). For additional discussion of this topic, *Limitation on Use of C Corporation NOL to Offset Net Recognized Built-In Gain of S Corporation May Depend on Timing of S Election*, 34 Tax Mgmt. Memo. 189 (June 14, 1993).

[274] Reg. §1.1374-1 through §1.1374-10.

[275] 232 F.3d 773 (10th Cir. 2000), *rev'g* 110 T.C. 46 (1998).

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Comment: The §1374 regulations do not specifically prohibit the use of closely held subchapter C passive losses against built-in gains recognized as an S corporation. The prohibitive language of the proposed regulations was not included in the final regulations because, as explained in the preamble to the final regulations,[276] losses suspended before the recognition period under §469 were thought to be unavailable during the recognition period under §1371(b)(1). Therefore, it would seem that positions contrary to the preamble can be taken successfully, citing *St. Charles* as authority with certainty in the Tenth Circuit.

e. Gain Passthrough and Timing

A C corporation is subject to a corporate-level tax on all its gains from dispositions of property, but its shareholders are taxed only when they receive a distribution, perhaps many years after the transaction(s) generating the corporate-level income, or when they sell their stock. In contrast, when §1374 applies, both the S corporation and the shareholders pay taxes immediately. Once the tax is calculated on the recognized built-in gains, each item of gain passes through to the shareholders under §1366. In addition a loss of the same character for the amount of tax paid at the corporate level is also passed through.[277] This rule works well if the built-in gains tax deduction and the built-in gain flows through to shareholders all in the same year; however, if the S corporation escapes a corporate-level tax in one year due to the taxable income limitation, but in the next year the suspense account is triggered, the shareholder receives their reduction for the taxes paid at the corporate level that second year. This presents a potential problem, in that the loss resulting from the payment of the built-in gains tax will generally be a capital loss, assuming that the gain that gave rise to the tax in a prior year was a capital gain. Therefore, shareholders could find themselves without an offsetting capital gain (the asset's gain flows through in year one for taxation at the shareholder level) and may be placed in a position where they are unable to fully deduct the loss in later years due to the lack of available capital gains.

Example: XYZ corporation elected S status in Year 1. Assume that in Year 2, XYZ recognizes $1,400 in built-in gain on the sale of a long-term capital gain asset, but XYZ has taxable income that year of only $400 due to operating deductions. In Year 3, the corporation has $2,000 in taxable income, and no other recognized built-in gains or losses. Under the taxable income limitation, only $400 of the gain will be taxed in Year 2 at the corporate level and the full $1,400 capital gain at the shareholder level offset by a $140 capital loss under §1366(f)(2) in addition to XYZ's Year 2 operating deductions. The remaining $1,000 in gain will be suspended and carried forward to Year 3 in which it will be taxed. The $210 tax paid in Year 3 (21%[278] × $1,000) will pass through to the shareholders, who will treat the payment as a long-term capital loss, subject to limitations on deductibility, e.g., the lack of available capital gains.[279] This mismatch could be aggravated even further if the shareholder is passive and deduction items are suspended under §469.

Form 1120-S, Schedule D reflects the reduction for the built-in gains tax at the entity level but the full amount of recognized built-in gain (without reduction for the taxable income limitation) with a deduction for the amount of corporate-level tax paid is shown on Schedule K as a flow-through item to shareholders.

Any recognized built-in gain or loss under §1374 is excluded from the definition of passive investment income under §1375, thereby making §1374 the only taxing provision for the gain.[280] This is a change from the coordination rule that existed before the 1988 TAMRA. While the priority of these corporate-level taxes was clarified by the 1988 TAMRA,[281] the taxable income limitation, which applies to both the passive income tax and the built-in gains tax, has not been changed. If an S corporation has both passive income tax and built-in gains tax in a given year, it is conceivable that an S corporation will incur more tax at the corporate level than if the corporation were a C corporation.

The accumulated adjustments account (AAA) is increased only by the built-in gain net of any built-in gains tax. Under §1368(e)(1)(A), the AAA is adjusted in a manner similar to adjustments made to shareholder stock and debt basis. Under §1366(f)(2), the built-in gain is reduced by the amount of any built-in gains tax before it flows through to shareholders. This amount is treated as a loss. This loss adjusts shareholder basis and, subsequently, AAA. Even though §1368(e)(1)(A) prohibits adjusting AAA for federal taxes, the built-in gains tax is apparently reflected as a loss in AAA and not as a federal tax.

6. Planning for the Built-in Gains Tax

There are several options that can be used to limit the built-in gains tax including the following:

- *Limit net unrealized built-in gain at the time of conversion from C to S status.* The most practical and straightforward approach to minimizing net unrealized built-in gain is through a competent appraisal or valuation of assets.

- *Limit the recognized built-in gain for the year.* This can be accomplished by using like-kind exchanges[282] to defer gain recognition (§1374(d)(6)) or by selectively disposing

[276] T.D. 8579.

[277] §1366(f)(2). Thus, this provision would require each item of built-in gain to be reduced by its proportionate share of the built-in gains tax.

[278] *See* §11(b). For tax years prior to 2018, a corporation's taxable income was subject to graduated rates, with a top rate of 35%. *See* pre-2018 §11(b).

[279] Note that if XYZ corporation had elected S status four years earlier, no tax would be imposed on the recognized built-in gain because it would be recognized after the end of the five-year recognition period. In addition, if XYZ corporation had elected S status only three years earlier, it seems that no tax would be imposed on the suspended recognized built-in gain because its suspended gains would be pushed beyond the 5-year recognition. §1374(a), §1374(d)(7)(A).

[280] §1375(b)(4).

[281] Pub. L. No. 100-647, §1006(f)(5)(B).

[282] Nonrecognition treatment of like-kind exchanges completed after December 31, 2017, is limited to the exchange of real property held for productive use in a trade or business or for investment. *See* §1031. A transition rule applied for exchanges of formerly eligible property if the property was either disposed of or received on or before December 31, 2017. Pub. L. No. 115-97, §13303(c) (noncode provision).

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of assets. The company, if given the opportunity, should dispose of assets with little or no built-in gain.

• *Use the installment method.* The use of the installment method may still be an important planning technique to defer gain recognition; however, the built-in gains tax may not easily be avoided through use of an installment sale.[283]

• *Use a lease of built-in gain assets to avoid a recognition transaction.* Make sure the lease is not a sale for tax purposes. Also beware that rents received from the lease arrangement can increase exposure to the passive income tax. Consideration should also be given to licensing assets as opposed to selling them outright.

• *Limit taxable income.* S corporation taxable income can be minimized during the recognition period. Specifically, taxable income can be reduced by the payment of compensation through year-end bonuses (when using this technique, the S corporation should be careful to avoid unreasonable compensation problems). An S corporation also should attempt to dispose of as many built-in gain assets as possible in a year the S corporation has little or no taxable income.

• *Generate recognized built-in losses to offset recognized built-in gains.* There is no carryover of excess recognized built-in losses. Therefore, to the extent possible, the built-in losses should be triggered only in years built-in gains are recognized.

D. LIFO Recapture Tax

1. General

After enacting the built-in gains tax, Congress was concerned that LIFO method C corporations electing S status could easily avoid tax on the built-in gain attributable to LIFO inventory as long as they did not have a decrement in pre-election LIFO layers during the recognition period.[284] To prevent this situation, Congress added §1363(d), the LIFO recapture tax, in the Revenue Act of 1987.[285]

Under §1363(d), a C corporation using the LIFO method for its last taxable year before an S election becomes effective must include in income for its last taxable year the LIFO recapture amount.[286] The LIFO recapture amount is defined as the amount by which the inventory's basis under an as if FIFO method exceeds its LIFO basis, as of the end of its last taxable year as a C corporation.[287]

The recapture tax has no effect on the corporation's continuing ability to use the LIFO method in S status. However, appropriate adjustments must be made to the corporation's basis in the inventory to reflect the LIFO recapture amount included in income.[288]

The tax attributable to the recaptured amount is payable in four equal installments, the first of which is payable by the due date of the C corporation's last tax return, determined without regard to any extensions.[289] The other installments are due by the respective due dates of the corporation's returns for the three succeeding years.[290] No interest is imposed on these installments if they are paid by their respective due dates.[291] In addition, unlike other corporate-level taxes, estimated payments need not be made for these additional installments.[292]

Comment: Even though a corporation is subject to the LIFO recapture tax, its inventory may still trigger the built-in gains tax if the inventory's fair market value exceeds its adjusted basis (including any LIFO recapture amount subject to §1363(d)). The two taxes are not mutually exclusive.

The electing corporation is not treated as a member of an affiliated group for its last C corporation year.[293] If, for example, an affiliated group of corporations filing consolidated returns sells the stock of a member corporation which then elects to be an S corporation, the LIFO recapture tax is imposed on the electing corporation itself. The selling group does not assume any liability for the tax. It also appears that such a rule would apply to a C corporation acquired from an affiliated group for which a QSub election is made effective immediately

[283] *See* Reg. §1.1374-4(h). The installment method may avoid the built-in gains tax if the taxable income limitation is met in all remaining periods of the recognition period.

[284] *See* H.R. Rep. No. 100-495, at 974 (1987).

[285] Pub. L. No. 100-203. The LIFO recapture tax was effective generally for C corporations making S elections after December 17, 1987. However, it did not apply to an S election made before January 1, 1989, if, before December 17, 1987: (i) the corporation's board of directors adopted a resolution to make the S election, or (ii) the corporation filed a ruling request with the IRS expressing an intent to make the election. See PLR 8923017, in which a corporation had adopted a board resolution before December 17, 1987, but did not make its S election until its tax year beginning January 1, 1989. The IRS ruled that the LIFO recapture tax did not apply upon the corporation's conversion to S status.

[286] §1363(d)(1). *See* PLR 200326023, PLR 200326024, and PLR 200326025 (transfer of S corporation to new LLP taxed as a corporation followed by S election for new LLP and QSub election for original S corporation did not require a LIFO recapture of original S corporation); PLR 9807023, PLR 9746011, PLR 9746015–PLR 9746028 (S corporation's transfer of LIFO inventory to qualified subchapter S subsidiary not subject to LIFO recapture tax). See also PLR 9424046, where the IRS ruled that a transitory C corporation, formed by an S corporation in a reorganization, did not have to include in income any LIFO recapture amount related to assets transferred to it in the reorganization. The IRS noted that, since the transitory C corporation will make an S election immediately after the reorganization, §1363(d) does not apply. In PLR 201010026 and PLR 9039005, the IRS ruled that the LIFO recapture tax does not apply to the incorporation of a sole proprietorship. Stating that Congress enacted §1363(d) to prevent C corporations using LIFO from avoiding the built-in gains tax upon electing S status, the IRS reasoned that because the sole proprietorship was never a C corporation, there was no potential for any built-in gains tax avoidance. The IRS also noted that a literal reading of §1363(d) indicates that it applies only if an S corporation was a C corporation for the last tax year before the S election was effective. But see FSA 199922011, in which the IRS advised that even though a C corporation merged into an S corporation prior to August 19, 1993, the effective date of Reg. §1.1363-2(a)(2), which applies prospectively, support exists in the legislative history for requiring C to recognize the LIFO recapture amount in income for the year of merger with S, a result that is consistent with long-standing law under §1374 of imposing a tax on built-in gain.

[287] §1363(d)(3).

[288] *See* §1363(d)(1).

[289] §1363(d)(2)(A), §1363(d)(2)(B); Reg. §1.1363-2(b). The first installment is due with the return for the corporation's last taxable year as a C corporation. On that return, the deferred tax must be noted to the left of the Total Tax line of Schedule J with the notation "Sec. 10227 deferral ---- $xx.xx." Announcement 88-60.

[290] §1363(d)(2)(B).

[291] §1363(d)(2)(C).

[292] *See* §6655(g)(4).

[293] §1363(d)(4)(D).

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after the acquisition.[294] Presumably a separate C corporation return showing only the LIFO recapture would be included on such a return.

The corporation pays the LIFO recapture tax under the guidelines in Announcement 88-60.[295] Under this guidance, the LIFO recapture amount must be included on the Other Income line of the corporation's Form 1120 for its last taxable year as a C corporation. The corporation must first complete Schedule J and then complete a separate worksheet (using the Schedule J format) based on taxable income minus the recapture amount. A comparison of the worksheet and Schedule J yields a difference which constitutes the tax due to LIFO recapture.

Because the LIFO recapture amount is computed at the close of the last subchapter C year, accumulated E&P may need to be adjusted upward.[296] In the case of accrual method taxpayers, E&P are generally reduced for accrued taxes in the year accrued. Therefore, with respect to accrual method taxpayers, the corporation's AAA should not be reduced for the annual payments of the LIFO recapture tax. With respect to cash method corporations, the IRS generally requires a reduction in E&P in the year the tax is paid.[297] Therefore, converting cash method C corporations may be required to reduce AAA in subsequent S corporation years as the LIFO recapture tax is paid; however, §1368(e)(1)(A) provides that AAA is adjusted in a manner similar to the adjustments under §1367 (relating to stock basis adjustments) and that no adjustment shall be made for federal taxes attributable to any taxable year in which the corporation was a C corporation. Presumably this means that no adjustment to AAA will be made in any case for payments of the federal LIFO recapture tax. Any payments made during the S corporation years may not reduce shareholder basis because the requirement to reduce the basis of stock of the S corporation by reason of nondeductible expenses under §1367(a)(2)(D) does not apply to an increase in tax as a result of the LIFO recapture.[298] Furthermore, the prohibition on adjustments of E&P of an S corporation under §1371(c)(1) also does not apply to an increase in tax as a result of the LIFO recapture.[299]

Practice Point: In an inflationary environment, the LIFO recapture tax can be a real deterrent to electing S status because the recapture amount could be sizable. The up-front LIFO recapture tax would be a heavy entrance fee to S status. On the other hand, in a low-inflation environment, there is less deferral in LIFO inventory and the recapture tax should not be as burdensome. In any event, the tax is a critical consideration in the calculus for making an S corporation election. Also, the C corporation marginal income tax rate is a flat 21%.[300] This reduces the LIFO recapture amount considerably for any C corporation using LIFO still considering an S corporation election (but note the 37% individual marginal income tax rate may deter many C corporations from considering a C-to-S conversion).

Beginning with 2018 tax years, under §471(c), corporations with annual average gross receipts that do not exceed a base statutory amount of $25 million (for inflation-adjusted amounts, see footnote) for the prior three-taxable-year period need no longer keep inventories (including LIFO), but rather may use a method of accounting for inventories that either (i) treats inventories as non-incidental materials and supplies, or (ii) conforms to the taxpayer's financial accounting treatment of inventories.[301] Section 471(c)(4) requires any change in accounting method be coordinated with §481 including any adjustments to move from inventory treatment to non-incidental materials and supplies. For this group of taxpayers, §471(c) could mitigate or eliminate the LIFO recapture tax on a conversion to S status.

2. *Successor Corporations*

Regulations providing guidance on LIFO recapture apply both when a C corporation elects to become an S corporation and when a C corporation merges into an S corporation in a nonrecognition transaction (within the meaning of §7701(a)(45)) in which the transferred assets constitute transferred basis property (within the meaning of §7701(a)(43)).[302] Under Reg. §1.1363-2(a), a corporation must include the LIFO recapture amount in its gross income either in: (i) its last taxable year as a C corporation if the corporation inventoried assets under the LIFO method for its last taxable year before its S corporation election becomes effective; or (ii) the year of transfer of the LIFO inventory assets.

Comment: Under this rule, it is no longer possible to merge a C corporation with LIFO inventory into an S corporation without triggering the LIFO recapture tax.

3. *C Corporations with Inventory*

Under §1363(d)(1)(B), a corporation is required to include the LIFO recapture amount in its gross income if the corporation maintained LIFO inventories for its last taxable year as a C corporation prior to electing S corporation status. Even if a corporation discontinued use of the LIFO method in a year prior to its first taxable year as an S corporation, the corporation must include in income the remaining balance of any positive §481(a) adjustment in its gross income in its last taxable year as a C corporation.[303]

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[294] The Chief Counsel's Office applied this rule to a C corporation, the common parent of a consolidated group, that had subsidiaries and disregarded entities, some of which used the LIFO method. *See* FAA 20153001F. The C corporation merged into a corporation wholly owned by an S corporation, resulting in the C corporation as the surviving corporation in the merger, and the S corporation filed QSub elections for the C corporation and its subsidiaries. The Chief Counsel's Office advised that under §1363(d)(4)(D), (1) the C corporation could not be treated as a member of the affiliated group with respect to the LIFO recapture amount; (2) a single-transaction return was necessary and valid; and (3) consolidated operating losses may not be used to offset the LIFO recapture amount.

[295] See the Worksheets for full text of Announcement 88-60.

[296] See §312(n)(4) for LIFO reserve adjustments already reflected in E&P.

[297] The Second, Sixth, and Seventh Circuit Courts of Appeals have allowed cash basis taxpayers to reduce E&P as taxes accrue while the Eighth Circuit Court of Appeals ruled that E&P is reduced as taxes are paid by cash method taxpayers. *See Hadden v. Commissioner*, 49 F.2d 709 (2d Cir. 1931); *Drybrough v. Commissioner*, 238 F.2d 735 (6th Cir. 1956); *Demmon v. United States*, 321 F.2d 203 (7th Cir. 1963). *Cf. Helvering v. Alworth Trust*, 136 F.2d 812 (8th Cir. 1943).

[298] §1363(d)(5).

[299] §1363(d)(5).

[300] *See* §11(b).

[301] *See* §471(c) (reference to §448(c)). For inflation-adjusted amounts, see Tables, Charts & Lists, Gross Receipts Test Limit by Year under §448(c).

[302] *See* Reg. §1.1363-2.

[303] Rev. Proc. 2015-13, §7.03(4).

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Is it possible for a C corporation holding partnership subsidiaries with LIFO inventories to elect S corporation status without triggering the LIFO recapture tax?

The IRS first attempted to answer this question in TAM 9716003. In this technical advice, a corporation with partnership subsidiaries was held to be subject to the LIFO recapture tax because the IRS applied aggregate partnership principles in determining the corporation's share of partnership LIFO inventory. In calculating the LIFO recapture amount, the LIFO amount of the inventory was determined by reference to the LIFO amount of the inventories in the partnerships' hands, and all inventory transactions that occurred during the year ending immediately before S status were elected was considered in calculating the FIFO inventory.

In *Coggin Automotive Corp. v. Commissioner*,[304] a parent corporation of a consolidated group and its subsidiaries underwent a restructuring to allow the parent to elect S corporation status. The taxpayer set up several new S corporations to be general partners in limited partnerships which contained the operations of subsidiaries. The subsidiaries liquidated into the parent and the parent became the limited partner in the separate operating partnerships. Prior to the restructuring, the subsidiaries maintained inventories of automobiles and light trucks under the dollar-value last-in, first-out (LIFO) method of accounting, but the parent corporation did not directly own any inventory.

The Tax Court applied the aggregate approach of partnerships to the group, asserting that it serves the underlying purpose of §1363(d) because it prevents a corporate taxpayer from using the LIFO method of accounting to permanently avoid gain recognition on appreciated assets. The Tax Court determined that the entity approach is inconsistent with the legislative history of §1363(d) and §1374 because it allows a corporate partner to avoid paying a second layer of tax on appreciated assets by encouraging transfers of inventory between related entities. The Tax Court also found that §1363(d)(4)(D) does not prevent attribution of the subsidiaries' LIFO reserves to the parent, explaining that it requires only a converting member of the affiliated group (not each member of the affiliated group) to be responsible for the tax imposed on the recapture of the corporation's LIFO reserves. Accordingly, the Tax Court concluded that the parent corporation was deemed to own a pro rata share of the partnerships' inventories, and that upon its election of S corporation status, the parent was required to include its ratable share of the LIFO recapture amount in its gross income.

Looking to the plain language of §1363(d), the Eleventh Circuit reversed the Tax Court's decision. The court determined that the parent corporation held no LIFO inventory requiring recapture upon its S corporation election, because, as a holding company, the parent did not own inventories (and therefore it could not have made an election to use the LIFO method) or any other stock in trade or other property of a kind that could be properly included in its inventory at the close of the taxable year. The court noted the potential windfall to a holding company making an S corporation election, but asserted that this must be cured by Congress, not the courts.

[304] 115 T.C. 349 (2000), *rev'd*, 292 F.3d 1326 (11th Cir. 2002).

Comment: In a footnote to the ruling, the court seems to indicate that the partnership anti-abuse regulations, which were not in effect at the time of *Coggin*, may now provide the IRS with authority to attack similar transactions. The partnership anti-abuse regulations grant the IRS the ability to "treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder."[305]

In July 2005, the IRS issued regulations[306] that provide that a C corporation that holds an interest in a partnership that owns LIFO inventory must include a lookthrough LIFO recapture amount in its gross income where the corporation either elects to be an S corporation or transfers its interest in the partnership to an S corporation in a nonrecognition transaction. The rules define the lookthrough LIFO recapture amount as the amount of income that would be allocated to the corporation under §704(c) and Reg. §1.704-3 if the partnership sold all of its LIFO inventory for the FIFO value.[307] Under the rules, this amount is determined as of the day before the effective date of the S corporation election or, if the recapture event is a transfer of a partnership interest to an S corporation, as of the date of the transfer.

If the partnership, however, is not otherwise required to determine inventory values on the recapture date, the lookthrough LIFO recapture amount could be determined based on inventory values of the partnership's opening inventory for the year that includes the recapture date. For this purpose, the lookthrough LIFO recapture amount must be adjusted to take into account any adjustments to the partnership's basis in its LIFO inventory that result from transactions occurring during the period from the start of the partnership's tax year to the end of the recapture date. Hence, the lookthrough LIFO recapture amount would have to reflect any adjustments to the basis of LIFO inventory during that period under §734(b), §737(c), or §751(b).[308]

Under the regulations, a corporation that owns LIFO inventory through a partnership must increase its basis in its partnership interest by the lookthrough LIFO recapture amount, and the partnership that owns the LIFO inventory could elect to adjust the basis of partnership inventory (or lookthrough partnership interests held by that partnership) to account for LIFO recapture. This adjustment is treated in the same manner and has the same effect as an adjustment under §743(b). This adjustment is made to the corporate partner's basis, not the partnership's basis.[309] There are no exceptions for partnership interests below a certain threshold.[310]

[305] Reg. §1.701-2(e)(1).

[306] Reg. §1.1363-2(b) through §1.1363-2(g), T.D. 9210, 70 Fed. Reg. 39,920 (July 12, 2005). The regulations apply to S elections and transfers made on or after August 13, 2004. Reg. §1.1363-2(g)(3).

[307] Reg. §1.1363-2(c)(4)(i).

[308] Reg. §1.1363-2(c)(4)(iii).

[309] Reg. §1.1363-2(e).

[310] *See* Reg. §1.1363-2(b) through §1.1363-2(g).

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4. Calculating the LIFO Tax

Rev. Proc. 94-61[311] provides guidance on the procedures for reporting the §1363(d) LIFO recapture amount. The revenue procedure provides the following guidance with respect to reporting §1363(d) LIFO recapture amounts:

- inclusion of the LIFO recapture amount in gross income does not result in a termination or discontinuance of a taxpayer's LIFO method;
- the taxpayer does not violate the LIFO conformity requirement by making the appropriate adjustment to the inventory basis for tax purposes but not for financial reporting purposes;
- the taxpayer may not reduce gross income if the amount of its inventory under the LIFO method exceeds the FIFO inventory amount;
- subject to certain Code restrictions, an NOL carryover may be applied against the LIFO recapture amount included in the gross income of the C corporation, though the adjustment to inventory basis is the LIFO recapture amount unreduced by the NOL carryover;
- using a LIFO method for less than four taxable years before the taxpayer's first year as an S corporation does not reduce the number of installments nor the period for their payment;
- an S corporation does not include an obligation to pay an installment of tax resulting from the LIFO recapture amount in its determination of its estimated tax payment under §6655; and
- if an S corporation files a final return, any remaining unpaid annual installments of the increase in tax resulting from the application of §1363(d) are accelerated and are due and payable with the S corporation's final return.

The revenue procedure also discusses the method of adjusting the inventory basis under §1363(d)(1), stating that it is appropriate to collapse any LIFO layers and add the LIFO recapture amount to the LIFO value of the ending inventory as of the end of the taxpayer's last taxable year as a C corporation. The method that the IRS provides to revalue the LIFO inventory is discussed below. However, the IRS revaluation method may create a problem, since most companies will not make the tax adjustment to their financial statement LIFO inventory value. Following the discussion of the IRS method is a discussion of a simplified method of computing the tax LIFO amount. The simplified calculation reaches the same results as the IRS method.

In Notice 2003-4, the IRS stated that a corporation that fails to properly include a LIFO recapture amount in gross income may be liable for a 20% accuracy-related penalty under §6662 and that a corporation that fails to make an installment payment by its required due date may be liable for a failure to pay penalty under §6651. In addition, any corporation that fails to make a timely installment payment is liable for interest under §6601; however, under §1363(d)(2)(C), no interest is payable with respect to a LIFO recapture installment payment that is paid by its due date. The IRS also stated that failure to pay or late payment of a LIFO recapture amount does not cause any remaining unpaid installments to become due immediately and also explained that the authority under §6159(b)(4) to alter or modify an installment agreement is limited to the specific payments described in that section and does not apply to installment payments under §1363(d).

A new LIFO inventory value must be computed by adding the LIFO recapture amount to the unadjusted LIFO inventory value reported in the last C corporation year. In addition, all prior years' LIFO layers should be collapsed into a single LIFO layer that has a LIFO carrying value equal to the new LIFO inventory value.

The revenue procedure gives an example of how to restate the LIFO inventory value.

Example: Company B, a calendar year taxpayer, elects S corporation status in Year 5. The LIFO recapture amount is $300 ($1,900 FIFO lower of cost or market value of the Year 4 inventory less the $1,600 LIFO value of such inventory).

Before being adjusted, the company's C corporation's LIFO inventory had a value of $1,600 computed as follows:

Year	Base Year Cost	LIFO Index	LIFO Value
Base Year	$1,000	1.000	$1,000
Year 1 Layer	200	1.100	220
Year 2 Layer	0	1.150	0
Year 3 Layer	100	1.200	120
Year 4 Layer	200	1.300	260
	$1,500		$1,600

All prior LIFO layers are collapsed and the LIFO value of the Year 4 inventory is increased by $300 from $1,600 to $1,900. The adjusted Year 4 LIFO inventory value would be:

Year	Base Year Cost	LIFO Index	LIFO Value
Base Year	$1,500	1.2667	$1,900

[311] See the Worksheets for full text of Rev. Proc. 94-61.

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Practical Method: The IRS method fails to take into account the fact that most LIFO taxpayers use their financial statement LIFO inventory method as the starting point to compute their tax LIFO inventory value. For example, a company using the simplified resale method to determine the amount of §263A costs allocated to ending inventory will use the financial statement LIFO inventory as the starting point for its tax calculation. If the financial statement LIFO inventory was not adjusted, it will still have LIFO layers for pre-S corporation years. The following example shows how to maintain the LIFO layers and reach the same result as the IRS method.

Example: Assume the same facts as in the above example. The LIFO values and base-year cost shown in the above example are tax values. As of December 31, Year 4, Company B had the following book and tax LIFO inventory values:

Year	Book Base Cost	Book LIFO Index	Book LIFO Value
Base Year	$909.10	1.000	$909.10
Year 1 Layer	181.82	1.100	200.00
Year 2 Layer	0	1.150	0
Year 3 Layer	90.91	1.200	109.09
Year 4 Layer	181.82	1.300	236.36
	$1,363.65		$1,454.55
Year	**Book Base Value**	**Tax LIFO Index**	**Tax LIFO Value**[312]
Base Year	$909.10	1.100	$1,000
Year 1 Layer	181.82	1.210	220
Year 2 Layer	0	1.265	0
Year 3 Layer	90.91	1.320	120
Year 4 Layer	181.82	1.430	260
	$1,363.65		$1,600

The problem with the IRS approach is that a taxpayer will not be able to use its book method to determine the LIFO recapture amount that is recovered when a subsequent LIFO decrement occurs. If the $300 LIFO recapture amount is allocated to LIFO layers based on the relative base year cost of each layer, the LIFO layers can be retained and the alternate calculation will produce the same results as the IRS method.

Year	Book Base Cost	Book LIFO Index	Book LIFO Value
Base Year	$909.10	1.000	$909.10
Year 1 Layer	181.82	1.100	200.00
Year 2 Layer	0	1.150	0
Year 3 Layer	90.91	1.200	109.09
Year 4 Layer	181.82	1.300	236.36
	$1,363.65		$1,454.55
Year	**Book Base Cost**	**Tax LIFO Index**	**Tax LIFO Value**
Base Year	$909.10	1.100	$1,000
Year 1 Layer	181.82	1.210	220
Year 2 Layer	0	1.265	0
Year 3 Layer	90.91	1.320	120
Year 4 Layer	181.82	1.430	260
	$1,363.65		$1,600
Year	**Tax LIFO Value**	**Recapture Layer**	**Tax LIFO Value**
Base Year	$1,000	$200	$1,200
Year 1 Layer	220	40	260
Year 2 Layer	0	0	0
Year 3 Layer	120	20	140
Year 4 Layer	260	40	300
	$1,600	$300[313]	$1,900

E. Overall Limitation on the Deduction of Business Interest Expense

For tax years beginning after 2017, there is a limitation on the deduction of business interest expense.[314] Treasury and the IRS issued final regulations in September 2020[315] and January 2021.[316]

[312] Book LIFO value plus additional §263A costs. For purposes of the example, it is assumed that §263A costs represent 10% of every book LIFO inventory layer.

[313] The total recapture amount of $300 multiplied by the ratio of the base year cost of the layer over the total base year cost for all layers.

[314] §163(j).

[315] T.D. 9905, 85 Fed. Reg. 56,686 (Sept. 14, 2020) (finalizing, with modifications, 2018 proposed regulations contained in REG-106089-18, 83 Fed. Reg. 67,490 (Dec. 28, 2018)), generally applicable to tax years beginning on or after November 13, 2020. For tax years beginning before the applicability of the 2020 final regulations, taxpayers and their related parties generally may apply either the final regulations in their entirety, or the 2018 proposed regulations in their entirety, so long as they apply either set of regulations consistently. Preamble to T.D. 9905, 85 Fed. Reg. at 56,686.

[316] T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021) (finalizing, in part, 2020 proposed regulations contained in REG-107911-18, 85 Fed. Reg. 56,846 (Sept.

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Section 163(j) limits a taxpayer's deduction of business interest expense (from non-excepted trades or businesses) to the sum of: (i) business interest income; (ii) 30% of adjusted taxable income (ATI); and (iii) floor plan financing interest.[317] The §163(j) limitation applies before the application of the at-risk rules, passive activity loss provisions, and limitation on excess business losses.[318]

The limitation applies at the S corporation level and any deduction for business interest expense is taken into account in determining the nonseparately stated income or loss of the S corporation.[319] Disallowed business interest is carried forward at the S corporation level and treated as business interest paid or accrued by the S corporation in the succeeding taxable year.[320] S corporations that are small business taxpayers are wholly exempt from the §163(j) limitation.[321] Additionally, some S corporations may have one or more excepted trades or businesses that are not subject to the limitation.[322]

For tax years beginning in 2019 and 2020, an S corporation's deduction was limited to the sum of: (i) business interest income; (ii) 50% of ATI; and (iii) floor plan financing interest.[323] Additionally, an S corporation could elect to substitute 2019 ATI for 2020 ATI.[324]

Note: Though the limitation applies at the S corporation level, shareholders may also have their own §163(j) limitation if the shareholder has business interest expense from another trade or business.

The discussion below addresses the limitation as it applies to S corporations and their shareholders. For a detailed discussion of §163(j), see 536 T.M., *Interest Expense Deductions*, at V.E.

1. Components of the Limitation

a. Business Interest Income and Expense

As stated above, §163(j) limits a taxpayer's deduction of business interest expense to the sum of: (i) business interest income; (ii) 30% of adjusted taxable income (ATI); and (iii) floor plan financing interest. Thus, in order to apply this limitation, a taxpayer must determine the amount of business interest expense, business interest and adjusted taxable income.

The §163(j) limit on the deduction of business interest expense applies only to business interest, which is defined as interest properly allocable to a trade or business.[325] The term trade or business does not include: (i) any electing real property trade or business; (ii) any electing farming business; (iii) certain regulated utilities trades and businesses; or (iv) the trade or business of performing services as an employee (together excepted trades and businesses).[326] Thus, business interest income and business interest expense from excepted trades or businesses are ignored for purposes of computing the §163(j) limitation. Reg. §1.163(j)-1(b)(22) provides an extensive list of items that are treated as interest for purposes of §163(j).[327] For further discussion of what constitutes interest under §163(j), see 536 T.M., *Interest Expense Deductions*, at V.E.3.

Note: For taxable years beginning after 2025, §163(j)(10) requires the BIE limitation to be calculated before applying any provisions that require interest to be capitalized — except for interest capitalized under §263(g) (regarding interest allocable to personal property that is part of a straddle) and §263A(f) (regarding interest allocated to property produced by the taxpayer) — which is excluded from the definition of business interest.[328] The limitation applies first to the aggregate amount of capitalized interest, and second to the aggregate amount of interest to be deducted. For this purpose, no portion of BIE deductions carried forward are treated as interest required to be charged to, or may be deducted from, a capital account.[329]

A double counting rule prevents shareholders from including business interest income from the S corporation that is used in computing the S corporation's §163(j) limitation (and therefore included in the nonseparately stated income or loss of the S corporation).[330] An S corporation has excess business interest income if in a tax year, its business interest income exceeds its business interest expense.[331] Any excess business interest income is allocated to the shareholders in accordance with the shareholders' respective pro rata interests in the S corporation pursuant to §1366(a)(1).[332] Shareholders subsequently include any allocated excess business interest income in computing their own §163(j) limitations.[333]

The 2020 proposed regulations would provide special rules for the allocation of interest expense in the case of a debt-financed acquisition of an interest in a pass-through entity or a debt-financed distribution by an entity to its owners.[334] These

14, 2020)), generally applicable to tax years beginning on or after March 22, 2021. Taxpayers and their related parties are permitted to continue to rely on rules from the 2020 proposed regulations that were not finalized in the 2021 final regulations, subject to certain consistency requirements. Preamble to T.D. 9943, 86 Fed. Reg. at 5513.

[317] §163(j)(1); Reg. §1.163(j)-2(b)(1).

[318] Reg. §1.163(j)-3(b)(4).

[319] §163(j)(4)(A)(i), §163(j)(4)(D); Reg. §1.163(j)-6(a), §1.163(j)-6(l)(1).

[320] §163(j)(2), §163(j)(4)(D); Reg. §1.163(j)-6(l)(5).

[321] *See* §163(j)(3); I.E.4., below.

[322] *See* §163(j)(7); I.E.5., below.

[323] §163(j)(12)(A)(i); Reg. §1.163(j)-2(b)(2)(i). The S corporation could elect not to apply the increased ATI limitation to either tax year. §163(j)(12)(A)(iii); Reg. §1.163(j)-2(b)(2)(ii). For guidance on making this election, *see* Rev. Proc. 2020-22, §6.01.

[324] §163(j)(12)(B)(i); Reg. §1.163(j)-2(b)(3)(i). Special rules apply for short tax years. *See* §163(j)(12)(B)(ii); Reg. §1.163(j)-2(b)(3)(ii). For guidance on this election, *see* Rev. Proc. 2020-22, §6.02.

[325] §163(j)(5). The One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70341(b), amended §163(j)(5) to specifically exclude interest that is capitalized under §263(g) or §263A(f) for taxable years beginning after December 31, 2025. *See* Reg. §1.163(j)-3(b)(5) (excluding from business interest expense any interest that is capitalized under §263A or §263(g)).

[326] §163(j)(7).

[327] The definition of interest adopted in the 2020 final regulations varies from the definition set forth in the 2018 proposed regulations. Notably, the 2020 final regulations do not include in the definition of interest amounts affecting a taxpayer's effective cost of borrowing, yield adjustments, certain amounts labeled as fees, debt issuance costs, and guaranteed payments. *Compare* former Prop. Reg. §1.163(j)-1(b)(20)(iii)(E)–(I), REG-106089-18, 83 Fed. Reg. at 67,539–40. In certain fact patterns however, these items may be caught by the anti-avoidance rules in Reg. §1.163(j)-1(b)(22)(iv)(A).

[328] §163(j)(5), as amended by the OBBBA, Pub. L. No. 119-21, §70341(b).

[329] §163(j)(10), added by the OBBBA, Pub. L. No. 119-21, §70341(a).

[330] Reg. §1.163(j)-6(l)(4)(iii).

[331] Reg. §1.163(j)-6(b)(4).

[332] Reg. §1.163(j)-6(l)(1).

[333] Reg. §1.163(j)-6(l)(4)(iii)(A).

[334] Prop. Reg. §1.163-14, REG-107911-18. For a detailed discussion, *see* Kelly Miller, *An Overview of Prop. Reg. §1.163-14 and its Impact on*

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rules would generally require an allocation method similar to the optional allocation rule provided in Notice 89-35.[335] Prop. Reg. §1.163-14 would apply before the application of Reg. §1.163(j)-10 which provides rules for allocating items between excepted and non-excepted trades or businesses.[336] The 2021 final regulations do not adopt this rule. This IRS continues to study this issue and Notice 89-35 remains in effect.[337]

Note: The 2021 final regulations require a trading partnership to bifurcate its interest income and expense between partners that materially participate and partners that are passive investors.[338] This rule does not apply to S corporations and their shareholders.

b. Adjusted Taxable Income

The determination of ATI begins with tentative taxable income, or taxable income determined without regard to the §163(j) limitation.[339]

ATI is equal to the tentative taxable income of the taxpayer computed without regard to:

(i) any item of income, gain, deduction, or loss which is not properly allocable to a non-excepted trade or business;

(ii) any business interest expense or business interest income;

(iii) the amount of any net operating loss deduction under §172;

(iv) the amount of any deduction allowed under §199A;

(v) for tax years beginning after 2017 and before 2022, and after 2024, any deduction allowable for depreciation, amortization, or depletion; and

(vi) for tax years beginning after 2025, (i) the amounts included in gross income under §951(a) (subpart F income), §951A(a) (net CFC tested income (NCTI; formerly known as GILTI)), and any associated gross-up under §78, and (ii) the portion of the deductions allowed by reason of those inclusions under §245A(a) (certain foreign-sourced dividends) and §250(a)(1)(B) (50% of NCTI).[340]

Thus, for tax years beginning before 2022, and after 2024, ATI will be higher (and, therefore, more business interest will be deductible) because taxable income is not reduced by depreciation, amortization and depletion. Additional adjustments provided in the regulations include: (i) subtraction of floor plan financing interest expense; (ii) add back of any deduction for capital loss carryover or carryback; and (iii) certain adjustments with respect to sales or dispositions of property or partnership interests.[341] For additional discussion of the computation of ATI, see 536 T.M., *Interest Expense Deductions*, at V.E.4.

In the case of an S corporation, the regulations provide that the tentative taxable income of an S corporation is determined under §1363(b), and includes: (i) any item described in §1363(b)(1); and (ii) any item described in Reg. §1.163(j)-1(b)(1) to the extent such item is consistent with subchapter S of the Code.[342]

For purposes of computing the shareholder's ATI, the shareholder does not include its distributive share of any items of income, gain, deduction, or loss of the S corporation.[343] However, if the S corporation's ATI exceeds the amount of its deductible business interest expense, the S corporation will have excess taxable income (ETI), which is allocated to the shareholders in accordance with the shareholders' respective pro rata interests in the S corporation pursuant to §1366(a)(1), and included in the ATI of the shareholders for purposes of computing the shareholders' §163(j) limitations.[344] ETI is equal to the amount (if any) that bears the same ratio to the S corporation's total ATI as the unused amount of the 30% of ATI limitation bears to 30% of ATI. The unused amount of the 30% of ATI limitation is the amount by which 30% of ATI exceeds the S corporation's net business interest expense not including floor plan financing interest expense.[345] Put another way, ETI is computed by multiplying ATI by a fraction, the numerator of which is the unused portion of the 30% of ATI limitation and the denominator of which is 30% of ATI. These rules allow shareholders of an S corporation to deduct additional business interest that the shareholder may have paid or incurred to the extent the S corporation could have deducted more business interest.

> *Example:* An S corporation has two equal shareholders. The S corporation's ATI computed under §163(j)(8) is \$30,000,000 and its only expense is \$6,000,000 of business interest. Under the provision, the deduction for business interest is limited to \$9,000,000 (30% × \$30,000,000 = \$9,000,000). The S corporation is able to deduct all \$6,000,000 of its business interest expense, leaving the S corporation with unused §163(j) limit of \$3,000,000. In this case, the ETI of the S corporation is \$10,000,000 (\$30,000,000 × \$3,000,000/\$9,000,000). As a result, each shareholder's distributive share of ETI from the S corporation is \$5,000,000, which may be used for computing the shareholders' §163(j) limitations.

If a shareholder disposes of S corporation stock, and the S corporation owns only non-excepted trades or businesses assets, any gain or loss recognized is included in the shareholder's ATI.[346] If the S corporation has assets that are properly allocable to both non-excepted and excepted trades or businesses, investment assets, or both, then the shareholder would include in ATI only the proportionate share of the amount proper-

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Passthrough Entities Including Partners and Shareholders, 61 Tax Mgmt. Memo. 272 (Aug. 31, 2020).

[335] If finalized, Prop. Reg. §1.163-14 will obsolete Notice 89-35.

[336] The application of Reg. §1.163(j)-10 to S corporations is discussed in I.E.5.a., below.

[337] Preamble to T.D. 9943, 86 Fed. Reg. 5498.

[338] Reg. §1.163(j)-6(c)(1), §1.163(j)-6(c)(2).

[339] Reg. §1.163(j)-1(b)(43). The 2020 final regulations clarify that §461(l), §465, and §469 are taken into account for purposes of determining tentative taxable income. Reg. §1.163(j)-3(b)(4).

[340] §163(j)(8)(A), as amended by the OBBBA, Pub. L. No. 119-21, §70303, §70342; Reg. §1.163(j)-1(b)(1).

[341] Reg. §1.163(j)-1(b)(1). Note that regulations have not been updated for amendments made to §163(j)(8) by the OBBBA.

[342] Reg. §1.163(j)-6(l)(3).

[343] §163(j)(4)(A)(ii)(I), §163(j)(4)(D); Reg. §1.163(j)-6(l)(4)(i).

[344] §163(j)(4)(A)(ii)(II), §163(j)(4)(D); Reg. §1.163(j)-6(l)(1).

[345] §163(j)(4)(C); Reg. §1.163(j)-1(b)(15).

[346] Reg. §1.163(j)-6(l)(4)(ii).

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ly allocable to non-excepted trades or businesses in accordance with the allocation rules in Reg. §1.163(j)-10(c)(5)(ii)(B)(3).[347]

c. *Floor Plan Financing Interest*

A taxpayer is allowed to fully deduct floor plan financing interest expense.[348] Floor plan financing interest expense is defined as interest paid or accrued on floor plan financing indebtedness.[349] Floor plan financing indebtedness is defined as indebtedness that a taxpayer uses to finance the acquisition of motor vehicles held for sale or lease as long as the indebtedness is secured by the inventory acquired.[350] For purposes of the regulations, all floor plan financing interest expense is treated as business interest expense.[351]

To prevent double counting, a shareholder calculating its own §163(j) limitation is not permitted to include the shareholder's share of floor plan financing interest expense that has already been included by the S corporation in determining its nonseparately stated income and loss.[352]

2. *Carryover at S Corporation Level*

S corporations are subject to rules regarding the carryover of disallowed business interest expense similar to the rules that would be applicable to C corporations.[353] An S corporation's current year business interest expense must be deducted in the current year before any disallowed business interest expense carryforward from a prior year may be deducted.[354] If the S corporation has any remaining §163(j) limitation after the deduction of all current-year business interest expense, the S corporation may deduct disallowed business interest expense carryforwards from prior years, in the order of the taxable years in which they arose (subject, if applicable, to limitation under §381 or §382).[355] If the S election terminates, any disallowed business interest expense carryforwards carry to the corporation's first C corporation year.[356] If a qualified subchapter S election terminates, any disallowed business interest expense of the QSub at the time of termination remains with the parent S corporation.[357]

3. *Application of §381 and §382*

The list of carryover items in §381(c) includes any disallowed business interest expense under §163(j) that has been carried over to taxable years ending after the date of distribution or transfer.[358] The regulations provide that an acquiring corporation which succeeds to and takes into account the carryover of disallowed business interest expense is subject to limitation on the use of such carryforward in the acquiring corporation's first taxable year ending after the date of distribution or transfer.[359] The preamble to the 2018 proposed regulations indicates that the rules of Reg. §1.381(c)(20)-1 are intended to be similar to the rules in Reg. §1.381(c)(1)-1 and §1.381(c)(1)-2, limiting the acquiring corporation's ability to use NOL carryforwards in the first taxable year ending after the date of distribution or transfer.[360]

For purposes of §382, the term pre-change loss includes a carryover of disallowed business interest expense.[361] A pre-change loss includes the portion of any disallowed business interest expense of the old loss corporation along with the loss corporation's current-year business interest expense attributable to the pre-change period.[362] The 2020 final regulations provide special rules for the allocation of business interest expense both for ratable allocation and taxpayers making a closing-of-the-books election.[363] Section 382(k)(1) provides that the term loss corporation includes a corporation entitled to use a disallowed business interest expense carryforward.[364] Solely for purposes of §163(j), §382 and the regulations thereunder are equally applicable to S corporations; however, the preamble to the final regulations states that this rule "should not be construed as creating any inference regarding the application of [§]382 to S corporations for other purposes."[365]

4. *Small Business Taxpayer Exemption*

Section 163(j) does not apply to an S corporation (other than a tax shelter defined in §448(d)(3))[366] if the average annual gross receipts for the three-taxable-year period ending with the prior tax year does not exceed a base statutory amount of $25 million (adjusted for inflation).[367] If an entity has not been in existence for this entire three-year period, this test can be applied on the basis of the period during which the entity has been in existence.[368] If an S corporation is a small business taxpayer, and therefore not subject to §163(j), it does not take its deduction for business interest expense into account in determining its nonseparately stated income and loss.[369] Additionally, if a shareholder is allocated business interest expense from an exempt small business S corporation, such business interest ex-

[347] Reg. §1.163(j)-6(l)(4)(ii), §1.163(j)-10(b)(4)(ii). *See also* I.E.5.a., below (discussing excepted trades or businesses).

[348] §163(j)(1)(C); Reg. §1.163(j)-2.

[349] §163(j)(9)(A); Reg. §1.163(j)-1(b)(17).

[350] §163(j)(9)(B); Reg. §1.163(j)-1(b)(16).

[351] Reg. §1.163(j)-1(b)(19).

[352] Reg. §1.163(j)-6(l)(4)(iii)(B).

[353] Reg. §1.163(j)-6(l)(5).

[354] Reg. §1.163(j)-5(b)(2), §1.163(j)-6(l)(5).

[355] Reg. §1.163(j)-5(b)(2), §1.163(j)-6(l)(5).

[356] Reg. §1.163(j)-6(l)(5).

[357] Reg. §1.163(j)-6(l)(8).

[358] §381(c)(20).

[359] Reg. §1.163(j)-5(c), §1.381(c)(20)-1.

[360] Preamble to REG-106089-18, 83 Fed. Reg. at 67,501–02.

[361] §382(d)(3); Reg. §1.382-2(a)(2)(vi).

[362] Reg. §1.382-2(a)(7).

[363] Reg. §1.382-2(a)(2), §1.382-2(b)(4). Thus the 2020 final regulations reverse the position taken in the 2018 proposed regulations that would have required that disallowed business interest expense be ratably allocated to each day in the year regardless of whether the loss corporation makes a closing of the books election under Reg. §1.382-6(b)(2) with regard to allocating its other taxable items. *See* former Prop. Reg. §1.382-2(a)(7), §1.382-6(b)(4) (REG-106089-18).

[364] *See also* Reg. §1.382-2(a)(1)(i)(A).

[365] Preamble to T.D. 9905, 85 Fed. Reg. at 56,723 (indicating Treasury and the IRS continue to study the extent to which §382 should apply to S corporations for other purposes of the Code).

[366] It is possible that an S corporation may qualify as a syndicate for purposes of the definition of a tax shelter by reason of §448(d)(3), §461(i)(3)(B), or §1256(e)(3)(B). The AICPA has requested Treasury and the IRS grant relief for entities that are unable to make certain election that would except them from the definition of tax shelters. *See* AICPA, *Small Business Relief from Definition of Tax Shelter* (Feb. 17, 2019).

[367] §163(j)(3) (reference to §448(c)); Reg. §1.163(j)-2(d). For inflation-adjusted amounts, see Tables, Charts & Lists, *Gross Receipts Test Limit by Year under §448(c)*.

[368] §448(c)(3)(A).

[369] Reg. §1.163(j)-6(m)(1).

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pense is not business interest expense in the hands of the shareholder and not subject to the shareholder's §163(j) limitation (if any).[370] If an S corporation is not an exempt small business taxpayer and has disallowed business interest expense carried forward into a year in which the S corporation is an exempt small business taxpayer, then such disallowed business interest expense remains an item of the S corporation, is not subject to the §163(j) limitation, and is taken into account in determining the nonseparately stated income or loss of the S corporation.[371]

5. Excepted Trades or Businesses

As discussed above, the §163(j) limitation applies to the deduction of business interest expense which is defined as interest paid on indebtedness allocable to a trade or business.[372] For purposes of this definition, a trade or business does not include: (i) the trade or business of performing services as an employee;[373] (ii) an electing real property trade or business;[374] (iii) an electing farming business;[375] or (iv) an excepted regulated utility trade or business.[376] These activities are referred to as excepted trades or businesses for purposes of the §163(j) rules.

The regulations provide that the election to treat an eligible trade or business as an electing real property trade or business or an electing farming business must be made for each such trade or business (though elections for multiple trades or businesses may be made on a single election statement).[377]

The amount of business interest expense that is properly allocable to an excepted trade or business is not subject to limitation under §163(j).[378] The regulations provide, therefore, that the amount of a taxpayer's other items of income, gain, deduction, and loss properly allocable to an excepted trade or business should likewise be excluded from the calculation of the §163(j) limitation.[379]

For purposes of the allocation rules, a taxpayer's activities are not treated as separate trades or businesses if the activities involve the provision of property, goods, or services to a trade or business of the taxpayer.[380] The allocation rules apply after a taxpayer has determined that interest income and expense, and other tax items, are properly allocable to a trade or business.[381] After determining that interest income and expense, and other tax items, are properly allocable to a trade or business, taxpayers engaged in both excepted and non-excepted trades or businesses, would have to allocate interest income and expense, and other tax items, subject to the rules discussed below.

If an S corporation shareholder is allocated any §163(j) item that is allocable to the S corporation's excepted trade or business, such items are also excluded from the shareholder's own §163(j) calculation.[382]

a. Allocation of Business Interest Income and Expense

The preamble to the 2018 proposed regulations indicated that the general view of Treasury and the IRS is that money is fungible and therefore "interest expense is attributable to all activities and property, regardless of any specific purpose for incurring an obligation on which interest is paid."[383] Thus, the regulations generally allocate business interest income and expense based on the adjusted bases of the assets used in the taxpayer's excepted and non-excepted trades or businesses.[384] A de minimis rule provides that if 90% or more of the taxpayer's basis in its assets for the tax year is allocated either to excepted or non-excepted trades or businesses, then all of the taxpayers business interest and expense is allocated to either excepted or non-excepted trades or businesses, respectively.[385] Floor plan financing interest expense is not subject to allocation and is always treated as allocable to a non-excepted trade or business.[386] The regulations require a taxpayer to make quarterly determinations of the adjusted basis in its assets.[387] The 2020 final regulations provide a limited exception from the quarterly determination rule permitting taxpayers to make annual determinations by averaging asset basis at the beginning and end of the year so long as asset basis does not differ by more than 20% from the beginning of the year to the end of the year.[388]

A shareholder's share of stock in the S corporation is treated as an asset of the shareholder.[389] For purposes of determining

[370] Reg. §1.163(j)-6(m)(1). The 2020 final regulations reversed the position taken in the 2018 proposed regulations that would have provided that any business interest expense allocated to a shareholder from an exempt small business S corporation would have been subject to the shareholder's own §163(j) limitation (unless the shareholder was also an exempt small business taxpayer). Former Prop. Reg. §1.163(j)-6(m)(1) (REG-106089-18).

[371] Reg. §1.163(j)-6(m)(4).

[372] The regulations define a trade or business as one treated as a trade or business within the meaning of §162. Reg. §1.163(j)-1(b)(44)(i).

[373] §163(j)(7)(A)(i); Reg. §1.163(j)-1(b)(44)(ii).

[374] §163(j)(7)(A)(ii); Reg. §1.163(j)-1(b)(44)(ii). An electing real property trade or business is a trade or business which makes an election under Reg. §1.163(j)-9 and is a real property trade or business described in §469(c)(7)(C) and Reg. §1.469-9(b)(2), qualifies for the safe harbor for REITs under Reg. §1.163(j)-9(h), or is specifically designated by the Secretary in additional guidance. Reg. §1.163(j)-1(b)(14). Rev. Proc. 2021-9 provides a safe harbor under which a qualified residential living facility may be treated as a real property trade or business solely for purposes of qualifying as an electing real property trade or business.

[375] §163(j)(7)(A)(iii); Reg. §1.163(j)-1(b)(44)(ii). An electing farming business is a trade or business that makes an election under Reg. §1.163(j)-9 and is a farming business as defined in §263A(e)(4) or Reg. §1.263A-4(a)(4), is a specified agricultural or horticultural cooperative defined in §199A(g)(4), or is specifically designated by the Secretary in additional guidance. Reg. §1.163(j)-1(b)(13).

[376] §163(j)(7)(A)(iv); Reg. §1.163(j)-1(b)(44)(ii) An excepted regulated utility trade or business is described in Reg. §1.163(j)-1(b)(15). In limited circumstances, a utility trade or business that is not an excepted regulated utility business may make an election to be an electing regulated utility trade or business. Reg. §1.163(j)-1(b)(15)(ii)(B), §1.163(j)-1(b)(15)(iii).

[377] Reg. §1.163(j)-9(b). The election applies to all subsequent years and is irrevocable. Under Rev. Proc. 2020-22, §5, a limited exception permitted taxpayers to withdraw an election made for tax years 2018, 2019, or 2020.

[378] §163(j)(7); Reg. §1.163(j)-10(a)(1)(i).

[379] Reg. §1.163(j)-10(a)(1)(i).

[380] The regulations provide, for example, that an in-house legal department is a type of activity that is not a separate trade or business. Reg. §1.163(j)-10(a)(1)(ii).

[381] Reg. §1.163(j)-10(a)(2)(i). *See* Reg. §1.163-8T; Prop. Reg. §1.163-14(b) (REG-107911-18). The 2021 final regulations did not adopt Prop. Reg. §1.163-14, which is being given additional consideration. Preamble to T.D. 9943, 86 Fed. Reg. at 5498.

[382] Reg. §1.163(j)-6(m)(2).

[383] Preamble to REG-106089-18, 83 Fed. Reg. at 67,519.

[384] Reg. §1.163(j)-10(c)(1)(i).

[385] Reg. §1.163(j)-10(c)(1)(ii).

[386] Reg. §1.163(j)-10(c)(4).

[387] Reg. §1.163(j)-10(c)(6)(i)(A).

[388] Reg. §1.163(j)-10(c)(6)(i)(B).

[389] Reg. §1.163(j)-10(c)(5)(ii)(B)(3)(i). The shareholder's adjusted basis is adjusted to take into account the modifications in Reg. §1.163(j)-10(c)(5)(i)(A) with respect to non-depreciable property other than land.

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the extent to which a shareholder's adjusted basis in its stock of an S corporation is allocable to an excepted or non-excepted trade or business, the shareholder may look to the shareholder's share of the S corporation's basis in the S corporation's assets, allocated on a pro rata basis and taking into account any adjustments for direct allocations under Reg. §1.163(j)-10(d)(4).[390] However, if the shareholder's interest in its stock in the S corporation is 80% or more of the S corporation's stock (by vote and value), then the shareholder would be required to apply the look-through rule unless the small business exemption applies to the S corporation.[391] If a shareholder chooses not to apply the look through rule, or is precluded from applying the rule, then the shareholder treats their basis in the S corporation stock either as an asset held for investment or as a non-excepted trade or business asset, determined under §163(d).[392] A de minimis rule provides that if at least 90% of a shareholder's share of an S corporation's basis in its assets is allocable to either excepted or non-excepted trades or businesses, disregarding assets not properly allocable to a trade or business, then the shareholder's entire basis in its stock in the S corporation is treated as allocable to either excepted or non-excepted trades or businesses, respectively.[393]

b. Allocation of Tax Items Other than Business Interest Income and Expense

The regulations provide additional allocation rules for the allocation of other tax items used to determine ATI when taxpayers have both excepted or non-excepted trades or businesses.[394]

If a shareholder recognizes gain or loss on the disposition of stock in an S corporation that owns: (i) non-excepted and excepted assets; (ii) investment assets; or (iii) both, the shareholder determines a proportionate share of the amount properly allocable to a non-excepted trade or business under the look-through rule of Reg. §1.163(j)-10(c)(5)(ii)(B)(3), and includes the proportionate share in the shareholder's ATI.[395] Tiered pass-through entities (e.g., an S corporation that is a partner in a partnership looks through each lower-tier partnership) apply the rule by looking through each tier, subject to the inapplicability of the look-through rule due to the small business exemption.

F. Estimated Tax Payments

S corporations must make estimated tax payments at the corporate level for income tax resulting from investment tax credit recapture, built-in gains, passive investment income, and capital gains. S corporation estimated tax payments are generally subject to the same rules as estimated payments made by C corporations, with certain exceptions.[396]

One difference between the C corporation and S corporation estimated tax rules is the method for computing the minimum required payment. For C corporations, in general, the minimum payment is the lesser of 100% of the current year's tax liability or 100% of the previous year's tax liability.[397] C corporations whose preceding taxable year was not a 12-month taxable year, or that did not incur any tax liability for the preceding taxable year, cannot use the safe harbor of the previous year's liability.[398] In addition, C corporations with taxable income of $1 million or more for at least one of the three preceding years are similarly prohibited from relying on the safe harbor.[399]

Unlike C corporations, S corporations are not required to show a passive investment income tax liability for the preceding taxable year in order for both of the above minimum payment alternatives to apply. An S corporation must pay the lesser of: (i) 100% of the current year's tax liability; or (ii) the sum of: (a) 100% of the current year's tax on built-in gains, capital gains, and investment credit recapture, and (b) 100% of the previous year's tax on passive investment income.[400] Note that although the second calculation incorporates the S corporation's prior year's tax only to its passive income tax liability (not its built-in gains tax or investment tax credit recapture), the annualization exception may be utilized for all three corporate level taxes.[401]

As with C corporations, if the preceding taxable year was not a taxable year of 12 months, the minimum required payment is 100% of the current year's tax liability.[402]

A corporation that does not pay an installment when due may be charged a penalty under §6655 for the underpayment period at the applicable rate under §6621. Corporations are required to make payments of estimated taxes electronically, generally through the IRS's Electronic Federal Tax Payment System (EFTPS).[403] Payment also may be made by electronic funds transfer, or through any other commercially acceptable means, such as by credit card, debit card, or charge card, under conditions as set out in regulations.

G. Consistent or Inconsistent Subchapter C Provisions

Given that an S corporation is a passthrough entity, whereby the income generated is taxed to its shareholders (generally individuals), and taking into account that income of an S corporation is generally computed in the same manner as in the case of an individual,[404] the application of subchapter C rules to an S corporation may be inappropriate in certain instances. Section 1371(a) provides that, except as otherwise inconsistent with the subchapter S provisions of the Code, subchapter C applies to an S corporation and its shareholders. This section clarifies the

[390] Reg. §1.163(j)-10(c)(5)(ii)(B)(3)(ii).

[391] Reg. §1.163(j)-10(c)(5)(ii)(B)(3)(ii), §1.163(j)-10(c)(5)(ii)(D). The look-through rules are not applicable to any S corporation that is eligible for the small business exemption unless the S corporation makes an election under Reg. §1.163(j)-9 for a trade or business.

[392] Reg. §1.163(j)-10(c)(5)(ii)(B)(3)(iv).

[393] Reg. §1.163(j)-10(c)(5)(ii)(B)(3)(iii).

[394] Reg. §1.163(j)-10(b)(1).

[395] Reg. §1.163(j)-10(b)(4)(ii).

[396] §6655(g)(4). For additional discussion, see 581 T.M., *Estimated Tax*.

[397] §6655(d)(1)(B).

[398] §6655(d)(1)(B), flush language.

[399] §6655(d)(2), §6655(g)(2).

[400] §6655(d)(1)(B), §6655(g)(4)(C).

[401] *See* §6655(e).

[402] §6655(d)(1)(B), §6655(g)(4)(D).

[403] Reg. §1.6302-1, effective for deposits and payments made after December 31, 2010. For further information about making estimated tax payments electronically or the pre-2011 timely-mailing rules for payment by paper coupons (Forms 8109 and 8109-B), see 581 T.M., *Estimated Tax*.

[404] §1363(b).

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fact that §332, §337, and §338 may be applied in appropriate circumstances and that §1371 does not preclude their use.[405]

1. *Subchapter C Provisions Consistent with Subchapter S*

Section 302. Section 302 provides that certain redemptions by a corporation will be treated as distributions in exchange for stock, thereby allowing sale or exchange (generally capital gain) treatment. Sale or exchange treatment is generally more desirable for a shareholder whose shares are redeemed by a C corporation with E&P because the shareholder may offset any stock basis in the shares against the redemption proceeds in determining the amount taxed to them. If the redemption were taxed as a distribution under §302(d) and §301, the proceeds would first be taxed dollar for dollar to the extent of the redeeming corporation's E&P before being able to be offset by any basis in the redeemed shares. Aside from §302(b)(4), to the extent treated as a sale or exchange, the provisions of subchapter C do not appear to be inconsistent with subchapter S. If the transaction results in exchange treatment, the S corporation's AAA balance is irrelevant in determining the tax effect to the shareholder receiving the distribution. Such shareholder must compare the amount of the distribution received with the basis of the shares redeemed to calculate gain or loss on the redemption. The AAA balance does not remain untouched, though, as §1368(e)(1)(B) provides that the AAA will be reduced in the same ratio as the number of shares redeemed bears to the total number of shares outstanding. Also, §1371(c)(2) provides that proper adjustment shall be made to any accumulated E&P as a result of the redemption. Although not specifically noted in the statute, presumably the provisions applicable to C corporations under §312(n)(7) would apply to determine the appropriate adjustment.

Comment: As it applies to shareholders in C corporations, sale or exchange treatment under §302(b) is not optional. If the redemption meets the requirements of §302(b)(1), §302(b)(2), §302(b)(3), or §302(b)(4) (taking into account attribution rules), a transaction will be treated as a sale or exchange. Sections 302(b)(2) and §302(b)(4) can be very mechanical in nature. As discussed below, one may argue that although mechanical in nature, §302(b)(4) is not consistent with subchapter S.

Sections 305 and 307, in general. The exclusion from income for stock dividends under §305(a) appears to apply to S corporation stock dividends along with the corresponding stock basis implications. However, if the distribution came within the scope of §305(b), the distribution would be subject to §301 as modified by §1368. Distributions of preferred stock by an S corporation generally will terminate S corporation status because of the prohibition against more than one class of stock (but see §306 regarding situations in which an S corporation could distribute preferred stock). Therefore, the portions of §305 related to preferred stock normally do not apply to S corporations.

Sections 311. Following the 1986 TRA repeal of the *General Utilities* doctrine, regular corporations are taxed on distributions of appreciated property. Even before the repeal, however, S corporations were subject to gain recognition on the distribution of appreciated property under former §1363(d). Although this provision was repealed in the 1988 TAMRA,[406] the legislative history indicates that this repeal was an attempt to eliminate deadwood rather than an indication that S corporations were to escape gain recognition on the distribution of appreciated property.

Comment: It would appear that the loss disallowed under §311 with respect to the distribution of depreciated property is not an equitable result for S corporation shareholders. This is because a distribution of depreciated property may have the effect of disallowing an economic loss permanently from the tax system. Where a C corporation may be prohibited from recognizing the loss on a distribution of property under §311(a), its E&P are reduced by the basis of the property distributed under §312(a)(3) and, to the extent the C corporation shareholder recognized dividend income, the shareholder's stock basis is not reduced. In the case of an S corporation, if the loss not recognized is a stock basis reduction, the shareholder may never recognize the loss. One might argue that §1367 and §1368 only require a basis reduction for the fair market value of the property distributed and since no loss is recognized, the shareholder may realize the benefit of the loss at a later time through subsequent stock basis recovery.

Comment: This position is supported by the Third Circuit's holding in *Ball v. Commissioner*.[407] In *Ball*, the taxpayer, relying on certain cancellation of indebtedness cases, took the position that gain not recognized under §332 on the liquidation of a subsidiary pursuant to a QSub election was tax-exempt income. Accordingly the shareholders increased their stock basis in the S corporation for the tax exempt income. The IRS argued and the Tax Court and Third Circuit agreed that when an item is not recognized it "does not rise to the level of income" and it is not "an item of income for tax purposes." Here, similar logic might suggest that a disallowed loss under §311 does not rise to the level of a loss and therefore does not trigger a reduction in stock basis under §1367 and §1368.

Sections 317 and 346. For corporate distributions, §317 defines property as money, securities, and any other property. Section 346 defines complete liquidation for purposes of subchapter C. Nothing about §317 or §346 and their operation makes them inconsistent with subchapter S.

Section 318. In general, §318 provides the constructive ownership rules for subchapter C. As part of the attribution rules, §318(a)(5)(e) provides that an S corporation is treated as a partnership for purposes of attributing ownership of stock of a corporation from or to an S corporation. Thus, §318 applies to S corporations.

Section 331. Distributions received by shareholders in complete liquidation of a corporation are governed by §331 and are treated as payments in exchange for stock rather than as §301 distributions. Section 331 is consistent with subchapter S in its treatment of distributions to the S corporation's shareholders or the receipt of liquidating distributions from other corporations. Section 1368 does not override §331; §1368 only

[405] The material in this section corresponds to similar material in the American Bar Association's *Task Force Report on Taxable and Tax-Free Acquisitions Involving S Corporations*, 45 Tax Law. 435, 483–92, of which one of the former co-authors of this Portfolio was the Co-Chair.

[406] Pub. L. No. 100-647, §1006(f)(7).

[407] 742 F.3d 552 (3d Cir. 2014), *aff'g* T.C. Memo 2013-39.

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applies to distributions to which §301(c) would apply but for the S corporation rules.

Sections 332 and 337. The IRS has advised that an S corporation should be treated as a corporation for purposes of §332, §337, and §338.[408] That view was codified with the amendment to §1371, discussed in I.A., above. An S corporation does not recognize gain under §332 and is treated as a distributee corporation for purposes of liquidation of the distributing corporation without recognition of gain or loss.

Section 334. As discussed in this chapter, the application of §331, §332, §336, and §337 appear consistent with subchapter S. Therefore, the basis rules for property distributed in complete liquidation should also be consistent.

Section 338. Allowing an S corporation to either be the acquiring or target corporation in a qualified stock purchase followed by a §338 election is consistent with subchapter S. Target assets remain in corporate solution (and, thus, are subject to all the rules of subchapter C) following a §338 election unless the target is liquidated subsequent to the election. Even after a liquidation, the assets remain in a corporation, because only a corporation may be an acquiror in a qualified stock purchase. Any assets distributed in liquidation to an S corporation acquiror are subject to the rules of subchapter S. An acquiring S corporation is in the same situation as if it had acquired the assets directly, so there is no potential for abuse.

Section 341 — Prior Law. The former collapsible corporation rules dealing with the ordinary income treatment of stock sales and redemptions were consistent with the S corporation rules.[409]

Section 351. In GCM 38969 (Mar. 9, 1983), the IRS considered whether a shareholder should be able simultaneously to contribute appreciated property to a corporation and to elect S status. Before SSRA, the IRS in GCM 31086 had reserved the issue of whether, in some situations, the combination of §351 and an S election could be abusive. GCM 38969 speculates that the perceived potential for abuse was the transfer of property that was held in the shareholder's trade or business to the S corporation, which would then sell the property at capital gain rates, and observes that the subsequent adoption of Reg. §1.1375-1(d)[410] prevents this abuse by providing that if the gain would have been ordinary income at the shareholder level, the gain of the S corporation is also ordinary if the property was contributed to the S corporation for the purpose of sale. The memorandum concluded that so as long as Reg. §1.1375-1(d) continues to apply, the use of §351 is consistent with subchapter S.

Sections 354, 355, 356, 358, 361, 362, and 368. GCM 39768 (Dec. 1, 1988) contemplates that reorganizations are available to subchapter S corporations. Related reorganization provisions regarding gain and loss recognition (or nonrecognition) and basis effects also should be available.

Comment: Regarding the application of §362(e) to transfers of property by S corporations, Reg. §1.362-3(d)(2) makes clear that a look-through rule applies. This means that the determination of whether any gain or loss on a hypothetical sale would be treated as subject to federal income tax is to be made by reference to the S corporation shareholders who would include such gain or loss in their taxable incomes. While the statute contains a look-through rule in the case of transfers by partnerships to determine if there is a loss importation transfer, the statute does not provide a look-through rule for transfers by S corporations. The regulations make clear that a look-through rule applies to S corporation shareholders as well.[411]

Section 357. To the extent §351 applies to S corporations, the effect of the assumption of liabilities on the shareholder and transferee corporation should also be applicable to S corporations.

Section 367. The §367 rules regarding transfers to foreign corporations are generally consistent with subchapter S. Therefore, §367 should apply to S corporations, except to the extent it modifies other subchapter C provisions that may not be applicable to S corporations.

Section 381. In general, §381 provides for the carryover of corporate attributes from an acquired corporation to its successor. To the extent §332 and the A, C, D, F, and G reorganizations apply to the S corporation, the §381 carryover attribute rules should likewise apply.

Sections 382, 383, and 384. Section 382 and §383 generally limit the use of losses and credits after an ownership change under §382(g). These limitations are consistent with subchapter S to the extent the S corporation has corporate-level losses and credits (presumably from subchapter C years).[412] These limitations are also relevant when an S corporation is subject to the built-in gains tax liability.

Section 384, which limits the use of pre-acquisition losses to offset the recognition of built-in gains of another corporation, should apply to the use of such losses in a built-in gains tax context.

Section 385. Section 385 is generally consistent with subchapter S;[413] the §1361(c)(5) straight-debt safe harbor is specifically designated as applicable only for purposes of the §1361(b)(1)(D) prohibition against multiple classes of stock. Section 385 (and related case law) control the classification of financial instruments as debt or equity for other purposes of the Code. The characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or debt is binding on such issuer and on all holders of such interest but may not be binding on the IRS. Such a characterization generally does not apply, however, to any holder of an interest if such holder discloses on the return that the holder is treating such interest in a manner inconsistent with the characterization made by the issuer.

[408] TAM 9245004.

[409] Note that §341 was repealed by §302(e)(4) of the 2003 JGTRRA, as amended by the 2012 ATRA, §102, for taxable years beginning after December 31, 2002.

[410] This rule is now in Reg. §1.1366-1(b)(2).

[411] T.D. 9759, 81 Fed. Reg. 17,066 (Mar. 28, 2016).

[412] *See* Notice 2003-65, as modified by Notice 2018-30, for a discussion on safe harbors in determining what items of income constitute built-in income and deduction items for purposes of §382.

[413] The final, proposed, and temporary §385 regulations issued in T.D. 9790, 81 Fed. Reg. 72,858 (Oct. 21, 2016), amended by T.D. 9897, 85 Fed. Reg. 28,867 (May 14, 2020), do not apply to S corporations. Reg. §1.385-1(c)(4). Additionally, S corporations cannot be either expanded group parents or non-parent members of an expanded group. Reg. §1.385-1(c)(4)(i).

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For a detailed discussion of debt-equity determinations and §385, see 702 T.M., *Capitalizing a Business Entity: Debt vs. Equity*.

2. Subchapter C Provisions Inconsistent with Subchapter S

Section 301. Except as otherwise provided, §301 sets forth the rules for the tax treatment of corporate distributions to shareholders. Under §301(c), a distribution is first taxed as a dividend within the meaning of §316 to the extent of accumulated earnings and profits (E&P), then as a return of basis and lastly as gain from the sale or exchange of property. However, §1368(a) explicitly provides for the tax treatment of distributions by S corporations "to which (but for this subsection) §301(c) would apply." Hence, under §1368, a distribution by an S corporation with accumulated E&P will be treated as a return of basis until the distribution exceeds the AAA and any excess will be treated as a dividend to the extent of E&P.[414] Under §1368(e)(3), an S corporation may elect to make distributions from E&P before making distributions from AAA.

Section 301(e) provides that in determining the taxable income of any 20% corporate shareholder and such shareholder's adjusted basis in the stock of the distributing corporation, the determination of the distributing corporation's E&P is made without reference to §312(k) and §312(n). A 20% corporate shareholder is defined as one that would be entitled to a §243, former §244 or §245 deduction. Because an S corporation is not entitled to any dividends received deductions by virtue of computing taxable income as an individual,[415] §301(e) seems to be inconsistent with subchapter S.

Section 302. Section 302(d) explicitly provides that those redemptions not treated as exchanges under §302 are to be treated as distributions under §301. Because §1368 modifies the effect of §301, a shareholder of an S corporation can be affected by whether a redemption qualifies under §302 for exchange treatment.

Section 302(b)(4) as it applies to an S corporation as a shareholder. A stock redemption will be treated as a sale or exchange as opposed to a distribution only under certain circumstances. One of those circumstances, set forth in §302(b)(4), is the redemption of stock held by a noncorporate shareholder in partial liquidation of the redeeming corporation. Section 302(e)(5) contains a look-through rule for partnerships, estates, and trusts in determining to what extent stock is held by noncorporate shareholders.

Under the principles of subchapter S, an S corporation has many features of a noncorporate entity. For example, it does not generate E&P and is not entitled to a dividends received deduction under §243. Moreover, §1363(b) states that an S corporation's income shall be computed as in the case of an individual (with certain exceptions). As such, it appears inconsistent with subchapter S to prevent an S corporation as a shareholder in a C corporation from obtaining the benefits of partial liquidation treatment with respect to redemptions of C corporation stock held by an S corporation.[416]

Section 302(b)(4) as it applies to S corporation shareholders. As discussed above, the application of most redemptive provisions in §302(b) appear consistent with subchapter S; however, one may argue that §302(b)(4) may not be consistent with subchapter S, especially in situations where the S corporation has no E&P. By treating a corporate redemption in partial liquidation as a sale or exchange, the drafters of the Internal Revenue Code of 1954[417] and current §302(b)(4) were acknowledging that if the requirements of a partial liquidation were satisfied, it was more appropriate to treat the transaction as one where the shareholders could recover their stock basis in the corporation and recognize capital gain, rather than the alternative of receiving a dividend that was treated as ordinary income with no basis recovery.[418] While gains on liquidating distributions have been taxable since at least 1913, but for a few years, it was not until the Internal Revenue Act of 1954 that dividends were consistently taxed at the shareholder (individual for this discussion) level. Subchapter S was introduced in the Small Business Tax Revision Act of 1958 (P.L. 85-866, 9/2/1958). Pre SSRA, subchapter S did not contain an equivalent to §1371(a) and the taxation of S corporation earnings and distribution of an S corporation was much more complicated until the SSRA where the flow through nature of an S corporation was more developed.

Under §1368, distributions by an S corporation are first and foremost a return of basis and then capital gain. In fact, only distributions by S corporations with historic C corporation E&P are treated as dividends, and even then, generally only after distributions have been sourced from the AAA. Thus, to the extent §302(b)(4) is intended to ensure that redemption distributions in partial liquidation are treated as return of basis and capital gain, rather than as a dividend, that provision may not serve much function in the S corporation context — and may even cause some adverse consequences if applicable. The following examples illustrate the difference in how §302(b)(4) could apply for shareholders of a C corporation and shareholders of an S corporation.

> *Example:* B, an individual owns all the stock of X, a C corporation. X has conducted businesses Y and Z for the last 10 years each representing 50% of the value of X. B has $5 million of basis in the X stock, and X had no basis in either business' assets. In Year 1, to get cash for personal endeavors, B decides to have X sell business Y for $10

[414] This rule continues to apply during the post-termination transition period of a former S corporation. *See* Rev. Rul. 2019-13.

[415] §1363(b).

[416] In PLR 200230002, the IRS specifically declined to opine if an S corporation was to be treated as a noncorporate shareholder for purposes of §302(b)(4). In PLR 200301029, the IRS stated that the "term 'corporation' does not include individuals but does include 'C' corporations and other appropriate entities … ." These two rulings indicate the possibility that the IRS may consider S corporations noncorporate shareholders for purposes of §302(b)(4). But *see Rath v. Commissioner*, 103 T.C. 196 (1993), where the court held an S corporation was still a corporation for purposes of determining the character of loss on the sale of §1244 stock which would have been ordinary had it been recognized by the individual shareholders of the S corporation. However, this was a character issue (which is determined at the S corporation level under §1366(b)) rather than a computation of the amount of the loss which may be affected by the application of §1363(b), which states that an S corporation computes its income in the same manner as an individual.

[417] Pub. L. No. 83-591.

[418] S. Rep. No. 83-1622 (Apr. 5, 1954); H.R. Rep. No. 83-1337 (Mar. 9, 1954).

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million and distribute the proceeds to B. Upon the sale, X recognizes $10 million of gain generating E&P of $10 million. Assuming the distribution of $10 million to B is characterized as a partial liquidation under §302(b)(4),[419] B may only be able to recover one-half of the basis ($2.5 million) against the distribution and be taxed on the remaining $7.5 million at capital gains rates. If the transaction were not treated as a partial liquidation, B would be taxed on the full $10 million as dividend income.[420]

Example: Assume the same facts as the prior example except that X is an S corporation. Upon the sale of business Y, X recognizes $10 million of gain that passes through to B increasing B's basis in X to $15 million. If §302(b)(4) applied to the distribution, B would only be able to recover one-half of the basis ($7.5 million), thus recognizing an additional $2.5 million of gain on the distribution. If §302(b)(4) were not applicable, B would treat the distribution under §1368 and have no additional income (assuming sufficient AAA) upon the receipt of the $10 million.

As shown in these examples, partial liquidation treatment provides a benefit to shareholders in a C corporation by allowing them to recover basis against certain distributions. But this is generally not required for S corporations, where the purpose of §1368 is to treat distributions first and foremost as "being generally a return of the shareholder's investment including previously taxed earnings." The legislative history supports this view of S corporation distributions:

> Thus, under the bill, shareholders of subchapter S corporations with accumulated earnings and profits will be assured of the tax-free treatment with respect to distributions, regardless of when made, to the extent of the corporation's accumulated adjustment account.[421]

Accordingly, the authors believe that §302(b)(4) may be inconsistent with subchapter S to the extent of any distribution that does not exceed the balance in the AAA. Nevertheless, in the event that §302(b)(4) does apply to shareholders of an S corporation, it may be advisable to avoid transactions that qualify as partial liquidations, for example, by waiting to make a partial liquidation for at least a year.[422]

Section 303. Similar to §302(b)(4), §303 provides limited circumstances whereby C corporation shareholders may recover their investment in lieu of having certain distributions taxed as dividend income. Accordingly, §303 seems inconsistent with subchapter S to the extent an S corporation has a AAA that equals or exceeds any distributions made to fund death taxes of an S corporation shareholder.

Section 304. The pre-SSRA regulations held that §304 could apply to S corporations.[423] However, if §304 continues to apply after SSRA, the rules for its application are unclear. Where the §304 redemption fails to qualify as an exchange under §302, §304(b)(2) provides that the distribution will be treated as a dividend based on the aggregate accumulated E&P of the related corporations.

Arguably, if the acquiring corporation is an S corporation, §1368(c)(1) acts to modify the §304(b)(2) ordering rules such that the distribution is viewed first as a distribution from the acquiror's AAA. If the issuing corporation is also an S corporation, its election will terminate under §1362(d)(2). Because §1371(e) allows a former S corporation to make distributions with respect to its stock from its AAA (but only in cash) during the post-termination transition period,[424] it is also arguable that the distribution should be viewed as reducing the issuing corporation's AAA before being treated as a distribution of E&P.[425]

Section 305(c) as it applies to certain periodic redemptions. Reg. §1.305-3(b)(3) provides that if a redemption is part of a series of transactions that have the result of a distribution of property to one shareholder and a shift in equity to another, the nonredeemed shareholders may be deemed to receive a taxable stock distribution under §305(b)(2) even if no actual stock distributions are made.[426] While this may prevent abuse in certain C corporation redemptions, to the extent an S corporation has no E&P (or nominal E&P relative to AAA) and shareholders have significant basis, application of this disguised stock distribution rule calling into effect §305(b)(2) only serves to create an administrative burden on the S corporation and its shareholders. This is because a stock distribution by an S corporation, even if not exempted under §305 is still taxed under §1368 and in many situations will remain tax free where the amount of the distribution does not exceed a shareholder's basis in all their S corporation stock. Accordingly in such situations, it may be appropriate to assert that Reg. §1.305-3(b)(3) invoking §305(b)(2) is inconsistent with subchapter S.

Section 306. In most situations, an S corporation will not have §306 stock because the creation of preferred stock would terminate the S election. In addition, the classification of stock (or stock rights) as §306 stock in the S corporation context is

[419] While §302(b)(4) normally requires that shares actually be redeemed, Rev. Rul. 90-13 provides that shares need not be redeemed when the distribution is pro rata and an actual redemption would not change the ownership percentage. See PLR 9436059, where §302(b)(4) was applied to an S corporation. For a discussion of the tax consequences of a redemption and requirements of §302(b)(4) generally, see 767 T.M., *Redemptions,* IV. and VIII., respectively. *See also* PLR 20221001 where the IRS specifically declined to opine on the treatment of a distribution of business assets qualifying under §302(b)(4) but did rule that a distribution of cash to pay taxes on the income of the S corporation (presumably including any gain recognized under §311(b)) would not be subject to §302(b)(4) treatment.

[420] *See* Rev. Rul. 77-245 (determining number of shares of stock and basis in shares of stock surrendered in partial liquidation by reference to fair market value of stock before and after distribution).

[421] S. Rep. No. 640, 97th Cong., 2ND Sess. 1982.

[422] Braitewaite, *S Corporations and Partial Liquidations — Two Favorable Tax Regimes; When Two Rights Make a Wrong*, 6 Bus. Entities No. 3 (May/June 2004).

[423] Pre-SSRA Reg. §1.1372-2(c).

[424] There is a special rule allowing eligible terminated S corporations to make cash distributions following the post-termination transition period. For a discussion of §1371(f) and its requirements, see 730 T.M., *S Corporations: Formation and Termination.*

[425] See FSA 200110004 and FSA 200111004 (which appear to be dealing with identical facts and supplementing FSA 200041009) for a discussion on the applicability of §304 when Acquiring is an S corporation. *See also Hurst v. Commissioner*, 124 T.C. 16 (2005) (analyzing the application of §304 to the sale of one S corporation to another but determining it did not need to consider the results at it ruled the IRS was procedurally prohibited from raising it as a new matter in the case).

[426] *See* Reg. §1.305-3(b)(3).

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further complicated by the no earnings and profits exception of §306(c)(2). Section 306(c)(2) excludes from the reach of §306 "stock no part of the distribution of which would have been a dividend at the time of the distribution if money had been distributed in lieu of the stock." Since §1368 governs distributions from S corporations, it is arguable that an S corporation with positive E&P and AAA balances could distribute stock to the extent of the AAA balance while avoiding the §306 taint. Alternatively, if the use of the term dividend in §306 is interpreted to mean the amount determined under §316 without reference to §1368, §306 would apparently function properly in the S corporation context.[427]

[427] This interpretation may not be possible as §316 defines dividend for purposes of Subtitle A as a distribution of property by a corporation to its shareholders out of E&P (with certain exceptions for personal holding companies).

Section 312. Section 312 is generally inapplicable to S corporations; under §1371(c)(1) an S corporation generally makes no adjustments to its earnings and profits. However, §312 remains relevant to S corporations for distribution purposes and for allocations of E&P in corporate separations and reorganizations.

Section 316. The §316 definition of the term dividend is applied for purposes of this subtitle. Section 1368(c)(2) (subject to modification by a §1368(e)(3) election) describes the amount that shall be treated as a dividend for purposes of §301(c) but does not formally replace the §316 definition for other purposes of the Code. Presumably the §316 definition of a dividend is inconsistent with subchapter S and therefore does not apply to S corporations.

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II. Treatment of S Corporation Distributions

A. General Rule — No Taxation at S Corporation Level

As previously mentioned, one of the main advantages of subchapter S is the fact that S corporation earnings are subject to only one layer of tax. In other words, for the most part, S corporations can distribute S corporation earnings tax free. The taxation of S corporation distributions can differ if the S corporation has accumulated earnings and profits (E&P).

Comment: S corporation distributions to shareholders can trigger tax consequences to shareholders, e.g., distributions in excess of stock basis. As an alternative to a distribution that results in a tax consequence, the S corporation could consider making loans to its shareholders. Any corporate shareholder loans would need to take into account any imputed interest under §7872. If a taxable distribution has already been made, the S corporation could consider rescinding the distribution within the same taxable year and issuing a loan to the shareholders instead.[428]

B. Corporations Without Earnings and Profits

1. General

When an S corporation has no E&P, the taxation of distributions is solely dependent upon the shareholder's basis in their S corporation stock.[429] The value of the property received (i.e., the amount of cash distributed plus the fair market value of any property distributions) is nontaxable to the extent of stock basis.[430] Any distributions received after stock basis has been exhausted are treated as gain from the sale or exchange of property (typically capital gain to the extent the shares are a capital asset in the hands of the shareholder).[431]

Distributions that are tax free under §1368 result in corresponding downward stock basis adjustments, essentially eliminating the positive stock basis adjustments generated by the S corporation earnings.[432]

Comment: E&P means accumulated E&P of a corporation from prior subchapter C tax years.[433]

Although §1368 may allow the receipt of a distribution to be tax free to the recipient shareholder, §311(b) continues to apply to a distribution of appreciated property by the S corporation. Any gain recognized on the deemed sale under §311(b) will pass through to all shareholders. See II.E., below.

A shareholder's stock basis *at the time of an S corporation distribution* to its shareholders is irrelevant in determining the tax treatment of the distribution. Instead, a shareholder's stock basis *at the close of the S corporation's taxable year* determines the distribution's tax treatment.[434] Under the stock basis adjustment rules, distributions made by an S corporation during a taxable year are taken into account before applying any loss limitation (related to stock basis) for the year.[435] That is, tax free distributions under §1368 during a year reduce the adjusted basis of stock in an S corporation first, for purposes of determining the allowable loss for the year; thus, the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.[436]

> *Example — Post-1996 Tax Year Distribution:* XYZ is a calendar year S corporation with no accumulated E&P. T, X's sole owner, has an adjusted basis in the stock of XYZ on January 1, Year 1, of $1,000. T holds no debt of X. During Year 1, XYZ distributes $600 to T, recognizes a capital gain of $200 and sustains an operating loss of $900. Accordingly, T's adjusted basis in the XYZ stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) to determine the effect of the distribution. T's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of §1366(d)(1). T is allowed to take into account $600 of XYZ's $900 operating loss, which reduces T's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to §1366(d)(2).[437]

Shareholders will generally recognize capital gain if the S corporation distributions exceed stock basis.[438] The capital gain can be either short- or long-term depending on the shareholder's holding period. It is unclear when the deemed sale or exchange will have occurred for purposes of determining whether the capital gain is short or long term. Presumably, the sale is deemed to occur at the time of the distribution as Reg. §1.301-1(c) provides that a distribution is includible in the gross income of a shareholder at the time the cash or other property is unqualifiedly made subject to the demands of the shareholder.

> *Example:* On September 30, Year 1, D purchased stock in XYZ, a calendar year S corporation. XYZ makes no distributions during Year 1. However, on January 15, Year 2, D receives a cash distribution. At the end of Year 2, D determines that their XYZ distributions exceeded their stock

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[428] Rev. Rul. 80-58.

[429] *See* §1368(b)(1).

[430] Basis from indebtedness of the S corporation to the shareholder may only be used to deduct losses. §1367(b)(2)(A). It may not be used to receive tax-free distributions. Instead, cash received in connection with such loans must take the form of a loan repayment.

[431] §1368(b)(2). *See Rogers v. Commissioner*, T.C. Memo 2011-277 (if S corporation does not have accumulated E&P, then distribution must be treated as gain from sale or exchange of property to extent it exceeds stock basis), *aff'd*, 728 F.3d 673.

[432] *See* 732 T.M., *S Corporations: Shareholder Tax Issues.*

[433] The 1996 SBJPA eliminated any E&P that may have been generated by an S corporation in a pre-1983 taxable year. The elimination is effective for taxable years beginning after 1996.

[434] *See* Reg. §1.1368-1(e), Reg. §1.1367-1(d)(1). *Compare* the partnership rules under Reg. §1.731-1(a)(1)(i).

[435] §1366(d)(1)(A).

[436] For tax years beginning before 1997, the order was reversed — stock basis adjustments under §1367 were made for income and loss items before distributions were taken into account. Pre-1996 SBA §1366(d)(1)(A). Adjusting basis for income and loss items before distributions was contrary to their treatment in a partnership where distributions adjust a partner's basis in the partnership first when applying the loss limitation rule under pre-2018 §704(d). Reg. §1.704-1(d)(2); Rev. Rul. 66-94. Some of the S corporation changes enacted by the 1996 SBA were the result of trying to conform the S corporation rules to the partnership rules.

[437] Joint Comm. on Tax'n, *General Explanation of Tax Legislation Enacted in the 104th Congress*, JCS-12-96 (1996).

[438] §1368(b)(2), which treats the excess distribution as gain from the sale or exchange of property.

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basis by $20,000, adjusted for Year 2 passthrough items. It appears that D's $20,000 capital gain is short-term because D's holding period for the S corporation stock was one year or less despite the fact that their stock basis could not be determined until after the close of XYZ's tax year.

The S corporation rules adopt a separate basis approach for determining the adjustments to basis in S corporation stock, computing stock basis on a share-by-share basis in the same manner as stock basis is computed for a shareholder in a C corporation.[439] A share-by-share (or block-by-block) approach permits shareholders to control gain recognition by the selective disposition of certain blocks of stock.[440] In other words, S corporation shareholders, like C corporation shareholders can decide to sell high-basis shares first, before lower-basis shares, in order to manage the taxable gain recognized. There is also a so-called spillover rule with respect to S corporation basis, under which any basis reductions in excess of the basis in a share are applied to reduce (but not below zero) the remaining bases of all other shares of stock in the S corporation owned by the shareholder in proportion to the remaining basis of each of those shares.[441]

2. *Form 1120-S and the Accumulated Adjustments Account*

If an S corporation has no accumulated E&P, it technically is not required to maintain an accumulated adjustments account (AAA) since the taxability of distribution is determined solely by reference to stock basis. However, for presentation purposes, the Form 1120-S requires all S corporations, with or without accumulated E&P, to track their S corporation earnings through an AAA.[442] In addition, the preamble to the regulations[443] under §1368 advises that an S corporation without accumulated E&P should consider tracking AAA in the event that the S corporation inherits E&P in a transaction to which §381(a) applies (i.e., a reorganization under §368 or liquidation under §332). For example, in PLR 9046036, an S corporation without E&P was merged into another S corporation with E&P. The target S corporation had accumulated losses from its inception. The IRS treated the target as having maintained an AAA, which was negative at the time of the merger. As a result, the successor corporation was forced to combine its positive AAA with the target's negative AAA under Reg. §1.1368-2(d)(2). This meant that the surviving corporation's ability to make tax-free distributions was diminished by the target's deficit AAA balance. Unfortunately, the regulations do not provide for a hovering deficit rule upon the combination of positive and negative AAA accounts like they do for positive and negative E&P balances.[444]

Comment: It is not clear if the acquiring company could have made a distribution of AAA prior to the reorganization. The ordering rules under Reg. §1.1368-2(a)(5) do not prescribe a time for making the adjustment under Reg. §1.1368-2(d)(2) which states the AAAs are combined as of the close of the reorganization date.

C. *Corporations with Earnings and Profits*

1. *General*

The distribution rules are considerably more complicated if the S corporation has accumulated E&P. To ensure that distributions of accumulated E&P would be taxed as dividends when ultimately distributed, but that distributions of income already taxed to shareholders either under the new S corporation or the former subchapter S corporation rules would be tax free, Congress, as part of the SSRA, enacted special rules under §1368(c) and §1371(c).

When a C corporation elects S status, its E&P is essentially frozen. Generally, under §1371(c)(1), no adjustments are made to an S corporation's E&P. However, adjustments can be made for E&P acquired from another corporation in a reorganization or in a liquidation (via a QSub election or actual dissolution), where E&P would be carried over from the acquired corporation under §381. In addition, accumulated E&P can be adjusted for:

- distributions to the extent made out of accumulated E&P;[445]
- distributions resulting from redemptions, liquidations, and reorganizations;[446] and
- any investment credit recapture tax paid by the S corporation.[447]

The rule that no adjustments are made to an S corporation's E&P is a strict one as illustrated by *Cameron v. Commissioner*.[448] In *Cameron*, the taxpayer calculated income under the completed contract method and switched from C corporation status to S status in the middle of the contracts. In order to minimize the amount of a distribution in excess of AAA classified as a dividend from E&P, the taxpayer wished to adjust the E&P for costs incurred after the S election in excess of reasonable estimates used to determine the E&P for the last C corporation year. The Tax Court held that E&P for the C corporation's last taxable year before converting to an S corporation must be computed on the basis of year-end estimates of total costs of long-term contracts and may not be revised retroactively when actual costs are known. The Eighth Circuit affirmed, noting that an adjustment to the accumulated E&P account to rectify ultimately inaccurate estimates of the costs necessary to complete the contracts is not the sort of transaction to which §1371(c)(2) applies. Once the taxpayer elected to switch from C to S status, it was required to track its earnings using the AAA account

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[439] *See* Reg. §1.1367-1(b)(2), §1.1367-1(c)(3).

[440] For a complete discussion of the basis rules, and the separate basis approach, see 732 T.M., *S Corporations: Shareholder Tax Issues.*

[441] Reg. §1.1367-1(c)(3).

[442] Instructions for Form 1120-S, Schedules L and M-2.

[443] T.D. 8508, 59 Fed. Reg. 12 (Jan. 3, 1994).

[444] Contrast Reg. §1.1368-2(d)(2), which simply adds the AAA of the acquiring and distributing S corporation, with Reg. §1.381(c)(2)-1(a)(5), which prevents an immediate combination of E&P balances when one is positive and the other is negative. Of course, this rule makes sure that any current positive accumulated E&P is taxed as a dividend as soon as distributions are made. A similar rule would have had just the opposite effect (current tax-free distributions) and therefore was not adopted under the §1368 regulations.

[445] §1371(c)(3).

[446] §1371(c)(2).

[447] §1371(d)(3).

[448] 105 T.C. 380 (1995), *aff'd sub nom.*, *Broadway v. Commissioner*, 97-1 USTC ¶ 50,355 (8th Cir. 1997).

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rather than the E&P account used while it was a C corporation. Costs incurred by the taxpayer in excess of its reasonable estimates were attributable to its operations as an S corporation. The Eighth Circuit held that the no retroactive recomputation rule represents a burden taxpayers assume in order to gain the benefits of being taxed as an S corporation instead of as a C corporation.

Items for which the timing for E&P and taxable income differ create timing differences when converting from C status to S status or S status to C status. This includes items such as depreciation methods, installment sale gains, and special LIFO inventory adjustments.

2. Tax-Free Distributions Out of the AAA

If an S corporation has E&P, tax-free distributions can generally be made to the extent of the corporation's AAA.[449] The AAA generally consists of the corporation's net income or loss for all S corporation years less any distributions made in prior years that were sourced from the AAA.[450] The AAA is discussed in detail at II.D., below.

Distributions from AAA are treated similarly to those made by a corporation without accumulated E&P.[451] Any distributions from AAA in excess of a shareholder basis (as determined at the end of the year) will result in gain from the sale or exchange of property (generally capital gain).

Although a distribution that is sourced from AAA may be tax free, §311(b) can cause gain to be recognized if the S corporation is distributing appreciated property. Any gain on the distribution of appreciated property would be allocated among all the shareholders under the income allocation rules under §1366 regardless of which shareholder received the distributed appreciated property.[452] Therefore, a corporation may have a substantial AAA balance, but because it chooses to distribute appreciated property, it incurs a gain on the distribution that passes through to the shareholders. This gain, in turn, increases the AAA and stock basis, allowing that distribution or later distributions to be distributed tax free.[453]

3. Dividends, Return of Capital, Capital Gain

Any amount distributed in excess of the AAA will generally be treated as a dividend to the extent of the corporation's accumulated E&P.[454] When multiple distributions in excess of AAA are made in one year, §1368(c) requires that the AAA be allocated pro rata to all distributions during the year. This precludes distributions from being tax-free in the earlier part of the year and fully taxable toward the end of the year.

> *Example:* Without taking into account any distribution, XYZ corporation has an AAA balance of $20,000 and an accumulated E&P balance of $10,000 at year-end Year 1. During Year 1, XYZ made a $22,500 distribution in March and a $7,500 distribution in October. Of the March distribution, $15,000 is sourced from AAA and $7,500 is from E&P, and of the October distribution, $5,000 is from AAA and $2,500 is from E&P.

Prior to 1997, S corporations could have subchapter S E&P (from pre-SSRA years) as well as subchapter C E&P (now referred to in the Code as accumulated E&P).[455] In such situations, Reg. §1.1368-1(f)(2)(iii) provides that if an election was made under §1368(e)(3) to distribute earnings before making distributions out of the AAA, subchapter C E&P would be deemed to be distributed first, and former subchapter S E&P would be deemed to be distributed second. This was important for those corporations with passive income problems because only subchapter C E&P, as defined in Reg. §1.1362-2(c)(3), would trigger the passive income tax or the passive income termination rule.[456]

Note: The 1996 SBA introduced a rule reducing the accumulated E&P of any corporation that was an S corporation for its first taxable year beginning after 1996 by the accumulated E&P (if any) accumulated in a taxable year beginning before 1983 for which the corporation was an electing small business corporation under subchapter S. This reduction ensures that such a corporation's accumulated E&P are solely attributable to taxable years for which an S election was not in effect.[457] The 2007 SBWOTA[458] reduced the accumulated E&P (determined as of the beginning of the first taxable year beginning after May 25, 2007) of any corporation that was not an S corporation for its first taxable year beginning after 1996 by the accumulated E&P (if any) accumulated in a taxable year beginning before 1983 for which the corporation was an electing small business corporation under subchapter S.[459]

After all accumulated E&P has been distributed, excess distributions are treated as returns of capital and reductions of stock basis.[460] After stock basis has been exhausted, any further distributions are taxed as gain from the sale or exchange of property (generally capital gain).[461] The adjustments to a shareholder's stock basis are made on a share-by-share basis.[462] As such, not all shares may have the same stock basis. A special rule under Reg. §1.1367-1(c)(3) permits a "spillover" for basis reductions. This spillover rule allows a taxpayer to absorb

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[449] §1368(c)(1).

[450] *See* Reg. §1.1368-2(a)(2), §1.1368-2(a)(3).

[451] §1368(c)(1); Reg. §1.1368-1(c).

[452] *See* II.E., below.

[453] *See* §1367(a)(1)(A), §1368(e)(1)(A).

[454] §1368(c)(2); Reg. §1.1368-1(d)(1). Special rules apply to corporations that were S corporations prior to the SSRA and have previously taxed income (PTI) from pre-SSRA years. See II.C.4., below, for a discussion of PTI.

[455] A corporation's subchapter S E&P would likely not have been large because any actual distributions qualifying as dividends under §316 would reduce an S corporation's E&P. In addition, undistributed taxable income of an S corporation was deemed distributed on the last day of the year and included in income as a dividend to the extent of any remaining E&P under pre-SSRA §1373(b). The corporation E&P would thus result only from differences in calculating E&P and taxable income.

[456] In addition, it would appear that the same rule of distributing subchapter C E&P (now referred to in the Code as accumulated E&P) before subchapter S E&P should apply if the distributions exceed the AAA, even if no §1368(e)(3) election is made. Subchapter S E&P does not exist in tax years beginning after 1996. *See* 1996 SBA, Pub. L. No. 104-188, §1311.

[457] *See* H.R. Rep. No. 280(II), 104th Cong., 1st Sess. 506 (1995) (reproduced in the Worksheets).

[458] Pub. L. No. 110-28, §8235.

[459] *See* Staff of the Joint Comm. on Tax'n, *Technical Explanation of the Small Business and Work Opportunity Tax Act of 2007,* JCX-29-07, at 25 (2007).

[460] §1368(c)(3), §1368(b)(1).

[461] §1368(c)(3), §1368(b)(2).

[462] Reg. §1.1367-1(b)(2), §1.1367-1(c)(3).

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excess stock basis in other shares before recognizing gain on distributions under §1368(c)(3) (or having losses limited under §1366(d)).

To the extent dividend distributions are made by an S corporation, Forms 1099-DIV must be provided to shareholders.[463] In addition, under §6042(d), the IRS is authorized to require corporations with accumulated E&P to file a report when making nontaxable dividend distributions using Form 5452, *Corporate Report of Nondividend Distributions*. In the case of S corporations, this form is not to be used to report distributions from the AAA, nor is it to be used to report dividend distributions from E&P. However, S corporations that make distributions under §1368(c)(3) that exceed the combined AAA and E&P balances must report such distributions on Form 5452.[464]

Note that, for purposes of the passive loss rules, dividends paid by an S corporation out of E&P from its former existence as a C corporation are treated as portfolio income, even though the S corporation's income or loss passed through to the shareholders would otherwise be treated as passive.[465]

4. *Distributions of Previously Taxed Income*

Pre-SSRA, S corporations maintained an account called previously taxed income (PTI). The PTI account balance equaled the total amounts included in the gross income of a shareholder for all prior years less any net operating losses of the S corporation allowed as a deduction to the shareholder and all amounts previously distributed during the taxable year and all prior years which were not considered dividends.[466] Under Reg. §1.1368-1(d)(2), if an S corporation has undistributed PTI that is otherwise distributable under the Code and distributes cash, the amount distributed in excess of the AAA is treated as first coming out of PTI. Any distribution in excess of PTI is generally treated as coming from accumulated E&P. Under §1379(c), a corporation's PTI can could be distributed only if the corporation was a subchapter S corporation for its last taxable year beginning before 1983, i.e., the last pre-enactment year before the effective date of the SSRA.[467] The statute is only applicable to corporations that were subchapter S corporations for the last taxable year beginning before January 1, 1983. Therefore, an S corporation that terminated S status before their last pre-enactment year and had reverted to subchapter C status for a period including the last pre-enactment year would not be able to distribute its PTI under this rule. Although not evident under the current statute and regulations, a corporation that was an S corporation for the last pre-enactment year that terminates S status after 1982 and then re-elects S status would not have a PTI account that can be distributed tax free. Pre-SSRA Reg. §1.1375-4(a) provided that a distribution of PTI could be made only during a taxable year in which a valid subchapter S election was in effect, and that if the election was terminated, the corporation could not, during the first taxable year to which the termination applied, or during any subsequent taxable year, make a nondividend distribution of PTI attributable to years prior to the termination.[468]

> *Example:* XYZ is a calendar year corporation with $10,000 of PTI from prior taxable years as a subchapter S corporation. If XYZ was a subchapter S corporation during 1982, its $10,000 of PTI can be distributed tax free under the S corporation rules. However, if XYZ was not a subchapter S corporation during 1982 but a regular corporation for that year, then its PTI cannot be distributed under the S corporation rules.

It is important to note that distributions from PTI can only be made in money. Distributions made in property in excess of AAA will therefore be sourced from accumulated E&P and not PTI. The PTI balance will not be affected by distribution of property in excess of AAA.

Where the total amount of distributions made throughout a year exceed the AAA balance as determined at the close of the year, §1368(c) requires that the AAA be allocated proportionately to all distributions during the year. Thus, if a calendar year S corporation distributes property in March and cash in November, the AAA is not allocated all to the property distribution; it is allocated ratably to both the cash and property distributions. As a consequence, a portion of the November distribution may still be sourced from PTI. When a corporation distributes, on the same day, property and cash in excess of AAA, it is unclear if the cash or the property portion of the distribution is deemed to be the excess distribution.

> *Example:* At the close of Year 1, ABC corporation has $25,000 of PTI, $50,000 of AAA and $50,000 of E&P. During the year, on June 1, ABC distributed cash of $40,000 and appreciated land with a fair market value of $60,000. If the land absorbs AAA first, then $25,000 of the distribution could be considered to be from PTI.

To be safe, if a company with PTI expects distributions during the year to exceed the AAA balance, all distributions during the year should be made in cash to ensure such excess distributions are sourced from PTI unless dividend income is desired.

A corporation may elect under Reg. §1.1368-1(f)(4) to forego previously taxed income. If such an election is made, distributions are first sourced from AAA, then E&P, then basis, and then treated as gain from the sale or exchange of property. Such an election may be beneficial to corporations that are in danger of losing their S status as a result of the passive income termination rule.

[463] Form 1099-DIV is not used to report distributions from the AAA. Instead, these distributions are reported on Schedule K of Form 1120-S. See Announcement 2003-55, for updated requirements for printing Form 1099-DIV, and Announcement 2003-56, (as modified by Announcement 2004-11) for requirements for reporting on Form 1120-S to accommodate changes made in the 2003 JGTRRA, Pub. L. No. 108-27.

[464] *See* Instructions for Form 5452.

[465] *See* Joint Comm. on Tax'n, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 231. For further discussion of the passive loss rules, see 732 T.M., *S Corporations: Shareholder Tax Issues*, at I.I.

[466] Pre-SSRA §1375(d)(2).

[467] §1379(e)(1). *See* PLR 8431017.

[468] *See also Oswald v. Commissioner*, T.C. Memo 1987-448, *aff'd in unpub. opinion* (3d Cir. 1988), in which a subchapter S corporation terminated its S status on February 1, 1980, and gave its sole shareholder a check for its cumulative PTI on April 8, 1980. The Tax Court held that the entire amount, except for the portion of PTI attributable to the immediately preceding tax year, was a dividend.

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The AAA and PTI operate independently of one another. Section 1379(c) provides only that pre-SSRA §1375(d) is to apply to PTI distributions; it does not suggest that either of the two accounts should affect the other. Thus, if PTI is negative, it should not affect the ability to make tax-free distributions out of AAA. Likewise, if the AAA is negative, the negative balance should not affect a shareholder's ability to withdraw PTI from an S corporation.

5. *Elections to Distribute Accumulated E&P Before the AAA*

a. *General*

An S corporation can elect under §1368(e)(3), with the consent of all its affected shareholders, to treat distributions made during an S year first as dividends (to the extent of E&P), rather than as tax-free distributions out of the AAA.[469] The election generally assists the corporation in distributing its accumulated E&P to avoid exposure to the tax on passive income or the passive income termination rule. Also, where the S corporation was a regular corporation during the immediately preceding year and has encountered an accumulated earnings tax (§531) or a personal holding company (§541) problem, the election in the first year of S status may facilitate a post-C corporation year distribution under §563 and serve to eliminate these problems. The election may not be necessary in these latter situations, however, if the corporation can qualify for the consent dividends procedure under §565. *See* 730 T.M., *S Corporations: Formation and Termination.*

The §1368(e)(3) election is an all or nothing election. In effect, this election shuts off §1368(c)(1) to the extent distributions in a year are equal to or less than the E&P balance. As indicated in PLR 8935013, a distribution subject to the election is treated as a dividend to the full extent of E&P; the S corporation cannot treat part of the distribution as coming out of AAA. Once this election is made, all distributions for the year are treated as made from E&P to the extent of the balance of E&P.[470]

> *Example:* XYZ, an S corporation, has $40,000 in E&P from its former C status. In addition, XYZ has $200,000 in AAA from S operations, all of which was generated by earnings in the current year. XYZ would like to strip out its E&P by making a §1368(e)(3) election. In the current year, XYZ distributes $100,000 to its shareholders. Of that $100,000, $40,000 must be treated as coming from E&P, and will be taxed as a dividend to the shareholders. In addition, the $200,000 in current earnings will also be taxed to the shareholders.

If a corporation with previously taxed income (PTI) makes this election but does not make the election to forego PTI under Reg. §1.1368-1(f)(4), distributions are treated as coming first from PTI, second from E&P, and third from AAA.[471] Any remaining portion is treated as stated under §1368(b). If the election to forego PTI is made, the distribution is treated the same way that a distribution is treated for a corporation with no PTI which elects to distribute E&P first.[472] If the corporation elects to forego PTI but does not make the election to distribute earnings first, the distributions are treated in the manner provided in §1368(c).[473]

The election to distribute E&P first and the election to forego PTI are irrevocable and are effective only for the taxable year for which they are made.[474] For models of these elections, see the Worksheets.

b. *Planning for E&P Distributions*

Unlike S corporations wishing to distribute PTI, an S corporation wishing to distribute E&P is not limited to making distributions in cash. If the corporation does not have sufficient cash on hand to distribute all of its E&P, it can eliminate E&P by distributing its own corporate notes or other assets to shareholders.[475] The IRS ruled in PLR 8917025 that a distribution of cash and notes, coupled with a §1368(e)(3) election, would reduce the corporation's E&P by the amount of cash and the principal amount of the notes distributed using the note's fair market value. In addition, the corporation did not need to recognize any gain under §311(b) on the distribution of the notes to the shareholders. Finally, the IRS ruled that the notes in this case were straight debt under §1361(c)(5) and that they did not create a second class of stock.[476]

Comment: If this technique is used, care should be taken that the notes represent a bona fide obligation. For instance, they should provide for payment of interest at no less than the applicable fair market rate, contain an appropriate maturity date, and the corporation and shareholders should treat the obligation as real debt.[477]

Because such a note reduces E&P to the extent of the note's value, an issue may arise as to the note's correct valuation. The credit worthiness of the company and prevailing interest rates may affect valuation. If an S corporation is unsure of the appropriate valuation, and would not have sufficient cash

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[469] Reg. §1.1368-1(f)(2). *See, e.g.*, PLR 202144001; PLR 202040006; 201320008, PLR 201248001 and PLR 201226013 (corporation able to amend return to treat distribution as sourced from E&P to obtain inadvertent termination relief due to excess passive income, requiring payment of §1375 tax and, in certain situations, amended corporate and shareholder returns); PLR 201221008 (§1368(e)(3) election effective under §9100 relief where taxpayers treated distributions as sourced from E&P, issued 1099 DIVs, but omitted filing election with return).

[470] Reg. §1.1368-1(f)(2)(i).

[471] Reg. §1.1368-1(f)(2)(ii).

[472] Reg. §1.1368-1(f)(4).

[473] Reg. §1.1368-1(f)(4).

[474] Reg. §1.1368-1(f)(5)(iv).

[475] However, a pro rata distribution of corporate stock will not be deemed to reduce E&P because it merely represents an adjustment to the number of shares outstanding, not a distribution of property. *See* §317(a).

[476] *See also* PLR 9342018 (sole property distributed in connection with a §1368(e)(3) election was a note of the distributing corporation); PLR 9003042 (distribution of 10-year notes bearing 10% interest along with §1368(e)(3) election purged corporation of E&P). In this situation, the IRS stated that E&P was reduced by the distribution of the notes either to the extent of the principal amount, or if the notes were subject to OID, their issue price. In addition, in *Moser v. Commissioner*, 914 F.2d 1040 (8th Cir. 1990), *aff'g* T.C. Memo 1989-142, the court held that notes created by a journal entry on the books of a gas and oil corporation and payable to the shareholders constituted distributions out of the corporation's E&P. In PLR 9149030, the IRS ruled that distributions of notes pursuant to a §1368(e)(3) election will reduce E&P and will not result in a second class of stock.

[477] In PLR 9342018, the IRS specifically expressed no opinion on whether the corporation's own note distributed in connection with an election under §1368(e)(3) constituted valid indebtedness.

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after a cash distribution to meet operating needs, this risk may possibly be avoided by structuring the transaction in two steps. First, the corporation makes a cash distribution to the shareholders in the amount of the planned E&P distribution. Second, the shareholders loan the funds back to the corporation in return for the corporation's promissory note.[478] Alternatively, the steps could be reversed.

c. Election to Make a Deemed Dividend

While there is no statutory provision permitting a consent dividend for S corporations, like under §565, Reg. §1.1368-1(f)(3) allows an S corporation to elect to distribute all or part of its subchapter C E&P (now referred to in the Code as accumulated E&P) through a deemed dividend. The amount of the deemed dividend may not exceed the corporation's accumulated E&P on the last day of the taxable year, reduced by actual distributions of accumulated E&P made during that year. The S corporation can elect to have only a portion of its E&P deemed distributed; however, if this election is made, the corporation will be considered also to have made the election to first distribute E&P.[479] In such a case, any prior distributions will also be sourced from E&P and not AAA as may have been expected when the actual distributions were made.

A deemed dividend is treated as a distribution of money on the last day of the taxable year immediately followed by a contribution by the shareholders receiving such distribution to the company of the money.[480] The deemed dividend election is irrevocable and is effective only for the taxable year for which it is made.[481]

Comment: The deemed dividend election has the effect of increasing stock basis to the extent of the deemed dividend. Such an election would be highly advisable to shareholders with suspended ordinary losses, especially taking into account the preferential rate afforded dividends.

> *Example:* On December 31, Year 1, X, the sole shareholder of the ABC S corporation, has a suspended loss of $250,000. The suspended losses consist solely of ordinary items. In addition, X has $1,000,000 of other ordinary income. ABC has accumulated E&P of $500,000. ABC makes a deemed dividend election with its 2013 tax return to distribute $250,000. Without the deemed dividend election, X would owe federal income tax of $370,000. As a result of making the election, X's federal tax will be reduced to $327,500 ($750,000 ordinary income taxed at 37% and $250,000 dividend income taxed at 20%).[482]

d. Filing the Election

A corporation that makes an election either to distribute E&P first, to make a deemed dividend, or to forego PTI, must attach a statement to a timely filed original or amended return. The statement must identify the election it is making under Reg. §1.1368-1(f) and must state that each shareholder consents to the election.[483] In the case of a deemed dividend election, the statement must include the amount of the deemed dividend that is distributed to each shareholder.[484]

In the case of an election to distribute E&P first, each shareholder who receives a distribution must consent to the election under the rules of §1368(e)(3).[485] A similar consent requirement applies to elections to forego PTI or to make a deemed dividend.[486] All of the above elections are irrevocable.[487]

Comment: Given the change in the tax rate on dividend income, elections under Reg. §1.1368-1(f) are much more attractive now than in the past.

6. Distributions by Former DISC Subsidiaries

Pre-SSRA S corporations could own 100% of a domestic international sales corporation (DISC). DISCs owned by S corporations pre-SSRA could continue to be held by S corporations post-SSRA even though, technically, the S corporation was a member of an affiliated group.[488] The 1984 TRA replaced the domestic international sales corporation (DISC) with the foreign sales corporation (FSC),[489] but the FSC rules have since been repealed themselves.[490] Any S corporations wholly owning a former DISC on January 1, 1985, would no longer be grandfathered and could possibly lose its S corporation status.[491] In addition to possible termination problems, the 1984 TRA DISC termination rules created a question regarding the effect of

[478] But see *Prescott v. Commissioner*, T.C. Memo 1983-709, where a corporation distributed to its sole shareholder a check for approximately $52,000 and, on the same day, the shareholder loaned the money back in exchange for a promissory note. The court held that these two transactions should be collapsed into a single transaction consisting of a note distribution. *See also McKelvy v. United States*, 478 F.2d 1217 (Ct. Cl. 1973); *Roesel v. Commissioner*, 56 T.C. 14 (1971); Rev. Rul. 83-142, (disregarding circular cash flow).

[479] *See* Reg. §1.1368-1(f)(2).

[480] Reg. §1.1368-1(f)(3).

[481] Reg. §1.1368-1(f)(5)(iv).

[482] This computation assumes a tax year beginning after December 31, 2017 and that the shareholder is not subject to §1411. For tax years prior to 2018, without the deemed dividend election, X would owe federal income tax of $396,000 and as a result of making the election X would owe $347,000.

[483] Reg. §1.1368-1(f)(5)(iii).

[484] Reg. §1.1368-1(f)(5)(iii).

[485] Reg. §1.1368-1(f)(5)(i).

[486] Reg. §1.1368-1(f)(5)(ii).

[487] Reg. §1.1368-1(f)(5)(iv). The former subchapter S rules also allowed an S corporation to elect to distribute accumulated E&P before PTI. The pre-SSRA regulations provided that to make this election, an election statement with signed shareholder consents had to be attached to a timely filed return. Pre-SSRA Reg. §1.1375-4(c). However, in PLR 9043010, an S corporation failed to attach a §1368(e)(3) election to its return. Nevertheless, the IRS, applying the pre-SSRA regulation, ruled that the corporation and its shareholders had substantially complied with the election requirement, and therefore, the corporation had successfully distributed its subchapter C E&P (now referred to in the Code as accumulated E&P) to avoid a tax on passive income. In this case, the corporation had reported the dividend distribution on its return and had issued a Form 1099-DIV to the shareholders. The shareholders in turn reported the dividend on their returns. Because these actions substantially complied with the election requirement, the IRS ruled that no formal election was necessary to effectuate the E&P distribution.

[488] Section 6(c)(1) of the Subchapter S Revision Act of 1982 provided that in the case of any corporation that on September 28, 1982, would have been a member of the same affiliated group as an electing small business corporation but for paragraph §1504(b)(3) or §1504(b)(7) of §1504(b) of the Code, subparagraph (A) of former §1361(b)(2) of such Code (as amended by §2) should be applied by substituting 'without regard to the exceptions contained in paragraphs (1), (2), (4), (5), and (6) of subsection (b) thereof' for 'without regard to the exceptions contained in subsection (b) thereof.'

[489] Former §921–§927; 1984 TRA, §805(b)(1)(A).

[490] *See* FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, §2.

[491] For a discussion of this issue, see 730 T.M., *S Corporations: Formation and Termination.*

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repatriated accumulated DISC income of a DISC subsidiary on the AAA of an S corporation parent. In Rev. Rul. 85-86, the IRS ruled that, because actual distributions of accumulated DISC income made after 1984 are to be treated as PTI within the meaning of §996(f)(2) (not PTI for §1368 purposes), an S corporation parent's AAA is increased by distributions from a pre-1984 TRA DISC subsidiary.

Comment: This ruling is significant because the AAA is increased by the PTI of the former DISC when the DISC subsidiary makes an actual distribution to the parent. The S corporation parent can make subsequent tax-free distributions of the repatriated accumulated DISC earnings out of the AAA to its shareholders.

7. AAA Adjustments for Redemptions and Reorganizations

a. Redemptions

In the case of a redemption that is treated as a sale or exchange of stock,[492] the AAA, whether negative or positive, is adjusted to reflect an amount equal to the ratable share of the S corporation's AAA attributable to the stock redeemed as of the redemption date.[493]

> *Example:* XYZ is an S corporation owned equally by B and C (unrelated shareholders). XYZ's AAA balance at the beginning of the year is $40,000. During that year, the corporation ratably earns $100,000, none of which is distributed to the shareholders. On June 30, XYZ redeems all of B's stock. XYZ's AAA is first increased to $90,000 ($40,000 + (6/12 × 100,000)) to reflect the increase in AAA through the date of redemption then it is decreased to $45,000 ($90,000 × 1/2) to reflect the redemption. XYZ's AAA at the end of the year is $95,000, the $45,000 remaining after the redemption plus the remaining adjustments attributable to the post redemption period.

The AAA is first adjusted for ordinary distributions before being adjusted for redemption distributions when both are made in the same year.[494]

> *Example:* On January 1, Year 1, ABC Corporation, an S corporation, has $200,000 of accumulated earnings and profits and an AAA balance of $100,000. ABC has two shareholders, G and H, each of whom owns 50 shares of S's stock. For Year 1, ABC generates taxable income of $160,000, which increases the AAA to $260,000 as of December 31, Year 1 (before taking into account distributions made during Year 1). On May 1, Year 1, ABC distributes $100,000 to each shareholder. On December 31, Year 1, ABC redeems for $500,000 all of shareholder G's stock in a redemption that is treated as a sale or exchange under §302(a). The sum of the ordinary distributions does not exceed ABC's AAA; therefore, ABC must reduce the $260,000 balance in the AAA by $200,000 for the May 1 ordinary distribution. The portions of the distribution by which the AAA is reduced are treated by the shareholders as a return of capital or as gain from the sale or exchange of property depending upon each shareholder's stock basis. ABC must adjust the remaining AAA, $60,000, in an amount equal to the ratable share of the remaining AAA attributable to the redeemed stock, or $30,000 (50% × $60,000). ABC also must adjust the earnings and profits by $100,000 (50% × $200,000), the ratable share of the earnings and profits attributable to the redeemed stock.[495]

Comment: While the example in the regulations illustrates the operative rules with post-distribution redemptions, it appears the same rules for adjusting AAA apply to redemptions occurring prior to ordinary distributions. The redemption rule requires adjustments to be made to the AAA *as of the date of the redemption,*[496] which intuitively would not contain adjustments for post-redemption distributions. The rule however does appear to be taxpayer favorable as AAA is irrelevant for determining the taxation of sale or exchange redemptions, while most taxpayers would prefer tax-free distributions of AAA.

If a former S corporation distributes cash in redemption of a shareholder's stock during the post-termination transition period and the distribution is characterized as a distribution under §301, the corporation reduces its AAA to the extent of the proceeds of the redemption.[497]

b. Reorganizations

Regulations discussing adjustments to AAA for reorganizations were not finalized until December 1993.[498] The IRS previously had issued private letter rulings stating that the AAA was a corporate account adjusted to reflect a reorganization (both divisive and acquisitive).[499] Reg. §1.1368-2(d)(2) and Reg. §1.1368-2(d)(3) continue this approach, stating that, in a reorganization involving a combination of S corporations, the AAA balances of the acquiror and target simply combine (even if either corporation's AAA balance is negative). This rule is simpler than the corresponding rules for combining E&P that prevent immediate combinations of positive and negative balances.[500] In divisive reorganizations (spin-offs, split-offs, or split-ups under §355), the AAA is divided in the same manner as E&P under Reg. §1.312-10(a), which generally states that E&P is allocated among the companies in relation to the fair market value of the respective corporations.

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[492] *See* §302(a), §303(a).

[493] §1368(e)(1)(b); Reg. §1.1368-2(d)(1)(i).

[494] Reg. §1.1368-2(d)(1)(ii).

[495] *See* Reg. §1.1368-3 *Ex.* 9 (ordinary and redemption distributions in same taxable year).

[496] Reg. §1.1368-2(d)(1)(i) (emphasis added).

[497] Rev. Rul. 2019-13.

[498] *See* T.D. 8508, 59 Fed. Reg. 12 (Jan. 3, 1994), *modified by* T.D. 8852, 64 Fed. Reg. 71,641 (Dec. 22, 1999), and T.D. 8869, 65 Fed. Reg. 3843 (Jan. 20, 2000).

[499] *See* PLR 9226079, PLR 9115059, PLR 9002051, PLR 8918080.

[500] §381(c)(2)(B). *See* PLR 9046036 (acquiring S corporation with positive AAA had to succeed to and take into account AAA of target S corporation in manner similar to that in which acquiring corporation succeeds to, and takes into account, E&P of distributor or transferor corporation under §381(c)(2)).

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8. *Elections to Terminate Year*

In certain circumstances, taxpayers may elect to treat one S corporation year as two or more separate taxable years for purposes of allocating income and determining the AAA balance at various points during the year. One opportunity is available under §1377(a)(2) upon a complete termination of a shareholder's interest.

A shareholder's interest is terminated in any event in which the shareholder ceases to own any stock of the corporation.[501] Such terminations include sales, redemptions, gifts, transfers pursuant to divorce, and death. A shareholder's interest is not considered terminated to the extent a shareholder retains ownership of any stock of the corporation that would cause the shareholder to continue to be considered a shareholder for purposes of §1362(a).[502]

An election under §1377(a)(2) is made by attaching a statement to a timely filed original or amended return for the tax year in which the shareholder's interest was terminated. The election must include:

- a declaration by the S corporation that it is electing under §1377(a)(2) and the regulations to treat the taxable year as if it consisted of two separate years;
- information setting forth when and how the shareholder's entire interest was terminated; and
- a statement by the corporation that each affected shareholder consents to the S corporation making the terminating election.[503]

An affected shareholder is generally any shareholder whose interest is terminated and any shareholder to whom such shares were transferred. In the case of a redemption, the term affected shareholder refers to all shareholders of the corporation for the year.[504]

Comment: Although the consent of the affected shareholder is not required to be attached to the election, it is advisable that the corporation obtain a signed written statement from each affected shareholder acknowledging consent to terminate the year, to avoid disputes later.

A corporation making an election to terminate a year under §1377(a)(2) must treat the taxable year as separate taxable years for all affected shareholders for purposes of allocating items of income, loss, deduction, and credits; adjusting the AAA, E&P, and basis; and determining the tax effect of distributions.[505] For purposes of §163(j), a separate limitation will apply to each separate tax year.[506] This election is irrevocable and can be made separately with respect to each shareholder termination occurring within a taxable year.

A second opportunity for separating a taxable year into two or more years arises upon a qualifying disposition. A qualifying disposition is defined as:

- a disposition by a shareholder of 20% or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's taxable year;
- a redemption treated as an exchange under §302(a) or §303(a) of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30-day period during the corporation's taxable year; or
- an issuance of an amount of stock equal to or greater than 25% of the previously outstanding stock to one or more new shareholders during any 30-day period during the corporation's taxable year.[507]

A corporation making an election under Reg. §1.1368-1(g)(2)(i) to terminate the year when there is a qualifying disposition must treat the taxable year as two separate taxable years for purposes of allocating items of income and loss; adjusting the AAA, E&P and basis; and determining the tax effect of distributions. Once a disposition is taken into account as part of a qualifying disposition, it is not taken into account in determining whether a subsequent qualifying disposition has occurred.[508]

The election in the case of a qualifying disposition is made for a taxable year by attaching a statement to a timely filed original or amended return.[509] The statement must state that the corporation is electing for the taxable year to treat the year as if it consisted of separate taxable years and must also set forth the facts relating to the qualifying disposition and state that each shareholder who held stock during the year consents to the election. For taxable years beginning after 2002, the statement is verified by signing the return to which the statement is attached. The election is irrevocable.[510]

Comment: Similar to the complete termination election, the consent of the shareholders is not required to be attached to the election; however, it is advisable that the corporation obtain a signed written statement from each shareholder acknowledging consent to terminate the year, to avoid disputes later.

If a transfer results in a termination of the shareholder's entire interest and the transfer is also a qualifying disposition under Reg. §1.1368-1(g)(2)(i), the terminating election rules under the §1377 regulations take precedence and a qualifying disposition election cannot be made.[511] If the termination of a shareholder's entire interest also results in a termination under §1362(d)(2), the corporation may not make the termination election.[512]

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[501] Reg. §1.1377-1(b)(4).

[502] Reg. §1.1377-1(b)(4).

[503] Reg. §1.1377-1(b)(5)(i). Former Reg. §1.1377-1(b)(5)(i) required elections to be signed under penalties of perjury by an officer of the corporation for taxable years beginning before 2003. For taxable years beginning after December 31, 2002, the election statement is verified by the signature on the Form 1120-S filed by the S corporation. Reg. §1.1377-1(b)(5)(i)(C).

[504] Reg. §1.1377-1(b)(2).

[505] Reg. §1.1377-1(b)(3)(i).

[506] Reg. §1.1377-1(b)(3)(ii), T.D. 9905, 85 Fed. Reg. 56,686 (Sept. 14, 2020) The §163(j) final regulations are generally applicable to tax years beginning on or after November 13, 2020; however taxpayers and their related parties could apply the final regulations to tax years beginning after 2017 so long as they did so consistently. For a discussion of the application of §163(j) to S corporations, see I.G., above.

[507] Reg. §1.1368-1(g)(2)(i).

[508] Reg. §1.1368-1(g)(2)(ii).

[509] Reg. §1.1368-1(g)(2)(iii).

[510] Reg. §1.1368-1(g)(2)(iii).

[511] Reg. §1.1377-1(b)(1).

[512] Reg. §1.1377-1(b)(1).

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Shareholders may also elect to assign income and loss to an S short year and a C short year under normal tax accounting rules in the case of an S termination year.[513] Taxpayers must assign income in this manner if there is a change in ownership in the corporation of 50% or more in an S termination year.[514] The AAA is allocated between the two short years in a manner consistent with the manner in which income for the year is allocated.[515]

9. Post-Termination Transition Period Distributions

Any S corporation earnings that have not been previously distributed can be distributed tax-free to shareholders after termination of S status during the post-termination transition period (PTTP). A PTTP distribution can only be made tax free if it is made in cash and does not exceed the AAA balance as of the termination.[516]

The PTTP is:

- the period which begins the day after the last day of the corporation's last taxable year as an S corporation and ends on the later of (i) the day one year later; or (ii) the due date, including extensions, for filing the last S corporation return,
- the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period, and
- the 120-day period beginning on the date of a determination that the corporation's S election had terminated for a previous taxable year.[517]

For further discussion of the post-termination transition period, see 730 T.M., *S Corporations: Formation and Termination.*

10. ETSC Period Distributions

The period that shareholders of an eligible terminated S corporation (ETSC) may benefit from the AAA following the PTTP was extended.[518] An ETSC is a C corporation that was an S corporation on December 21, 2017 and both: (i) voluntarily revoked its election during the two-year period beginning on December 22, 2017 and ending on December 23, 2019, and (ii) the S corporation had the same shareholders (with the same ownership proportions) on December 22, 2017 and the day of the revocation.[519] For ETSCs, cash distributions following the PTTP are treated as made from the AAA and are chargeable to the accumulated earnings and profits (AE&P) in the same ratio the AAA bears to the AE&P. The ETSC period begins on the first day after the PTTP and ends on the date the ETSC's AAA reaches zero.[520]

For further discussion of the ETSC period, see 730 T.M., *S Corporations: Formation and Termination.*

11. Summary of Operating Distribution Rules for S Corporations with Accumulated E&P

In the case of an S corporation with accumulated E&P, the default order and treatment of distributions to shareholders is:

- Step One — a tax-free distribution (with a downward stock basis adjustment) to the extent of the S corporation's AAA determined under §1368(e). If the distribution exceeds stock basis, but not the AAA, capital gain will generally result (§1368(c)(1));
- Step Two — a tax-free distribution (with a downward stock basis adjustment) to the extent of any PTI earned in former subchapter S years and remaining stock basis (exclusive of any amount distributed under (1), above), but only if made in cash (§1379(c));
- Step Three — a dividend to the extent of the corporation's accumulated E&P (but no downward stock basis adjustment) (§1368(c)(2));
- Step Four — a reduction in stock basis (§1368(c)(3)); and
- Step Five — as proceeds from the sale or exchange of property once stock basis is exhausted (§1368(c)(3)).

D. Accumulated Adjustments Account

1. Definition and Adjustment Ordering

For S corporations with accumulated E&P, the accumulated adjustments account (AAA) tracks the corporation's ability to make tax-free distributions to shareholders. The AAA represents the earnings of the corporation that have been previously taxed to shareholders for all S years, less any amounts already distributed, i.e., the AAA is generally the accumulation of previously taxed, but undistributed, earnings of the S corporation. Therefore, to the extent the corporation has a positive balance in the AAA, tax-free distributions can be made to shareholders (limited to stock basis). Under Reg. §1.1368-2(a)(1), the AAA is an account of the S corporation and is not apportioned in any manner to the shareholders.

Section 1368(e)(1) defines the AAA as an account of the S corporation[521] that is adjusted during the S period in a manner similar to basis under §1367, except that the AAA is not adjusted for tax-exempt income and related expenses.[522] The balance of the AAA at year end is important in that it represents the extent to which distributions made during the year can be distributed tax free to shareholders. The S period is the most

[513] §1362(e)(3); Reg. §1.1362-3(b)(1).

[514] §1362(e)(6)(D).

[515] For a more detailed discussion on this election, see 730 T.M., *S Corporations: Formation and Termination.*

[516] *See* §1371(e).

[517] Reg. §1.1377-2(a).

[518] §1371(f).

[519] §481(d)(2). *See also* Reg. §1.1362-2(a)(2)(iii), T.D. 9914, 85 Fed. Reg. 66,471 (Oct. 20, 2020) (providing for the application of §7503 (Saturday, Sunday, or legal holiday rule) to revocations of S corporation elections).

[520] Reg. §1.1371-1(a)(2)(vii), T.D. 9914. Special rules apply in the case of a PTTP that arises after a determination pursuant to an audit. *See* Reg. §1.1371-2, T.D. 9914.

[521] The AAA is an account of the S corporation and is not apportioned in any manner to the shareholders of the corporation. Reg. §1.1368-2(a)(1).

[522] As enacted by SSRA, §1368(e) did not require that the AAA be reduced for nondeductible items; however, the 1984 TRA, §721(r)(1), amended §1368(e) to reduce the AAA for nondeductible items.

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recent continuous period of taxable years (excluding years beginning before 1983) during which the corporation has been an S corporation.[523] If an S election terminates, distributions may be taken tax free to the extent a balance exists in the AAA.[524] Furthermore, cash distributed during the post-termination transition period in redemption of a shareholder's stock reduces the AAA balance to the extent of the proceeds of the redemption.[525] The IRS has stated that any AAA remaining at the end of a post-termination transition period will disappear and the AAA balance would be zero upon a subsequent re-election of S status by the S corporation.[526]

The IRS's position is subject to debate. Reading §1368(e)(1) and §1368(e)(2) together, one could interpret that the statute merely intends that the corporation's AAA will not be adjusted during any period that the corporation is not an S corporation. Reg. §1.1368-2(a)(1) states that on "the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero." If a C corporation elects S status for the first time, then the first day of the first year for which the corporation is an S corporation will depend on when the S election is made, whether within the first two and one-half months of its taxable year or not. Reg. §1.1368-2(a)(1) clearly states that the AAA balance is zero on that date because it is the first day of the *first year* for which the corporation is an S corporation. If a C corporation has a prior history of S status and reelects S status, it is not clear that this regulation applies to define AAA as zero. That is, if a C corporation has a prior history of S status and reelects S status, the effective date of the S election is not the first day of the *first year* for which the corporation is an S corporation. This interpretation would lead to a position where the AAA balance would include balances from prior subchapter S periods. This position is supported by the enactment of §1371(f) that clearly continues a AAA for subchapter C years following S termination.

The AAA is adjusted in the following manner:[527]

• Step One — increased for separately and nonseparately stated income (other than tax-exempt income) and for the excess of depletion deductions over the basis of the property subject to depletion,

• Step Two — decreased, but only to the extent of the increases in (1) above, for separately and nonseparately stated loss or deduction items, nondeductible expenses (other than federal taxes attributable to any C corporation years and expenses related to tax exempt income), and shareholders' depletion deductions,

• Step Three — decreased for distributions that are tax free under §1368(b) or §1368(c)(1),

• Step Four — decreased, for separately and nonseparately stated loss or deduction items, nondeductible expenses (other than federal taxes attributable to any C corporation years and expenses related to tax-exempt income), and shareholders' depletion deductions in excess of (1) above, and

• Step Five — decreased or increased (as appropriate) for any redemptions distributions qualifying under §302(a) or §303(a).

These rules conform the distribution rules for S corporations to those of partnerships, thus shareholders can make distributions to the extent of the year's opening AAA balance tax free regardless of the operations of the company for the year.

Example: B, the sole shareholder of XYZ, a calendar-year S corporation, has $1,000 in basis in XYZ stock. On January 1, XYZ has AAA of $1,000 and accumulated E&P of $500. During the tax year, XYZ distributes $600 to B, recognizes a capital gain of $200 and an operating loss of $900. XYZ's AAA is first increased by $200, the capital gain. It is then decreased by $200, the amount of its loss items but only to the extent of income items under Reg. §1.1368-(2)(a)(5)(ii). The AAA is then reduced by the $600 distribution, all of which can be made from AAA. Finally, the AAA is reduced by the remaining deduction items of $700. As a result, XYZ has a deficit in AAA of $300 at the end of the tax year. As to B, the $600 distribution is a tax-free distribution of XYZ's AAA, with no dividend of accumulated E&P.[528]

B's stock basis is adjusted in the following manner:

• increased by $200, the items of income, to $1,200,[529]

• decreased by $600, the distribution sourced from AAA, to $600,[530] and

• decreased by $600, the items of loss and deduction to the extent of basis.[531] The remaining $300 of the $900 operating loss is suspended.[532]

Comment: Under the rules in effect for pre-1997 tax years, in the example above, XYZ's AAA was increased first by the $200 capital gain to $1,200, then reduced by the $900 operating loss resulting in a $300 balance. The AAA was then reduced by $300, the lesser of the distribution or the remaining AAA, to zero. Of the distribution, $300 was tax-free from AAA and $300 was taxable as a dividend.[533] Although the change in ordering AAA adjustments may have been intended to be favorable to the taxpayer, in most circumstances, it will actually be detrimental, especially given the current preferential tax rate on dividends. The net effect of the change was to allow taxpayers to receive distributions tax free at the expense of delaying the ability to utilize losses or deductions generated by the S corporation. Prior to the change, a shareholder would have utilized basis to absorb losses and then recognized income in the form

[523] §1368(e)(2).
[524] §1371(e).
[525] *See* Rev. Rul. 2019-13.
[526] In CCA 201446021, the Chief Counsel's Office advised that §1368(e)(2), which defines "S period" as the most recent continuous period during which a corporation has been an S corporation, requires that an AAA balance be reset at the end of a post-termination transition period and that the AAA balance is zero after a corporation reelects S corporation status after an intervening C corporation period.
[527] Reg. §1.1368-2(a)(5).
[528] Reg. §1.1368-3 *Ex.* 5.
[529] Reg. §1.1367-1(f)(1).
[530] Reg. §1.1367-1(f)(2).
[531] Reg. §1.1367-1(f)(4).
[532] §1366(d)(1).
[533] Reg. §1.1368-2(a)(4).

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of a dividend or distribution in excess of basis. If those losses were ordinary, they would have been able to offset other ordinary income of the shareholder at ordinary income tax rates. The distribution under current law would be taxed at 20% either as a dividend or capital gain. After the change, the distribution is received tax free; however, the shareholder must generally wait until future years when basis is restored before utilizing any suspended losses and deductions. Prior to the reduction in the tax rate on dividends, the ordering rule change was generally neutral at best. A taxpayer would have been able to deduct operating losses (at ordinary rates) while recognizing dividend income (taxed at ordinary rates) if the S corporation had accumulated E&P under the old rules. After the change, shareholders receive a tax-free distribution generally with a corresponding increase in suspended losses (due to the basis reduction for the tax-free distribution). Alternatively, prior to the change in the ordering rule, if the S corporation did not have accumulated E&P, shareholders would have been able to deduct (at ordinary rates) operating losses that passed through to them while recognizing gain under §302(c)(2) taxed at capital gains rates of 28% for distributions in excess of basis.

Unlike basis, losses and deductions of the S corporation may cause the AAA to become negative, in which case future income must be used to restore the negative balance before tax-free distributions can be made.[534] This rule applies even if the losses and deductions cannot be currently utilized by shareholders due to inadequate stock or debt basis.

If an S corporation that is subject to the built-in gains tax utilizes subchapter C NOL carryovers to reduce its built-in gain, any NOLs so utilized have no effect on the AAA. The NOLs are taken into account only for purposes of determining the corporation's built-in gain subject to tax.

2. *Tax-Exempt Income*

Tax-exempt income and related deductions earned by an S corporation will not increase or decrease the AAA.[535] Thus, if the S corporation distributes all of its S corporation earnings, including those from tax-exempt sources, the shareholders will recognize dividends if the corporation has accumulated E&P to the extent of the tax-exempt income. S corporations with accumulated E&P may wish to avoid holding tax-exempt obligations so that they will not find themselves in this position. Consideration should be given to making property distributions to the shareholders of tax-exempt obligations held by the corporation. Note, however, that distributions of appreciated property may result in taxable gain to the S corporation under §311.

By not increasing AAA for tax-exempt income, C corporations cannot avoid dividend distributions by converting to S status, investing in tax-exempt obligations, and distributing the earnings from the tax-exempt obligations. In addition, the fact that tax-exempt income is considered to be passive income for purposes of the passive income rules[536] further harms S corporations with accumulated E&P that carry tax-exempt obligations.

[534] Reg. §1.1368-2(a)(3)(ii).

[535] §1368(e)(1)(A); Reg. §1.1368-2(a)(2)(i), Reg. §1.1368-2(a)(3)(i)(C)(2). *See, e.g.*, PLR 201440013 (subaward from low-income housing tax credit program not included in AAA).

[536] *See* Reg. §1.1362-2(c)(5)(ii)(D).

3. *Nondeductible Expenses*

The rules for adjusting AAA closely follow the stock basis rules (with the exception for adjustments for tax-exempt income and related expenses); therefore, AAA is reduced by any expense of the S corporation "not deductible in computing its taxable income and not properly chargeable to a capital account."[537] As a result, for S corporations with accumulated E&P and large nondeductible expenses, distributions have a greater chance of being taxed as dividends.

Under Reg. §1.1367-1(c)(2), noncapital, nondeductible expenses generally include bribes and kickbacks, nondeductible fines and penalties, expenses and interest relating to tax-exempt income, losses with respect to transactions between related taxpayers for which the deduction is disallowed, the disallowed portion of meal and entertainment expenses, and the nondeductible portion of damages paid for antitrust violations.[538] Arguably, foreign taxes might also be considered nondeductible expenses as they are expenses of the S corporation but the shareholder makes the determination of whether to deduct the items or claim a credit.

Federal income taxes attributable to subchapter C years (including any LIFO recapture tax), but paid during S corporation existence, do not reduce the AAA.[539] It would appear appropriate to reduce accumulated E&P for such taxes given that they cannot reduce AAA; however, §1371(c) provides only limited situations where accumulated E&P can be adjusted by an S corporation, none of which deal with the payment of subchapter C taxes.[540] Any corporate-level tax paid under §1374 or §1375 would, however, reduce AAA. If accumulated E&P is not adjusted, then the payment of such taxes by the S corporation might simply be reflected as a reduction to shareholder basis.

Any state or local income taxes assessed directly against an S corporation on its income would generally be included in line 1 of the schedule K net income number and will indirectly reduce both the AAA and shareholder basis.

In Rev. Rul. 2008-42, the IRS ruled that premiums paid by an S corporation on an employer-owned life insurance contract of which the S corporation is directly or indirectly a beneficiary do not reduce the AAA. The IRS noted that under §264(a)(1), no deduction is allowed for premiums paid on any life insurance policy with respect to which the taxpayer is directly or indirectly a beneficiary, and that Reg. §1.264-1(a) explicitly provides that premiums on the life of a key person in the taxpayer's business are not deductible where the taxpayer is directly or indirectly a beneficiary under the policy.

4. *Negative AAA*

Although AAA is adjusted in a manner similar to basis, unlike stock basis, AAA can become negative. AAA can only

[537] §1367(a)(2)(D); Reg. §1.1368-2(a)(3)(i)(C).

[538] For further discussion, see 732 T.M., *S Corporations: Shareholder Tax Issues*, II.A.1.c.(2), above. The partnership rules also give some guidance in determining which nondeductible items reduce the AAA. *See* Reg. §1.705-1(a)(3)(ii).

[539] §1368(e)(1)(A); Reg. §1.1368-2(a)(3)(i)(C)(1).

[540] §1371(c)(1). *See also Cameron v. Commissioner*, 105 T.C. 380 (1995), *aff'd sub nom., Broadway v. Commissioner*, 97-1 USTC ¶ 50,355 (8th Cir. 1997).

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become negative (or be made more negative) due to loss and deduction items. Distributions in excess of AAA will not cause the AAA balance to go negative.[541] If AAA becomes negative, the S corporation must generate future income in an amount in excess of the negative balance before tax-free distributions can be made.

Comment: When an S corporation makes distributions in a year where the income is not sufficient to restore a beginning negative AAA balance, shareholders are, in essence, double taxed: once on the flow through of earnings and a second time on the distribution either as a dividend or as a sale or exchange. This double tax could be avoided if the current year earnings were permitted to be distributed apart from the prior year's negative AAA.

Since AAA is a corporate-level account and independent of shareholder basis, the AAA is decreased by deduction items even if such items are suspended at the shareholder level by §1366(d)(1).[542] When a shareholder generates basis to absorb a suspended loss, no further adjustments are made to the AAA for the loss absorption.[543]

In general, the AAA is determined at the close of the S corporation's year.[544] Thus, if an S corporation has a negative AAA balance at the beginning of the year, distributions made during the course of the corporation's year can be made tax free to shareholders as long as at the close of the S corporation's year there is sufficient positive AAA (before taking into account the distribution). It is only when the year-end balance in the AAA is negative that problems in making tax-free distributions out of S corporation earnings may arise.

Comment: Note that a distribution will not necessarily be tax free if the corporation declares the distribution in a year in which the AAA is positive but there is a loss for the year and the company does not make payment until the following year. This occurs because a distribution is taken into account on the date the corporation makes the distribution.[545] A previous IRS ruling indicates that the corporation is considered to have made the distribution on the date a distribution is paid.[546] Consequently, the taxability of the distribution is determined based on the balance in the AAA at the end of the year in which the distribution is paid.

The income tax accounting rule for adjusting the AAA is different from the financial statement reporting rules. The declaration of a distribution will create a liability that is accrued on financial statements. However, the financial statement rule does not control the tax accounting for the distribution.

5. *Distributions Contingent in Amount*

Frequently, distributions are made just before the close of the S corporation's tax year, at a time at which the year's actual closing AAA balance is unknown. If too large a distribution is taken at that time, the shareholders risk a distribution out of accumulated E&P. To avoid this result, the corporation could make distributions throughout the year contingent on not exceeding the year's actual closing AAA balance. If the contingency creates under local law an obligation on the shareholders to repay any excess distributions, this contingency may act to protect the shareholders from potentially taxable distributions. From a federal income tax perspective, it is not clear how this issue would be resolved. If local law acknowledges that contingent distributions create a liability from the shareholders back to the corporation, then a realistic possibility exists, in the absence of further guidance from the IRS, that loans rather than distributions were made to the shareholders for any excess payments. Alternatively, in connection with declaring the distribution, the corporation could require any distributions in excess of the closing AAA balance would be required to be returned to the corporation with appropriate interest from the date of the distribution. Another alternative would be to lend funds to shareholders and then to the extent there was sufficient AAA, such loans could be forgiven in the subsequent year. Under Reg. §1.301-1(k) a cancellation of shareholder debt by a corporation is treated as a distribution. This later approach may be the safest given the higher degree of certainty of establishment of a liability that reduces the amount of a distribution.

6. *Distributions in Excess of AAA*

Since the AAA balance cannot be determined until year end and distributions are often made throughout the year, it is not uncommon for taxpayers to find themselves in a position where distributions have exceeded the AAA. When such circumstances arise, §1368(c) provides that the AAA is allocated pro rata to all distributions during the year based on the relative value of each distribution to the total amount of distributions Specifically, Reg. §1.1368-2(b) provides that a portion of AAA is allocated to each distribution if:

- the S corporation makes more than one distribution of property with respect to its stock;
- the AAA has a positive balance at the close of the year (before taking into account distributions); and
- sum of the distributions made during the corporation's taxable year exceeds the balance of the AAA at the close of the year.

Where these conditions are met, the amount of AAA allocated to each distribution equals:

> The AAA balance at the close of the taxable year (without regard to any distributions) multiplied by a fraction, the amount of the distribution divided by the total of all distributions made during the year.

For this purpose, all distributions does not include distributions treated as from E&P or PTI pursuant to the §1368(e)(3) election to distribute E&P first.

Because of this allocation rule, where an S corporation has E&P and makes distributions in excess of AAA, a portion of each distribution will be tax free and a portion will be taxable as a dividend.[547]

[541] Reg. §1.1368-2(a)(3)(ii), §1.1368-2(a)(3)(iii).
[542] Reg. §1.1368-2(a)(3)(ii).
[543] Reg. §1.1368-2(a)(3)(ii).
[544] *See* Reg. §1.1368-2(a)(4).
[545] Reg. §1.1368-1(b).
[546] Rev. Rul. 62-131, (ruling that the date of payment rather than the date of declaration determines whether a distribution comes out of a C corporation's accumulated E&P).

[547] This treatment of distributions is based on an analogy to subchapter C under Reg. §1.316-2(b), which apportions distributions between current and accumulated E&P.

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7. Effect of Stock Transfers on the AAA

Absent a closing of the books election, transfers of S corporation stock during a year generally will not have a significant impact on either selling or purchasing shareholders since §1368(c) requires a proportionate allocation of AAA to the distributions made during a year. In other words, absent a closing of the books election, a selling shareholder cannot minimize taxes by making distributions of AAA prior to a sale in order to prevent the buying shareholder from receiving any distributions sourced from AAA in the same year as the sale.[548] Thus, although the balance in the AAA cannot be directly transferred to a purchasing shareholder (because it is a corporate-level account that is not apportioned among shareholders),[549] the purchasing shareholder nevertheless benefits from a positive balance in the AAA that exists before the purchase.[550]

Comment: In the case of a sale of a shareholder's complete interest in an S corporation, a selling shareholder generally realizes no tax benefit by making tax-free distributions of the positive AAA balance before selling the stock. Since the distribution of AAA reduces the shareholder's stock basis and presumably the stock's selling price in an equal amount, the cash/tax effects to the selling shareholder are often the same.

As discussed in II.C.8., above, if either a complete termination of interest or qualifying disposition occurs, the corporation may elect to compute the AAA as if the taxable year consisted of two separate years, the first of which ends on the day on which the shareholder's interest terminated or the qualifying disposition occurred.[551] This means that any distributions up through the date of termination are allocated pro rata to all shareholders on the termination date. If distributions exceed the AAA on the termination date, the AAA is allocated to each distribution based on its relative value under §1368(c). The AAA as of the close of the corporation's actual tax year (taking into account any adjustments for distributions or redemptions occurring prior to the termination date or qualifying disposition) is then allocated to distributions occurring after the termination date.[552]

If the transferee-shareholder is an ineligible shareholder, the tax treatment of distributions during the post-termination transition period is not completely clear. A new ineligible shareholder will terminate the corporation's S status.[553] During the post-termination transition period (PTTP), under §1371(e)(1), tax-free distributions of money can be made to shareholders out of the AAA. In tax years beginning on or before October 20, 2020, a no-newcomer rule provided that only those shareholders who were shareholders of the S corporation at the time of the termination were eligible to receive the special treatment under §1371(e)(1).[554] Thus, the benefit of tax-free distributions out of AAA during the PTTP appeared not to be available to any transferee-shareholder before repeal of the no-newcomer rule. To avoid the problem, the transferor-shareholders may have made a distribution of the AAA before they transferred their stock, thereby reducing its value, and effectively giving both the transferor- and transferee-shareholders tax-free distributions. Otherwise, they may have considered trading their stock ex-dividend under local law which would allow them to claim any distributions declared but unpaid before the transfer. When received, the distribution would be treated as capital gain because, under §1371(e)(1), distributions during the PTTP are applied against basis (of which the transferor shareholder has none). The repeal of the no-newcomer rule should eliminate the need for this type of tax planning, as nothing in the regulations as currently written limit the benefits of the PTTP to eligible shareholders.

For further discussion of the post-termination transition period, see 730 T.M., *S Corporations: Formation and Termination*.

8. Form 1120-S Reconciliation

The instructions to Form 1120-S require all S corporations to complete the Schedule M-2. Schedule M-2 reconciles changes to the AAA, the other adjustments account (OAA), and the undistributed previously taxed income (PTI) account. Although all S corporations are required to complete Schedule M-2, S corporations without E&P are only recommended to maintain a AAA. Since AAA is not adjusted for tax-exempt income or expenses incurred to generate such income, those items, as well as the payment of any federal income tax attributable to C corporation years, are reflected in the OAA.

Comment: The Form 1120-S Schedule M-2 balances do not need to be reconciled to the Form 1120-S Schedule L Balance Sheet equity items. Some tax preparers provide this service as a control between book and tax records; however, it is not required by the IRS, and the reconciliation need not be attached to the income tax return.

As explained earlier, the AAA provides a tracking mechanism for the corporation's S earnings, representing an amount generally equivalent to the corporation's income for all S corporation years (beginning after 1982) that has been taxed to shareholders, less the amount of such income distributed to shareholders in prior years. The AAA is significant because, to the extent the corporation has a positive balance in the account, tax-free distributions generally can be made to shareholders.

The OAA provides for adjustments of nontaxable income and related expenses, e.g., excluded extraterritorial income, tax-exempt interest, life insurance proceeds, and expenses associated with these items.

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[548] However, transfers of S corporation stock during the year could leave a number of unanswered questions with respect to basis and flow-through of income and loss items. *See* 732 T.M., *S Corporations: Shareholder Tax Issues*, II.

[549] Reg. §1.1368-2(a)(1).

[550] This contrasts with the treatment of the PTI of a pre-SSRA S corporation, which is personal to each shareholder and is lost when a shareholder transfers his shares. Pre-SSRA Reg. §1.1375-4(e).

[551] Reg. §1.1368-1(g)(1). For further discussion of this election, see II.C.8., above.

[552] *See* PLR 8842024 (AAA year-end determination does not apply if shareholder terminates interest and corporation makes §1377(a)(2) election to close books).

[553] *See* §1362(d)(2), §1361(b).

[554] *See* Reg. §1.1377-2(b), before amendment by T.D. 9914, 85 Fed. Reg. 66,471 (Oct. 20, 2020). A corporation may apply the removal of the no-newcomer rule to earlier tax years with respect to which the §6501(a) limitation on assessment has not expired. If the corporation chooses to apply current Reg. §1.1377-2(b) early, all shareholders must report consistently. Reg. §1.1377-3(c)(2).

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The shareholders' PTI is the amount of PTI earned under the former subchapter S rules (years beginning before 1983) that has not yet been distributed.

E. Distributions to Shareholders of Fiscal Year S Corporations

Generally, distributions by a fiscal year C corporation are treated as taxable dividends to the shareholders in the year in which the shareholders receive them, even though the corporation's current E&P cannot be determined until year end.[555] In comparison, partnership advances or drawings of money or property against a partner's distributive share of income are treated as current distributions made as of the last day of the partnership's taxable year.[556] Determination of the tax treatment of a distribution made by a fiscal year S corporation is not entirely clear.

The S corporation's AAA generally is determined at the corporation's year end.[557] Shareholders must be able to determine the tax consequences of the distribution in the year received since the regulations state that distributions are taken into account on the date the corporation makes the distribution.[558] Given the somewhat contradictory rules, it follows that shareholders will not always be able to determine the taxability of distributions received from an S corporation if the corporation's tax year in which the distribution was made ends after the shareholder's year. The following example illustrates the dilemma for a shareholder of a fiscal year S corporation:

> *Example:* XYZ is an S corporation with a September 30 year end. On December 1, Year 1, after two months of profitable operations, XYZ makes a distribution to B, its sole shareholder. Should B include the distribution in their Year 1 tax return (when the distribution was received), or in Year 2 (after the corporation completes its year ending September 30, Year 2 and the AAA balance can be accurately determined)?

Practice Point: In such a situation, a conservative approach may be to close the books for tax purposes at December 31, in order to determine the AAA balance and the tax consequences to the shareholder for the December 1 distribution. Any correction based on the actual activities of the company could be reflected on the shareholder's succeeding tax return. Assuming this approach results in income recognition, it may be conservative in that the taxation of the distribution is determined in the year the distribution is received as opposed to relying on the open transaction doctrine and determining the taxation of the distribution in a subsequent tax year.

F. Property Distributions

Similar to a C corporation, the distribution of appreciated property by an S corporation will require the recognition of gain under §311 or §336. As discussed in I.G.1., above, the application of these two sections of subchapter C to subchapter S is not inconsistent.

The recognition of a corporate-level gain on the distribution of appreciated property occurs regardless of the tax treatment of the distribution at the shareholder level (i.e., if sourced from AAA, E&P, or a recovery of stock basis). The AAA is decreased by the fair market value of the property distributed.[559] Because the distribution of appreciated property is treated as a sale of the property by the corporation, any depreciation (§1245 or §1250) or investment credit recapture inherent in the asset is triggered.

If appreciated property subject to a liability is distributed to shareholders, for purposes of determining the gain under §311 or §336, the fair market value of the property cannot be less than the amount of the liability.[560] Any gain recognized using this measure of fair market value then increases the AAA and flows through to increase shareholder basis. The AAA is decreased by the net of the property's fair market value and its associated liability.[561] The amount received by the taxpayer is also reduced by any liabilities to which the property was subject or otherwise assumed by the taxpayer.

The gain recognized by the corporation will reflect the property's character in the hands of the corporation.[562] If appreciated inventory is distributed to shareholders, the corporation recognizes ordinary income, and the shareholders take a fair market value basis in the inventory received. If depreciable property is distributed to a shareholder who owns more than 50% of the S corporation stock, §1239 converts what would otherwise be capital gain to ordinary income.

Distributions of appreciated property also could affect the tax on passive income under §1375 or the built-in gains tax under §1374 if the capital gain recognized on the distribution is significant. Recapture under §1245 or §1250, as well as investment credit recapture, may also need to be recognized when depreciable property is distributed.

In the case of a distribution of depreciated property, corporations are prohibited from recognizing loss under §311(a). In PLR 8908016, an S corporation distributed appreciated and depreciated passive income property to reduce its exposure to a termination under §1362(d)(3). The IRS ruled that the distributing corporation would recognize gain under §311(b) on the distribution of appreciated property but no loss would be recognized with respect to the depreciated property distributions. Further, the amount of the distribution was determined to be the total of any cash and the fair market value of any property distributed. Although not stated in the ruling, the AAA would be reduced by the fair market value of the distribution.

Comment: The effect on AAA for any loss not recognized under §311 is not entirely clear. As the loss is not recognized,

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[555] §6042(b)(3); Reg. §1.316-2(b). For a fiscal year subchapter C corporation, if current E&P are not known, the E&P for the year in which the distribution is made is prorated to the date of distribution not counting the date on which the distribution was made, making many mid-year distributions taxable as dividends. Rev. Proc. 75-17, provides guidance in determining the taxable status of corporate distributions to stockholders and data to be furnished to the IRS.

[556] Reg. §1.731-1(a)(1)(ii).

[557] *See* Reg. §1.1368-2(a).

[558] Reg. §1.1368-1(b).

[559] *See* §312(a), §312(b); Reg. §1.1368-2(a)(3)(iii).

[560] §311(b)(2), §336(b). *See also* §7701(g).

[561] *See* §301(b)(1), §301(b)(2).

[562] *See* §311(b).

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there is no item of deduction or loss to cause a basis reduction. The IRS has expressed its view in CCA 201421015. In the CCA, the IRS concluded that losses disallowed under §311(a) are treated as noncapital, nondeductible expenses which reduce shareholders' stock basis and require S corporations to reduce its AAA. If a distribution of depreciated property by an S corporation results in a loss disallowed under §311(a) and requires a stock basis reduction, that loss is permanently lost to the individual because the distributee-shareholder's basis in the distributed property is limited to its fair market value. CCA 201421015 appears contrary to the IRS's position in *Ball v. Commissioner*[563] where the IRS successfully argued that an amount not recognized by an S corporation (i.e. gain under §332) is not an item that passes through to shareholders to increase stock basis. If gain not recognized under §332 is not an item that adjusts stock basis, it seems to follow that loss not recognized under §311(a) should similarly not be an item that adjusts stock basis.

Reg. §1.1368-2(c) addresses the situation where the corporation distributes money and other property, the adjusted basis of which exceeds its fair market value on the date of the distribution, where the distribution exceeds the amount of the corporation's AAA properly allocable to the distribution.[564] This regulation also suggests that no reduction to AAA is made for the nonrecognized loss as it requires a reduction for the fair market value of the distribution. The following formula demonstrates this concept:

$$\text{Amount of AAA Allocable to Loss Property} = \text{Amount of AAA Allocable to Total Distribution} \times \frac{\text{FMV of Loss Property}}{\text{FMV of Distribution}}$$

Comment: It seems strange to apply Reg. §1.1368-2(c) only when money and depreciable property is distributed. This application leaves a gap where appreciated and depreciated property are distributed but no money is distributed. The logic of the rule found in Reg. §1.1368-2(c) ought to also apply in such an instance.

G. Disproportionate Distributions

S corporation income or loss items must be allocated on a pro rata basis to shareholders as required by §1377(a). There is nothing in the statute that requires distributions to be made on a proportionate basis to shareholders. Implicit in the single class of stock requirement of §1361(b)(1)(D) and clearly stated in the regulations is that all shareholders must have equal rights to distributions; thus meaning disproportionate distributions may threaten continued S corporation status.[565] However, the IRS has stated that it will not treat disproportionate distributions as violating the single class of stock requirement so long as the corporation's governing provisions provide for identical distribution and liquidation rights.[566] For a more complete discussion of the effect of disproportionate distributions, see 730 T.M., *S Corporations: Formation and Termination.*

Comment: While distributions should be made proportionate to ownership interests, that does not necessarily mean each shareholder must receive a proportionate amount of each asset distributed. The fact that one shareholder receives a distribution in kind while another receives cash does not create a second class of stock so long as the amount of money and the fair market value(s) of the asset(s) distributed to each shareholder are proportionate to their ownership interests.

H. Former Subchapter S Corporation Tax-Free Distributions

1. Distributions Attributable to Prior Year

a. Qualifying Distributions — General Requirements

Pre-SSRA §1375(f) generally permitted the tax-free distribution, within two months and 15 days after the close of a subchapter S corporation's taxable year, of amounts equal to the constructive dividends taxed to its shareholders on the last day of such taxable year.[567] This grace period alleviated the burden of trying to estimate and distribute the corporation's taxable income prior to the end of the taxable year. The corporation could determine its taxable income and then decide how much of the income should be distributed. A distribution qualified under pre-SSRA §1375(f) if it met the following requirements:[568]

- it was an actual distribution of money and not property;
- it was made by a corporation that was a subchapter S corporation for its immediately preceding taxable year;
- it was made within two months and 15 days of the close of such taxable year;
- it was made to a person who was a shareholder of the corporation on the last day of such taxable year; and
- when added to all prior money distributions made to such shareholder within such two and one-half month period, it did not exceed the amount of the constructive dividend taxed to the shareholder under pre-SSRA §1373(b) on the last day of such taxable year.

If the above requirements were met, a money distribution made during the two and one-half month period was automatically treated as a nondividend distribution under pre-SSRA §1375(f). However, any money distributed during such period, in excess of the amount of the constructive dividend taxed to a shareholder, or any distribution of property during such period, produced the same consequences as a distribution outside such period.

[563] 742 F.3d 552 (3d Cir. 2014), *aff'g* T.C. Memo 2013-39.

[564] *See* PLR 9444048.

[565] Reg. §1.1361-1(l).

[566] Rev. Proc. 2022-19, §3.02. The IRS will not issue a PLR addressing these situations. Rev. Proc. 2026-3, §3.01(111), Rev. Proc. 2022-19, §4.01(2)(a).

[567] In *E-B Grain Co. v. Commissioner*, 81 T.C. 70 (1983), the Tax Court held that when the last day of the grace period falls on a Saturday, Sunday or legal holiday, the last day for performance under the statute extends to the next succeeding day which is not a Saturday, Sunday, or legal holiday under §7503.

[568] Pre-SSRA Reg. §1.1375-6(a)(2).

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b. Effects of Qualifying Distribution

A qualifying distribution was treated as a distribution which was not a dividend, and reduced the recipient shareholder's basis in their stock (which basis was increased by the amount of the constructive dividend included in income for the prior year) to the extent thereof. The E&P of the corporation that made a qualifying distribution was not reduced by the distribution.[569] This is because the accumulated E&P of the corporation was already reduced by the amounts of the constructive dividends included in income by shareholders.

Comment: Because accumulated E&P was reduced by dividends (actual and deemed), pre-SSRA subchapter S corporations did not generate much accumulated E&P. Earnings and profits were generated where the calculation of accumulated E&P differed from the calculation of the income, e.g., tax-exempt income was not included in taxable income but did increase accumulated E&P.

c. Nontransferability of Right to Receive Qualifying Distributions

A shareholder's right to receive nondividend distributions under pre-SSRA §1375(f) was personal and nontransferable. Thus, if a shareholder transferred all or a part of their stock in the corporation, their share of the corporation's undistributed taxable income was not reduced by such transfer, and the transferee did not acquire any part of such share. However, the shareholder's total basis for their stock was reduced by the basis of the stock transferred.[570]

Example: The sole shareholder of a subchapter S corporation without any prior existence had a basis in their stock of $25,000. As of the last day of the corporation's first taxable year, the shareholder had to include a $40,000 constructive dividend in income. As a result, the shareholder's basis in their stock increased to $65,000. Two weeks later, the shareholder sold one-half of their stock to another individual for $50,000. The shareholder realized a capital gain on such sale of $17,500, which equaled the difference between the amount realized ($50,000) and the shareholder's basis allocable to the transferred shares ($32,500). The shareholder's basis in their remaining shares was reduced to $32,500. Subsequently, but within two months and 15 days after the end of the taxable year, the corporation distributed $40,000 in cash to the original shareholder. As a result of this distribution, the shareholder's basis in the remaining shares was reduced to zero, and the shareholder realized a capital gain of $7,500 on the excess distribution.

d. Survival of Right to Receive Qualifying Distributions

Unlike the right to make nondividend distributions of PTI pursuant to pre-SSRA §1375(d), the right to make nondividend distributions under pre-SSRA §1375(f) survived the termination of a subchapter S election.[571] In Rev. Rul. 71-102, the IRS ruled that a cash distribution made on March 1, 1969, by a corporation whose subchapter S election terminated as of January 1, 1969, was to be treated as a nondividend distribution under pre-SSRA §1375(f) to the extent of the corporation's undistributed taxable income from its 1968 taxable year.

e. Pre-1983 Accumulated E&P Eliminated

The 1996 SBA introduced a rule reducing the accumulated E& P of any corporation that was an S corporation for its first taxable year beginning after 1996 by the accumulated E&P (if any) accumulated in a taxable year beginning before 1983 for which the corporation was an electing small business corporation under subchapter S. This reduction ensures that such a corporation's accumulated E&P are solely attributable to taxable years for which an S election was not in effect.[572] The 2007 SBWOTA[573] reduces the accumulated E&P (determined as of the beginning of the first taxable year beginning after May 25, 2007) of any corporation that was not an S corporation for its first taxable year beginning after 1996 by the accumulated E&P (if any) accumulated in a taxable year beginning before 1983 for which the corporation was an electing small business corporation under subchapter S.[574]

2. Distributions of Previously Taxed Income (PTI)

a. General

When a shareholder of a subchapter S corporation included a constructive dividend in income under pre-SSRA §1373(b), the accumulated E&P of the corporation was reduced and the shareholder's basis in their stock was increased by the amount of the constructive dividend. The effect was as if such amount had been actually distributed to the shareholder and then immediately returned to the corporation as a capital contribution. As discussed above, pre-SSRA §1375(f) gave the corporation a two month and 15 day grace period to make a nondividend distribution of such amount. In many cases, the corporation would be unable to take advantage of this provision because it needed the funds represented by the constructive dividend for working capital or to finance future growth. At some later time, e.g., post-SSRA, however, these funds may no longer be needed by the corporation. At such time, it may be possible, if certain conditions are met, to distribute such funds without incurring dividend taxation.

Pre-SSRA §1375(d)(1) provided that a subchapter S corporation could distribute, in accordance with regulations, all or any portion of a shareholder's net share of the corporation's undistributed taxable income for prior taxable years (hereinafter referred to as the shareholder's PTI account), and any such distribution would be considered a distribution which is not a dividend. Since a distribution under pre-SSRA §1375(d) was not a dividend, it was treated as a return of capital. Thus, a distribution of PTI was first applied against the shareholder's basis in their stock to the extent thereof (and thus was tax free

[569] Pre-SSRA Reg. §1.1375-6(a)(1).
[570] Pre-SSRA Reg. §1.1375-6(a)(4).
[571] Pre-SSRA Reg. §1.1375-6(a)(1).

[572] *See* H.R. Rep. No. 280(II), 104th Cong., 1st Sess. 506 (1995) (reproduced in the Worksheets).
[573] Pub. L. No. 110-28, §8235.
[574] *See* Staff of the Joint Comm., on Tax'n, *Technical Explanation of the Small Business and Work Opportunity Tax Act of 2007,* JCX-29-07, at 25 (2007).

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to this extent), and any excess over basis was then treated as a capital gain from the sale of property (assuming the stock was a capital asset in the hands of the shareholder).[575]

b. Requirements for a PTI Distribution

(1) Basic Rules

Pre-SSRA Reg. §1.1375-4 specified the rules under which a distribution would be treated as a nondividend PTI distribution. The rules can be summarized as follows:

- a distribution of PTI may occur only if during the taxable year of the distribution the corporation makes cash dividend distributions in excess of its current E&P;
- only an actual distribution of money, and not property, can constitute a distribution of PTI;
- a distribution of PTI may be made only during a taxable year in which the distributing corporation is a subchapter S corporation;
- a shareholder's right to receive nondividend distributions from their PTI account are personal and may not be transferred in any manner;
- a distribution in exchange for stock is never treated as a distribution of PTI; and
- a distribution of money made during the first two months and 15 days after the close of the corporation's taxable year is automatically treated as a nondividend distribution under pre-SSRA §1375(f) to the extent that section applies and may not be denominated as a distribution of PTI from a prior year.

(2) Order of Distributions

Pre-SSRA §1375(d) and the regulations thereunder determined the character and sequence of distributions made by former subchapter S corporations. The ordering for distributions was:

- a tax-free distribution (with a downward adjustment in stock basis) of constructive dividends for the previous tax year if the distribution was made in cash within two months and 15 days of the close of the taxable year;
- a taxable dividend (with an increase in stock basis) to the extent of current E&P;
- a tax-free distribution (with a downward basis adjustment) if made in cash to the extent of any PTI earned in any prior subchapter S year;
- a taxable dividend to the extent of the corporation's accumulated E&P (an election under pre-SSRA Reg. §1.1375-4(c) would allow a distribution of accumulated E&P before PTI);
- a reduction in stock basis; and
- after stock basis was exhausted, taxation as capital gain.

Although PTI could be distributed before accumulated E&P, it could not be distributed unless money distributions equal to the E&P of the corporation for the year of the distribution were also made. This was true even if it could be shown that all of the current E&P were actually earned by the corporation after the purported distribution of PTI.[576]

Under pre-SSRA Reg. §1.1373-1(d), current E&P were allocated ratably to all money distributions (other than nondividend distributions under pre-SSRA §1375(f) made during the taxable year). Thus, if the corporation had current E&P, any distribution, including PTI, was partially composed of current E&P and, to that extent, was treated as a dividend.

Pre-SSRA §1377(d) stated that for purposes of determining whether a distribution constituted a distribution of PTI, the current E&P of the corporation were to be computed without regard to §312(k), which provides that a corporation's E&P is not reduced by accelerated depreciation in excess of straight-line depreciation. Pre-SSRA §1377(d) addressed only one of the instances when the current E&P of a subchapter S corporation exceeded its taxable income. Therefore, unless pre-SSRA §1377(d) applied, a distribution of PTI could be made only if money in excess of the corporation's current E&P, and not its taxable income, was distributed during the taxable year.

(3) Property Distributions

A property distribution by a former subchapter S corporation never constituted a distribution of PTI. The requirement that PTI be distributed as money is not found under pre-SSRA §1375(d), but instead is provided in pre-SSRA Reg. §1.1375-4(b).[577] If a property distribution was made by a subchapter S corporation, the distribution was treated as made out of accumulated E&P and PTI was left unadjusted. If property was distributed during a year in which the corporation did not have any accumulated E&P, the distribution had no immediate tax effect. This is because, in the absence of accumulated E&P, any property distribution that was made after current E&P had been exhausted was treated as a return of capital to the extent of basis and then as a capital gain. This is the same treatment afforded cash distributions of PTI.

(4) Right to Distribute PTI Did Not Survive Termination of Election

Pre-SSRA Reg. §1.1375-4(a) provided that a distribution of PTI could be made only during a taxable year in which a valid subchapter S election was in effect, and that if the election was terminated, the corporation could not, during the first taxable year to which the termination applied, or during any subsequent taxable year, make a nondividend distribution of PTI attributable to years prior to the termination.[578]

[575] Pre-SSRA Reg. §1.1375-4(a).

[576] *Bonner v. Commissioner*, T.C. Memo 1979-435.

[577] This rule has changed under the current S corporation rules. However, courts have upheld the regulation as reasonable as applied to former subchapter S corporations. *See DeTreville v. United States*, 445 F.2d 1306 (4th Cir. 1971); *McKelvy v. United States*, 478 F.2d 1217 (Ct. Cl. 1973); *Clark v. Commissioner*, 58 T.C. 94 (1972); *Fountain v. Commissioner*, 59 T.C. 696 (1973); *Bonner v. Commissioner*, T.C. Memo 1979-435.

[578] See also *Oswald v. Commissioner*, T.C. Memo 1987-448, *aff'd in unpub. opin.* (3d Cir. 1988), in which a subchapter S corporation terminated its S status on February 1, 1980 and gave its sole shareholder a check for its cumulative PTI on April 8, 1980. The Tax Court held that the entire amount, except for the portion of PTI attributable to the immediately preceding tax year, was a dividend.

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In Rev. Rul. 79-52, the IRS ruled that the merger of two subchapter S corporations did not preclude the right to make nondividend distributions of PTI. The shareholder's PTI accounts of the merged corporations were deemed to have carried over to the surviving corporation.

(5) PTI Not Distributed by a Distribution in Exchange for Stock

A distribution in exchange for stock could never be a distribution of PTI. In most cases, this was unimportant since a distribution in exchange for stock did not result in dividend treatment anyway. However, this was important for §333 liquidations, and Rev. Rul. 76-47[579] points out the correct way to proceed. The ruling states that a cash distribution to the sole shareholder of a former subchapter S corporation liquidated under §333 could not qualify as a tax-free distribution of PTI if made after the adoption of the plan of liquidation, but that if the cash was distributed before the plan of liquidation was adopted, it would qualify as a nondividend distribution of PTI to the extent it exceeded the corporation's current E&P for the year of the liquidation.

Rev. Rul. 71-272 concludes that in a §303 redemption, the distribution of an amount of money equal to the decedent's PTI account would qualify as a distribution in exchange for stock under §303.

(6) Right to Receive PTI Distributions Is Nontransferable

The right to receive nondividend distributions of PTI, like the right to receive nondividend distributions of undistributed taxable income under pre-SSRA §1375(f), was personal to the shareholder and could not be transferred in any manner. If a shareholder transferred part but not all of their stock in a subchapter S corporation, their PTI account was not reduced by such transfers and the transferee did not acquire any part of such account. However, the transferor's total basis in their stock was reduced by the basis allocable to the transferred shares, and any distribution of PTI in excess of their remaining basis was treated as a capital gain. When a shareholder transferred all of their stock in a subchapter S corporation, their right to receive PTI distributions lapsed entirely unless they again became a shareholder in the corporation while it was still subject to the same subchapter S election.[580]

The IRS's position that the right to withdraw PTI is personal in nature was illustrated clearly in Rev. Rul. 66-172. The decedent (H) and his wife (W) owned all of the stock of a subchapter S corporation as tenants by the entirety. Applicable state law required that income from property held in a tenancy by the entirety be divided equally between the spouses and, pursuant thereto, H and W each reported their respective halves of the undistributed taxable income on joint returns filed for each of the years in question. H died in 1965 and W became sole owner of all of the stock by right of survivorship. In 1965, the corporation had no net earnings or losses but made a cash distribution to W. W sought to have the entire distribution treated as PTI on the grounds that she succeeded to H's share of PTI.

The IRS ruled that H's right to receive distributions not considered as dividends under pre-SSRA §1375(d)(1) was personal to him and therefore lapsed at his death and did not pass to his surviving spouse who acquired exclusive ownership of the stock by reason of her right of survivorship. W was entitled to treat only one-half of the 1965 distribution as a nondividend. The IRS relied on the fact that a shareholder's PTI account is determined by reference to the amounts required to be included in the shareholder's gross income for his prior taxable years under pre-SSRA §1373(b), and, under state law, W, as co-owner of the stock, was entitled to one-half of the dividends. Furthermore, the fact that H and W filed joint returns did not affect the above result, since a joint return is deemed to be a return of two separate taxpayers under Reg. §1.6013-4(b).

The IRS ruled that the above result would also apply if W acquired absolute ownership of the stock as a surviving joint tenant with right of survivorship, or as a surviving spouse in a community property state, and if prior to her acquisition of absolute ownership, one-half of the corporation's undistributed taxable income had been included in her gross income pursuant to pre-SSRA §1373.

c. Computation of PTI Account

At the time of any distribution, a shareholder's net share of PTI was an amount equal to:[581]

- the sum of the constructive dividends included in income under pre-SSRA §1373(b) by the shareholder for all their taxable years ending before the distribution, minus
- the sum of —
    - o the amount of net operating losses that were allowable to the shareholder under pre-SSRA §1374(b) for all of their taxable years ending before the distribution,
    - o the amounts previously distributed to the shareholder during their current taxable year and all of their prior taxable years which were considered nondividend distributions of PTI under pre-SSRA §1375(d)(1), and
    - o the amounts previously distributed to the shareholder during their current taxable year and all of their prior taxable years which were considered nondividend distributions under pre-SSRA §1375(f) (distributions within two months and 15 days of the close of taxable year) for taxable years of the corporation ending prior to the shareholder's current taxable year.

Note that in computing the sum of the constructive dividends included in income by the shareholder for prior taxable years, only constructive dividends actually included on the shareholder's returns for such years (plus or minus any adjustment of such amounts in any redetermination of their tax liability) were taken into account, unless the shareholder was not required to file a return for any such prior taxable year. On the other hand, the shareholder was required to make a reduction for their deductible share of the corporation's net operating loss

[579] *Obsoleted by* Rev. Rul. 2003-99, (relating to former §333, repealed in 1986).

[580] Pre-SSRA Reg. §1.1375-4(e).

[581] Pre-SSRA Reg. §1.1375-4(d).

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whether or not claimed on their return and whether or not it resulted in a tax benefit.

Furthermore, if a corporation's subchapter S election was terminated and a new election was made later, a shareholder's PTI account was determined solely by reference to taxable years which were subject to the new election.[582]

Comment: If an S corporation has PTI and its election of subchapter S status has been continuously in effect, S corporation status should not be terminated until PTI has been distributed or the PTI will be lost forever. The requirement that PTI be distributed in cash and the fact that distributions are sourced from PTI after AAA has been distributed may make such a distribution of PTI prior to termination difficult.

3. Distributions of Money

Under pre-SSRA §1373(c), only distributions of money served to reduce a corporation's undistributed taxable income. Similarly, pre-SSRA §1375(f) expressly provided that a nondividend distribution of the prior year's undistributed taxable income had to be made in money. Although pre-SSRA §1375(d) did not itself provide that a nondividend distribution of PTI had to be made in money, such a requirement was contained in pre-SSRA Reg. §1.1375-4(b).

The former regulations expressly provided that for purposes of pre-SSRA §1373(a) and §1375(f), a distribution of money would not include a distribution of an obligation of the corporation or a distribution of property other than money in satisfaction of a dividend declared in money.[583] The regulations under pre-SSRA §1375(d) did not contain such a statement, but its rules also applied to distributions of PTI.[584]

[582] Pre-SSRA Reg. §1.1375-4(d).

[583] Pre-SSRA Reg. §1.1373-1(d), Reg. §1.1375-6(a)(2)(iii).

[584] *See Prescott v. Commissioner*, T.C. Memo 1983-709; *Hauer v. United States*, 85-2 USTC ¶ 9,447 (D. N.D. 1985).

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III. Redemptions, Liquidations, Taxable and Nontaxable Mergers and Acquisitions

A. General

The 1996 SBJPA vastly expanded eligibility for corporations to claim S corporation status. This along with the 1986 TRA increased the involvement of S corporations in corporate reorganizations, redemptions, and liquidations. As discussed above, most of the rules governing these types of transactions are found in subchapter C of the Code. While an S corporation computes its taxable income in the same manner as an individual, subchapter C continues to apply to S corporation except to the extent inconsistent with the purposes of subchapter S. Accordingly, one of the primary advantages of the S corporation when compared with a partnership is the ability to use the tax-free reorganization provisions of subchapter C.[585]

B. Redemptions

1. General

Under §317(b), a redemption occurs when a shareholder exchanges their stock in a corporation for corporate property, whether or not the corporation cancels, retires, or holds the stock as treasury stock. Under the following scenarios, a redemption distribution is generally treated as an exchange, and any resulting gain or loss is capital in nature:

- if a shareholder substantially reduces their corporate interest in relation to other shareholders;
- if there is a termination of a shareholder's interest in the company;
- if the redemption is not essentially equivalent to a dividend;
- if there is a partial liquidation;[586] or
- if the proceeds of the redemption are used to pay death taxes.[587]

If capital gain treatment is not available under these rules, the shareholder is regarded as having received a distribution under §301.[588]

2. Sale or Exchange Redemptions

If a redemption results in capital gain treatment to the shareholder under §302 or §303, there is no immediate tax effect to the S corporation unless it distributes appreciated property as consideration in the redemption. The rules of subchapter C determine whether and to what extent an S corporation recognizes gain on the distribution of property in redemption of its stock.[589] A distribution of appreciated property results in gain to the S corporation under §311(b), which flows through to all shareholders, not just the shareholder being redeemed with such property.[590] A distribution of property with an adjusted basis in excess of its fair market value results in a realized loss but the loss is not recognized notwithstanding the IRS assertion that shareholders' stock basis and the S corporation's AAA must be reduced for the loss that is not recognized under §311(a). This result appears contrary to case law holding that gain not recognized under §332 is not an item that increases stock basis.[591]

In PLR 9436059, the IRS ruled that a proposed distribution in redemption of a portion of the stock of an S corporation pursuant to a plan to sell part of the business would be treated as a partial liquidation under §302(b)(4) to the extent attributable to the net sale proceeds, provided the distribution was made during the taxable year in which the plan was adopted or in the succeeding taxable year. The distribution is treated as being in full payment in exchange for the stock actually redeemed provided that the value of the shares redeemed is equal to the amount distributed. Gain or loss will be recognized to the extent of the difference between the amount distributed in partial liquidation and the adjusted basis of the shares actually surrendered for the nonqualifying portion of the distribution.[592] However §302(b)(4) may be inconsistent with Subchapter S.[593]

A redemption under §302 or §303 requires a reduction in the corporation's AAA, whether negative or positive, by an amount determined as of the redemption date reflecting the proportionate shares redeemed.[594] As a result, in a simple situation where only a redemption (but no operating) distribution occurs, the AAA is reduced by the amount of the AAA balance multiplied by the fraction the numerator of which is equal to the number of redeemed shares and the denominator of which is the number of outstanding shares immediately before the redemption.

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[585] §1363(b), §1371(a).

[586] *See* I.G.2., above, regarding possible inconsistency of partial liquidations applying to S corporations.

[587] §302, §303. Although temporarily repealed under the 2003 Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27, and permanently repealed under the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, §102(a), the collapsible corporation rules under former §341 applied to convert capital gain into ordinary income in certain circumstances. In addition, under §318(a)(5)(E), an S corporation is treated as a partnership for purposes of the §318 attribution rules, which assist in determining whether distributions qualify for exchange treatment under §302.

[588] §302(d). Prior to 2003, §301 distributions were taxed as ordinary income. For taxable years beginning after 2002, qualified dividends are taxed at the capital gains rate. *See* §1(h)(11). In effect, the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, §102(a) made permanent the taxation of qualified dividends at capital gains rates.

[589] *See Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).

[590] If the distribution does not involve appreciated property, then the general nonrecognition rule of §311(a) applies to the S corporation. In PLR 9237015, the IRS ruled that gifts of stock in the years before redemption and the sale of stock by the taxpayer to related parties did not have a tax-avoidance purpose and was a complete termination under §302(b)(3). The taxpayer received capital gain treatment under §302(a) on the redemption and the S corporation recognized no gain or loss.

[591] §311(a); CCA 201421015 (concluding that disallowed §311(a) losses should reduce shareholder's basis in S corporation stock, and S corporation should reduce its AAA). But see *Ball v. Commissioner*, 742 F.3d 552 (3d Cir. 2014), holding that gain not recognized under §332 is not an item that can pass through to shareholders for purposes of increasing basis under §1366. Accordingly, CCA 201421015 appears contradictory to case law.

[592] *See* Rev. Rul. 56-513, *as clarified by* Rev. Rul. 77-245. For a discussion of the consequences following receipt by shareholders of consideration worth more or less than the fair market value of the stock surrendered, see 767 T.M., *Redemptions.*

[593] See I.G.2., above, for a discussion on Subchapter C inconsistencies with Subchapter S.

[594] §1368(e)(1)(B); Reg. §1.1368-2(d)(1).

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Example: If an S corporation has 100 outstanding shares and the S corporation's AAA balance is $100,000 when 30% of the S corporation's shares are redeemed, the AAA is reduced by $30,000 ($100,000 × 30/100).

Although the amount of the redemption is determined based on the balance in the AAA as of the redemption date, the balance of the AAA, and therefore the redemption reduction, is not actually calculated until the close of the taxable year.[595] Calculating the AAA balance and the amount of the redemption adjustment is relatively simple in a year when there are no ordinary distributions. Income and loss items for the year are allocated ratably up through the redemption date and then added to the balance of the AAA from the previous year.[596] To determine the redemption adjustment, this balance is then multiplied by the fraction reflecting the proportion of shares redeemed.

Example: XYZ is an S corporation owned equally by B and C. XYZ's AAA balance at the beginning of the year is $40,000. During that year, the corporation has net earnings of $100,000, none of which is distributed to the shareholders. On June 30, XYZ redeems all of B's stock. XYZ's AAA is first increased to $90,000 ($40,000 + (6/12 × $100,000)) to reflect the balance in the AAA at the date of redemption. Then XYZ's AAA is decreased to $45,000 ($90,000 × 1/2) to reflect the redemption adjustment. XYZ's AAA balance at the end of the year would be $95,000 ($45,000 AAA post redemption + pro rata AAA for the remainder of the year).

When both ordinary and redemption distributions are made in the same year, the calculation of the AAA adjustment can become more complex. In such cases, the AAA must be adjusted, at the end of the taxable year, for ordinary distributions before it is adjusted for redemption distributions, but the redemption adjustment amount must be determined as of the redemption date, which could be before one or more ordinary distributions are made.[597] An example in the regulations demonstrates application of Reg. §1.1368-2(d)(1)(ii) when an S corporation with E&P makes ordinary distributions to its shareholders during its taxable year and distributes cash to one shareholder in complete redemption of its stock on the last day of the S corporation's taxable year.[598] In the example, the AAA is increased at the end of the year to take into account the S corporation's operations then decreased by the amount of the ordinary distribution prior to the reduction for the redemption. Because no special rule is provided regarding situations in which a redemption occurs before ordinary distribution, the result should not be different if a shareholder is redeemed during the taxable year and the S corporation made an ordinary distribution on the last day of its taxable year.[599]

[595] Reg. §1.1368-2(a)(2), §1.1368-2(a)(3). For further discussion of how the AAA is adjusted, see II.C., above.

[596] Reg. §1.1368-2(d)(1)(i).

[597] Reg. §1.1368-2(d)(1)(ii).

[598] Reg. §1.1368-3 *Ex.* 9. *See* II.C.7.a., above.

[599] The preamble to the final regulations states, without qualification that, under the final regulations, "adjustments to the AAA are made first for passthrough items, second for ordinary distributions, and third for redemption distributions." T.D. 8508, 59 Fed. Reg. 12 (Jan. 3, 1994).

Comment: The final regulations also modified Reg. §1.1368-2(d)(1)(iii) which states that E&P are adjusted under §312 independently of any adjustments made to the AAA. Former Prop. Reg. §1.1368-2(d)(iii) required the taxpayer to apply §312(n)(7) and the regulations thereunder to determine the adjustments to E&P for a redemption treated as an exchange. This change in language seems to imply that taxpayers must determine the AAA adjustment for a redemption after taking into account ordinary distributions even if the redemption occurred prior to an operating distribution.

Comment: Making adjustments to the AAA for redemptions after taking into account ordinary distributions may be beneficial to shareholders as it allows for a larger amount of the AAA to be allocated to ordinary distributions which can be received tax-free to the extent of basis. The redeemed shareholder is no worse off since the AAA balance does not affect the tax treatment of a redemption qualifying under §302.

Although the final regulations do not specify how to calculate the redemption adjustment amount, the following approach is reasonable:[600]

- Step One — at the end of the taxable year, ratably allocate current year earnings to the redemption date;
- Step Two — add this amount to the AAA balance from the previous year;
- Step Three — from the total AAA balance (determined under step (2)) the amount of any ordinary distributions made before the redemption;
- Step Four — multiply the net AAA balance (determined under step (3)) by the fraction reflecting the portion of shares redeemed. This will be the redemption adjustment amount.

Once the redemption adjustment amount is determined, the balance of the AAA at the end of the taxable year would be calculated as follows:

- Step One — add (or subtract) the corporation's net earnings to the AAA balance from the previous taxable year;
- Step Two — subtract the total amount of all ordinary distributions made during the taxable year (this amount may not go below zero);
- Step Three — subtract the redemption adjustment amount from the amount determined under step (2).[601]

Example: XYZ is an S corporation owned equally by B and C. XYZ's AAA balance at the beginning of the year was $40,000. During that year, the corporation ratably earned $100,000 and distributed $80,000 from operations to the shareholders on March 15 and $40,000 on September 15. On June 30, XYZ redeemed all of C's stock. Under the final regulations, the redemption adjustment amount could be calculated as follows:

[600] This method would only be used when the S corporation does not have a net negative adjustment as discussed at II.C.4., above. Braitewaite, *S Corporations and Partial Liquidations — Two Favorable Tax Regimes; When Two Rights Make a Wrong,* 6 Bus. Entities No. 3 (May/June 2004).

[601] *See* Reg. §1.1368-2(a)(4).

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- total AAA up to redemption date:
  - o $40,000 + (6/12 × $100,000) = $90,000
- total AAA less ordinary distributions made before redemption date:
  - o $90,000 – $80,000 = $10,000
- redemption adjustment amount:
  - o 50% × $10,000 = $5,000

The AAA balance at the end of the taxable year would then be:

- total AAA balance:
  - o $40,000 + $100,000 = $140,000
- less total ordinary distributions:
  - o $140,000 – $120,000 = $20,000
- less redemption distributions:
  - o $20,000 – $5,000 = $15,000

Alternatively, if a shareholder's interest is terminated, or if the redemption is of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30-day period during the corporation's taxable year, the corporation may elect with the consent of all affected shareholders to close the corporation's books and treat the year as two independent tax years for allocation purposes; one year ending at the close of the termination date, and the second ending at the normal year end.[602]

Comment: These elections apply only for purposes of allocating corporate items among the shareholders. They do not cause the corporation to actually have a short taxable year.

A capital gain redemption under §302 or §303 also has the favorable effect of concurrently reducing accumulated E&P under §1371(c)(2), without the recipient's receiving ordinary dividend income. Under the final regulations, E&P is reduced under §312, independently of any adjustments made to the AAA.[603]

3. Non-Sale or Exchange Redemptions

If the redemption does not qualify for sale or exchange treatment, it is instead considered to be a §301 distribution. Therefore, under §1368, the recipient shareholders, to the extent of the corporation's AAA balance, first treat the distribution as nontaxable recovery of basis in their stock, then as sale or exchange gain; if the distribution exceeds AAA, the remainder is a taxable dividend to the extent of the corporation's accumulated E&P, next as a nontaxable reduction in any remaining shareholder stock basis, and finally as sale or exchange gain.

In some cases, consideration might be given to not qualifying the redemption for exchange treatment, perhaps by structuring a redemption as a distribution which is essentially equivalent to a dividend when a shareholder being redeemed would recognize gain on the distribution.[604] If there is both an adequate AAA balance and shareholder basis, the distribution would be deemed to be from the AAA in any event, and thus would be tax free to the recipient shareholder. For example, in PLR 9404020, the IRS ruled that a proposed redemption would not meet any of the safe harbors of §302(b) and, therefore, would be treated as a §301 distribution. The shareholders, however, did not realize any taxable income because the S corporation's AAA and the shareholders aggregate basis were sufficient to cover the redemption in full.[605]

The shareholder in Rev. Rul. 95-14[606] was similarly able to receive a distribution tax free. In that ruling, the S corporation, which had E&P, redeemed a portion of the shareholder's stock for cash in a non-sale or exchange redemption. Because the corporation had AAA in excess of the distribution and the shareholder's stock basis also exceeded the amount of the distribution, the entire amount of the distribution reduced the corporation's AAA under Reg. §1.1368-2(a)(3)(iii) and the shareholder could exclude the distribution from income under §1368(c).[607]

A non-sale or exchange redemption is not generally considered a disproportionate distribution that creates a second class of stock in violation of the S corporation eligibility rules. The final single-class-of-stock regulations generally disregard such distributions in determining whether the corporation's outstanding shares of stock confer identical distribution and liquidation rights, unless the redemption agreement is entered into to circumvent the single-class-of-stock requirement and the purchase price, when the agreement is entered into, is significantly more or less the fair market value of the stock.[608] Thus, non-sale or exchange redemptions will not generally trigger a termination of S corporation status.

4. Tax Treatment Compared

If the redeeming S corporation has no accumulated E&P, a complete redemption of a shareholder's interest produces essentially the same tax results whether it is treated as a distribution of property under §1368 or as a capital gain redemption under §302 or §303.[609]

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[602] §1377(a)(2); Reg. §1.1368-1(g)(1), §1.1368-1(g)(2), §1.1368-2(e).

[603] Reg. §1.1368-2(d)(1)(iii).

[604] *Cf.* Rev. Rul. 76-364 (distribution not essentially equivalent to dividend where shareholder loses power to combine with another shareholder to exercise majority control).

[605] *See also* PLR 8842024 (non-sale or exchange redemption excludible from shareholder income where balance in AAA measured at end of year, thus reflecting earnings for the year).

[606] *See also* PLR 9810020 (redemption treated as a distribution excluded from income to the extent of stock basis and did not create a second class of stock); PLR 9607003 (after application of §318(a), stock held by trusts is attributed back to S corporation shareholders and a redemption of such stock is treated as a §301 distribution which is not taxable to extent it does not exceed corporation's AAA or the taxpayers' adjusted stock basis for all shares owned, i.e., not limited to the basis of the redeemed shares).

[607] The IRS also noted that the provision of §1368(e)(1) that refers to redemptions does not apply on these facts because that provision applies to capital gain redemptions under §302(a) or §303(a) and this is a non-sale or exchange redemption under §301.

[608] Reg. §1.1361-1(l)(2)(iii). *See also* PLR 201207002, PLR 9810020, PLR 9404020 (noncapital gain redemption does not create second class of stock under §1361(b)(1)(D)).

[609] Under §1368(b), the taxation of distributions depends on the shareholders' stock basis when there is no corporate E&P. As a result, the AAA balance is effectively irrelevant.

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Example: XYZ is an S corporation with no accumulated E&P. B owns stock in XYZ with a value of $100,000 and a basis of $60,000. XYZ redeems all of B's stock for $100,000. If treated as a sale or exchange redemption, B has a capital gain of $40,000 ($100,000 less $60,000). If regarded as a §1368(b) distribution, B would again recognize a $40,000 capital gain ($100,000 distribution in excess of $60,000).

Qualified dividend income is taxed at the capital gains rates.[610] Under §1(h)(11)(B), qualified dividend income is dividend income received from domestic corporations and qualified foreign corporations. As a result, the tax rate imposed on distributions from an S corporation sourced from accumulated E&P has been reduced. A non-sale or exchange redemption will first be sourced from the AAA and then from accumulated E&P.

Example: XYZ is an S corporation with an AAA of $90,000 and accumulated E&P of $50,000. Shareholder B owns stock with a fair market value of $100,000 and an adjusted basis of $60,000. Shareholder B would like to have 100% of the stock redeemed. If treated as a sale or exchange, Shareholder B would recognize a $40,000 capital gain ($100,000 less $60,000). However, if treated as a distribution under §1368, Shareholder B would recover the first $60,000 of the $100,000 distribution as a tax-free return of capital. XYZ's AAA balance would be reduced to $30,000 and B's stock basis would be reduced to $0. The remainder of the distribution would be treated as a sale or exchange to the extent of the adjusted AAA balance, $30,000. After exhausting the AAA balance, any remaining portion of the distribution, $10,000, would be taxed to Shareholder B as a dividend from XYZ corporation's accumulated E&P. Thus, after the distribution, XYZ's AAA balance would be $0 and XYZ's accumulated E&P would be $40,000.

The benefit of achieving sale or exchange treatment is the ability to utilize stock basis against the amount received in the transaction; however, in certain circumstances, distribution treatment may be more beneficial.

Example: XYZ is an S corporation with an AAA of $50,000 and accumulated E&P of $75,000. Shareholder B has owned 40% of XYZ stock for 10 years. The fair market value of B's stock is $400,000 and B's stock has a tax basis of $28,000. Shareholder B would like to have 25% of the stock redeemed. If the redemption were treated as a sale or exchange under §302(a), then Shareholder B would recognize capital gain of $93,000 ($100,000 amount realized less $7,000 basis). If the redemption were treated as a distribution, Shareholder B would recover the first $28,000 of the $100,000 distribution as a tax-free return of capital. XYZ's AAA balance would be reduced to $22,000 and Shareholder B's basis in the redeemed shares and their retained shares would be reduced to $0. The remainder of the distribution would be treated as a sale or exchange to the extent of the adjusted AAA balance, $22,000. After exhausting the AAA balance, any remaining portion of the distribution, $50,000, would be taxed to Shareholder B as a dividend from accumulated E&P. Thus, after the distribution, XYZ's AAA balance would be $0 and XYZ's accumulated E&P would be $25,000.

Observation: While capital gains on redemptions and distributions of E&P are both taxed at capital gain rates, dividend income may be subject to the net investment income tax while capital gain on the sale of S corporation stock sold by shareholders may not.[611]

5. Basis Adjustments

The adjustments to stock basis are generally determined as of the close of the corporation's taxable year.[612] However, when a shareholder disposes of stock during the year, the adjustments are effective immediately before the disposition.[613] Thus, the shareholder's basis in stock reflects earnings up to the date of redemption so that the redeemed shareholder can take these earnings into account in computing gain on their sale or exchange of stock. Note also that under Reg. §1.1367-1(b)(2) and Reg. §1.1367-1(c)(3), stock basis of an S corporation is computed on a share-by-share basis in the same manner as stock of a C corporation. Thus, in a sale or exchange redemption transaction, a shareholder can select high basis stock to be redeemed to minimize gain on the transaction.[614] This differs from a partnership where an aggregate basis is used.

The method for computing the amount includible in the redeemed shareholder's basis should parallel the method used to compute the AAA up to the redemption date. Thus, earnings may either be ratably allocated throughout the year,[615] or, if the shareholder either completely terminates their interest or redeems at least 20% of the corporation's outstanding stock in a capital gain redemption, the shareholders and the corporation may elect to close its books and treat the taxable year as two separate years for purposes of allocating its earnings.[616]

6. Other Considerations

Generally, S corporations do not recognize gain as a result of a redemption distribution. However, if appreciated property

[610] The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, §102(a), made permanent the taxation of qualified dividends at capital gains rates.

[611] §1411(c)(4). In the case of the disposition of stock in an S corporation, gain or loss is taken into account for purposes of the net investment income tax only to the extent gain or loss would be taken into account by the shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account. For additional discussion, see 511 T.M., *Net Investment Income Tax*.

[612] Reg. §1.1367-1(d)(1).

[613] Reg. §1.1367-1(d)(1).

[614] In PLR 8613040, the IRS ruled that in a liquidation where a shareholder had several blocks of stock with different bases, the distribution was allocated ratably among the separate blocks of stock in proportion to the number of shares in a particular block over the total number of shares held by that shareholder. *See* Rev. Rul. 68-348, *amplified by* Rev. Rul. 85-48, and Rev. Rul. 69-334.

[615] *See* §1377(a)(1).

[616] *See* §1377(a)(2); Reg. §1.1368-1(g), Reg. §1.1367-1(d)(3).

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is distributed in a redemption transaction, the property is treated as sold for its fair market value, and the corporation must recognize gain.[617] This gain then passes through to all shareholders. Any gain recognized must be considered in determining the corporation's AAA and shareholder stock basis. Thus, the redeemed shareholder's stock will reflect an increase for gains recognized at the corporate level that result from using appreciated property to redeem their stock.[618]

If the redemption price is less than the shareholder's basis, a redemption that is treated as an exchange triggers a loss at the shareholder level. It is possible that this loss will be disallowed under §267(a) if the redeemed shareholder is an individual who owns 50% of the corporation's stock directly (or by virtue of the §267(c) attribution rules).[619]

Redeeming an estate shareholder can frequently result in a capital loss due to the time lag between the date of death (when basis step-up occurs under §1014) and the redemption date. Any S corporation income for the decedent's last taxable year is allocated to the decedent and their estate. Section 1367(d)(4) provides that a person acquiring S corporation stock from a decedent must treat as IRD their pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent.[620] The stepped-up basis of such stock is reduced by the extent to which the stock value is attributable to IRD items.[621] The §267(a) loss disallowance rule appears to not affect an estate that is being redeemed because it would not be treated as a related party under §267(b).

Redemptions involving grantor trusts may also have variable tax consequences. In one ruling, the IRS disregarded three qualified subchapter S trusts (QSSTs) as separate entities when the S corporation in which they held stock proposed to make a cash distribution to the shareholders in a §302(d) stock redemption.[622] The transaction was instead treated as a cash distribution to the trusts' beneficiaries, and §1368 determined whether the distribution was includible in the shareholders' income. Under the grantor trust rules of §671 through §678, the trust is disregarded as a separate entity and its distributions are treated as distributions to the person who is treated as the owner. However, the IRS also ruled that the treatment of the proposed distribution by the trusts as a distribution of principal rather than income would not cause the trusts to fail to satisfy the §1361(d)(3) income distribution requirement, and would not adversely affect the corporation's subchapter S election. Under this scenario, an S corporation can distribute cash for the benefit of a QSST beneficiary without any income tax consequences and without the beneficiary ever receiving the cash since the distribution from the S corporation does not need to be distributed by the trust to the beneficiary if it does not represent income of the trust under state law.

C. Liquidations

1. General

Under §1371(a), subchapter C applies to S corporations unless specifically provided otherwise or unless it is inconsistent with subchapter S. The liquidation provisions of subchapter C should apply to S corporations.[623]

Under §331, amounts received by shareholders in liquidation of their corporation are treated as received in full payment in exchange for their stock. In addition, §301 dividend treatment is specifically prohibited from applying to liquidating distributions.[624] Thus, in an S corporation context, it would seem that §1368 distribution treatment would not apply because §1368 applies to S corporation distributions to which §301(c) would otherwise have applied. Regardless, the actual difference to the shareholder on whether the liquidating distribution comes out of the AAA under §1368, or is treated as a payment in exchange for stock under §331, should be minimal. Liquidating distributions are characterized as a return of capital to the extent of the shareholder's stock basis. Any excess is recognized as taxable capital gain at the shareholder level.

Comment: The capital nature of this excess amount assumes that the stock is a capital asset in the shareholders' hands.[625]

Under §336(a), the liquidating S corporation generally recognizes gain or loss when distributing appreciated or depreciated property to its shareholders. Such gain or loss is determined as if the property were sold to the shareholders at fair market value. Therefore, any property the shareholders receive in liquidation has a fair market value basis.[626] If an S corporation distributes encumbered assets to a shareholder in exchange for the shareholder's stock in liquidation, the liabilities associated with the distributed assets are taken into account for purposes of determining the S corporation's gain or loss under §336 and the shareholder will reduce the amount realized by the amount of any liability assumed.[627]

Generally, a corporation may recognize loss on the distribution of depreciated property in complete liquidation.[628] Section §336(d) contains an exception to the general rule. Losses may not be recognized by the corporation if property is distributed to a related party, as defined in §267, and the distribution is either not pro rata or the property is disqualified property. Disqualified property is defined under §336(d)(1)(B) as property

[617] §311(b). In addition, this distribution could also trigger the built-in gains tax, if applicable. *See* §1374.

[618] Under §1366(f)(2), such gains must be reduced by any corporate-level built-in gains taxes paid.

[619] *See* Rev. Rul. 57-387, *modified by* Rev. Rul. 77-293.

[620] §1367(b)(4)(A). For decedents dying before August 21, 1996, such income increased stock basis because it was not treated as income in respect of a decedent (IRD).

[621] §1367(b)(4)(B).

[622] PLR 9349009. *See also* PLR 200451021, PLR 9710026 (where distributions qualify as §302(d) redemptions, §1368(b) and §1368(c) apply in determining amount includible in QSSTs' income).

[623] *See* PLR 9543017 (merger of an S corporation into an LLC is treated as an asset transfer by the S corporation in exchange for the LLC's assumption of the corporation's liabilities and the corporation's receipt of an interest in the income and loss items of the LLC followed by a complete liquidation of the S corporation under §331); PLR 9747035 (taxation of liquidation of S corporation determined under §331). See also pre-SSRA Reg. §1.1372-1(c)(3), which, under the former subchapter S rules, specifically applied §331 to former subchapter S corporations.

[624] §331(b).

[625] See PLR 8613040 for a general discussion of liquidating consequences to an S corporation.

[626] §334(a).

[627] CCA 201237017; *Ford v. United States*, 311 F.2d 951 (Ct. Cl. 1963); Rev. Rul. 58-228.

[628] §267(a)(1).

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which is acquired by the liquidating corporation in a transaction to which §351 applied, or as a contribution to capital during the five-year period ending on the date of the distribution.

In addition, if the corporation recognizes gain or loss on any distributed property to which the built-in gains tax applies, this tax will be triggered. Thus, in the year of liquidation, an S corporation may find itself subject to substantial corporate-level taxes.

Any gain or loss recognized at the corporate level then flows through to the shareholders and increases or decreases their stock bases. The shareholders first adjust their stock basis for current year passthrough items under Reg. §1.1367-1(d)(1) and then take into account corporate-level gain or loss for purposes of computing the gain or loss on the liquidation of their investment based on the difference between the amounts received on liquidation and their stock bases.[629]

Comment: Passthrough losses suspended by basis limitation rules and that remain after the basis of the redeemed stock has been reduced to zero do not reduce gain or increase loss resulting from liquidation. If a shareholder is going to increase basis to use up suspended losses, this must be done before the final distribution through additional capital contributions or loans, otherwise the loss will be permanently disallowed under Reg. §1.1366-2(a)(5). There is no authority allowing a shareholder to restore basis after a liquidation is completed as can be done under the post-termination transition period rules.[630]

If the S corporation and its shareholders have different tax years, a mismatching of gain or loss could result if liquidating distributions are made in separate taxable years.

> *Example:* XYZ, an S corporation with a February 28 year end, has $2,000 in cash at December 20X1. At that time, XYZ makes a $1,000 distribution to T, its sole shareholder. T has a stock basis on that date of $500. As a result, T recognizes $500 in capital gain in 20X1, assuming that distributions are subject to tax at the close of the shareholder's tax year. For the year ending February 28, 20X2, XYZ has $2,000 in income (all of which was earned before December 20X1) which adjusts T's basis to $2,000. When XYZ liquidates its remaining cash, T will have a $1,000 capital loss.

In this example, the capital gain and loss can offset, but do so in different taxable years.

As a result of the liquidation, the corporation's AAA and accumulated E&P disappear without further tax consequences.

When an S corporation is owned by QSSTs, gain or loss on liquidation of the S corporation (or on other disposition of the S corporation stock) generally belongs to the QSSTs rather than to the income beneficiaries,[631] although, the disposition is treated as a disposition by the income beneficiaries solely for purposes of applying §465 and §469 to the income beneficiaries.[632]

Finally, in the case of gain on the distribution of appreciated depreciable property, §1239 can apply to convert capital gain into ordinary income if the distribution of such property is to a related person.[633]

2. Section 337 Liquidations

Under current rules, §337 provides that a corporation recognizes no gain or loss when it makes a liquidating distribution under §332 to an 80% corporate shareholder.[634]

If an S corporation attempts to liquidate an 80%-owned subsidiary, the §332 nonrecognition provisions apply.[635]

3. Distribution of Installment Obligations

In certain circumstances, §453(h) allows individual shareholders to avoid current taxation upon the receipt of an installment obligation in liquidation of a corporation. The liquidating corporation generally will recognize any gain deferred under the installment method upon liquidation under §336. However, pursuant to §453B(h), an S corporation distributing, in a complete liquidation, an installment obligation meeting the requirements of §453(h) is not required to recognize any of the deferred gain.

The rule permitting an S corporation not to recognize gain does not apply for purposes of any tax imposed by subchapter S.[636] Thus, an installment sale of an S corporation's assets followed by a liquidating distribution of the installment obligations does not enable the corporation to avoid the built-in gains tax, if that tax is otherwise applicable. On the other hand, the shareholders can effectively step into the shoes of the corporation and continue to defer gain on the liquidation of the corporation during the outstanding term of the installment obligation(s).

For an installment obligation to meet the requirements of §453(h)(1), and therefore qualify for nonrecognition at the shareholder level, the following conditions must exist:

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[629] Reg. §1.331-1(b). *See* PLR 200817012 (liquidation and dissolution plan for S corporation that is wholly owned by trust qualified to hold S corporation stock for two-year period after grantor's death); PLR 9441018 (exchange of assets by S corporation for limited partnership interest pursuant to a plan of complete liquidation and followed by the distribution of all the S corporation's property to a marital trust causes gain or loss to be recognized under §336(a)).

[630] CCA 201237017.

[631] *See* Reg. §1.1361-1(j)(8); PLR 9721020. *See also* PLR 201232003, PLR 199920007, PLR 9838006 (deemed asset sale gain resulting from §338(h)(10) election that of QSST not beneficiary), PLR 199905011 (gain from actual asset sale attributable to QSST when sale was undertaken pursuant to plan of liquidation).

[632] Reg. §1.1361-1(j)(8). This rule was effective August 14, 2008.

[633] §1239(a).

[634] Before the 1986 TRA, §337 allowed C corporations to adopt a plan of liquidation under which they would avoid recognition of any gain on the sale of corporate assets within one year of the plan's adoption. Even though S corporations generally could achieve a single level of tax without undergoing a §337 liquidation, there were occasions where it was desirable for S corporations to engage in such liquidations. The 1986 TRA repealed §337, generally effective for liquidations completed after December 31, 1986, and replaced it with a revised §337. There was a transitional rule, however, for qualified corporations.

[635] §1371(a); TAM 9245004. The 1996 SBJPA eliminated a rule that had provided that an S corporation, in its capacity as a corporate shareholder, was treated as an individual. *See* pre-1996 SBJPA §1371(a)(2). Prior to TAM 9245004, the IRS had taken the position that this provision prevented the tax-free liquidation of a C corporation into an S corporation because the C corporation could not liquidate tax free when it was owned by an individual shareholder. *See* PLR 8818049. Applicable for tax years beginning after 1996, this provision was repealed in order to help clarify that the provisions of §332, §337, and §338 may be applied in appropriate circumstances. Pub. L. No. 104-188, §1310. *See* J. Comm. on Tax'n, *General Explanation of Tax Legislation Enacted in 104th Congress*, 104th Cong., 2d Sess. 124 (1996) (Blue Book).

[636] §453B(h) (flush language).

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- the liquidation is one to which §331 applies;
- the obligation must be acquired during the 12-month period beginning on the date the corporation adopts a plan of complete liquidation; and
- the liquidation must be completed within that 12-month period.[637]

If the obligation is received in exchange for inventory, stock in trade, or property held for sale to customers in the ordinary course of business, another condition must be satisfied:

> Substantially all of the corporation's inventory or similar property must be sold to one person in a single transaction.[638]

If the S corporation disposes of depreciable property for an installment obligation and the obligor thereof is a related person (within the meaning of §1239(b)), then the favorable treatment for shareholders under §453(h) (and thus the favorable treatment for S corporations under §453B(h)) is not available.[639]

If all of the above requirements are met, the distributee shareholders do not recognize gain on receipt of the obligations. They instead treat payments received under the obligations as payments received for their stock.[640] Although a shareholder's gain or loss on cancellation of stock is normally considered gain or loss on a sale or exchange, the payments received by a shareholder under an installment obligation to which §453(h)(1) and §453B(h) apply are characterized under the principles of §1366.[641] Thus, the character of a shareholder's gain or loss is determined as if the corporation had recognized gain or loss on the sale in which it received the installment obligation and passed that gain or loss through to the shareholder.[642]

Under this rule, the shareholders' stock bases must be apportioned between installment obligations and any other property distributed on liquidation. Because stock basis is allocated in this manner, it is possible for S corporation shareholders to accelerate gain recognition.

> *Example:* XYZ is an S corporation with a sole shareholder, B. B's stock basis is $500. XYZ has $2,000 in cash and $2,000 in appreciated property with an adjusted basis of $1,000. If XYZ adopts a plan of liquidation and subsequently enters into an agreement to sell its appreciated property on the installment basis for a $500 down payment and the receipt of three $500 payments over the next three years, it will recognize $250 of gain ($500/$2,000 × $1,000) in the year of sale. This $250 gain will flow through to B and increase their stock basis to $750.

If XYZ then liquidates and distributes its cash and installment obligation, B's stock basis will be apportioned $469 ($2,500 ÷ $4,000 × $750) to the $2,500 cash and $281 ($1,500 ÷ $4,000 × $750) to the $1,500 installment obligation. The distribution of the installment obligation will not cause gain recognition under §453B(h). The receipt of the installment obligation will not be treated as payment for B's stock under §453(h)(1). However, B will recognize $2,031 gain ($2,500 − $469) on the receipt of cash for their stock. In contrast, XYZ could have distributed the cash prior to the liquidation, and only $1,750 ($2,500 − $750) would have been taxable to B. As the installment note is repaid, the remaining deferred gain will be recognized.

Comment: This example points out a possible trap. To avoid this problem the shareholders would need to make advance distributions to eliminate their stock basis before the liquidating distribution so that none of their stock basis is apportioned to other assets received on liquidation. Alternatively, if the S corporation has no accumulated E&P, the S corporation could remain in existence until all payments under the obligation have been received. If the S corporation has accumulated E&P, planning must be done to ensure the tax on excess passive income would not apply.

D. Acquisitions by an S Corporation

As subchapter C applies to S corporations (unless otherwise provided or inconsistent with subchapter S), S corporations are free to use any of the acquisitive reorganization provisions or structure their acquisition in any manner that a C corporation could use. Owners of S corporations must consider the ability to continue S corporation status after the acquisition. This generally limits an S corporation's ability to utilize the tax-free reorganization provisions if issuing stock in the acquisition would result in excessive or ineligible shareholders of the acquiring S corporation. In certain situations, stock options, stock warrants or convertible debentures could be used where such eligibility rules pose a problem.[643]

There are a number of considerations that need to be taken into account in determining whether an asset or stock purchase will be used. For instance, the seller may be concerned about qualifying for installment sale treatment. However, if the seller's assets trigger recapture income, thus precluding favorable installment method treatment, an asset sale may not appear as attractive as a stock sale. Similarly, if an asset sale triggers recapture income, this ordinary income is not reduced by any capital loss recognized by the shareholders on liquidating their stock interest in the S corporation. A purchaser may desire the step up in depreciable or amortizable asset basis while a seller may wish to avoid built-in gains tax. Finally, state transfer taxes could be yet another factor in driving the structure of the sale.

1. Direct Taxable Asset Acquisitions

a. Tax Consequences to an Acquiring S Corporation

(1) Effect on S Election

An S corporation should not use its own stock as consideration in an asset purchase to the extent the stock would be held

[637] §453(h)(1)(A).
[638] §453(h)(1)(B).
[639] §453(h)(1)(C).
[640] §453(h)(1)(A).
[641] §453B(h). *See* PLR 9622012 (S corporation recognizes capital gain on the distribution of an installment note in which it has no basis; since note was not a §1374(d)(8) asset, its disposition does not trigger built-in gains tax).
[642] H.R. Rep. No. 100-795, at 64 (1988).

[643] But see Reg. §1.1361-1(l)(4), which limits the use of these instruments in a second-class-of-stock context.

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by an ineligible shareholder. To the extent the S corporation does not issue stock in the acquisition, the S election should remain in effect. If the S election terminates as a result of an asset purchase, the corporation may not make another S election for five years unless IRS consent is obtained.[644]

Comment: Depending upon the terms of the instrument, certain convertible debt instruments or options could be issued without terminating S status yet still providing the seller with an upside equity potential.

(2) Income Allocation in Year of Purchase

If the S election does not automatically terminate, income allocation for the acquiring S corporation is unaffected by the purchase (other than to include income and expenses associated with the acquired assets).[645] An S corporation may make an election to terminate the S corporation year (i.e., treat a full taxable year as consisting of two taxable years) if the acquisition resulted in a qualifying disposition of S corporation stock. In the case of an acquisition of assets by an S corporation, a qualifying disposition would result if the acquiring S corporation issued stock representing at least 25% of the previously outstanding shares to the target asset owners.[646] If the S election does terminate, the taxable year of the acquiring S corporation will generally consist of a short S and a short C year. Income is allocated in the S termination year on a per-share per-day basis unless the shareholders elect to close the books on date of termination or if there was a change in ownership of 50% or more in the termination year.[647]

(3) Corporate Level Tax

In the case of a wholly taxable acquisition of assets, the S corporation obtains a cost basis in the assets acquired[648] and is not subject to the §1374 built-in gains tax with respect to the acquired assets.

(4) Distributions

The treatment of post-acquisition distributions depends on whether the S election of the acquiring corporation terminates as a result of the acquisition. If the S election does not terminate, the distribution rules of §1368 generally apply. If the S election does terminate, the corporation may be able to make nontaxable cash distributions during the post-termination transition period that reduces the adjusted basis of stock under §1371(e)(1). After this period, unless the corporation is an eligible terminated S corporation,[649] the normal dividend distribution rules apply.[650]

b. Tax Consequences to Selling S Corporation

Generally, the target corporation (and possibly its shareholders) will recognize gain or loss on the transaction.[651] The sale could trigger depreciation recapture. There may be a corporate-level tax if the S corporation is subject to the built-in gains tax on the assets transferred. In any event, any gain recognized at the S corporation level will flow through and be taxed to shareholders. If the acquiring S corporation is a related party, §267 (disallowance of losses) and §1239 (treatment of gain as ordinary income) could also apply.

Practice Point: If the selling corporation is subject to the built-in gains tax, the parties should carefully consider the allocation of purchase price to minimize any tax leakage. For instance, allocation to newly created intangibles may be possible thus reducing the corporate-level tax associated with an asset sale. Proper documentation of the allocation of purchase consideration among the assets acquired may preserve the installment sale treatment for those assets that qualify.[652]

An all cash (no consideration other than cash) statutory merger of an S corporation into another corporation would also be treated as a direct taxable asset acquisition and liquidation of the target S corporation as continuity of interest would not be satisfied provided the owners of the two corporations were not identical.[653]

If the selling S corporation is selling interests in a qualified subchapter S subsidiary (QSub), the QSub election will generally terminate as the QSub may no longer meet the requirement of being wholly owned by an S corporation parent.[654] Immediately prior to termination of QSub status, the QSub is deemed to be a new corporation that acquires all of the assets and assumes all of the liabilities of the QSub in exchange for its stock.[655] The termination (alone or as part of a larger plan that includes the termination) must be treated accordingly under general principles of tax law.[656] Depending upon the facts and circumstances, the QSub termination may be afforded tax-free status under §351, §355, and §368(a)(1)(D), or may result in a taxable transfer to a new corporation.

Section 1361(b)(3)(C)(ii) provides that when the sale of a QSub results in the termination of the QSub election, the sale is treated as: (i) a sale of an undivided interest in the assets of the QSub (based on the percentage of stock sold) followed by (ii) a deemed transfer to the QSub in a §351 transaction. If an S corporation sells 21% of the interests in a QSub, it is treated as selling a 21% interest in all of the QSub's assets to the unrelated party, and all of the assets are then treated as transferred to a new corporation in a §351 transaction, with the result that the S corporation recognizes 21% of the gain or loss in the QSub's

[644] §1362(g).

[645] §1377(a)(1).

[646] Reg. §1.1368-1(g)(2)(i)(C).

[647] §1362(e)(3), §1362(e)(6)(D).

[648] §1012.

[649] There is a special rule allowing eligible terminated S corporations to make cash distributions following the post-termination transition period. For a discussion of §1371(f) and its requirements, see 730 T.M., *S Corporations: Formation and Termination.*

[650] §1368.

[651] §1001.

[652] Rev. Rul. 68-13.

[653] *See* Rev. Rul. 69-6. In PLR 9008068, the IRS ruled that a taxable merger of an S corporation into a C corporation, where the S shareholders received cash in exchange for their stock, was a purchase of the S corporation's assets by the C corporation. The result is the same when a disregarded entity is interposed. *See* PLR 200628008 (cash merger of two target S corporations into LLC that was disregarded as entity separate from its owner, another LLC taxed as partnership, was treated as deemed sale of assets by targets to parent LLC, followed by distribution of cash by targets to their sole shareholder in complete liquidation of targets). However, where there is identity of ownership among the target and acquiring corporations, the transaction may qualify as a D reorganization. *See* Reg. §1.368-2(b)(1)(i)(A).

[654] *See* §1361(b)(3)(B), §1361(b)(3)(C).

[655] §1361(b)(3)(C)(i). For an example of the termination of a QSub election in the context of a D reorganization, *see* PLR 201010023 and PLR 201045018.

[656] Reg. §1.1361-5(b)(1)(i).

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assets.[657] The regulations dealing with terminations of QSub status have not been updated to reflect changes in the law. Accordingly, some of the examples contained in Reg. §1.1361-5(b)(3) may no longer be applicable.

Example 9 of Reg. §1.1361-5(a)(3) suggests that when all the stock of a QSub is acquired in one transaction, the transaction is treated as an acquisition of all the assets and liabilities of the QSub and a subsequent transfer to a new corporation. If the acquiring corporation is an S corporation that subsequently makes a QSub election for the acquired QSub, the deemed reformation after the purchase and deemed liquidation resulting from the subsequent QSub election are both disregarded for federal income tax purposes.[658]

Example 9 may seem inconsistent with the statute since the example does not state whether the acquisition is taxable or tax free; it simply states there was an acquisition of the QSub. Accordingly, there may be some disagreement on whether the holding under the example is still valid as it relates to treating the transfer as a transfer of assets or stock assuming no subsequent QSub election. This regulation was issued prior to the statutory change in §1361(b)(3)(C)(ii) that addresses a termination of QSub status by sale of QSub stock.

2. Deemed Asset Acquisitions Under §338

a. Tax Consequences to an Acquiring S Corporation

(1) Section 338 Election

A §338 election is a unilateral election by an acquiring corporation to treat the stock purchase as an asset purchase.[659] A §338(h)(10) election is a bilateral election made by the acquiring corporation and the selling shareholder(s) of the acquired corporation to treat the stock purchase as a deemed asset purchase and liquidation of the target corporation. Under a §338(h)(10) election, the selling shareholder(s) generally takes into account the tax effect of a deemed asset sale and liquidation of the target corporation, while the deemed asset sale consequences of a §338 election are recognized on a one day return and generally do not affect the selling shareholders' reporting of the sale as a stock sale.[660] Under Reg. §1.338-10(a)(3), a target S corporation for which a §338 election (but not a §338(h)(10) election) is made must file a one-day deemed sale tax return as a C corporation reflecting its activities on the acquisition date, including the sale. The S corporation is also considered a component member of the controlled group of corporations including the purchasing corporation for purposes of the return unless the target is treated as an excluded member under §1563(b)(2). Given the potential double tax associated with a §338 election (without a §338(h)(10) election), such elections are rarely made for S corporation targets. Accordingly this discussion will focus on the much more common §338(h)(10) election. For a comprehensive discussion of §338, see 788 T.M., *Stock Purchases Treated as Asset Acquisitions — Section 338.*

(2) Section 338(h)(10) Election

The regulations provide that a §338(h)(10) election may be made for a target if the purchaser (a corporation) acquires the target in a qualified stock purchase. An S corporation may be the acquiror or the target in an acquisition for which an election is made under §338(h)(10).[661]

When the S corporation is the acquiror in a §338(h)(10) transaction, it is treated as creating a new corporation (New Target) that acquires all the assets of the target corporation for the grossed up stock price and liabilities assumed. Absent a QSub election, the acquiring S corporation will have a new C corporation subsidiary, New Target, following the election.

A subsequent liquidation of the target corporation (either via a qualified subchapter S subsidiary (QSub) election, actual dissolution or upstream merger of the target) in order to maintain flowthrough status of all operations should not invalidate the §338(h)(10) election.[662] In addition, although the subsequent liquidation may be treated as a transaction under §1374(d)(8), New Target's assets should not be subject to the built-in gains tax in the S corporation's hands as they have a tax basis equal to fair market value as a result of the §338(h)(10) election.

(3) Income Allocation in Year of Acquisition

The method of allocating income will depend on whether the acquiror S corporation's election terminates. In general, the results will be the same as in an outright purchase of assets if the S corporation election does not terminate and a QSub election is made for New Target effective the date of the acquisition. However, if a termination should occur as a result of the asset acquisition, the income would be allocated under the §1362(e) rules. Income may be allocated under the closing of the books method if stock sufficient to meet a qualifying disposition under Reg. §1.1368-1(g)(2)(i)(C) is issued in the transaction.

b. Tax Consequences to the Acquired Corporation and Its Shareholders

When the target corporation in a §338(h)(10) transaction is a member (but not the parent) of a consolidated group, the selling members do not recognize gain or loss on the sale of their Target stock. Instead, under the consolidated return rules, Target's recognized amounts in the deemed asset sale tier up to its owners and any gain or loss recognized on the deemed asset sale is reported on the consolidated return for the group that included Target. The deemed liquidation while in the group in

[657] *See* Staff of the J. Comm. on Tax'n, *Technical Explanation of the Small Business and Work Opportunity Tax Act of 2007*, at 24–25 (J. Comm. Print 2007). The Technical Explanation states that §1361(b)(3)(C)(ii) is not intended to change the treatment of an S corporation's disposition of QSub stock in an otherwise nontaxable transaction (e.g., an S corporation's transfer of QSub stock to the S corporation's shareholders in a distribution to which §368(a)(1)(D) and §355 apply).

[658] Reg. §1.1361-5(b)(3) *Ex.* 9.

[659] In TAM 9245004, the IRS National Office advised that S corporations are treated as corporations, and not as individuals, for purposes of §338 and §332. Subsequently, the 1996 SBJPA repealed the rule treating S corporations as individuals when they were shareholders of another corporation. Pub. L. No. 104-188, §1310. See former §1371(a)(2), which treated an S corporation as an individual when it held stock in another corporation.

[660] A §338 election may affect certain selling U.S. shareholders of foreign corporations under Reg. §1.338-9.

[661] *See, e.g.*, Reg. §1.338(h)(10)-1(b)(4) (defining S corporation target), Reg. §1.338(h)(10)-1(b)(5) (defining S corporation shareholder), and Reg. §1.338(h)(10)-1(d)(3) (effect of deemed sale, including special provisions for S corporation targets).

[662] Reg. §1.338-3(c)(1)(i).

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most instances qualifies as tax free to the shareholders under §332; however, in certain circumstances, where Target is insolvent, the liquidation may not be tax free.

When the target is an S corporation, the S corporation election continues in effect through the close of the acquisition date notwithstanding §1362(d)(2).[663] In addition, any QSubs remain QSubs through the close of the acquisition date.[664] Normally, the last day of S corporation status is the day immediately preceding the day on which the terminating event occurred.[665] In the case of a qualified stock purchase, absent the exception in the regulations, the S corporation election would terminate on the day of the sale and all gain would be taxed at the corporate level instead of flowing through to the shareholders under §1366.

Comment: When an S corporation is the target of a §338(h)(10) transaction, it is essential that the target S corporation actually has retained it S status since the inception of its S corporation election. As part of the tax due diligence of the target, the buyer will want to assure that the target is in fact an eligible S corporation. If there is an inadvertent termination in the target's history, the §338(h)(10) election is invalid because a stand-alone C corporation cannot participate in a §338(h)(10) transaction. If a problem arises with the target's S corporation eligibility, consider an alternative to the §338(h)(10) transaction. The selling target shareholders could contribute their existing S corporation into a NewCo and elect QSub status for their existing S corporation. This is treated as an F reorganization under Rev. Rul. 2008-18 and NewCo will continue to use the existing S corporation's S election.[666] As a next step, the selling target shareholders could cause the QSub to convert under local law into an LLC. The LLC could be sold to the buyer as a disregarded entity which would be treated as an asset purchase with a stepped-up basis for the buyer. This leaves the issue of the original target's S corporation status to the sellers and does not taint the buyer's ability to obtain a stepped-up basis in the target assets.

Practice Point: While a QSub election can be made retroactively, it is important to make sure that the QSub election is actually made (considered by most to mean filed) before converting to the LLC in the steps suggested above. In order for a QSub election to be effective, the company for which the election is to be effective must be an eligible corporation at the time filed. Reg. §1.1363-3(a) requires the electing entity meet all the requirements of §1361(b)(3)(B) "*at the time the election is made…*" Thus if the corporation was converted to an LLC prior to making (filing) the election, it would not be a corporation at the time of filing and thus the QSub election would be invalid.[667]

In a §338(h)(10) transaction, the S corporation is treated as if it transferred all of its assets to an unrelated person in exchange for consideration (including the assumption of liabilities). Subsequently, the S corporation is deemed to transfer all remaining assets (including the deemed consideration received) to its shareholders in liquidation.[668] The deemed sale gain under §338(h)(10) is reported on the target's final S corporation return and, therefore, is taken into account under §1366 and §1367 in determining the target shareholder's basis in the target stock and resulting gain or loss on the deemed liquidation of the target.[669] However, S corporation shareholders will recognize no gain or loss on the sale of their S corporation stock in the qualified stock purchase, thus providing one layer of tax consistent with the benefits of S corporation status.[670] The shareholders may recognize gain or loss with respect to their stock on the deemed liquidation of the S corporation. The §338(h)(10) election must be made jointly by the purchasing corporation and all target shareholders whether or not they are disposing of the target S corporation stock.[671] S corporation stock retained by a non-selling shareholder in the transaction is treated as if the shareholder acquired the stock on the day after the acquisition date for fair market value with the deemed cash distributed to the non-selling shareholders in the deemed liquidation.[672]

Generally, the total gain recognized by S corporation shareholders is the same under a stock sale or an asset sale followed by a liquidation (or the §338 election). The effect of state and local income taxes on the two alternatives may create a difference in net cash flows and income characterization. The character of the gain will likely differ to some extent depending upon the assets of the S corporation. To the extent the S corporation holds assets subject to depreciation recapture or that are of an ordinary nature (i.e., inventory or cash basis accounts receivable), a shareholder may pay more tax due to the different tax rates applicable to ordinary and capital gain income.

Comment: The requirement that all S corporation shareholders consent to the §338 election may require some form of compensation to be paid to non-selling shareholders in order to induce them to consent to a §338(h)(10) election as they will recognize their proportionate share of the deemed sale income and gain even though they receive no cash consideration in the transaction. While the fiction of the §338(h)(10) election would imply disproportionate liquidating distributions as a result of such separate negotiations, this ought not create a second class of stock under Reg. §1.1361-1(l)(2)(v).

The concepts of a §338(h)(10) election made for an S corporation target are illustrated by the example below.

> *Example:* An S corporation's (T) sole class of stock is owned 40% each by X and Y and 20% by Z. T, X, Y, and Z all use the cash method of accounting. X and Y each have an adjusted basis of $10,000 in the stock. Z has an adjusted basis of $5,000 in the stock. X, Y, and Z hold no

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[663] Reg. §1.338(h)(10)-1(d)(3)(i).

[664] Reg. §1.338(h)(10)-1(d)(3)(i).

[665] §1362(d)(2)(B).

[666] Situation 1. *See, e.g.*, PLR 201635001.

[667] *See* PLR 201724013.

[668] Reg. §1.338(h)(10)-1(d)(3)(i), §1.338(h)(10)-1(d)(4)(i).

[669] Reg. §1.338(h)(10)-1(d)(5). The rule applies to both selling and non-selling S corporation shareholders. Reg. §1.338(h)(10)-1(d)(6).

[670] Reg. §1.338(h)(10)-1(d)(5)(iii).

[671] Reg. §1.338(h)(10)-1(c)(2). See the instructions to Form 8023 for more guidance on making the election.

[672] Reg. §1.338(h)(10)-1(d)(5)(ii). Under Reg. §1.338(h)(10)-1(d)(5)(i), S corporation shareholders are deemed to receive the assets transferred by old T in the deemed liquidation (presumably cash for the non-selling shareholders based on the grossed-up purchase price). Fair market value equals the grossed-up amount realized on the sale of the target's stock to the purchasing corporation as calculated under Reg. §1.338-4(c). *See also* Reg. §1.338(h)(10)-1(e) *Ex.* 10.

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installment obligations to which §453A applies. On March 1, Year 1, X sells its stock to P for $40,000 in cash and Y sells its stock to P for a $25,000 note issued by P and real estate having a fair market value of $15,000. The $25,000 note, due in full in Year 7, is not publicly traded and bears adequate stated interest. X and Y have no selling expenses. T's sole asset is real estate, which has a value of $110,000 and an adjusted basis of $35,000. This real estate is encumbered by long-outstanding purchase-money indebtedness of $10,000.

The real estate does not have built-in gain subject to §1374. X, Y, and Z join with P in making a §338(h)(10) election for T.

Solely for purposes of application of §453, §453A, and §453B, old T is considered in its deemed asset sale to receive back from new T the $25,000 note (considered issued by new T) and $75,000 of cash (total consideration of $80,000 paid for all the stock sold, which is then divided by .80 in the grossing-up, with the resulting figure of $100,000 then reduced by the amount of the $25,000 installment note). Absent an election under §453(d), gain is reported by old T under the installment method.

In applying the installment method to old T's deemed asset sale, the contract price for old T's assets deemed sold is $100,000, the $110,000 selling price reduced by the indebtedness of $10,000 to which the assets are subject. (The $110,000 selling price is itself the sum of the $80,000 grossed-up to $100,000 and the $10,000 liability.) Gross profit is $75,000 ($110,000 selling price less old T's basis of $35,000). Old T's gross profit ratio is 0.75 (gross profit of $75,000 divided by $100,000 contract price). Thus, $56,250 (0.75 × the $75,000 cash old T is deemed to receive in Year 1) is gain attributable to the sale, and $18,750 ($75,000 – $56,250) is recovery of basis.

In its liquidation, old T is deemed to distribute the $25,000 note to Y, since Y actually sold the stock partly for that consideration. To the extent of the remaining liquidating distribution to Y, it is deemed to receive, along with X and Z, the balance of old T's liquidating assets in the form of cash. Under §453(h), Y, unless it makes an election under §453(d), is not required to treat the receipt of the note as a payment for the T stock; P's payment of the $25,000 note in Year 7 to Y is a payment for the T stock. Because §453(h) applies to Y, old T's deemed liquidating distribution of the note is, under §453B(h), not treated as a taxable disposition by old T.

Under §1366, X reports 40%, or $22,500, of old T's $56,250 gain recognized in Year 1. Under §1367, this increases X's $10,000 adjusted basis in the T stock to $32,500. Next, in old T's deemed liquidation, X is considered to receive $40,000 for its old T shares, causing X to recognize an additional $7,500 gain in Year 1.

Under §1366, Y reports 40%, or $22,500, of old T's $56,250 gain recognized in Year 1. Under §1367, this increases Y's $10,000 adjusted basis in its T stock to $32,500. Next, in old T's deemed liquidation, Y is considered to receive the $25,000 note and $15,000 of other consideration. Applying §453, including §453(h), to the deemed liquidation, Y's selling price and contract price are both $40,000. Gross profit is $7,500 ($40,000 selling price – Y's basis of $32,500). Y's gross profit ratio is 0.1875 (gross profit of $7,500 divided by $40,000 contract price). Thus, $2,812.50 (0.1875 – $15,000) is Year 1 gain attributable to the deemed liquidation. In Year 7, when the $25,000 note is paid, Y has $4,687.50 (0.1875 × $25,000) of additional gain.

Under §1366, Z reports 20%, or $11,250, of old T's $56,250 gain recognized in Year 1. Under §1367, this increases Z's $5,000 adjusted basis in its T stock to $16,250. Next, in old T's deemed liquidation, Z is considered to receive $20,000 for its old T shares, causing Y to recognize an additional $3,750 gain in Year 1. Finally, under Reg. §1.338(h)(10)-1(d)(5)(ii), Z is considered to acquire its stock in T on the day after the acquisition date for $20,000 (fair market value = grossed-up amount realized of $100,000 × 20%). Z's holding period in the stock deemed received in new T begins at that time.[673]

One final item to consider in connection with a §338(h)(10) election for an S corporation is the effect on built-in gains. Since the transaction is treated as a deemed asset sale, any remaining NUBIG would be triggered upon the sale and a corporate-level tax would arise. Any built-in gains tax would likely become the responsibility of the buyer unless agreed to otherwise. The imposition of the built-in gains tax (an up-front tax) in many situations may outweigh the benefit of a step up in assets (a deduction taken over time via depreciation and amortization).

3. *Deemed Asset Acquisitions Under §336(e)*

a. *In General*

Section 336(e) authorizes regulations under which an election may be made to treat the sale, exchange, or distribution of at least 80% of the voting power and value of the stock of a corporation (target) as a sale of all its underlying assets. Section 336(e) was enacted as part of *General Utilities* repeal. Similar to an election under §338(h)(10) available with respect to certain purchases of target stock, §336(e) is meant to provide taxpayers relief from a potential multiple taxation of the same economic gain that can result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in the basis of the assets of the corporation.[674] For 27 years, §336(e) remained inoperative until the IRS released its final regulations in May 2013.[675]

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[673] Reg. §1.338(h)(10)-1(e) *Ex.* 10. *See also* Reg. §1.338(h)(10)-1(d)(8) (availability of installment method).

[674] *See* H.R. Rep. No. 99-841, at 204 (1986) (Conf. Rep.). *See also* Bogdanksi, *Section 336(e) Elections Finally Arrive*, 40 Corp. Tax. 3 (2013); Cummings, *Final Regulations on Qualified Stock Dispositions*, 140 Tax Notes 805 (Aug. 19, 2013); Harvey, Harris & Kugler, *Deemed Asset Sales and S Corporations*, 141 Tax Notes 1057 (Dec. 9, 2013); Orr, *Sec. 336(e) Elections for S Corp. Targets: Get a Step-Up Without a Letter Ruling*, The Tax Advisor (May 1, 2018); Sobol, Prillaman & Starr, *Section 336(e) Deemed Asset Acquisitions and S Corporations*, 33 TMWR 475 (Apr. 7, 2014).

[675] T.D. 9619, 78 Fed. Reg. 28,467 (May 15, 2013) (effective for any qualified stock disposition for which the disposition date is on or after May 15, 2013). Note that in CCA 201009013, the Chief Counsel's Office advised that a

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The §336(e) regulations generally adopt the structure and principles of §338(h)(10) and the §338(h)(10) regulations.[676] For example, the §336(e) regulations generally incorporate the rules of §338 governing the allocation of consideration in the resulting deemed sale of the target's assets and the determination of target's basis in its underlying assets resulting from such deemed sale.[677] However, unlike an election under §338(h)(10), which is available only if target stock is acquired by a corporate purchaser, the §336(e) regulations do not require an acquirer of target stock to be a corporation, or even necessarily a purchaser.[678] Also, unlike §338(h)(10), which generally requires that a single purchasing corporation acquire the stock of a target, the §336(e) regulations permit the aggregation of all stock of a target that is sold, exchanged, and distributed by a seller to different acquirers for purposes of determining whether there has been a qualified stock disposition of a target.[679]

Note: Just like §338(h)(10) transactions, any §336(e) elections will put a premium on making sure the S corporation election is valid. Due diligence of the S corporation's eligibility will be critically important to obtaining the §336(e) benefits.

Under Reg. §1.336-2(a), an election under §336(e) is available for qualified stock dispositions (QSDs), as defined in Reg. §1.336-1(b)(6),[680] i.e., "any transaction or series of transactions in which stock meeting the requirements of section 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or by the S corporation shareholders in a disposition … during the 12-month disposition period," meaning the 12-month period beginning with the date of the first sale, exchange, or distribution of stock included in a qualified stock disposition.[681] For this purpose, the term disposition is defined to mean any sale, exchange, or distribution of stock, if all the following requirements are met:

- Step One — the purchaser's basis in the stock is not determined in whole or in part by reference to either the basis of the stock in the hands of the person from whom it was acquired or under §1014;
- Step Two — the stock is not sold, exchanged, or distributed (1) in a transaction to which §351, §354, §355, or §356 applies (unless the stock is distributed to an unrelated person in a transaction in which the full amount of stock gain would be recognized under §355(d)(2) or §355(e)(2), for disqualified distributions), or (2) in a transaction in which the transferor does not recognize the entire amount of gain or loss realized in the transaction; and
- Step Three — the stock is not sold, exchanged, or distributed to a related person.[682]

If a §336(e) election is made for a QSD that is not described in §355(d)(2) or §355(e)(2), the shareholders will not be considered to sell their stock for federal income tax purposes. Instead, the S corporation will be treated as selling its assets to an unrelated party in exchange for the aggregate deemed asset disposition price (ADADP) and liquidating on the disposition date while the selling shareholders are still shareholders.[683] The shareholders take into account the consequences of the deemed sale under §1366 and §1367 and recognize gain or loss on the liquidating distribution. New target is deemed to purchase the old target's assets from an unrelated person for an amount equal to the adjusted grossed-up basis (AGUB) allocated under §1060 principles.[684]

Note: A sale of stock in an S corporation with respect to which an election under §336(e) or §338(h)(10) would be treated as a fully taxable disposition of the S corporation's assets followed by a liquidation of the S corporation and no additional gain or loss will be included in net investment income under Reg. §1.1411-4(a)(1)(iii).[685]

The S corporation will be considered to be the old target for the period ending at the close of the disposition date and will be considered to be the new target for the period beginning on the day following the disposition date. Old target's S election continues in effect through the close of the disposition date (including the time of the deemed asset disposition and the deemed liquidation) at which time old target's S election terminates, and old target ceases to exist. If new target qualifies as a small business corporation within the meaning of §1361(b) and wants to be an S corporation, a new election for new target under §1362(a) must be made.[686] New target should continue to use old target's EIN.[687] Also, any direct or indirect subsidiaries of old target that old target has elected to treat as QSubs under §1361(b)(3) remain QSubs through the close of the disposition date and new elections must be made to treat those subsidiaries as QSubs thereafter.

Note: Because old target's attributes do not carryover, new target would not be subject to either the built-in gains tax (there is no conversion from subchapter C status to subchapter S status) or to the passive income tax (there is no carryover of sub-

taxpayer may not make an election under §336(e) prior to the effective date of the final regulations.

[676] Reg. §1.336-1(a). For a comparison of §338(h)(10) and §336(e), *see* Harper & Anderson, *Section 336(e) — Another Tool in the Toolbox*, 102 Daily Tax Rep. J-1 (May 28, 2014).

[677] *See* Reg. §1.336-3, §1.336-4.

[678] Reg. §1.336-1(b)(2).

[679] Reg. §1.336-1(b)(6), §1.336-1(b)(7).

[680] Reg. §1.336-2(a).

[681] Reg. §1.336-1(b)(6), §1.336-1(b)(7).

[682] Reg. §1.336-1(b)(5). For purposes of the §336(e) regulations, two persons generally are considered related if stock of a corporation owned by one would be attributed to the other under §318(a), other than §318(a)(4); however, neither §318(a)(2)(A) nor §318(a)(3)(A) apply to attribute stock ownership from a partnership to a partner, or from a partner to a partnership, if such partner owns, directly or indirectly, interests representing less than 5% of the value of the partnership. Reg. §1.336-1(b)(12).

[683] Reg. §1.336-3 provides the definition of ADADP, which is simply the amount for which old target is deemed to have sold all of its assets in the deemed asset disposition. The ADADP is allocated among the S corporation assets in the same manner as the aggregate deemed sale price (ADSP) is allocated under §338. Reg. §1.338-2(b)(1). Reg. §1.336-4 provides the definition of AGUB, which is simply the amount for which new target is deemed to have purchased its assets. Note that disparities between ADSP and AGUB can occur when the purchaser uses contingent consideration, the purchaser has stock that was not recently purchased, or the target has contingent or other liabilities that are taken into account differently for ADSP and AGUB under tax accounting rules. *See* Seago & Schnee, *Section 338 Transactions: Why ADSP and AGUB Can Differ*, 119 J. Tax'n 158 (2013).

[684] Reg. §1.336-2(b)(1).

[685] Prop. Reg. §1.1411-7(a)(4), REG-130843-13, 77 Fed. Reg. 72,612 (Dec. 2, 2013).

[686] Reg. §1.336-2(b)(1)(i)(A).

[687] *See* Reg. §1.338-1(b)(3)(iii). A similar approach should apply for purposes of §336(e).

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chapter C E&P to trigger monitoring for such tax) if an S election is made unless new target later acquires assets from a C corporation in a carryover basis transaction or otherwise inherits subchapter C E&P.

If a §338(h)(10) election is made with respect to an S corporation target, all of the S corporation shareholders, including those who do not sell their S corporation target stock, must consent to the election. With respect to a §336(e) election, the regulations provide the same requirement for purposes of making a §336(e) election. While S corporation shareholders consent to a §338(h)(10) election by signing Form 8023, to make a §336(e) election, the S corporation shareholders do not file a §336(e) election statement. Instead, consent to make a §336(e) election is established by all the S corporation shareholders, including those who do not dispose of their stock in the transaction, and target by entering into a written, binding agreement to make the election, on or before the due date (including extensions) of the S corporation target's income tax return.[688] The §336(e) election statement for an S corporation target is filed with the income tax return of the S corporation target.[689]

b. Distributions of QSub Stock

A distribution of QSub stock raises interesting issues. In general, distributions of C corporation stock meeting the requirements of §1504(a)(2) are treated as disposed stock for the deemed asset disposition election under §336(e). Shareholder distributees would be treated as purchasers[690] and counted in tabulating the 80%of disposed stock as long as they aren't related to the distributing S corporation.[691] For example, a distribution of C corporation stock to a 50-percent-or-more S corporation shareholder (calculated by applying modified attribution rules of §318) wouldn't be treated as a disposition for purposes of §336(e). Also, it is important to remember that distributions of appreciated property, e.g., QSub stock, are treated as a sale to the distributee under Section 311(b) for purposes of determining gain.

But is a QSub stock distribution really a stock distribution? Under §1361(b)(3)(C)(i), the distribution of the QSub stock would be treated as terminating QSub status resulting in a deemed incorporation of the QSub's assets immediately preceding the terminating event (the distribution). However, §1361(b)(3)(C)(ii) states that when a QSub election terminates as a result of the sale of QSub stock the transaction is treated as a sale of a percentage of the QSub's assets followed by a transfer of those assets into a new corporation (either wholly owned by the purchaser if 100% of the QSub stock were sold or jointly by the purchaser and S corporation if less than 100% were sold).

If §1361(b)(3)(C)(ii) were to apply to the distribution of QSub stock, such distribution would be treated as a distribution of a proportionate amount of the QSub assets and therefore not eligible to be included in a qualified stock disposition.

Practice Point: The authors believe that in the case of a distribution of QSub stock, §1361(b)(3)(C)(ii) likely does not govern as the distribution is not truly a sale of QSub stock notwithstanding that §311(b) requires gain to be recognized *as if* the QSub stock were sold to the distributee shareholder. As discussed above in D.1.b., pursuant to Example 9 of Reg. §1.1361-5(b)(3), the transfer of 100% of the stock of a QSub is treated as a transfer of 100% of the assets of the QSub followed by the formation of a new corporation. In contrast, Example 4 of Reg. §1.1361-5(b)(3) states that the distribution of 100% of the stock of a QSub may qualify as a spin off under §355, and Example 1 of Reg. §1.1361-5(c)(3) holds that the distribution terminates the QSub election and an S election may be made for the new corporation without consent. The holding of Example 4 may rely on general tax principles and the holding in Rev. Rul. 77-191, in which a distribution of assets followed by an incorporation of such assets was held to a reorganization under §368(a)(1)(D) and §355.[692] The authors believe that taxpayers may have authority to treat the distribution of a QSub either as a distribution of assets or stock unless general principles or other authorities would require a certain characterization. Accordingly, the distribution of QSub stock may (in certain circumstances) be a qualified stock disposition for purposes of §336(e).

While a distribution of a partial interest (or even 100%) of the stock of a QSub may be a disposition of stock for purposes of §336(e), an outright transfer of such stock in a sale transaction would not be a disposition taking into account §1361(b)(3)(C)(ii). Any sale of more than 20% of the stock of a QSub will generally preclude a §336(e) election. While a sale of less than all of the stock of a QSub is treated as an asset purchase, the asset step-up will generally not provide a tax benefit to the purchaser unless the former QSub is able to join a consolidated group of the purchaser. This is because following the deemed sale, the assets of the former QSub are deemed contributed to a new corporation that cannot be an S corporation or a QSub, and thus the earnings are subject to double tax if distributed.

Therefore, if a purchaser wishes to directly obtain the benefits on a partial QSub acquisition, consideration should be given to converting the QSub to a limited liability company prior to any sale of interests. This would cause the LLC to spring to existence as a partnership following the purchase.[693]

c. Retained Stock

The §336(e) rules provide for situations where certain minority shareholders may retain their S corporation stock when their S corporation is a target in a §336(e) transaction.

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[688] In PLR 201721011 the IRS granted an S corporation and purchaser a 45-day extension to file an election under Reg. §301.9100-3 because they reasonably relied on a qualified tax professional, the request for relief was filed before the failure to file the §336(e) election was discovered by the IRS, and granting relief did not prejudice the interests of the government. *See also* PLR 201825014 (for same reasons, granting 60-day extension for corporate parent and target company to file protective § 336(e) election).

[689] Reg. §1.336-2(h)(3). *See also* Reg. §1.336-2(h)(5) (election statement), §1.336-2(h)(6) (contents of election statement).

[690] Reg. §1.336-1(b)(2) states that a purchaser includes both a transferee and a distributee of target stock. See also Reg. §1.336-1(b)(5)(iii), which prescribes rules for transactions for related persons.

[691] Reg. §1.336-1(b)(5)(i)(C). A disposition cannot include stock that is sold, exchanged or distributed to a related person. Under Reg. §1.336-1(b)(5)(iii), determining relatedness for stock sold, exchanged, or distributed, the principles of §338(h)(3)(C) and Reg. §1.338-3(b)(3) apply. In general, under these rules, the timing for testing relationship is determined after the stock has been sold. This means that in general redemptions of related shareholders can be counted as part of a qualified stock disposition.

[692] 1977-1 C.B. 94.

[693] Rev. Rul. 99-5.

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Example: An S corporation is owned by three unrelated shareholders. A and B each own 40% of S corporation's stock and C owns 20%. A and B agree to sell their S corporation stock to an unrelated, ineligible third-party noncorporate purchaser. Such a sale would normally cause the Target S corporation's status to terminate on the disposition date. C decides not to sell any shares and will remain active in the Target S corporation after the purchase takes place.

A, B, C, and the S corporation enter into a binding, written agreement to make a Section 336(e) election, and the S corporation attaches a Section 336(e) election statement to its timely filed, liquidating tax return for the tax year that includes the disposition date. Target S corporation will retain its S status through the close of the disposition date. Under Reg. §1.336-2(b)(1)(v), C is treated as purchasing the stock of new target from an unrelated person on the day after the disposition date for its fair market value. The holding period for the retained stock starts on the day after the disposition date. The fair market value of the new target stock would be the grossed-up amount realized on the sale of the recently sold S corporation stock.[694] Along with A and B, C will be treated as receiving its proportionate share of the S corporation's operating income up through the date of the deemed liquidation (close of disposition date), as well as the gains or losses on the deemed asset dispositions, which will increase A's, B's, and C's outside stock basis in the Target S corporation. C will need to report this income on its individual income tax return even though C didn't actually sell any stock to the purchaser and may not have received cash consideration as a result of A's and B's sales.

Practice Point: The previous example demonstrates why it is important that C, as a retaining shareholder and subject to taxation, must actively participate in making the §336(e) election. The end result for C as a retaining shareholder is a stepped-up basis in new target stock with a new holding period, with an inside step-up in the corporation's assets. Before the actual disposition, the S corporation can make distributions to cover income taxes on operating income for the last S corporation tax year. But C will need to negotiate with the purchasers for some additional compensation or a stay bonus (if employed by the Target S corporation) to help cover taxes related to their share of the deemed asset disposition.

d. Getting the Right Participation

There is no formal election form to make the §336(e) election. The target S corporation and its shareholders must enter into a binding written agreement to make the §336(e) election, and an election statement needs to be prepared. Making sure the right parties participate in the §336(e) election process will be a challenge, especially where dispositions of stock take place over a period of time (not exceeding 12 months) and possibly span two tax years.

Example: An S corporation is owned by three unrelated shareholders. A and B each own 45% of the S corporation's stock and C owns 10%. All shareholders have owned their S corporation stock for more than one year. In Year 1, on Date 1, A agrees to have its stock redeemed by the S corporation. The shareholders elect to close the books under Section 1377(a)(2). In Year 2, on Date 2, but within 12 months of A's stock redemption, B sells their S corporation stock to an unrelated eligible S corporation shareholder, P. P requests that a §336(e) election be made with respect to their purchase. There is no overlap with §338(h)(10). Because P is not a corporation, a §336(e) election should be considered. B's outright sale of their target S corporation stock to P would be a qualifying disposition (B sells approximately 82% — 45/55 — of the outstanding shares on Date 2 to an unrelated purchaser). A's stock redemption on Date 1 isn't part of B's qualified stock disposition and presumably doesn't need to participate in the §336(e) election. The regulations are clear that "any transaction or series of transactions … during a 12-month period disposition period" can constitute a qualified stock disposition.[695] The normal S corporation consequences would apply to A. A's termination of interest likely would lead to a §1377(a)(2) shareholder election to close the books as to A in Year 1. A receives a short-period Schedule K-1 for Year 1 and doesn't participate in the proceeds or gain or loss on the shares sold by B in Year 2.

Example: Assume the same facts in the previous example, except that the ownership percentages of A and B are each 40% owners and C is a 20% shareholder. Again A is redeemed on Date 1, Year 1 and B sells their stock on Date 2, Year 2 to P. B's sale of stock isn't a qualifying stock disposition because it is only a sale of 66.6% (40/60) of the outstanding shares. C doesn't sell any stock. If P wants a basis step-up in the corporation's assets when buying the stock, a §336(e) election must be made. Under Reg. §1.336-1(b)(6)(i), any transaction or series of transactions within the 12-month disposition period can constitute a qualified stock disposition.[696] But getting A's participation presents some very practical problems. A has been redeemed and may no longer be in contact with their former S corporation, or for that matter B and C. Even if A's location is known, will A be willing to participate in the deemed asset disposition? A actually might be quite receptive to participating in the election as long as they are adequately compensated.

A was redeemed under §302 and received long-term capital gain on the redemption transaction. They received their per-day, per-share allocation of operating income of the S corporation up through the date A was redeemed under

[694] Reg. §1.336-3(c) provides a definition of the grossed-up amount realized on the disposition of the recently disposed stock.

[695] Reg. §1.336-1(b)(6)(i) provides the definition of a qualified stock disposition or QSD.

[696] Under Reg. §1.336-1(b)(5), the term disposition means any sale, exchange or distribution of stock as long as three requirements are met: (1) there is no carryover-of-basis transaction; (2) generally the stock isn't sold, exchanged or distributed in a §351, §354, §355, or §356 transaction; and (3) the stock isn't sold, exchanged or distributed to a related person.

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the closing-of-the-books election. A has already filed their Year 1 federal and state income tax returns consistent with this treatment. If A participates in the deemed asset disposition election, can they, or do they, participate in any of the deemed asset gains or losses triggered on Date 2, Year 2 as a result of the §336(e) election when they are no longer a shareholder?

Under Reg. §1.336-2(c), the S corporation and P will both be treated as acquiring their stock on Dates 1 and 2, respectively. Because the qualified disposition date is Date 2, only shareholders on that date should be affected by the election.

Since A is no longer a shareholder, the deemed asset gains or losses should flow to B and C in Year 2 in the S corporation's liquidating return. B and C bear the tax burden on the deemed asset disposition. B should have the wherewithal to pay their taxes out of their consideration received from the noncorporate buyer. C will need to negotiate some payment from P, possibly in the form of a stay-bonus, so that he has cash to pay the tax on their portion of the deemed asset disposition gains. A may receive a payment from B and/or the buyer for participating in the §336(e) election, and would likely treat the payment as ordinary income in Year 2 for services rendered.

All the parties will need to carefully calculate their payments to make sure they are left economically whole relative to the other shareholders in the transaction. P will need to make sure that whatever payments are made to A and B are offset by the benefit of the asset step-up from the §336(e) election.

Under Reg. §1.1361-1(l)(2)(v), in a §338(h)(10) transaction, S corporation shareholders can receive varying amounts on a per-share basis from a purchaser without causing the S corporation to have more than one class of stock as long as they are negotiated at arm's length.[697] This rule was adopted to eliminate possible concerns regarding identity in liquidating distributions and to avoid any second class of stock issues on the deemed liquidation of the S corporation in a §338(h)(10) transaction.

In the previous example, A and B will likely receive disparate amounts for their shares, but not necessarily from the noncorporate buyer. A's redemption consideration isn't disproportionate to the consideration received by B because A is no longer a shareholder at the time of the deemed asset disposition and liquidation. A was appropriately compensated for their stock under the shareholders' agreement, and they should negotiate reasonable compensation for their participation in the §336(e) election.

Practice Point: It would seem if disproportionate distribution issues are raised in §336(e) transactions, taxpayers should have two arguments against such assertion. Either the extra payments are compensation for service or, similar to §338(h)(10) transactions, that any varying amounts received have been negotiated at arm's length with the purchaser and are disregarded for purposes of determining if the S corporation has more than one class of stock.

e. Redemptions as QSDs

The fact that a redemption appears to be a disposition for purposes of §336(e) can lead to strange results, as highlighted in the following example:

Example: An S corporation is owned by three unrelated shareholders. A owns 60 of the 100 outstanding shares, B owns 25 shares and C owns the remaining 15 shares. All shareholders have owned their S corporation stock for more than one year. In Year 1, on Date 1, A agrees to sell its 60 shares to P, an unrelated eligible S corporation shareholder. A and P elect to close the books under §1377(a)(2). In Year 2, on Date 2, but within 12 months of A's stock sale, B's 25 shares are redeemed by the S corporation. B, C and P elect to close the books under §1377(a)(2) for Year 2. Can a §336(e) election be made? Who needs to consent to this election? What are the tax consequences?

The combination of B's redemption and A's sale appear to result in a QSD as the total shares outstanding within 12 months of A's sale is reduced by B's redemption, giving P 80% of the S corporation's stock (60/75). As discussed above, under Reg. §1.336-1(b)(6)(i), any transaction or series of transactions within 12 months can constitute the qualified stock disposition. In this example, a §336(e) election appears possible. It also appears that A, B, and C at a minimum must consent to such an election. As in the previous example, A participates in the qualified stock disposition election but their tax consequences in Year 1 likely don't change.

But what happens to P, and must they also consent to the election? Even though P is the buyer in the §336(e) transaction, it would seem P would need to consent to the election because they are a shareholder at the time a qualifying disposition takes place. Notwithstanding the fact that the regulations state that generally a §336(e) election doesn't affect the federal income tax consequences to the purchaser,[698] the fictions of the deemed asset sale and liquidation appear to apply to P, B, and C (A's sale of stock would not be affected) on Date 2. Because P is a more-than-50-percent owner, they are a related party under §1239, which could recharacterize their gain to ordinary. The parties should also be cautious about the §197 anti-churning rules and their possible application to this transaction.[699]

E. Tax-Free Asset Acquisitions by an S Corporation

1. General

There are several alternatives available to an S corporation in structuring a tax-free acquisition of assets. An S corporation is able to use an A (statutory merger), C, or acquisitive D reorganization under §368(a).[700] An S corporation may also acquire

[697] *See* T.D. 8940.

[698] Reg. §1.336-2(c).

[699] *See* §197(f)(9)(C).

[700] *See* §1371(a); GCM 39768 (Dec. 1, 1988).

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assets in a §351 transaction. Three important factors to consider in structuring a tax-free asset acquisition by an S corporation are the single-class-of-stock requirement, the number of allowable shareholders, and the restriction on type of shareholders. Thus, a reorganization or §351 transaction in which an S corporation is the acquiring corporation may be more limited than in a similar transaction involving a C corporation.

The following discussion regarding asset reorganizations assumes that all statutory and legislative requirements are satisfied for reorganization treatment.

2. *Acquisitive Asset Reorganizations*

A transaction defined as a reorganization is subject to special treatment under certain provisions of the Code. The qualification of a given transaction as a reorganization requires compliance with, not only the applicable statutory definition, but also a host of judicial and administrative rules and limitations. Assuming all of the requirements of a reorganization are met, under §361 and §357, the corporation transferring assets (i.e., Target) to Acquiror recognizes neither gain nor loss if, pursuant to the plan of reorganization, it receives stock or securities of another corporation that is also a party to the reorganization. Under §354 and §356, shareholders and creditors of Target who, pursuant to the plan of reorganization, exchange their stock or securities for stock or securities of another corporation that is a party to the reorganization recognize no loss and generally recognize gain only to the extent that other property is received. Sections 358 and 362(b) provide for substituted basis in these exchanges. Finally, §381 provides that in certain reorganizations Target's tax attributes (e.g., E&P, FTCs, NOLs, etc.) are inherited by Acquiror subject to certain limitations. Section 368(a)(1) defines reorganization to include several different types of transactions.

An A reorganization, or statutory merger, generally involves the merger or consolidation effected pursuant to the laws of the United States or a State or the District of Columbia of two or more corporations with one corporation surviving.[701]

In a C reorganization, one corporation acquires substantially all[702] of the assets of another corporation solely in exchange for its voting stock. The acquiring corporation may also transfer a small amount of money or other property as long as 80% of the value of the assets of the target is acquired solely in exchange for voting stock.[703] Generally, liabilities assumed by the acquiring corporation will not be considered as other property issued in the reorganization for purposes of the solely-for-voting-stock requirement; however, to the extent any other consideration is issued, then any liabilities assumed are taken into account for purposes of determining whether 80% or more of the target corporation's assets were acquired solely in exchange for voting stock.[704] The stock and other consideration must then be distributed to the shareholders of the target corporation unless that requirement is waived.[705]

Comment: In practice, there appear to be few C reorganizations involving S corporations. In general, nontaxable acquisitions more frequently than not are undertaken via statutory mergers or stock acquisitions followed by QSub elections. Most reorganizations involving S corporation acquirors result in D reorganizations as discussed below.

An acquisitive D reorganization results when one corporation (T) transfers all or part of its assets to another corporation (A) if immediately after the transfer, one or more of T's shareholders (including T shareholders that were A shareholders prior to the transfer), or any combination thereof, is in control of A, but only if, in pursuance of the plan, stock or securities of A are distributed in a transaction which qualifies under §354, or §356, which means that the corporation to which the assets are transferred must acquire substantially all of the assets of the transferor of such assets and the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.[706]

Comment: In many instances, taxpayers may be undertaking D reorganizations unknowingly when they combine brother-sister S corporations by contributing one S corporation into another and making a QSub election for the contributed S corporation. In Rev. Rul. 67-274, the IRS collapsed a stock-for-stock exchange (otherwise qualifying as a B reorganization) followed by a liquidation under §332 into a transaction governed by §368(a)(1)(C). Given the common control of brother-sister S corporations, such transactions often result in a D reorganization.

a. *Effect on S Status*

If a target S corporation ceases to exist in connection with a tax-free asset reorganization under §368(a)(1) (either pursuant to the state merger laws, actual liquidation or deemed liquidation — check-the-box election, conversion to QSub or de facto liquidation), its S status is not technically terminated.[707] Likewise, the acquiror's S status is not affected by the merger unless as a result of the merger, an ineligible shareholder is admitted, a second class of stock is issued, or the merger results in too many shareholders.[708] Thus the momentary ownership of S corporation stock by a target corporation under §361 should not terminate the S status of the acquiring S corporation. The target shareholders who receive stock of the acquiring S corporation must all be eligible S corporation shareholders and the total number of shareholders in the acquiring S corporation (the

[701] The requirements for a transaction to qualify as an A reorganization were amended to allow for a merger of a target corporation into a disregarded entity owned by a corporation to qualify as an A reorganization. For a complete discussion of Reg. §1.368-2(b)(1), see 771 T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations.*

[702] For advance ruling purposes, the substantially all requirement will be considered satisfied if the acquiring corporation acquires at least 90% of the target corporation's net assets (by value) and 70% of the target corporation's gross assets (by value). Rev. Proc. 77-37, §3.01.

[703] §368(a)(2)(B).

[704] §368(a)(2)(B).

[705] §368(a)(2)(G).

[706] §368(a)(1)(D), §354(b)(1).

[707] Rev. Rul. 64-94. *See also* GCM 37677 (Sept. 15, 1978); PLR 200628008, PLR 200218017, and PLR 200107018 (the merger of the target S corporation into a disregarded entity (a qualified real estate investment trust subsidiary) followed by a transfer of the target's built-in gain assets and liabilities to a partnership whose sole general partner is the disregarded entity qualifies as a §368(a)(1)(A) reorganization and as long as the target met the requirements to be treated as an S corporation at the date of conversion from a C corporation, the built-in gains will not be triggered by the reorganization).

[708] Rev. Rul. 69-566; Rev. Rul. 79-52. *See also* GCM 37677 (Sept. 15, 1978).

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surviving entity after the reorganization) cannot exceed 100 to preserve S corporation status of the acquiring company.[709]

If the target corporation has ineligible shareholders, or if there will be too many shareholders after the merger, the acquiror will need to cash out certain target shareholders in the merger or certain of its own shareholders prior to the merger to retain S corporation status. Keep in mind that target shareholders must receive sufficient stock in the acquiring company to maintain continuity of interest in the surviving entity.[710] In general, consideration consisting of at least 40% of the stock of the acquiring company will satisfy continuity of interest.[711]

Even if the target has no ineligible shareholders, the acquiror/survivor's S election may terminate if shareholders owning more than 50% of the shares consent to revoke the election.[712] To avoid this problem, the acquiror should consider including a provision in the merger agreement that would prevent revocation of the S election after the reorganization.

Note that, under Reg. §1.1377-2(b), a post-termination transition period does not arise in the case where an S corporation acquires the assets of another S corporation in a transaction to which §381(a)(2) (i.e., certain tax-free reorganizations) applies. However, a post-termination transition period does arise the day after the last day that an S corporation was in existence if a C corporation acquires the assets of the S corporation in a transaction to which §381(a)(2) applies.[713]

b. Nontaxable Transaction

In the subchapter C context, a reorganization where solely stock of the acquiring corporation is issued will generally be nontaxable to the parties involved. Under §1371(a), subchapter C applies to an S corporation unless inconsistent with subchapter S and to the extent otherwise provided.[714]

A target will generally not recognize any gain subject to corporate-level taxes with respect to the assets transferred in an asset reorganization. Gain may be recognized and subject to tax to the extent of the appreciation in any target assets retained and distributed in liquidation of the target. In the case of a target S corporation, any built-in gains taint on transferred assets is carried over to the acquiror.[715] Only if the acquiror were to dispose of the assets within the requisite recognition periods (determined with reference to the target S corporation) would any corporate-level tax be triggered.

Similarly, under §1374(d)(8), if the target were a C corporation, its assets would be tainted under the built-in gains tax in the hands of the acquiror, even though the acquiror may have made its S corporation election before 1987. For purposes of §1374(d)(1), the net unrealized built-in gain of any transferred basis property will be measured when it is received by the acquiring corporation. In the case of a C corporation target, the target's property will be tainted for 5 years beginning at the merger date. Thus, if the acquiror disposes of the property within 5 years of the merger transaction, the built-in gains tax will be triggered.[716]

In addition, if the target corporation is a C corporation subject to the LIFO recapture tax under §1363(d), the LIFO recapture is triggered by the corporation's merger into an acquiring S corporation in a tax-free reorganization.[717]

c. Accumulated Adjustments Account (AAA)

Although not specifically identified under §381(c), the acquiror and target combine their respective AAA after the reorganization.[718] Under Reg. §1.1368-2(d)(2), the AAAs of the two S corporations are combined even if one of the accounts is negative. Thus, the AAA of the acquiring corporation after the transaction is the sum of the AAAs of the corporations before the transaction. This contrasts with the way in which corporate E&P is accounted for under §381(c)(2). Under §381(c)(2), any deficit in one of the parties' accumulated E&P would be available only to offset E&P accumulated after the transaction date, while the positive balance is essentially frozen. By segregating negative accumulated E&P in this way, the rule preserves pre-transaction positive earnings and profits. Thus, any post-transaction distributions are deemed to be from the frozen positive E&P balance.[719]

The regulations governing the AAA represent a change from the position taken in earlier IRS rulings. In PLR 9046036, for example, two S corporations were merged, one of which had a negative AAA balance. In that ruling, the IRS ruled that the AAA should be combined in a way similar to the way in which corporate E&P is accounted for under §381(c)(2).[720]

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[709] *See* PLR 200011030 (S status inadvertently terminated where target corporation had an ineligible shareholder). The number of shareholders is limited to 35 for tax years beginning before 1997, and 75 for tax years beginning after 1996 and before 2005. The 2004 American Jobs Creation Act, Pub. L. No. 108-357, §232, amended §1361(b)(1)(A) to expand the limit to 100. T.D. 9422, 73 Fed. Reg. 47,526 (Aug. 14, 2008), conformed references in the regulations to the specific numbers of S corporation shareholders permissible under §1361. For purposes of determining the number of shareholders of an S corporation under §1361(b)(1)(A), the regulations provide rules relating to stock owned by family members.

[710] Reg. §1.368-1(b). This assumes no identity of ownership between the acquiring and target corporations.

[711] Reg. §1.368-1(e)(2)(v) *Ex.* 1. Nonqualified preferred stock as defined in §351(g) will generally not be considered stock or securities for purposes of obtaining tax-free treatment at the shareholder level. *See* §354(a)(2)(C). The issuance by an S corporation of NQSP would terminate subchapter S status.

[712] §1362(d)(1)(B).

[713] Reg. §1.1377-2(b).

[714] Prior to the 1996 SBJPA, §1371(a)(2) read "For purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual. However, the IRS issued numerous favorable rulings on the application of §368(a)(1) to S corporations. In GCM 39768, the IRS concluded that pre-1996 SBJPA §1371(a)(2) did not prevent S corporations from engaging in A, C, acquisitive D, divisive D, or F reorganizations under §368.

[715] *See* PLR 200320013 (F reorganization does not restart §1374 built-in gain clock), PLR 200107018 (in merger of two S corporations, the §1374 built-in gains tax will be imposed on acquiror during the remaining recognition period), PLR 9206011 (in merger of two S corporations, built-in gains taint applies to acquiror under §1374(d)(8)), PLR 9115029 (built-in gains taint of target applies to survivor of merger).

[716] *See, e.g.,* PLR 9011042, PLR 9005021, PLR 8937051.

[717] Reg. §1.1363-2. *See also* PLR 9039005.

[718] Reg. §1.1368-2(d)(2). *See* Rev. Rul. 79-52 (subchapter S corporation survivor of a merger of two subchapter S corporations could make non-dividend distributions of the target's PTI and UTI). *See also* PLR 9115029.

[719] Reg. §1.381(c)(2)-1.

[720] See also PLR 8714065, a ruling involving the merger of two S corporations, one with a positive AAA and one with a negative AAA, in which the IRS stated that any deficit in target's earnings and profits will be used only to offset E&P accumulated after the transfer date (citing §381(c)(2) and Reg. §1.381(c)(2)-1). The use of the term earnings and profits does not clearly indicate that the same treatment be accorded to AAA but in the context of the ruling this seems to be the intent. The IRS does not view the specific attributes listed in §381(c) as an exclusive list. Reg. §1.381(a)-1(b)(3). For example, in

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d. S Election After Termination

If the acquiror's S election terminates as a result of the acquisitive asset reorganization, it may not make another S election until the fifth taxable year following the year of the reorganization unless prior IRS approval is obtained.[721]

On the other hand, if the acquiror is a C corporation and it acquires an S corporation target, it should be able to elect S status effective for its first tax year beginning after the merger.[722] Similarly where two S corporations form a new entity in a consolidation, the S corporation elections of both entities are not terminated, rather the two corporations cease to exist and therefore the new entity should be allowed to make a new S election without regard to the five-year waiting rule.[723]

e. Income Allocation in Year of Reorganization

If the acquiror's S election does not terminate as a result of the acquisitive asset reorganization, income will be allocated in the same manner as if the acquisition had not occurred, i.e., on a per-share, per-day basis.[724] With respect to income generated by the acquired assets, only post-acquisition income would be included in the acquiror's income.[725] If a shareholder of the acquiring corporation terminates their interest in connection with the merger, the acquiring corporation's books may be closed as of the date of termination.[726]

If the acquiror's S election does terminate, income is allocated on a per-share per-day basis between the short S and short C years.[727] The acquiror's shareholders can elect to close the books on the date of termination.[728] If there is a 50% or more change in ownership of the acquiror in the termination year (including in connection with the reorganization), the books must be closed unless the issuance of its stock in the reorganization is not considered a sale or exchange under §1362(e)(6)(D).

Comment: Presumably, the issuance of the acquiror's stock in a reorganization should be considered an exchange since §354 considers the transaction an exchange from the shareholders' perspective. Section 354(a)(1) states:

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, *exchanged* solely for stock or securities in such corporation or another corporation a party to the reorganization.[729]

If the acquiror's S election terminates, losses suspended under §1366(d)(2), after taking into account activity through the date of termination, will be treated as incurred on the last day of the post-termination transition period.[730] The losses will be deductible to the extent of the shareholder's basis in the stock on such date.[731]

Under §381(c)(4), where the acquiring and target corporations have different accounting methods, the accounting methods are integrated such that the acquiring corporation will use the principal method for each integrated trade or business operated by the acquiror.[732]

f. Tax Attribute Consequences to Target and Its Shareholders

Although §381 would apply, §1371(b)(2) prevents any carryover between an S year and a C year at the corporate level (except to the extent C corporation attributes may be carried over to apply against built-in gains or excess passive income tax). Section 382 continues to apply where there are corporate-level subchapter C losses that still reside with the converted corporation. Similarly, §384 may apply to prevent the utilization of any pre-acquisition losses from offsetting any recognized built-in gains.

Under §1366, any loss or deduction items that flow through and exceed a shareholder's basis are suspended indefinitely and "treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder."[733] Thus, suspended losses technically do not remain at the shareholder level; they are treated as incurred by the corporation in each successive year and flowed through to the shareholder year after year until the shareholder has sufficient basis to use them. Based on the statute, the losses are corporate and shareholder specific. These losses are also not enumerated in §381 as a corporate attribute. Where both the target and acquiring corporation are S corporations, the regulations provide that if an S corporation acquires an S corporation's assets in a transaction to which §381(a) applies, a target shareholder's suspended losses may be used by that shareholder as a shareholder of the acquiring corporation.[734] As such, if an S corporation acquires another S corporation in an acquisitive reorganization, a target shareholder's suspended losses are treated as incurred by the acquiring S corporation with respect to that shareholder if that shareholder is a shareholder of the acquiror after the transaction.[735] Accordingly, a target shareholder's suspended losses are sub-

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Rev. Rul. 80-144, the IRS has ruled that Acquiror succeeds to the foreign tax credits of Target as a result of an A reorganization, although foreign tax credits are not listed in §381(c). In addition, note that proposed regulations would modify the definition of the acquiring corporation. For purposes of §381(a)(2) transactions (i.e., asset reorganizations), Reg. §1.381(a)-1(b)(2)(i), as amended by T.D. 9700 (Nov. 10, 2014), defines the acquiring corporation as the corporation that directly acquires the assets transferred by the transferor corporation even if that corporation ultimately retains none of the assets so transferred, e.g., if those assets are transferred downstream to a lower-tier subsidiary.

[721] §1362(g). In this situation, consent for a reelection is not likely. *See* Reg. §1.1362-5.

[722] *See, e.g.*, PLR 200218017 (C corporation acquiror in a reorganization able to make S election subsequent to acquisition of S corporation target); PLR 8648037 (S corporation acquiror purchases C target's stock and merges downstream into target; target permitted to elect S corporation status without permission under §1362(g)).

[723] Rev. Rul. 70-232.

[724] §1377(a)(1).

[725] *See* §381(b)(1).

[726] §1377(a)(2).

[727] §1362(e)(2).

[728] §1362(e)(3).

[729] §354(a)(1) (emphasis added).

[730] §1366(d)(3).

[731] *See* FSA 200223052 (shareholders of target S corporation who also owned stock in acquiring C corporation could utilize stock basis in previously owned acquiring stock to deduct suspended losses in the post-termination transition period).

[732] Reg. §1.381(c)(4)-1(c).

[733] §1366(d)(2).

[734] Reg. §1.1366-2(c)(1). These regulations, issued in 1999, clarified the treatment of a target S corporation shareholder's losses suspended under §1366(d)(2) when acquired by another S corporation. The effect of a reorganization on target losses suspended under §1366(d)(1) was previously unclear.

[735] Reg. §1.1366-2(c)(1).

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ject to the post-termination transition period rules if the acquiring corporation is a C corporation.[736]

If a target shareholder held stock in the successor corporation before the merger transaction, guidance suggests that the stock basis in the acquiring corporation shares is available to use against suspended losses from the target corporation. In FSA 200223052, the Chief Counsel's Office advised that a shareholder of a target S corporation, who also was a shareholder of the acquiring C corporation, could apply his suspended losses under §1366(d) against his historic basis in the C corporation stock and then reduce the historic basis in the C corporation stock for the losses taken.

The investment credit is another §381 attribute that a target S corporation was permitted to carryover without subjecting its shareholders to recapture. In *Giovanini v. United States*,[737] a district court held that the shareholders of the target S corporation would not need to recapture investment credit after the merger of the S corporation with a C corporation because the merger qualified as a tax-free reorganization to which §381(a) applied. Consequently, the court concluded that pre-1990 §47(b)(2), which provided an exception to recapture for transactions to which §381(a) applies, foreclosed any recapture.

Even though the target corporation does not recognize gain or loss in an asset reorganization (provided it transfers all of its assets to the acquiring company), target shareholders may recognize gain (but not loss) to the extent they receive any consideration other than stock of the acquiror.[738]

g. Tax Attribute Consequences if Target Was a C Corporation

In general, the target's tax attributes will carry over to the acquiring corporation under §381, e.g., accumulated E&P, net operating losses, capital loss carryovers. In addition, §382 applies to limit utilization of any loss carryovers of the target. However, these losses would not be available to the acquiror until it terminates its S corporation status (except to the extent usable against built-in gains under §1374) because C corporation carryovers generally cannot be used by an S corporation.[739]

h. Distributions

Under §356(a)(1), target shareholders in an acquisitive reorganization generally recognize gain to the extent of the lesser of the gain realized or cash or property (boot) received. Such gain may be capital or treated as a dividend depending upon the relationship of the target shareholders and the acquiring company. In some instances, a distribution made in connection with a reorganization may also be treated as separate from the reorganization.[740] Treating distributions made by an S corporation prior to and in anticipation of an asset reorganization may be inconsistent with subchapter S as it prevents S corporation shareholders from recovering basis created on undistributed earnings to the extent of any AAA at the time of the reorganization. In Rev. Rul. 71-266, the IRS ruled, under Pre-SSRA, that distributions of prior year accumulated S corporation earnings and profits and a distribution of estimated current year S corporation earnings and profits, were distributions separate from the reorganization which occurred one month later and would not treated as boot under §356.[741] The provisions relied upon in the ruling that allowed for a tax-free recovery of prior earnings were effectively replaced by §1368 and thus S corporation shareholders are likely able to continue relying on this ruling especially when the source of the distribution is the target S corporation.

Comment: If the boot is funded by the acquiring company the tax treatment may be less clear. To the extent the target S corporation would be able to service any debt distributed or generate sufficient operating cash flows without assistance from the acquiror, a pre-reorganization distribution may be respected as a distribution and not as boot.[742] The distribution must still be considered for purposes of meeting the substantially all criteria of certain reorganizations.

Pro-rata distributions by the acquiror after an acquisition will normally be treated in a manner similar to those following a tax-free stock acquisition, i.e., §1368 will apply. In addition, if the target is also an S corporation, the AAA of both companies will be combined for purposes of determining the taxation of distributions. If the S corporation's status terminates as a result of the asset acquisition, cash distributions of AAA may be made during the post-termination transition period.

i. Taxable Year

Unanswered questions arise if two S corporations merge and they both have §444 fiscal year elections in place. For instance, should the §7519 depository payment of the target entity be available in computing the surviving corporation's deposit amount? Likewise, what base year should the survivor use in computing its deposit payments after the merger?

With respect to the target's deposit amounts, the rules will require the target to make a §7519 payment even in the year it goes out of existence.[743] Because there is little guidance here, it probably is best to make the deposit payment for the target, even though it is no longer in existence, and seek a refund afterwards.

A more difficult question is how to compute the surviving corporation's §7519 payment after the merger. Probably the best way to make this computation is to include the target entity's income in the survivor's base year to account for any deferral the target shareholders may have received, although there seems to be no technical requirement that the corporation do so.

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[736] Reg. §1.1366-2(c)(1).

[737] 90-2 USTC ¶ 50,542 (D. Ore. 1990), *aff'd*, 93-2 USTC ¶ 50,600 (9th Cir. 1993).

[738] §356(a)(1).

[739] §1371(b)(1).

[740] *See* Reg. §1.301-1(l).

[741] Rev. Rul. 71-266.

[742] See *Waterman S. S. Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971), where a pre-acquisition distribution from a subsidiary prior to the sale of the subsidiary stock was viewed as part of the purchase price received from the buyer of the stock. *But see Litton Indus. v. Commissioner*, 89 T.C. 1086 (1987), where a pre-acquisition distribution was viewed as a distribution separate from the acquisition. *See also TSN Liquidating Corp., Inc. v. United States*, 624 F.2d 1328 (5th Cir. 1980) (distinguishing *Waterman Steamship*).

[743] Reg. §1.7519-2T(a) (deposit payments due for any tax year the §444 election is in effect).

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If the merging corporations choose to terminate their §444 elections before the merger, they must do so by the due date of their respective short period returns.[744]

j. Effect on Shareholder Debt

Shareholders' low-basis indebtedness can be a tax trap when an S corporation is the target in a statutory merger or consolidation (an A reorganization). There are two alternatives for dealing with low-basis indebtedness. Although each approach carries some degree of risk in certain situations, it should be possible to structure the merger to avoid triggering gain on the low-basis indebtedness.

Under §354, shareholders of the target (T) in an A reorganization generally will not recognize gain or loss on the exchange of their T stock and T securities for stock and securities of the acquiror (A). For these purposes, the usual guidelines regarding qualification of loans as securities apply. The term of the shareholder loan, while not the sole aspect, is often the most important factor. Demand loans and informal advances typically used by small businesses will rarely, if ever, qualify as securities. Therefore, when such shareholder debt is exchanged for stock, securities, debt of the acquiror not evidenced by securities, or any other consideration, gain or loss is not protected by §354.

Another interesting issue arises if the debt has a fair market value less than its face amount. Generally, under §108(e)(8), a corporation recognizes cancellation of indebtedness income to the extent the fair market value of stock issued in satisfaction of its debt is less than the adjusted issue price of such debt.

(1) Deferral Approach

One approach to avoid triggering the gain on low-basis shareholder loans is to ensure that there is no exchange of the debt. The general rule for determining whether a taxable exchange has occurred is stated by Reg. §1.1001-1(a): "Except as otherwise provided in subtitle A of the Code, the gain or loss realized … from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."

Regulations contain specific rules for when a modification of a debt instrument results in an exchange of the original debt instrument.[745] In general, an exchange of a debt will arise if there has been a significant modification of the obligation.[746] Modifications that are not significant will generally not result in an exchange of a debt instrument. A change in the obligor of an instrument is a significant modification.[747] There are two exceptions to this general rule that are significant in the context of acquisitions. A substitution of a new obligor is not a significant modification if the substitution occurs in connection with an acquisition subject to §381(a), there is no change in payment expectations as a result of the acquisition, and there is no significant alteration of the obligation.[748] In addition, to the extent the new obligor acquires substantially all of the original obligor's assets, there is no change in payment expectations as a result of the acquisition and there is no significant alteration of the obligation, the change in obligor will not be considered a significant modification.[749]

In the context of low-basis indebtedness of S corporations, it may be extremely important to ensure that no significant modification results from an asset acquisition to defer gain inherent in the note.

A potential shortcoming of this approach is that the gain recognition problem has only been deferred. If the acquiror repays a shareholder's low-basis debt shortly after the reorganization, the former debt holders will recognize gain at that time. Debt basis could be restored by the flow through of positive income to the old T shareholders that held the debt after the merger. This restoration will reduce any gain on repayment of the debt. However, if the acquiror is a C corporation, the gain inherent in the low-basis debt will be locked in. Regardless of the profitability of the combined entity, the shareholders' basis in the debt will not be restored; the gain will eventually be recognized when the debt is retired at its face amount. Thus, the attractiveness of this approach depends in part on: (i) whether the acquiror will be an S corporation or a C corporation after the acquisition, and (ii) whether the acquiror is expected to generate sufficient taxable income after the acquisition to restore the shareholders' basis in the debt before payments are made under the terms of the debt (or distributions are made with respect to the stock). Furthermore, in some cases the acquiror may be unwilling to assume the debt without substantial modification of its terms.

(2) Capital Contribution Approach

An alternative approach would be for T's shareholders to forgive T's debt by contributing it to capital before the acquisition. Under §108(e)(6) and §108(d)(7), T would be treated as having satisfied the debt with an amount of cash equal to the shareholders' adjusted bases in the loans, ignoring for this purpose basis adjustments under §1367(b)(2) (adjustments resulting from flow through of S corporation income and loss items). The contribution usually will not trigger forgiveness of indebtedness income to the S corporation. Also, the contributing shareholders generally would not recognize gain upon such a contribution of low-basis debt to capital. This approach is simple when shareholders hold debt in proportion to stock ownership. In the case where debt is not held proportionately, other income tax consequences may arise.

> *Example:* A closely held S corporation, X, is owned 1/3 each by F, S, and D. F is the father of S and D. Five years ago, F lent $300 to X. In the current year, F contributes the debt to capital of X and does not receive any stock of X in exchange. F has effectively enriched S and D as the value of their S corporation stock has increased by $200. This wealth transfer may be viewed as a gift to S and D.

[744] *See* TAM 9419002. For further discussion of TAM 9419002, see 730 T.M., *S Corporations: Formation and Termination.*

[745] For a detailed discussion of these regulations, see 181 T.M., *Time Value of Money — Holders of Debt Instruments*, 535 T.M., *Time Value of Money: OID and Imputed Interest.*

[746] Reg. §1.1001-3(b).

[747] Reg. §1.1001-3(e)(4)(i)(A).

[748] Reg. §1.1001-3(e)(4)(i)(B).

[749] Reg. §1.1001-3(e)(4)(i)(C).

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The tax results are substantially different if T issues stock in exchange for the debt. Under §108(e)(8), T would be treated as though it had satisfied the indebtedness for an amount of money equal to the fair market value of the stock issued; this treatment will result in forgiveness of indebtedness income if the FMV of the stock issued is less than the adjusted issue price (within the meaning of Reg. §1.1275-1(b)) of the retired debt.[750] Furthermore, the shareholders would likely be viewed as having engaged in a taxable exchange under §1001 of their low-basis debt for stock; gain or loss could not be protected by §351 because of the §351(d) exception. Although unlikely, there may be some risk that the IRS could argue that a deemed exchange of debt for stock occurred if the debt forgiveness is pro rata among all shareholders (or in a sole shareholder situation).[751]

In addition, the contribution to capital should be structured with economic significance and business purpose, independent of the merger, to avoid attack under the step-transaction doctrine. In Rev. Rul. 78-330, the IRS ruled that a parent corporation's cancellation of the indebtedness of its wholly owned subsidiary immediately before a D reorganization was effective in avoiding application of §357(c) because the capital contribution had independent economic significance. In response to a legislative amendment conforming the treatment of acquisitive D reorganizations to the treatment of other acquisitive reorganizations,[752] Rev. Rul. 2007-8 modified Rev. Rul. 78-330 to the extent it ruled that §357(c)(1) is applicable in an "A" reorganization or an acquisitive D reorganization involving a transfer of assets subject to liabilities in excess of basis.[753]

3. *Tax-Free Acquisitions as Alternatives to Liquidation of a Subsidiary*

a. *Downstream Merger*

An acquiring S corporation can merge downstream into its newly acquired target. This transaction could qualify as a tax-free A reorganization.

> *Example:* P is a calendar year S corporation. P wishes to acquire all of T, a calendar year S corporation, with a subsequent merger of the two entities. P acquires all of the stock of T for cash, and immediately merges into T. P's longstanding shareholders receive T stock in the merger. P wants T to continue to operate as an S corporation subsequent to the merger.

In this example, P's downstream merger into T qualifies as a reorganization under §368(a)(1)(A).[754] The transaction will likely be treated as a reorganization under §368(a)(1)(D) as well.[755] P is the target for reorganization purposes, and therefore, the continuity of interest requirement is met with respect to P's shareholders. This transaction can be a nontaxable alternative to the upstream liquidation of a target corporation.

b. *Effect on S Status*

Assuming T is an S corporation, absent a QSub election effective immediately after the acquisition of T, T's S corporation status likely terminates as P, a corporation, is an ineligible shareholder of an S corporation. As a result of the downstream merger, P's existence terminates (similar to any other acquisitive asset reorganization). P's assets are now owned by T, a C corporation. Absent a private letter ruling, T may not be able to elect S status for five taxable years. If T had always been a C corporation, consent for electing S status would not be necessary as the dissolution of P's S status as a result of the downstream merger is not an event terminating S status and T never had S status to terminate.[756]

Reg. §1.1361-4(b)(3)(ii) provides special rules to disregard momentary stock ownership in the case of an acquisition of an S corporation (S2) by another S corporation (S1) where a QSub election is made effective on the date of the acquisition of S2. This prevents terminating S2's S election and subjecting S2's asset to the built-in gains tax as a result of the S status termination and subsequent transfer of assets to S1 in a §1374(d)(8) transaction. Regulations also provide that in certain circumstances, a termination of a QSub election can be followed by an S election for the terminated QSub if (i) immediately following the termination, the corporation is otherwise eligible to make an S election or have a QSub election made for it; and (ii) the relevant election is made effective immediately following the termination of the QSub election.[757] Such a situation may arise in the case of a distribution of a QSub to the S corporation's shareholders or the acquisition of a QSub by another S corporation which would like to treat the acquired corporation as a QSub.

If a QSub election were made for T immediately following the acquisition and, P subsequently merged into T, the downstream merger would likely qualify as a reorganization under §368(a)(1)(F).[758]

Comment: Absent a private letter ruling granting continued S status in the case of a downstream reorganization of an S corporation into a recently acquired S corporation, taxpayers would be well advised to structure such a transaction in an alternate manner. One alternative would be to merge P directly into T followed by a redemption of the former T shareholders. This would preserve S status and avoid any built-in gains tax taint on any of the assets of either P or T. Alternatively, a QSub election could be made for T immediately following the acquisition and prior to the downstream merger, qualifying the merger as a reorganization under §368(a)(1)(F). Under Rev.

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[750] *See* §108(e)(8); Reg. §1.61-12(c)(2)(ii). Note that §108(e)(8) no longer contains the stock-for-debt exception to discharge of indebtedness income for certain bankrupt or insolvent taxpayers that was contained in pre-1993 RRA §108(e)(10).

[751] *See Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989), *rev'g* 85 T.C. 824 (1985) (a transfer of assets and liabilities of a sole proprietorship to a wholly owned corporation was held to be a §351 transaction even though no additional stock was issued).

[752] American Job Creation Act of 2004 (AJCA), Pub. L. No. 108-357; S. Rep. No. 108-192, at 185 (2003).

[753] *See* §368(a)(1)(A), §368(a)(1)(D); *see also* §354(b)(1).

[754] Rev. Rul. 70-223; GCM 39768 (Dec. 1, 1988). In Rev. Rul. 70-223, the continuity of interest requirement needs only to be met by the acquiring corporation's shareholders because in a downstream merger these shareholders technically become target shareholders.

[755] See III.E.4., below, for a more detailed discussion of D reorganizations.

[756] *See* PLR 8648037, PLR 8643032.

[757] Reg. §1.1361-5(c)(2).

[758] *See* Reg. §1.1361-5(b)(3), *Ex.* 8.

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Rul. 64-250, P's S election would automatically carry over to T.

4. *Other Tax-Free Transactions*

a. *Divisive D Reorganizations*

In a divisive D reorganization, the transferor corporation (Distributing) generally transfers part of its assets to a transferee corporation (Controlled) in exchange for stock of such corporation.[759] Stock representing control of the subsidiary is then distributed to one or more of the shareholders of the transferor. Control is defined as 80% of voting power and 80% of each class of nonvoting stock of the transferee.[760]

> *Example:* XYZ is a calendar year S corporation and made its S corporation election effective January 1, Year 1. For valid corporate business reasons, XYZ wants to split off one of its operating divisions to P, one of its two shareholders. On July 1, Year 5, XYZ transfers the assets and liabilities of one of its operating divisions to NewCo in exchange for NewCo stock. On the same day, XYZ distributes the NewCo stock to P solely in exchange for all of P's stock in XYZ. NewCo elects S corporation status for its taxable year beginning July 1, Year 5.

(1) *Business Purpose*

If a corporation engages in a tax-free separation under §355 of one or more of its existing businesses, it must establish, in whole or substantial part, one or more corporate business purposes.[761] In fact, the IRS has made clear that a corporate separation undertaken solely to allow a resulting NewCo to elect S corporation status will not meet the business requirement.[762] However, where any tax motivations to the business separation are secondary, and the taxpayer can show under the facts and circumstances that a corporate business purpose predominates, then the potential avoidance of federal taxes with an S corporation election can be surmounted.[763]

Reduction in federal income taxes will never satisfy the business purpose test under the regulations. Furthermore, reducing state taxes is not a business purpose if: (i) both federal and state taxes are reduced;[764] and (ii) the federal tax reduction is greater than any state tax reduction. To make this a tax-free transaction, the shareholders must identify a business purpose other than NewCo's S corporation election. In addition, to qualify for §355 treatment, the non-device, continuity of interest, and five-year active trade or business requirements must be met.

The IRS requires that taxpayers follow certain guidelines when requesting a private letter ruling on transactions under §355.[765] Rev. Proc. 2017-52,[766] *as modified by* Rev. Proc. 2025-30, includes information and representations required to be included with a request for a transactional ruling[767] under §355.[768] In order to lessen the concern about business purpose, Rev. Proc. 2017-52 provides that certain representations be made when S corporation elections are possible. For example, if a C corporation were to spin off a corporation that becomes an S corporation, the IRS might be concerned that obtaining S status was the real business purpose for the transaction. Therefore, the IRS requests a representation that parity in tax status between the distributing and controlled corporations would continue after the spin.[769]

Taxpayers satisfy the representation requirement for requesting rulings for S corporation matters by making one of two alternative representations:

- distributing corporation is not an S corporation (within the meaning of §1361(a)) and will not be an S corporation at the time of the distribution, and there is no plan or intention by distributing corporation or controlled corporation to make an S corporation election pursuant to §1362(a); or
- if distributing corporation is an S corporation within the meaning of §1362(a) on the first available date after the distribution, and there is no plan or intention to revoke or otherwise terminate the S corporation election of either distributing or controlled corporation.[770]

[759] §368(a)(1)(D). *See, e.g.*, PLR 202235002, PLR 200809017 (D reorganizations to divide an existing business conducted by an S corporation between the existing corporation and a newly formed corporation that will elect S status, each to be independently operated). Typically, Distributing's momentary ownership of stock of Controlled as part of the reorganization does not cause Controlled to have an ineligible shareholder for any portion of its first taxable year, nor cause Controlled to be ineligible to make an S election for its first taxable year. PLR 202235002.

[760] §355(a)(1)(D).

[761] Reg. §1.355-2(b).

[762] Reg. §1.355-2(b)(5) *Exs.* 6, 7.

[763] Reg. §1.355-2(b)(5) *Ex.* 8.

[764] *See* PLR 9230028 (ruling that a spin-off to reduce city taxes did not result in loss of S corporation status).

[765] For a detailed discussion of the IRS ruling policy related to §355, see 776 T.M., *Corporate Separations*, and 772 T.M., *Corporate Acquisitions — D Reorganizations*.

[766] Rev. Proc. 2017-52 announced a pilot program for ruling requests made between September 21, 2017 and March 21, 2019, under which the IRS temporarily expanded the scope of private letter rulings to include transactional rulings for covered transactions on tax consequences of distributions of stock, or stock and securities, of controlled corporations under §355. The pilot program was extended indefinitely. *See* Statements from the Office of Chief Counsel (Mar. 12, 2019); *see also* Rev. Proc. 2026-1, Appendix F (incorporating procedures from Rev. Proc. 2017-52).

[767] A transactional ruling is a letter ruling that addresses the general federal income tax consequences of a covered transaction, which is defined as: (i) a transaction intended to qualify under §368(a)(1)(D) and §355 or (ii) a distribution that is intended to qualify under §355(a) and §355(c). Rev. Proc. 2017-52, §2.03(1).

[768] If a divisive reorganization involves the assumption or satisfaction of Distributing debt, additional representations are required. *See* Rev. Proc. 2025-30, §3.03 (restating the guidance generally provided in Rev. Proc. 2018-53, §3, which *amplified and modified* Rev. Proc. 2017-52).

[769] *See* Rev. Proc. 2017-52, Appendix, §3(41).

[770] Rev. Proc. 2017-52, Appendix, §3(41). In the past, the IRS issued several private letter rulings that took a less restrictive stance on the ability for either the distributing corporation (Distributing) or controlled corporation (Controlled) to elect or not elect S status after the spin-off. *See, e.g.*, PLR 200227016 (it was anticipated that Controlled would elect S status after spin-off), PLR 200138025 and PLR 200129030 (either Distributing or Controlled, or both, may elect S status after spin-off), PLR 200137019 (Distributing was C corporation and Controlled would elect S status after the spin), PLR 200047024 (no representation regarding continuation or election of S status for either Distributing or Controlled), PLR 200042024 (Distributing loses S status after spin-off while Controlled is S corporation), PLR 199917052 (both Distributing and Controlled agreed to make or refrain from making S corporation elections if the IRS was concerned about an adequate corporate business purpose for the spin-off at issue).

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(2) Corporate Level Tax

The transfer of assets to NewCo followed by the distribution of NewCo qualifying under §355 is not a recognition event and therefore no built-in gains tax is due as a result of the spin-off.[771]

Although it is clear that the spin-off does not trigger built-in gains tax and the recognition period does not start anew for the distributed corporation (Controlled), less clear is the method of allocation of the net unrealized built-in gains (NUBIG) limitation between the distributing corporation (Distributing) and Controlled. Private letter rulings simply conclude that Controlled will be subject to §1374 with respect to any asset transferred to Controlled from Distributing to the same extent Distributing was subject to §1374 with respect to such asset.[772] This is reasonable as Controlled should not be allowed to escape the built-in gains tax merely because it was never a C corporation yet it received assets from an S corporation that was subject to the built-in gains tax. Technically, there is no provision that reduces Distributing's net unrealized built-in gain on the disposition. Thus, built-in gain may be taxed more than once at the corporate level.

Example: Upon its conversion to S status in Year 1, Corporation X had assets with basis and fair market value as follows:

	Basis	FMV	Gain/(Loss)
Asset A	$5,000	$15,000	$10,000
Asset B	$20,000	$10,000	($10,000)
Asset C	$0	$25,000	$25,000
Asset D	$10,000	$18,000	$8,000
Net Unrealized BIG			$33,000

In Year 4, in connection with a valid spin-off under §355, X contributes to Newco, among other things asset, Asset C. At the time of the distribution, Asset C had a fair market value of $35,000. Prior to the spin-off, X had not sold any assets. Announcement 86-128 and private letter rulings are clear that Newco will be subject to built-in gains tax to the same extent X would have been. That implies that if Newco sells Asset C within the recognition period at a gain of at least $25,000, all of it should be subject to the built-in gains tax. This amount was less than the remaining NUBIG of X at the time of the distribution. However, if X also subsequently sells Asset A for $15,000, it would recognize a gain of $10,000. Since the remaining NUBIG at the time of the distribution was $33,000, this gain may also be subject to built-in gains tax (as well as the remaining $8,000 of gain in Asset D). Thus, a total of $43,000 could be subject to built-in gains tax as $25,000 may be allocated to Controlled but no provision reduces Distributing's NUBIG.

Comment: A reasonable application of the intent of the law would be to reduce X's NUBIG by $25,000 (the built-in gain inherent in Asset C at the time of conversion) and allocate to Newco a $25,000 NUBIG; however absent an operating provision reducing X's NUBIG, a taxpayer may require a private letter ruling to achieve such a result.

Even the above suggested approach may not be appropriate in all situations.

Example: Assume the same facts above except at the time of the distribution, Asset C is worth only $7,000. If X's NUBIG were reduced by $25,000, X would only have recognized BIG of $8,000 upon the sale of both asset A and D ($33,000 original NUBIG less $25,000 allocated to Newco). If Newco sold Asset C during the recognition period post spin, it would recognize BIG of $7,000, in total only $15,000 of gain would be subject to tax whereas had all the gain assets been sold by X prior to the distribution, $25,000 would be subject to the BIG tax.

One other issue not addressed by the IRS is the allocation of carryover recognized BIG from a prior year due to the taxable income limitation. How should such BIG be allocated when there is a spin-off in a subsequent year where there is sufficient income to absorb the carryover recognized BIG? Possible alternatives include allocating the suspended BIG based on the relative value of assets transferred or applying it solely to the distributing corporation.

(3) Accumulated Adjustments Account/ITC

In general, the §381 carryover rules do not apply to divisive reorganizations.[773] However, under §312(h), there is an exception for E&P. As an analogy to §312(h)(1) (allocation in certain corporate separations and reorganizations), the AAA of Distributing is allocated between Distributing and Controlled in a manner similar to the allocation of E&P.[774] Under these rules, E&P is generally allocated in proportion to the relative

[771] Announcement 86-128. *See* PLR 200231006, PLR 200228008. Presumably, §1374(d)(8) may apply to subject Controlled's assets to §1374 as those assets were obtained from Distributing which either acquired them from a C corporation in a carryover basis transaction or held them on the date of conversion. It is not certain that holding assets on the date of conversion would be considered an acquisition of assets to call into effect §1374(d)(8), and therefore, if Distributing simply converted to S status and never acquired assets in a carryover basis transaction, §1374(d)(8) is likely not the operative provision. In December 2004, the IRS issued regulations providing that, for taxable years beginning after December 22, 2004, §1374(d)(8) applies to any transaction described in §1374(d)(8) that occurs after December 27, 1994, regardless of the date of the S corporations §1362 elections. Reg. §1.1374-8(a), T.D. 9170, 69 Fed. Reg. 76,612 (Dec. 22, 2004).

[772] *See, e.g.*, PLR 201117009 (Ruling 11).

[773] §381(a)(2).

[774] Reg. §1.1368-2(d)(3) states that AAA is divided in a corporate separation in the same manner as E&P under Reg. §1.312-10(a). *See* PLR 202235002, where the IRS expressly stated it was not ruling on the allocation of AAA between Distributing and Controlled. In PLR 8810045, the IRS stated that it could not rule on the allocation of the AAA between the transferor and transferee corporations in a spin-off transaction. However, it did rule that previously taxed income (PTI) under pre-SSRA §1375(d) would not be allocated between the transferor and transferee corporations. Pre-SSRA Reg. §1.1375-4(a), §1.1375-4(e). Thus, shareholders of the transferee corporation would lose any benefit associated with their PTI accounts.

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fair market values of the assets transferred and retained by the transferor corporation.[775]

Note that investment credit recapture could be triggered as to a shareholder under Reg. §1.47-4(a)(2). On the other hand, if the transaction is deemed to be a mere change in form under §50(a)(5),[776] no investment credit recapture would be required by the corporation or its shareholders.[777]

b. Section 351 Transactions

In a §351 transaction, property is transferred to a corporation solely in exchange for stock or securities of such corporation and immediately after the exchange, the transferor(s) must be in control of the corporation within the meaning of §368(c).

For a complete discussion of transfers to controlled corporations, see 758 T.M., *Transfers to Controlled Corporations.*

(1) S Corporation as Transferee Corporation

In general, no gain or loss will be recognized by an S corporation in a §351 transaction where property is transferred to a corporation in exchange for its stock.[778] Likewise, the shareholders will not recognize any gain on property transferred to the corporation if the transferors control (as defined under §368(c)) the corporation after the transfer.

Section 351 applies to an S corporation transferee. In GCM 38969, the IRS reconsidered an earlier memorandum and concluded that, under the SSRA, §351 should apply to controlled S corporations as long as the general §351 requirements are met. In reaching this conclusion, GCM 38969 stated that under former §1371(a)(1) (now §1371(a)) the subchapter C rules apply to subchapter S unless otherwise inconsistent. Given that §351 applies to S corporations, the following issues should be considered in connection with a §351 transaction:

- the transferors must be eligible shareholders;
- the 100-shareholder limit[779] must be met after the transfer;
- if the S election is terminated, §1362(g) would require a five-year waiting period before reelection; and
- if the S election does not terminate, the general income allocation rule will control.

In general, the transferee S corporation will take a carryover basis (increased by the amount of gain recognized to the transferor, if any) in a §351 exchange.[780] If a person transfers property to an S corporation in a loss duplication transaction, the transferee S corporation's basis in each loss duplication property is reduced by the property's allocable portion of the transferor's net built-in loss.[781] However, under §362(e)(2)(C), the parties to the transaction can make an irrevocable election to apply the reduction to the transferor's basis in the stock received in the exchange instead of to the transferee's basis in the property received in the exchange. No stock basis reduction is required under §1367(a)(2)(D) by reason of a reduction to the S corporation's basis in acquired assets if a §362(e)(2)(C) election is not made.[782]

(2) S Corporation as Transferor Corporation

In general, if an S corporation transfers assets in a §351 transaction, no gain or loss will be recognized if the S corporation, along with any other transferors, controls the transferee corporation after the transfers.[783]

In general, the transferor S corporation will take a carryover basis (increased by the amount of gain recognized on the transfer, if any) in stock received in a §351 exchange.[784] If the transferor S corporation transfers property to a corporation in a loss duplication transaction and the parties to the transaction elect to reduce the transferor S corporation's basis in the stock received in the exchange, the resulting reduction to the S corporation's basis in the transferee corporation's stock received in exchange for the loss duplication property is treated as a noncapital, nondeductible expense of the S corporation described in §1367(a)(2)(D).[785]

Comment: S corporation shareholders should evaluate §362(e)(2)(C) elections carefully. First, if the S corporation shareholders transfer built-in loss property to their S corporation and the shareholders and the S corporation make the election to preserve the inside asset basis and reduce outside stock basis, the shareholders could forego any economic/tax benefit from the built-in loss. This is highlighted in Reg. §1.362-4(h)

[775] Reg. §1.312-10(a). However, the rules note that in certain cases, allocations based on the net basis of assets transferred and retained would be appropriate.

[776] Reg. §1.47-3(f)(1), §1.47-3(f)(2).

[777] *See* PLR 8810045.

[778] §1032.

[779] The number of shareholders is limited to 35 for tax years beginning before 1997 and to 75 for tax years beginning after 1996 and before 2005. The 2004 American Jobs Creation Act, Pub. L. No. 108-357, §232, amended §1361(b)(1)(A) to expand the limit to 100. T.D. 9422, 73 Fed. Reg. 47,526 (Aug. 14, 2008), conformed references in the regulations to the specific numbers of S corporation shareholders permissible under §1361. For purposes of determining the number of shareholders of an S corporation under §1361(b)(1)(A), the regulations provide rules relating to stock owned by family members.

[780] §362.

[781] §362(e)(2); Reg. §1.362-4(b). The term loss duplication transaction means any §362(a) transfer in which the transferee's aggregate basis in the property transferred by the transferor would exceed the aggregate value of such property immediately after the transaction. Reg. §1.362-4(g)(2). The term loss duplication property refers to individual property transferred in the loss duplication transaction that the transferee would take with a basis that would exceed value immediately after the transfer. Reg. §1.362-4(g)(2). Finally, the term transferor's net built-in loss is defined as the excess of the transferee's aggregate basis in property received from the transferor over the aggregate value of such property immediately after the transaction. Reg. §1.362-4(g)(3). For purposes of applying each of these definitions, the transferee's basis in property is determined immediately after the transfer, disregarding §362(e)(2) but taking into account all other applicable rules, including §362(e)(1). T.D. 9633, 78 Fed. Reg. 54,156 (Sept. 3, 2013).

[782] Reg. §1.362-4(f). *See, e.g.*, §1.362-4(h) *Ex.* 9(i)(A). The form and contents of the §362(e)(2)(C) election statement are prescribed by Reg. §1.362-4(d)(3)(i). The S corporation, and not its shareholder(s), files the election statement. Reg. §1.362-4(d)(3)(ii).

[783] In CCA 201433014, as part of its analysis of the issue of the proper methods of allocating tax items between the short tax years resulting from a mid-year S election termination, the Chief Counsel's Office appears to have taken the position that §351 requires a net value exchange, citing *Meyer v. United States*, 129 Ct. Cl. 214 (1954), *H.G. Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941), and Rev. Rul. 59-296. Under this position, a transaction would not qualify for §351 nonrecognition treatment if the amount of liabilities assumed by the transferee exceed the fair market value of the assets transferred by the transferor.

[784] §358.

[785] Reg. §1.362-4(e)(2). *See, e.g.*, §1.362-4(h) *Ex.* 9(ii)(B). The reduction in stock basis is treated as an expense of the S corporation that is not deductible in computing taxable income and not properly chargeable to capital account. §1367(a)(2)(D).

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Ex. 9 where loss duplication property is sold at a loss after a loss duplication transaction for which a §362(e)(2)(C) election was made. The loss flows through to the shareholders and further reduces their stock basis so that when they sell their stock, gains recognized on the stock sale will offset the benefit of the built-in loss flowed through to them from the S corporation. Section 362(e)(2)(C) eliminates the tax benefit of the built-in loss in this situation. Furthermore, when an S corporation transfers built-in loss property to a C corporation subsidiary and a §362(e)(2)(C) is made to reduce the outside basis of the subsidiary's stock, the regulations create a parallel expense that flows up to the S corporation shareholders reducing the outside stock basis as well.[786] In this case, the S corporation shareholders will not enjoy any direct benefit from the built-in loss because that benefit is locked inside the C corporation subsidiary.

F. Taxable and Nontaxable Stock Acquisitions by an S Corporation

1. Taxable Stock Acquisitions

a. Tax Consequences to the Acquiring S Corporation

An S corporation is allowed to own up to 100% of a C corporation's stock or 100% of a qualified subchapter S subsidiary. The following discussion assumes no election under §338 is made with respect to the stock acquisition. For a discussion of the tax consequences associated with a stock purchase and §338 election, see III.D.2.a., above. In a taxable stock acquisition, the acquiring S corporation takes a basis in the stock of the target equal to its cost.[787] S corporation status of the acquiror generally will not terminate as a result of an acquisition of stock of a target (unless stock is issued as consideration to ineligible shareholders or excess shareholders result from the acquisition); therefore, the general rules of subchapter S continue to apply to the acquiring S corporation.

b. Tax Consequences to the Acquired Corporation and Its Shareholders

The following discussion assumes no election under §338 is made with respect to the stock acquisition. For a discussion of the tax consequences associated with a stock purchase and §338 election, see III.D.2.a., above.

(1) C Corporation as Target

In general, a C corporation target does not recognize gain or loss on its assets when its stock is acquired. The tax attributes of the target remain with the target since §381 does not apply to a taxable stock acquisition. Under §1001(a), the target's shareholders recognize gain or loss based on the difference between the amount realized and the basis of the stock sold.

If the acquiring S corporation terminates its S status after the purchase and files a consolidated return, the target must change its taxable year to conform to the consolidated return group's taxable year. In addition, any pre-acquisition losses may be subject to either the separate return limitation year (SRLY) rules under the consolidated return provisions or §382 loss limitation rules.

An S corporation's acquisition of a C corporation target that was the parent of a consolidated group followed by QSub elections for the parent and subsidiaries could result in certain deferred intercompany transactions and excess loss accounts of the target consolidated return group being taken into account.

The following discussion focuses on stock acquisitions that cannot be collapsed into tax-free asset acquisitions under any of the step transaction authorities.

(a) Deferred Intercompany Transactions

If an S corporation acquires all of the stock of a C corporation that is the parent of a consolidated group in a taxable transaction and no QSub elections are made for the parent, the consolidated group may continue to file a consolidated return. As a result, any deferred intercompany transactions (DITs) between members of the consolidated group remain deferred. Since an S corporation is not an includible corporation under §1504(b)(6), this transaction is treated similarly to the treatment of an individual or a foreign corporation acquiring all the stock of a parent of a consolidated group.

The making of a QSub election for the parent of a consolidated group alone terminates the consolidated group because its C corporation subsidiaries will no longer have an includible corporation as their common parent.[788] As a result, any intercompany transactions deferred under Reg. §1.1502-13 would likely be taken into account under the acceleration rule.[789]

> *Example:* X, an S corporation acquires for cash all the stock of P, the parent of a consolidated group. P owns all the stock of Y and Z. X makes a QSub election for P. The P group terminates since X is not an includible corporation.

If instead all the subsidiaries of the consolidated group were to liquidate into the parent C corporation, DITs would still continue to be deferred provided a QSub election is not made for the parent C corporation.[790] Generally, under both the current and prior regulations, DITs continue to be deferred when one of the parties to a DIT transfers its assets to another member of the group in a nonrecognition transaction subject to §381(a).[791] In such an instance, the successor member (the acquiring corporation in the §381 transaction) must apply the regulations as if it were the original party to the DIT.[792]

Reg. §1.1361-4(b)(2) prescribes the ordering of the liquidations deemed to occur when QSub elections are made for a

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[786] Reg. §1.362-4(e)(2).

[787] §1012.

[788] §1504(a)(1)(A). As a result of the QSub election, the S corporation would be the parent of the group of C corporation. §1504(b)(6) excepts S corporations from being includible corporations.

[789] Reg. §1.1502-13(d).

[790] Reg. §1.1502-13(j)(6); former Reg. §1.1502-13(c)(6).

[791] Reg. §1.1502-13(j)(2)(i); former Reg. §1.1502-13(c)(6). The regulations addressing deferred intercompany transactions (DITs) were substantially modified in 1995. The current regulations generally apply to DITs entered into in taxable years beginning on or after to July 12, 1995, while the prior regulations generally continue to apply to DITs entered into in taxable years beginning prior to July 12, 1995. Reg. §1.1502-13(l)(1). For a detailed discussion of the differences between the current and prior regulations, see 756 T.M., *Computation of Consolidated Tax Liability*.

[792] Reg. §1.1502-13(j)(2)(ii); former Reg. §1.1502-13(c)(6).

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tiered group of corporations. Unless the taxpayer specifies a different order, QSub elections are deemed to occur first for the lowest-tier entity and proceed successively upward until all the liquidations have occurred.[793] If the QSub elections are ordered from the bottom up and result in liquidations under §332,[794] then the former parent of the consolidated group would be a successor to the liquidated subsidiaries immediately before its QSub election becomes effective.[795]

However, as noted above, making a QSub election for the parent would likely cause any DITs of its subsidiaries entered into under current regulations to be triggered as the former parent would presumably be viewed as becoming a nonmember of the group under current Reg. §1.1502-13(j)(7).[796] The former parent becomes a nonmember when it has a separate return year. The former parent's items of income for the post-QSub election period would be includible in the separate return of the S corporation acquiror.[797]

Similarly, DIT gains generated under the prior regulations also may be triggered when the former parent liquidates pursuant to the QSub election as the former parent ceases to appear to be a member of any consolidated group.[798] Although the parent may have been viewed as a successor under former Reg. §1.1502-13(c)(6), it is no longer a member of the group immediately after its QSub election becomes effective, and therefore, it appears that pre-1996 DIT gains would also be taken into account.

It may be possible for DITs generated under the former regulations to be preserved if the acquisition of the C corporation stock followed by the QSub elections were collapsed and treated as an asset reorganization. Former Reg. §1.1502-13(f)(2)(i)(a) contains an exception to taking into account DITs when a nonmember acquires the assets of the common parent in a reorganization described in §368(a)(1)(A), §368(a)(1)(C), or §368(a)(1)(D).

Comment: From a policy perspective, triggering of pre-1996 DIT gains does not appear to be the correct answer since both a QSub election treated as a liquidation and an asset reorganization are governed by §381; however, the former regulations only provide relief for asset reorganizations to which paragraphs §354(A) and §354(B) of §354 are met and do not focus on §381 transactions.

The current regulations do not provide as broad an exception. Under Reg. §1.1502-13(j)(5), if a consolidated return group ceases to exist because, for example, the common parent's assets are acquired in an asset reorganization, the mechanism for continuing to defer DITs is that the surviving group is treated as the terminating group for purposes of applying the intercompany transaction rules to the DITs. The regulations are specific that this treatment does not apply to members of the terminating group that are not members of the surviving group immediately after the terminating group ceases to exist. Here, in the event that a QSub election is made for the common parent of the consolidated group and it is treated as part of an asset reorganization of the common parent into an S corporation, the common parent goes out of existence and there is no surviving group to continue applying the intercompany transaction rules to the historic DITs because the acquiring S corporation is not an includible corporation under §1504(b)(6). As a result, those DITs appear to be taken into account.

If the common parent of a consolidated group is not acquired but instead makes an S election and makes QSub elections for its subsidiaries, any DITs between the former members would presumably be triggered as the common parent would become a nonincludible corporation described in §1504(b)(6).[799] No similar provision existed under the prior regulations so DIT gains and losses arising under the prior regulations appear to remain deferred.

(b) Excess Loss Accounts

Another problematic issue involves the treatment of excess loss accounts (ELAs) if a member of a consolidated group becomes a QSub. Under the investment basis adjustment rules of the consolidated returns regulations, an ELA — essentially negative basis in member stock — arises when basis reductions exceed basis increases.[800] The ELA must be included in income by the member owning the stock upon the disposition of the stock of the subsidiary.[801]

Consider a situation in which an S corporation owns 100% of X, which in turn owns 100% of Y. X and Y file a consolidated return, and X has an ELA with respect to Y. S makes an election to treat X as a QSub. The ELA rules specify a number of situations in which a member will be deemed to have disposed of its stock of a subsidiary.[802] These rules do not address the effect of a QSub election with respect to a member of a group; however, the QSub regulations are clear that general principles of tax law should be applied to determine the effect of a QSub election.[803] A QSub election for X but not Y has the effect of deconsolidating X and Y as the X-Y group would no longer exist. Under Reg. §1.1502-19(c)(1)(ii), the deconsolidation causes the ELA with respect to the Y stock to be taken into by X.[804]

If a QSub election were to be made for Y and X, then under Reg. §1.1361-4(b)(2), Y would be deemed to liquidate as a result of the QSub election prior to X liquidating. Under Reg. §1.1502-19(b)(2), the liquidation of Y into X would not be a

[793] Reg. §1.1361-4(b)(2).

[794] The effects of a QSub election are determined by taking into account general principles of federal income tax. A QSub election may not be governed by §332 if the subsidiary were insolvent. *See* Rev. Rul. 59-296; *see also* Rev. Rul. 2003-125 (check-the-box election not considered to qualify as a §332 liquidation where entity for which the election was made was insolvent).

[795] Section 381(a) applies to liquidations to which §332 apply. §381(a)(1).

[796] Other principals of tax law, including §267, may continue to defer intercompany losses.

[797] Reg. §1.1361-4(a)(1).

[798] Reg. §1.1502-13(f)(1)(iii).

[799] Under Reg. §1.1502-13(j)(6), the treatment of a former parent as a continuation of the consolidated group ceases upon becoming a corporation described in §1504(b).

[800] Reg. §1.1502-32(a)(3)(ii). For this purpose, basis reductions can result from several factors. *See, e.g.*, Reg. §1.1502-32(b)(3)(i) (requiring basis decrease when losses attributable to a member are absorbed) and Reg. §1.1502-32(b)(3)(v) (requiring basis decreases when a member makes a §301 distribution).

[801] Reg. §1.1502-19(a)(1).

[802] Reg. §1.1502-19(c). For example, P is treated as disposing of a share of S's stock upon transfer or cancellation of the stock.

[803] Reg. §1.1361-4(a)(2).

[804] Reg. §1.1502-19(b)(1).

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disposition of Y stock that would cause the ELA to be triggered provided the liquidation qualified under §332.[805]

(c) Section 1374 Built-in Gains

The IRS has issued several private letter rulings addressing whether the §1374 built-in gains tax is triggered by the deemed liquidation resulting from a QSub election. A sample of the rulings follows.

In PLR 200010022, an S corporation (Z) acquired the stock of two S corporations (X and Y) and subsequently made QSub elections for them, resulting in a tax-free acquisition of the assets of X and Y. The IRS ruled that Z is subject to the built-in gains tax of §1374 with respect to assets deemed to have been received from X pursuant to the QSub election.

In PLR 200010039, a new corporation (NewCo), electing S corporation status, was created. NewCo exchanged its stock for all the stock of two existing S corporations (S1 and S2) and then made QSub elections for S1 and S2. NewCo acquired the assets of S1 and S2 in a tax-free transaction. The IRS ruled that none of the assets transferred from S1 or S2 to NewCo are subject to the built-in gains provisions under §1374(d)(8).

In PLR 9801015, an S corporation made QSub elections for its three subsidiaries. The IRS ruled that neither the S corporation nor the subsidiaries would be required to recognize income from built-in gains solely because of the deemed liquidations resulting from the QSub elections. Instead, the IRS indicated that the deemed liquidations would be treated as a §1374(d)(8) transaction and §1374 would apply accordingly (i.e., the §1374 tax would be imposed on any net recognized built-in gain attributable to the assets acquired in the deemed liquidations during the recognition period provided for in §1374(d)(8)).

(d) Employment Taxes and Employer Identification Numbers

Section 1361(b)(3)(A) provides that a corporation for which a QSub election is made is not treated as a separate corporation for federal tax purposes, and all assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation. However, under regulations, a QSub is liable for employment taxes on wages paid to its employees and is responsible for satisfying other employment tax obligations (including backup withholding, making timely deposits of employment taxes, filing returns, and providing Forms W-2 to employees).[806] A QSub is also required to pay and report federal excise taxes (other than excise taxes specifically excluded from the regulations), is required and allowed to register under §4101 (with respect to taxes on motor fuels), §4412 (in the case of persons subject to the occupational tax on wagering), and §4222 (to obtain tax-free treatment of sales for certain exempt purposes), and is allowed to claim any credits other than income tax credits and to claim refunds and payments.[807]

Reg. §301.6109-1 provides clarification regarding employer identification numbers for QSubs, restating the general rules that: (i) when an entity's classification changes as a result of an election, it retains its EIN; and (ii) unless regulations or published guidance provides otherwise, a disregarded entity must use its owner's EIN for federal tax purposes. The preamble to the these regulations also states that if a subsidiary's QSub election terminates, the new corporation formed as a result of that termination must use its own EIN for federal tax purposes. If the new corporation had an EIN before the effective date of its QSub election or during its QSub status, it should use that EIN. Otherwise, the new corporation must apply for a new EIN.

(2) S Corporation as Target

In general, an S corporation target will not recognize gain or loss on the acquisition assuming no §338 election is made. Section 381 will not apply to the transaction and the tax attributes of the target will generally remain with the corporation.

If the acquirer is a C corporation or a partnership, the target's S election will terminate on the date of the acquisition as a result of having an ineligible shareholder. Because the target's S status terminates, it will have an S termination year consisting of a short S and a short C year. The target's income will be allocated between these two years on a per books basis assuming at least 50% of its stock has been acquired (otherwise, income will be allocated on a per-share, per-day basis).[808] Re-election of S corporation status by the target would be prohibited for the five-year period under §1362(g).

If the acquisition constitutes a change in ownership under §382(g), §382 could apply if the target S corporation had any NOLs from former subchapter C status. Any S corporation corporate-level losses would be unavailable.[809] The target's taxable year may change if a consolidated return is filed with the acquiring corporation.

The target's shareholders would recognize gain or loss under §1001(a) based on the difference between the amount realized and the adjusted basis of the stock sold. The stock basis presumably will be adjusted for any income or loss allocated to the short S portion of the S termination year. The target's shareholders' suspended losses under §1366(d)(2) would probably be lost because they no longer would hold stock after the acquisition.

2. Nontaxable Stock Acquisitions

a. General

Stock acquisitions by S corporations should be tax free, absent any recognition events that may occur if S corporation status of the acquiring company is terminated as a result of the acquisition.

b. B Reorganization

In a B reorganization, an S corporation acquires stock of the target corporation solely in exchange for its voting stock.[810]

[805] *See also* Reg. §1.1502-19(g) *Ex.* 2(d).

[806] Reg. §1.1361-4(a)(7). These regulations, which place ultimate responsibility for employment taxes on the disregarded entity, obsoleted Notice 99-6, as of January 1, 2009, the effective date of Reg. §1.1361-4(a)(7).

[807] Reg. §1.1361-4(a)(8).

[808] §1362(e)(6)(D).

[809] §1371(b)(2).

[810] §368(a)(1)(B).

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Immediately after the exchange, the S corporation must control the target corporation within the meaning of §368(c).[811]

If the S corporation issues shares to ineligible shareholders or to an amount of shareholders that cause it to exceed the 100-shareholder limit, S election will terminate. Under §1362(d)(2), the S status would terminate on the date of the reorganization.

A qualified subchapter S subsidiary (QSub) election may be made by the acquiring S corporation with respect to the target corporation.[812] In effect, the QSub will be treated as if it is a division of the acquiring S corporation and all the assets, liabilities, and items of income, deduction, loss, and credit (including accumulated E&P, passive investment income, built-in gains, etc.) are treated as those of the parent.[813] For a more in-depth discussion, see III.D., above.

A QSub election following a B reorganization acquisition may be treated as a C reorganization.[814]

G. Recapitalizations and Changes in Form (F Reorganizations)

1. Recapitalizations

A recapitalization normally does not involve the acquisition of another corporation but entails the restructuring of an existing corporation's debt and/or equity.[815] Neither the statute nor the regulations provides much in the way of guidance to accomplish a tax-free recapitalization. However, under §368(a)(1)(E), such a recapitalization is tax free. For example, exchanging preferred stock for common stock or securities for common stock are potential recapitalization transactions.[816]

In an S corporation context, recapitalizations will be limited because the S corporation can only have one class of stock.[817] However, an S corporation is permitted to have differences in voting rights; thus, tax-free recapitalizations involving common stock with voting rights,[818] would be permissible. Similarly, recapitalizations of debt constituting securities for common stock would be feasible in an S corporation setting.

Under §354, in order for a recapitalization to be tax free, it needs to involve exchanges of stock or securities. The term security is not defined in the statute. However, normally a security is a written instrument of a corporation that represents its obligation to pay to the holder a specified sum of money. Such instruments could include stock, bonds, or notes of a corporation. The time period that the instrument will be outstanding is not determinative of whether a particular instrument is a security, but it is a factor.[819] Generally, the longer the time frame, the more likely the instrument would be a security. In an S corporation context, if a corporation has an open account arrangement obligating it to its shareholders, the account would not be considered a security under §354 and any attempt to recapitalize the open account into stock would fail to qualify as a reorganization.

Another potential transaction would involve recapitalizing a shareholder's low-basis corporate indebtedness, in exchange for stock, to eliminate any gain potentially inherent in the repayment of the debt by the corporation. Presumably, this transaction could be accomplished on a nonrecognition basis as long as the debt involved is a security under §354. This transaction may also be accomplished via a stock-for-debt exchange under §108(e)(8) or just as a contribution to capital under §108(e)(6).[820]

A recapitalization of S corporation stock in a stock-for-stock exchange would also qualify for tax-free treatment under §1036 which provides that no gain or loss is recognized when common stock of one corporation is exchanged solely for common stock of the same corporation. Finally, recapitalizing an S corporation into voting and nonvoting common stock should qualify as a nonrecognition transaction.[821]

2. Changes in Form

An F reorganization is defined in §368(a)(1)(F) as "a mere change in identity, form, or place of organization of one corporation, however effected." In general, F reorganizations can take several forms and include single-entity transactions such as a change in corporate charter or a change in corporate name, changes in the forms of business organizations, or reincorporations.[822]

A mere change can consist of a transaction that involves an actual or deemed transfer of property from one corporation (a transferor corporation) to one other corporation (a resulting corporation). Such a transaction qualifies as an F reorganization only if all the following requirements are met: (i) immediately

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[811] §368(a)(1)(B).

[812] §1361(b)(3)(B). Form 8869, *Qualified Subchapter S Subsidiary Election*, must be filed in order to elect QSub status, the IRS stated in Notice 2000-58. Notice 2000-58 supersedes Notice 97-4. See also Reg. §1.1361-3(a) for QSub elections guidance.

[813] §1361(b)(3)(A). Reg. §1.1361-4(a)(3) provides a limited exception to the general rule of disregarding the QSub if the S corporation is a bank or the S corporation makes a valid QSub election for a subsidiary that is a bank. In both of these situations, special rules applicable to banks under the Code continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of the QSub had not occurred.

[814] *See* Rev. Rul. 67-274 and discussion in III.E.4.b.(1), above. The transaction may even be characterized as an acquisitive D reorganization.

[815] *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

[816] Reg. §1.368-2(e).

[817] §1361(b)(1)(D).

[818] §1361(c)(4).

[819] *Camp Wolters Enterprises, Inc. v. United States*, 230 F.2d 555 (5th Cir. 1956), *aff'g* 22 T.C. 737 (1954).

[820] *See* discussion in III.E.2.j., above.

[821] *But see* Notice 2004-30 (identifying as tax shelter listed transaction certain transactions in which S corporation issues nonvoting stock and warrants exercisable into nonvoting stock to its shareholders, shareholders donate nonvoting stock to exempt organization but retain voting stock, and exempt organization asserts that S corporation income allocated to it is not UBTI or is offset by exempt organization's UBTI net operating losses); IRS Industry Specialization Program Coordinated Issue Paper on S Corporation Tax Shelter Notice 2004-30 UIL: 9300.36-00 (Nov. 8, 2004) (directing examiners to apply judicial doctrines — substance over form and economic substance — in disallowing improperly claimed deductions, and to examine whether the capital structure created in the transactions violate the single class of stock requirement under §1361(b)(1)(D)). Note that the economic substance doctrine is no longer exclusively a judicial doctrine, having been codified as §7701(o) by the Health Care and Education Reconciliation Act (HCERA) of 2010, Pub. L. No. 111-152, §1409(a), generally applicable to transactions entered into after March 30, 2010. *See* LB&I-04-0422-0014 (guidance for managers and examiners on how to determine it is appropriate to raise economic substance doctrine and when to seek approval in asserting the doctrine and related penalties). *See also* Notice 2010-62 (providing interim guidance on codification of economic substance doctrine). The doctrine is discussed in detail in 508 T.M., *The Economic Substance Doctrine*.

[822] *See, e.g.,* Rev. Rul. 72-206.

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after the potential F reorganization, all the stock of the resulting corporation has been distributed (or deemed distributed) in exchange for stock of the transferor corporation in the potential F reorganization; (ii) subject to certain exceptions, the same person(s) owns all the stock of the transferor corporation at the beginning of the potential F reorganization and all of the stock of the resulting corporation at the end of the potential F reorganization, in identical proportions; (iii) the resulting corporation does not hold any property or have any tax attributes (including those specified in §381(c)) immediately before the potential F reorganization; (iv) the transferor corporation completely liquidates, for federal income tax purposes, in the potential "F" reorganization; (v) immediately after the potential F reorganization, no corporation other than the resulting corporation holds property that was held by the transferor corporation immediately before the potential F reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in §381(c); and (vi) immediately after the potential F reorganization, the resulting corporation does not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as a result, succeed to and take into account the items of such other corporation described in §381(c).[823]

Reincorporations take place in various forms, including: (i) the merger of the transferor Oldco corporation into the transferee Newco corporation under state law;[824] (ii) a transfer by the Oldco shareholders of their Oldco stock to Newco in exchange for the newly issued stock of Newco, followed by a liquidation of Oldco into Newco;[825] or (iii) a transfer by Oldco of all of its properties to Newco in exchange for the newly issued Newco stock, followed by a distribution of the Newco shares by Oldco to its shareholders in liquidation.[826]

Depending upon the form of the transaction, the S corporation's election may continue without the need for a new election. In Rev. Rul. 64-250,[827] the IRS ruled that the merger of an S corporation into a newly formed corporation in another state was an F reorganization. Since the surviving corporation also met the requirements to be an S corporation and an F reorganization is simply a mere change in identity form or place of incorporation, the old S corporation's election did not terminate and no S election needed to be made for the new corporation which continued as an S corporation.

As discussed above, an F reorganization may result from the contribution of stock of one corporation to a new corporation followed by the liquidation of the contributed corporation. This transaction is similar to the outcome of the drop of one S corporation to another followed by a QSub election for the contributed company. However, this transaction poses a chicken and the egg situation. Rev. Rul. 64-250 states that no new S election must be made in an F reorganization of an S corporation. However, in order to recharacterize the drop and QSub election as an F reorganization, the QSub election can only be made for a subsidiary of an S corporation. The IRS issued Rev. Rul. 2008-18, which describes two methods (similar to the one discussed above) of accomplishing an "F" reorganization via a QSub election. In Situation 1, individual B transferred all of their stock in Y to a Newco and made a QSub election for Y immediately following the transfer. Similarly in Situation 2, Z, an S corporation forms Newco which forms Mergersub. As part of a plan, Mergersub merges with and into Z with Z's shareholder receiving solely Newco Stock in exchange for stock of Z and a QSub election is made for Z immediately following the merger. The ruling holds that no S election needs to made for Newco in either situation; however, Newco in both situations is required to obtain a new EIN while Y and Z retain their old EINs.[828]

The IRS also ruled that the merger of an S corporation into a newly formed corporation qualifying as an F reorganization did not terminate any QSub elections with respect to the subsidiaries of the first S corporation.[829] In contrast, the tax-free asset acquisition of an S corporation other than in an F reorganization (i.e., a reorganization under §368(a)(1)(A), §368(a)(1)(C) or §368(a)(1)(D)) would terminate the QSub election of subsidiaries of the acquired S corporation.[830]

Observation: In the context of taxable acquisitions of S corporations, it is common practice for the target S corporation to undertake an F reorganization similar to that described in Rev. Rul. 2008-18, and subsequently convert to a limited liability company under state law prior to the acquisition. The buyer will then purchase all the interests in the LLC (the former S corporation) from the new corporation. This ensures the buyer a step up in the assets of the target and limits the buyer's exposure to historic taxes of the target S corporation to those up to the date of the F reorganization. From the seller's standpoint, it is important to pay attention to the timing of the QSub election and LLC conversion to minimize the risks of potentially creating built-in gain on the sale. A QSub election is only valid if, at the time the election is made, the company meets all the requirements of a QSub. In PLR 201723013, taxpayers requested relief from an inadvertent invalid QSub election because the election was filed after the conversion to LLC, albeit with an effective date prior to the conversion. Relief was requested because at the time of filing of the QSub election, it was no longer a corporation and thus not eligible for such an election.

[823] Reg. §1.368-2(m).

[824] *See, e.g.*, *Newmarket Mfg. Co v. United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957); *Dunlap and Assoc., Inc. v. Commissioner*, 47 T.C. 542 (1967); Rev. Rul. 57-276.

[825] *See, e.g.*, *George Whittel and Co. v. Commissioner*, 34 B.T.A. 1070 (1936), *nonacq.*, 1937-1 C.B. 53.

[826] *See, e.g.*, *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2d Cir. 1934), *cert. denied*, 293 U.S. 611 (1934).

[827] *Amplified by* Rev. Rul. 2008-18. *See also* PLR 201007043 (downstream merger of S corporation into wholly owned QSub, with subsidiary surviving, is F reorganization and does not affect S corporation status); PLR 200835002 (reincorporation in same state, accomplished by merger of Oldco into Newco, following state administrative dissolution, was F reorganization; Oldco's status as corporation for federal tax purposes was not terminated by administrative dissolution; Oldco's S election was not terminated by merger, and remained in effect for Newco); PLR 201115016 (transfer of S corporation stock to new wholly owned corporation, followed by QSub election for original S corporation is F reorganization; S election does not terminate, but remains in effect for new corporation).

[828] Rev. Rul. 2008-18.

[829] Rev. Rul. 2004-85.

[830] At the same time the IRS issued Rev. Rul. 2004-85, it also issued Rev. Proc. 2004-49, which provides automatic relief for terminated QSub elections resulting from a tax-free asset reorganization of an S corporation other than an F reorganization.

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While the transaction may still have been an F reorganization under the step transaction principles used in Rev. Rul. 2008-18 (conversion to LLC is equivalent to QSub election for purposes of the F reorganization analysis), this fault raises a hypertechnical issue. Is there a period of time between the contribution of shares and conversion to LLC that temporarily causes the target S corporation to be a C corporation under Newco because it has an ineligible S corporation shareholder? If so, then built-in gain tax may apply to the subsequent sale. Case law suggests that the mere intent to liquidate does not cause a liquidation and that a company must be respected as a separate entity until the completion of the liquidation.[831] It is unclear how the holding in *Snively* applies in the context of a step transaction reorganization that spans more than one day; should the transfer of stock be respected and S termination result if the asset transfer does not happen on the same day or should the fiction of the asset reorganization apply regardless of the time span between the stock transfer and asset transfer (via QSub election, LLC conversion or actual liquidation)? Given the potential exposure to significant corporate-level tax, care should be taken to avoid this potential issue.

The IRS has generally indicated a willingness to rule on the tax effects of F reorganizations involving S corporations. The IRS will generally not rule whether a transaction is an F reorganization but rather required taxpayers to represent that a transaction was intended to qualify as an F reorganization. Rev. Proc. 2026-3 outlines IRS letter ruling practice.

An F reorganization should have no effect on the reorganizing corporation's exposure to the built-in gains tax or LIFO recapture,[832] and the reorganized company succeeds to the AAA of the original corporation.[833]

H. Other Acquisition Issues

1. Utilization of Shareholder Suspended Losses

Frequently, an S corporation target has incurred operating losses during its operations and its shareholders have suspended losses due to a lack of stock or debt basis. If the S corporation is acquired in a reorganization transaction, what happens to these suspended losses? Are they lost or do they carry over to the successor corporation?

Section 1366(d)(2) states that any loss or deduction disallowed for any taxable year is treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder. In general, a target corporation's attributes carryover under §381 to a successor corporation. Because the target shareholder's suspended losses are treated as incurred in succeeding taxable years by their corporation, it is possible to conclude that any suspended losses are corporate attributes available to the successor (and its shareholders).

However, because suspended losses are corporation and shareholder specific, such losses available to the successor's shareholders must have been incurred by target shareholders who are also shareholders of the successor. If a target shareholder is cashed out and does not become a shareholder of the successor, then any suspended losses attributable to the shareholder would be lost.

Reg. §1.1366-2(c)(1) provides rules regarding the carryover of disallowed losses and deductions in the event of certain corporate reorganizations. If a corporation acquires the assets of another S corporation in a transaction to which §381(a) applies and the corporation has disallowed losses and deductions that would carry over under §1366(d)(2) with respect to a shareholder but for the reorganization, then the losses and deductions will be available to that shareholder as a shareholder of the acquiring corporation. Thus, where the acquiring corporation is an S corporation, the losses and deductions will be treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder in the acquiring S corporation after the transaction. Where the acquiring corporation is a C corporation, the regulations provide special rules for a shareholder to carry over disallowed losses and deductions to any post-termination transition period under §1377 if the shareholder is a shareholder of the C corporation after the transaction.

If target shareholders held stock in the successor corporation before the merger transaction, the stock basis in the acquiring corporation shares may be available to use suspended losses from the target corporation. In FSA 200223052, the Chief Counsel's Office advised that a shareholder of a target S corporation, who also was a shareholder of the acquiring C corporation, could apply his suspended losses under §1366(d) against his historic basis in the C corporation stock and then reduce the historic basis in the C corporation stock for the losses taken.

Reg. §1.1366-2(c)(2) provides that in the case of an S corporation that transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which §368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which §355 (or so much of §356 as relates to §355) applies, any disallowed loss or deduction with respect to a shareholder of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. This allocation is made in proportion to the fair market value of the shareholder's stock of the distributing corporation and the shareholder's stock of the controlled corporation, determined immediately after the transaction.

Finally, if the suspended losses are corporate attributes, then it is possible to conclude that the §382 rules would limit the utilization of these suspended losses if there is an ownership change.[834] This conclusion is far from clear and may be inappropriate in that §382 was enacted to limit trafficking in corporate NOLs. Section 382 applies to a corporation's net operating losses, capital loss carryforwards, and net unrealized built-in losses. Losses suspended under §1366(d) do not technically fall into the definition of any of these items. Applying §382 to shareholder suspended losses presumably would be inconsistent with subchapter S under §1371(a).

[831] *See Snively v. Commissioner*, 19 T.C. 850 (1953), *aff'd* 219 F.2d 266 (5th Cir. 1955).

[832] PLR 9213026, PLR 9123049 (NewCo not subject to built-in gains tax because OldCo made its S election prior to 1987; likewise, no LIFO recapture tax would be triggered as a result of the F reorganization).

[833] PLR 9118029, PLR 9123049.

[834] §382(g).

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2. Loss Limitation Rules

Section 382 limits the use of net operating losses (NOLs) and other tax attributes where there is an ownership change, i.e., 5% shareholders' collective stock holdings in the loss corporation increase by more than 50%.[835] In general, this limitation is keyed to the value of the loss corporation (most frequently the target) multiplied by the long-term tax-exempt rate. This provision was enacted primarily to deter trafficking in NOLs.

S corporations do not generate operating losses that are retained at the corporate level. These loss items flow through to shareholders under §1366 and are available to shareholders to the extent of their stock and debt basis.[836] Any losses that cannot be utilized are suspended and flow through to shareholders in succeeding taxable years.[837] If the S corporation was formerly a C corporation, the corporation may still have unexpired subchapter C NOLs. It would seem appropriate to apply the §382 limits to any C corporation NOLs (or built-in losses to the extent the C corporation had a net unrealized built-in loss at the time of the ownership change). Section 382(h)(1)(A) increases the §382 limitation by built-in gains recognized during the taxable year to the extent the corporation can prove it had a net unrealized built-in gain in its assets (as determined under §382(h)(3)).[838] Therefore, there may be situations where the §382 limitation may not provide any practical limitation on an S corporation to utilize C corporation NOLs against recognized built-in gains. If the target S corporation is subject to the built-in gains tax, a further complicating factor is introduced.

> *Example:* T is a calendar year S corporation that made its S election effective for its tax year beginning on January 1, Year 1. T is owned 60% by B and 40% by C. T was formerly a C corporation and has subchapter C NOL carryforwards. In addition, on date of conversion, T had both built-in gains and built-in losses in its assets. In Year 4, T merges into XYZ, another S corporation, wholly owned by D, that made its S election after 1986. C is cashed out and B takes 60% of XYZ's stock, leaving D with 40% of XYZ.
>
> Under §1374(b), any subchapter C NOL carryforward is allowed as a deduction against the net recognized built-in gain of the S corporation. In the example, T's subchapter C NOLs carry over to XYZ under §381. T's subchapter C NOLs cannot be applied against XYZ's built-in gain to reduce XYZ's built-in gains tax exposure.[839] To utilize T's subchapter C NOLs, XYZ would need to dispose of T's built-in gain assets.
>
> Because there is no ownership change of T under §382 in this example, the §382 loss limitation rule does not apply to T's NOLs. However under §384, XYZ's built-in gain probably cannot be offset by any of T's preacquisition losses (subchapter C NOLs or built-in losses).

Under Reg. §1.1374-5, the utilization of any subchapter C corporation NOLs against built-in gains tax would be subject to the same limitations applying to C corporations. Thus, ownership changes in an S corporation could create a limitation on the amount of C corporation NOLs that can be used to offset built-in gains of the S corporation.

3. S Corporation Capital Purchase Program

In response to the 2008–2009 financial and economic crisis, the Emergency Economic Stabilization Act of 2008 (EESA),[840] enacted on October 3, 2008, authorized Treasury to provide assistance for troubled assets of financial institutions. Section 101(a) of EESA authorizes the Treasury Secretary to establish the Troubled Assets Relief Program (TARP) to "purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and policies and procedures developed and published by the Secretary." Treasury's TARP authority extended from October 3, 2008, to December 31, 2009, subject to extension to a later date (but not later than October 3, 2010) upon Treasury's certification to Congress.[841] TARP was, in fact, extended to October 3, 2010.[842]

TARP effectively gave Treasury up to $700 billion to buy mortgages and other troubled assets owned by financial institutions. On October 14, 2008, Treasury announced one of the TARP programs, which was focused on preferred stock: a voluntary Capital Purchase Program (CPP), under which Treasury planned to purchase up to $250 billion of senior preferred shares on standardized items. CPP was available to qualifying U.S.-controlled banks, savings associations, and certain banks and savings and loan holding companies engaged only in financial activities. CPP officially ended on December 29, 2009.[843] For further discussion, see 541 T.M., *Tax Aspects of Restructuring Financially Troubled Businesses.*

Absent special provisions, CPP would not have been available to S corporations without costing them their S status. S corporations cannot issue a second class of stock, such as the preferred stock that other corporations issued to Treasury under CPP.[844] To solve the problem, Treasury released a CPP term sheet specifically for S corporations, providing for issuances of debt instead of stock. Under this S corporation CPP, an S corporation issued subordinated debt that is referred to as Senior Securities because, while subordinated to other debt, it was senior to all equity. The Senior Securities were designed to count as capital (and, thus, counted toward an S corporation's capital requirements) under guidelines issued by the federal banking agencies. The interest rate that an S corporation owed on Senior

[835] §382(g).
[836] §1366(d).
[837] §1366(d)(2).
[838] It should be noted that the definitions of recognized built-in gain for §382 and §1374 purposes are not the same.
[839] Reg. §1.1374-8(b).
[840] Pub. L. No. 110-343, Div. A.
[841] Pub. L. No. 110-343, Div. A, §120(a).
[842] Letter dated December 9, 2009, from Treasury Secretary Timothy F. Geithner to U.S. House of Representatives Speaker Nancy Pelosi, http://www.financialstability.gov.
[843] *See* 26 BNA Fin. Plan. J. 9 (Jan. 19, 2010).
[844] *See* §1361(b)(1); 730 T.M., *S Corporations: Formation and Termination.*

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Securities was higher than the dividend rate on preferred stock of other qualified financial institutions participating in CPP, to account for the fact that an S corporation can deduct its interest payments on the subordinated debt while other corporations cannot deduct their dividend payments.[845]

4. *Net Investment Income Tax*

Dispositions of S corporation stock may trigger the net investment income tax to some shareholders.[846] The tax is imposed on individuals (as well as trusts and estates) in the amount of 3.8% of the lesser of: (i) net investment income, which is essentially unearned income, for the taxable year, or (ii) the excess of modified adjusted gross income for the taxable year, over a threshold amount of $250,000 in the case of a taxpayer making a joint return or a surviving spouse, $125,000 in the case of a married taxpayer filing a separate return, and $200,000 in any other case.[847] Net investment income is the excess over federal income tax deductions of the sum of the following three amounts: (i) gross income (not derived in the ordinary course of a trade or business) from interest, dividends, annuities, royalties, and rents; (ii) gross income derived from a trade or business that is a passive activity or that is in the business of trading financial instruments or commodities; and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property that is either: (a) not held in a trade or business, or (b) held in a trade or business that is a passive activity or that is in the business of trading financial instruments or commodities.[848]

Note: The net investment income tax puts pressure on what passive activities are grouped together under the passive activity rules.[849] Depending on how certain activities are grouped, passive activity income can be managed.[850]

Comment: Shareholder-employees are subject to FICA taxes on their wages earned from their S corporation. This FICA tax includes a Medicare tax amount equal to 3.8% of the overall employer-employee FICA tax burden of 16.2%.[851] Note that the Medicare tax is imposed only on the S corporation shareholder-employee's wages and not on their distributive share of S corporation income. Under the §1411 net investment tax, shareholder-employees could be subject to an additional 3.8% tax on interest, dividends, annuities, royalties, rents or passive activity income derived from investment in their S corporation or lower-tier flow-through subsidiaries, if these items of income flow-through and are not derived in the ordinary course of a trade or business. Income derived from working capital invested by the S corporation is be treated as net investment income under §1411. The net investment income tax also applies to passive shareholders of an S corporation. In the case of the passive shareholder, their entire allocable distributive share of S corporation income is subject to the net investment tax.[852] This will be of particular concern to passive family members who invest in S corporations.

The net gain attributable to the disposition of S corporation stock not held in a trade or business, or held in a trade or business that is a passive activity or that is in the business of trading financial instruments or commodities, may trigger the net investment income tax. To ensure that only unearned income is subject to the tax, however, §1411(c)(4) limits the amount of such net gain included in net investment income to the amount of net gain that the transferor would take into account if all of the S corporation's property were sold for fair market value immediately before the disposition. A similar rule applies to losses.

For a more complete discussion of §1411 and the regulations, see 511 T.M., *Net Investment Income Tax.*

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[845] *See* Treasury News Release HP-1354, "Treasury Department Announces Notice on Release of Capital Purchase Program Terms, FAQs for Subchapter S Corporations" (Jan. 14, 2009); "Treasury Department Frequently Asked Questions on TARP for Subchapter S Corporations" (Jan. 14, 2009).

[846] §1411, effective for tax years after 2012.

[847] §1411(a), §1411(b).

[848] §1411(c)(1), §1411(c)(2).

[849] Reg. §1.469-4. *See also* Rev. Proc. 2010-13.

[850] Because the net investment income tax applies to passive activity income, Reg. §1.469-11(b)(3)(iv) allowed taxpayers (including S corporation shareholders) a limited regrouping opportunity. For more information, see 511 T.M., *Net Investment Income Tax* and 549 T.M., *Passive Loss Rules.*

[851] §3101(b).

[852] §1411(c)(2).

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IV. Foreign Operations

A. General

Most S corporations operate in an entirely domestic setting due to their unique eligibility rules. Nevertheless, S corporations increasingly have expanded their operations into foreign countries to obtain better access to foreign markets, to achieve lower production costs, and for other reasons.

The choices confronting an S corporation wishing to expand its operations abroad are generally the same choices facing any business planning to conduct operations internationally. One critical choice is whether to have the S corporation directly conduct the foreign operations or to have the S corporation establish a foreign entity — of a type to be determined — to conduct them. Factors that affect this choice include business considerations, U.S. tax considerations, and foreign tax considerations.

The business considerations often include the desire to limit liability, the applicability and impact of foreign regulatory requirements, and whether the existence of a foreign entity will help facilitate the conduct of foreign operations.

U.S. tax considerations include whether it is desirable for income or loss to flow through the S corporation to its shareholders or for those items to remain in a foreign C corporation. The availability of foreign tax credits for foreign taxes paid on foreign income, and treaty benefits, which historically have been available to both S and C corporations equally, are also important considerations. However, the this relative parity going forward was changed be legislation.

Although this Portfolio focuses on the U.S. federal income tax considerations of an S corporation's foreign operations, there are also a variety of foreign tax considerations. These foreign tax considerations include the differing foreign tax regimes that apply to locally organized corporations, on the one hand, and branches or flow-through entities, on the other hand, and withholding taxes on dividends paid by a foreign subsidiary. While a QSub is generally treated as a branch for U.S. income tax purposes, it will generally be respected as a corporation under foreign tax law. S corporations should also be closely monitoring developments regarding Pillar Two, the new global minimum tax framework, to understand how S corporations may be impacted. For example, an S corporation with foreign operations may be treated as an ultimate parent entity and have some of its income subject to tax by other countries. S corporations present particularly unique issues due to the incorporation of aggregate and entity U.S. tax rules. Transparent for most U.S. federal tax purposes, S corporations are generally treated no differently than C corporations in foreign jurisdictions, leaving aside special treatment under U.S. income tax treaties. The view taken by some treaty partners appears to be that an S corporation is a resident corporation of the United States for treaty purposes.[853] While an S corporation shareholder may not take advantage of the former §902 indirect tax credit or the §960 deemed paid credit for subpart F inclusions[854] available to U.S. C corporations, S corporation shareholders may benefit from available treaty provisions, which often include special withholding tax rates on interest and dividends.

The eligibility rules of §1361(b) generally prevent corporations and nonresident aliens from owning equity in an S corporation; nonetheless, properly structured foreign participation in the business of an S corporation is possible. Certain dual residents may own stock in an S corporation. Foreign equity investments could also be made through joint ventures with the S corporation. The door has been opened to nonresident aliens by permitting them to be potential current income beneficiaries of electing small business trusts (ESBTs).[855]

B. Structuring Foreign Operations

Assuming that the business activities of an S corporation in a foreign country rise to the level that they require the establishment of a foreign presence — in the form of personnel and business assets — the question becomes what form should that foreign presence take? From a U.S. and foreign tax perspective, choosing a structure for the foreign operations contemplated by an S corporation will depend on the degree to which the corporation's shareholders desire that foreign income or loss to flow through to the S corporation and the availability of a foreign tax credit or deduction at the shareholder level for foreign taxes paid on foreign income.

Taxpayers must generally choose between the following basic structures to conduct foreign operations:

- use of a foreign branch, partnership or disregarded entity that allows a flow through of foreign income for U.S. tax purposes; or
- use of a foreign entity that is treated as a corporation for both U.S. and foreign tax purposes.

Because S corporation status is elected in order to eliminate a second level of tax, the shareholders of an S corporation will generally wish to structure foreign operations so as to avoid an additional level of U.S. or foreign tax on dividends paid from a foreign entity to the S corporation. Use of a flow-through entity for foreign operations also allows the shareholders of the S corporation to claim a foreign tax credit for taxes paid on the foreign income. Thus, a foreign branch or partnership may be the most desirable structure for foreign operations absent business exigencies requiring use of a non-flow-through foreign entity. Depending on the circumstances, the flow-through structure was generally preferrable prior to legislative changes and may still be preferable after legislative changes.

1. Operating Abroad Through a Foreign Branch

a. Foreign Taxation

An S corporation may choose to conduct its business activities in a foreign country through a branch, partnership, or a disregarded entity in that country. A disregarded entity can take the form of a variety of legal entities in foreign jurisdictions and is generally treated as a branch for U.S. tax purpos-

[853] *See* Berg, *The Treatment of Partnerships, LLCs, and S Corporations Under Income Tax Treaties*, 1 Bus. Entities 20 (Jul./Aug. 1999); *see also* Plewka & Renger, *Do S Corporations Have Rights to Germany-U.S. Treaty Benefits?*, 45 Tax Notes Int'l 349 (Jan. 29, 2007).

[854] Former §902 was repealed. *See* §960.

[855] §1361(c)(2)(B)(v).

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es.[856] However, it should be noted that virtually all countries other than the United States treat limited liability companies — including U.S. limited liability companies — as separately taxable corporations for their own tax purposes, even if such entities are treated as disregarded or as pass-through entities for U.S. tax purposes. As a branch, this generally means that the S corporation registers to do business in the foreign country (or in an administrative subdivision that is the equivalent of a U.S. state or city) but does not establish a separate foreign entity for the purpose of conducting business. In general, the law in most foreign countries recognizes an S corporation as a separate legal entity for both business purposes (such as limited liability) and for tax purposes, even though it is treated as a flow-through entity for U.S. tax purposes. However, the treatment of an S corporation under foreign law should be confirmed with local advisors before a branch is established.

The earnings of a foreign branch of a U.S. corporation are generally taxed at the prevailing foreign corporate rate (or rates, if regional or municipal taxes are also imposed), although some countries have special tax regimes that apply to foreign corporations. The foreign tax laws generally provide rules for determining what income is attributable to a foreign branch and what deductions are allocable to the branch income. The operation of these rules has considerable impact on the amount of profits that will be taxed by the foreign country and can offer advantages and disadvantages compared to the taxation of business operations carried out through a foreign subsidiary.[857]

In some countries, including the United States, the earnings of a foreign corporation doing business in the country will be subject to a second-level tax, sometimes referred to as a branch profits tax. This tax is intended as a substitute for the withholding tax that would be imposed on dividends paid to a foreign corporation by a subsidiary incorporated in the country. In some cases, a branch tax is imposed only when branch earnings are repatriated. In other cases, the branch tax takes the form of a higher tax rate on branch earnings.[858]

[856] *E.g.*, Rev. Rul. 2004-77 (if an entity has two members under local law, but one of the members of the eligible entity is disregarded as an entity separate from the other member of the eligible entity for federal tax purposes, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation).

[857] Suppose, for example, an S corporation manufactures goods in the United States and sells the goods through a foreign branch. In order to determine how much foreign taxable income is earned by the branch from the sale, foreign tax law may determine what expenses are properly allocable to the manufacturing and sale of the goods (including overhead, direct manufacturing expenses, freight, and branch selling expenses) and then determine how much of the resulting profit was earned by the U.S. manufacturing operations and how much of the profit was earned by the foreign branch sales operations. Alternatively, foreign tax law could attempt to determine an arm's-length price for the goods as if they had been sold to the foreign branch, and then determine the foreign branch's taxable income by reducing the final sales price for the goods by this cost of goods sold and any branch expenses. The latter method would also apply if the foreign operations were carried out through a foreign subsidiary. Foreign rules governing the taxation of branches might also affect the amount of debt attributed to the branch and thus the branch's interest expense. The permanent establishment and business profits articles of U.S. income tax treaties (generally, Articles 5 and 7) may modify the treaty country's ability to tax and method of taxing the income of an S corporation's foreign branch.

[858] The U.S. branch profits tax is imposed on earnings of a foreign branch that are deemed repatriated from the United States. *See* §884; Reg. §1.884-1 through Reg. §1.884-5.

An income tax treaty between the United States and a foreign country may affect the taxation of U.S. corporations doing business in the foreign country. In general, U.S. income tax treaties attempt to prevent double taxation by prohibiting foreign taxation of U.S. corporations unless the U.S. corporation has a permanent establishment (generally a branch or fixed place of business) in a foreign country.[859] They may also affect the computation of the income and expenses of a branch, and prevent the imposition of discriminatory taxes or administrative requirements on the branch.[860] For example, the U.S. generally taxes a resident on its worldwide income while other counties tax based on the source of income. Thus, treaties attempt to mitigate the instances in which a person is taxed by several countries on the same income.

b. U.S. Taxation of Branch Operations

S corporation shareholders are subject to current U.S. tax on their pro rata share of the profits of a foreign branch. In a branch structure, foreign earnings are subject to immediate taxation in the current tax year without deferral. In addition, for U.S. foreign tax credit purposes, the shareholders are treated as having paid any foreign income taxes owed by the corporation.[861]

> *Example:* If a branch operation earns $100 and pays a 20% tax to the foreign government on its profits, then $100 of earnings and $20 of foreign taxes flow through the S corporation to its shareholders in the year earned. The foreign earnings are subject to the same rate of U.S. tax as other income. Prior to 2018, the maximum marginal income tax rate for an individual was 39.6%, or roughly $40 out of the $100 of earnings. Assuming that the foreign tax credit limitations under §904 do not otherwise restrict the shareholders' ability to credit the foreign income taxes, the $40 tentative U.S. tax would be subject to a $20 foreign tax credit, resulting in a net U.S. tax of $20. Under the post-2017 tax rates, the $100 of profits flow through to the S corporation shareholders along with the $20 of foreign taxes paid. The 2018 maximum marginal income tax rate is 37%, or $37 on the $100 of profits, less a $20 foreign tax liability, or a $17 U.S. tax liability.

Comment: Compared to a C corporation with a controlled foreign corporation (CFC) subsidiary, some of the earnings of which may be permanently free from U.S. tax by virtue of §245A (or at least not taxed until actually distributed to the parent company's shareholders), the S corporation's branch operations can be expensive post-2017. There is no deferral of U.S. tax on the earnings of the branch, and those foreign earnings are subject to the same maximum marginal income tax rates as oth-

[859] *See, e.g.*, U.S.-U.K. Income Tax Treaty, Art. 7. *See also* 2016 U.S. Model Income Tax Convention (2016 U.S. Model Income Tax Treaty), Art. 7. The standard for determining when a U.S. corporation's presence in a treaty country amounts to a permanent establishment, is contained in Article 5 of the foregoing treaties, and the same article of most other treaties as well.

[860] *See, e.g.*, U.S.-U.K. Income Tax Treaty, Arts. 7, 24. *See also* 2016 U.S. Model Income Tax Treaty, Arts. 7, 23.

[861] §1373(a); Reg. §1.1361-1(c)(2)(iii); Reg. §1.901-2(f)(4)(i), *amended by* T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022).

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er U.S. income, albeit with some relief from foreign tax credits. For further information, see CFC discussion in IV.B.2., below.

The lack of deferral of tax on foreign branch income means that branch losses flow through to the S corporation shareholders currently as well. These losses can generally be used to offset other income to the same extent that losses generated by the S corporation in the U.S. may offset such income under the normal basis rules.[862] They may also be subject to the §1366(d) stock and debt basis limitations, the §465 at-risk limitation, the §469 passive loss limitation, and the §461(l) excess business loss disallowance rule, as would any domestic operating losses.

Under §1373(a), an S corporation is treated as a partnership and its shareholders are treated as partners for purposes of the foreign tax credit, the provisions dealing with controlled foreign corporations, and the international boycott rules. In the context of foreign branch operations, this means that the shareholders[863] of an S corporation may elect to receive a foreign tax credit for foreign taxes that are paid or accrued with respect to the branch operations and are of the type for which a credit is available, subject to the foreign tax credit limitation for the year.[864]

After 2017, foreign branch income must be allocated to a specific foreign tax credit limitation basket.[865] Foreign branch income is the business profits (but not passive category income) of a U.S. person that are attributable to one or more qualified business units (QBU), in one or more foreign countries.[866] A QBU is "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records."[867] The allocation of foreign branch income to a separate foreign tax credit limitation basket may have the effect of limiting S corporation shareholders' ability to fully credit any foreign income taxes paid by the corporation.

Alternatively, the shareholders may choose to deduct the foreign taxes paid, although this will generally not be as advantageous. In either case, the Office of Chief Counsel has advised that the basis limitation of §1366(d)(1) applies to limit the amount of an S corporation shareholder's deduction or credit for their pro rata share of the S corporation's creditable foreign income taxes to the shareholder's basis in its stock at the end of its taxable year.[868]

This ability to obtain a tax credit for foreign taxes is an important benefit of conducting foreign operations through a branch or an entity that is treated as a partnership for U.S. tax purposes.[869] If foreign taxes imposed on foreign branch income are higher than U.S. taxes on that income, inclusion of the branch income in the income of the S corporation shareholder generally does not result in additional U.S. tax, because the U.S. tax on the income will be offset by the foreign tax credit for the foreign tax on the income. If the foreign taxes are lower, then the foreign tax credits could reduce the taxes owed to the U.S. government dollar-for-dollar.

Many foreign countries allow substantial flexibility in creating legal entities that limit the liability of their owners, and it is frequently possible to treat such entities as partnerships or as disregarded for U.S. tax purposes.[870] The result of such an arrangement is that an S corporation can achieve a flow-through of income, loss, and foreign taxes for U.S. tax purposes — the same result as operating in the foreign country through a branch or an entity that is treated as a partnership for both U.S. and foreign tax purposes. The foreign country, on the other hand, will generally tax the entity as a separate entity. This results in taxation of all income or loss earned by the entity, rather than taxation of some portion of income or loss earned by the S corporation attributable to the foreign branch.

However, the ability of the S corporation to obtain flow-through treatment or disregarded status for the foreign entity for U.S. tax purposes may be limited by Reg. §301.7701-2(b)(8), which lists approximately 80 foreign entities that are designated as per se corporations for U.S. entity classification purposes.[871] A per se corporation cannot elect its classification.[872] In addition, regulations treat a dually chartered entity (i.e., an entity that is created or organized in multiple jurisdictions) as a corporation if Reg. §301.7701-2(b)(9) treats it as a corporation in any one of the jurisdictions in which it is created or organized.[873] Such an entity may elect its classification only if it is

[862] §1366(a), §1367. The loss may be subject to recapture under §904(f). In addition, C corporations with foreign branch operations are subject to the dual consolidated loss rules of §1503(d), which may limit the use of foreign losses. It appears unlikely that these rules would apply to an S corporation with a foreign branch. *See* §1363(b) (providing generally that the taxable income of an S corporation shall be computed in the same manner as in the case of an individual). Reg. §1.1503(d)-1 through §1.1503(d)-8 (providing rules concerning the determination and use of dual consolidated losses pursuant to §1503(d)).

[863] Under §703(b)(3), the election is made by the shareholders (treated as partners under §1373).

[864] *See* §901, §903 (availability of a foreign tax credit), §904 (limitations on the foreign tax credit); *see also* PLR 9612017 (gain from sale of S corporation's stock would be foreign source income under §865(e)(1) if that gain was subject to an effective rate of at least 10% in the foreign country in which the corporation's sole office or fixed place of business was located since all of the corporation's assets were located there as well; the S corporation's office was deemed to be that of its shareholders).

[865] *See* §904(d)(1)(B). For a detailed discussion of §904, see 6060 T.M., *The Foreign Tax Credit Limitation under Section 904* (Foreign Income Series).

[866] §904(d)(2)(J).

[867] §989(a). *See* Reg. §1.989(a)-1.

[868] CCA 201429025 (the §1366(d)(1) basis limitation rule applies to limit the amount of creditable foreign income taxes paid or accrued by an S corporation that the S corporation's shareholder may take into account in computing the shareholder's allowable foreign tax credit under §901).

[869] An individual, including an S corporation required to compute its taxable income as an individual under §1363(b), could not generally receive an indirect foreign tax credit under former §902 for foreign taxes that are paid by a corporation in which it is a shareholder, although in certain circumstances an individual could elect to be treated as a corporation in order to obtain the indirect credit. *See* §901, former §902, §962. Section 902 was repealed for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholder in which or with which such tax years of foreign corporations end. *See* Pub. L. No. 115-97, §14301(a). *See also Eaton Corp. v. Commissioner*, 164 T.C. No. 4 (2025) (holding for pre-TCJA tax years that interposing a domestic partnership between tiered controlled foreign corporations (CFCs) within a U.S.-parented group results in the U.S. corporate parent being unable to claim deemed paid foreign tax credits (FTCs) from the lower-tier CFC's subpart F income).

[870] *See* Notice 97-1. For determining foreign entity classification, see the discussion in 700 T.M., *Choice of Entity: Business and Tax Considerations*, and 6680 T.M., *Partners and Partnership — International Tax Aspects* (Foreign Income Series).

[871] There is an exception in Reg. §301.7701-2(d) for entities in existence on May 8, 1996, that meet certain other requirements.

[872] Reg. §301.7701-3(a).

[873] Reg. §301.7701-1(d); Reg. §301.7701-2(b)(9); Reg. §301.7701-5; T.D. 9246, 71 Fed. Reg. 4815 (Jan. 30, 2006). The final regulations were effective August 12, 2004, subject to a transition rule. Reg. §301.7701-2(e)(3).

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an eligible entity in each jurisdiction in which it is created or organized.[874]

Section 987 provides guidance on how taxpayers with one or more QBU, with a functional currency other than the U.S. dollar, determine their taxable income from their branch operations. Final regulations issued in 2016 provide guidance on how to apply §987, but that guidance does not apply to S corporations, limiting application to 987 aggregate partnerships.[875]

Specifically, under Reg. §1.987-1(b)(1)(ii), the 2016 final regulations do not apply to specified entities unless the entity was engaged in transactions primarily with related persons (as defined in §267(b) and §707(b)) that are not themselves specified entities. Among the specified entities are banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies (RICs), real estate investment trusts (REITs), trusts and estates, S corporations, and partnerships other than §987 aggregate partnerships. The IRS contemplated that these specified entities would eventually be covered by the rules, once it could determine what special provisions were needed to do so in an appropriate manner. Until scope expansion, these excluded entities were required to use a reasonable method to comply with §987 and could not rely on the final regulations.[876]

In a series of Notices issued annually since 2017,[877] the IRS repeatedly deferred the applicability date of the 2016 and 2019 final regulations.[878] under §987 by one year, and announced that it intended to amend the regulations under §987 to reflect an updated applicability date, with the most recent Notice providing that the 2016 and 2019 final regulations would apply to taxable years beginning after December 7, 2023.[879] However, in November 2023, the IRS and Treasury issued another set of proposed regulations under §987 and announced that, because these proposed regulations would replace or modify parts of the 2016 and 2019 final regulations, those final regulations were not expected to become applicable as previously stated in the Notices.[880]

The 2023 proposed regulations generally removed the exclusion for specified entities described above, such that S corporations would be subject to the regulations under §987.[881] These regulations proposed new rules specific to S corporations and their shareholders, providing treatment consistent with the rules applicable to partnerships.[882] Specifically, the regulations would have applied to an S corporation that is an owner of a §987 QBU in the same manner as they apply to other owners of §987 QBUs, with special rules addressing issues such as shareholder allocations, elections, and basis adjustments.[883] For instance, if an S corporation is the owner of a §987 QBU, the unrecognized §987 gain or loss of the §987 QBU would be allocated annually to its shareholders.[884] In general, a §987 QBU is an eligible QBU with a functional currency that differs from the functional currency of its direct owner.[885]

In 2024, the IRS and Treasury issued regulations finalizing the 2023 proposed regulations, including their limited applicability to specified entities.[886] Although the final regulations do not provide detailed rules for S corporations to determine §987 taxable income or loss and §987 foreign currency gain or loss, Reg. §1.987-7(b) provides that taxpayers must apply §987 and §989(a) to an S corporation and its eligible QBUs in a reasonable manner that is consistently applied.[887]

Reg. §1.987-7 provides the rules applicable to S corporations, including rules requiring basis adjustments under the principles of §704(d) and §705, and recognition of suspended §987 losses if at least 95% of the capital and profits interests are owned by related persons.[888] If an S corporation that owns an eligible QBU or a shareholder treat the QBU as subject to §987 under an entity or aggregate approach, or if a shareholder treats the S corporation as a QBU subject to §987 under an entity approach, a number of the other 2024 final regulations apply to the eligible QBU(s), including:

- Reg. §1.987-3(b)(4)(ii) (§988 mark-to-market election);
- Reg. §1.987-5(b)(2) (annual recognition election);

[874] Reg. §301.7701-2(b)(9).

[875] Reg. §1.987-1(b)(1)(ii); *see* T.D. 9794, 81 Fed. Reg. 88,806 (Dec. 8, 2016) (2006 proposed regulations; finalizing 2006 proposed regulations); *see also* REG-128276-12, 81 Fed. Reg. 88,882 (Dec. 8, 2016) (proposed regulations issued the same day); T.D. 9795, 81 Fed. Reg. 88,884 (Dec. 8, 2016) (temporary regulations issued the same day; unfinalized portions expired on Dec. 6, 2019) (collectively, 2016 proposed and temporary regulations).

[876] *See* Preamble to T.D. 9794, 81 Fed. Reg. 88,806, 88,812 (Dec. 8, 2016).

[877] *See* Notice 2022-34, Notice 2021-59, Notice 2020-73, Notice 2019-65, Notice 2018-57, Notice 2017-57; *see also* Michael Rapoport, *IRS Again Delays Rules on Foreign Currency Gains and Losses*, Daily Tax Rep. (Aug. 15, 2022).

[878] *See* T.D. 9857, 84 Fed. Reg. 20,790 (May 13, 2019) (2019 final regulations; finalizing parts of the 2016 proposed and temporary regulations).

[879] Notice 2022-34, §2. Therefore, for a calendar year taxpayer, the final regulations would have applied to the taxable year beginning on January 1, 2024.

[880] *See* Preamble to REG-132422-17, 88 Fed. Reg. 78,134, 78,156 (Nov. 14, 2023) (2023 proposed regulations).

[881] Prop. Reg. §1.987-1(b)(1)(i), §1.987-1(b)(1)(ii), REG-132422-17, 88 Fed. Reg. 78,134 (Nov. 14, 2023). Once finalized, the regulations would apply to taxable years beginning after December 31, 2024. Prop. Reg. §1.987-14(a), REG-132422-17, 88 Fed. Reg. 78,134 (Nov. 14, 2023).

[882] Treasury requested comments on whether additional guidance was needed for S corporations and if there were circumstances in which the S corporation rules should differ from the partnership rules. Preamble to REG-132422-17, 88 Fed. Reg. at 78,148, *corrected by* 88 Fed. Reg. 84,770 (Dec. 6, 2023) (technical corrections to preamble).

[883] *See* Prop. Reg. §1.987-7A(b), §1.987-7A(c), §1.987-7A(d), §1.987-7A(g), REG-132422-17, 88 Fed. Reg. 78,134 (Nov. 14, 2023).

[884] Prop. Reg. §1.987-7A(g).

[885] Reg. §1.987-1(b)(3)(i), *finalized by* T.D. 10016, 89 Fed. Reg. 100,138 (Dec. 11, 2024), *corrected by* 90 Fed. Reg. 5606 (Jan. 17, 2025).

[886] T.D. 10016, 89 Fed. Reg. 100,138 (Dec. 11, 2024) (2024 final regulations; finalizing the rules applicable to S corporations under Prop. Reg. §1.987-7A as Reg. §1.987-7), *corrected by* 90 Fed. Reg. 5606 (Jan. 17, 2025), applicable to taxable years beginning after Dec. 31, 2024. *See also* REG-117213-24, 89 Fed. Reg. 99,782 (Dec. 11, 2024) (proposed regulations issued on the same day).

[887] *See* Reg. §1.987-7(b) (limited applicability for partnerships), *corrected by* 90 Fed. Reg. 5606 (Jan. 17, 2025), §1.987-7(c) (provisions applicable to partnerships), §1.987-7(f) (treating S corporations as partnerships, and shareholders as partners, for purposes of §987), *added by* T.D. 10016; *see also* Reg. §1.987-1(b)(4) (defining eligible QBU), *added by* T.D. 10016. The preamble to the 2024 proposed regulations seeks comments on a number of issues related to application of the §987 regulations to partnerships (and thus, to S corporations). Preamble, 89 Fed. Reg. at 99,785–86. *See* Preamble to T.D. 10016, 89 Fed. Reg. at 100,151.

[888] *See* Reg. §1.987-7(e) (basis adjustments for §987 gain or loss), Reg. §1.987-11(c) (loss suspension rule, generally inapplicable to S corporations). *But see* Reg. §1.987-7(d)(2) (exceptions to inapplicability of loss suspension rule).

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• Reg. §1.987-6 (character and source of §987 gain or loss; to facilitate application of the loss-to-the-extent-of-gain rule);

• Reg. §1.987-9(d) (translation rule and Form information);

• Reg. §1.987-11 through Reg. §1.987-13 (suspended §987 loss, deferral of §987 gain or loss, and suspended §987 loss upon terminations, respectively; to prevent the selective recognition of losses); and

• Reg. §1.987-15 (applicability dates).[889]

The 2024 regulations also finalized rules relating to the applicability date of the 2016 and 2019 final regulations.[890] Taxpayers are permitted to apply the 2016 and 2019 final regulations and 2016 temporary regulations (if applicable) to taxable years beginning after December 7, 2016, and before December 31, 2024, subject to certain conditions.[891]

For a detailed discussion of §987, see 6660 T.M., *Tax Aspect of Foreign Currency* (Foreign Income Series).

c. Special Purpose S Corporations

Although the owners of an S corporation may wish to conduct foreign operations through a foreign branch in order to insure that losses and foreign taxes from the branch flow through to shareholders, they may not want to expose the corporation to legal liability in the foreign country. In this case, the S corporation shareholders may consider creating another S corporation: a special purpose S corporation owned by the same shareholders as the original S corporation. The special purpose S corporation would conduct its business operations abroad in branch form, and branch income, loss, and foreign taxes paid would still flow through to the S corporation shareholders.

Creation of a special-purpose S corporation to hold the foreign operations may affect foreign taxation of the foreign branch's earnings because the foreign operations will be separated from the domestic operations and it will not be necessary to allocate income and expenses between the U.S. and foreign operations. This may present planning opportunities; however, transactions between these related companies are subject to transfer price adjustment in the United States (under §482) and in the foreign jurisdiction if they are not at arm's length.[892]

The creation of a special-purpose S corporation may offer an additional benefit with respect to foreign taxes. Some countries treat a corporation as a resident for tax purposes if it is managed and controlled in that country. Thus, if the shareholders of an S corporation operating in one of those countries can arrange the S corporation's operations so that they are managed and controlled in the foreign country, it may be possible for the S corporation to be treated as a resident of the foreign country. This may affect the rate of tax paid by the special-purpose S corporation in the foreign country, particularly in countries that have an integrated tax system that allows the corporation to reduce its tax liability by a portion of the taxes paid by shareholders when they receive dividends from the corporation. This does not generally affect the taxability of the S corporation in the United States.

Comment: Prior to 1996, S corporations could not own subsidiaries and shareholders wishing to establish special-purpose S corporations would need to do so as separate brother-sister corporations to the domestic operating entity. Now that S corporations can own subsidiaries, the special-purpose entity could be conducted through a qualified subchapter S subsidiary (QSub). A QSub is a separate legal entity for local law purposes but is disregarded for U.S. income tax purposes.

d. Foreign Partnerships

Where an S corporation operates in a foreign country through an entity that is treated as a partnership for both U.S. and foreign tax purposes, the tax consequences will generally be the same as for an S corporation operating in a foreign country through a branch. However, the additional rules under subchapter K will apply to the partnership. For example, allocations of partnership items of income, loss, deduction, and credit will be subject to §704 and transfers of appreciated property to a foreign partnership may be subject to gain recognition under §721(c).

2. Operating Abroad Through a Foreign Entity That Is Treated as a Separate Taxable Entity for Both U.S. and Foreign Tax Purposes

a. Foreign Taxation

In many cases, it is desirable for an S corporation to establish a presence in a foreign country through a separate legal entity that is organized in that country, particularly where the S corporation conducts substantial business operations in the country. In many cases, customers, suppliers, or lenders prefer to do business with a corporation that is a resident of the same country as they are, and these parties may otherwise refuse to do business, or may do business only on less favorable terms, with foreign entities. In other cases, regulatory requirements or the desire to limit liability may be a consideration.

The earnings of a foreign subsidiary of a parent S corporation are generally taxed at the prevailing foreign corporate rate (or rates, if local taxes are also imposed). The foreign tax laws generally provide transfer pricing rules for determining what income and deductions arising from transactions with related parties may or must be taken into account by the foreign subsidiary for tax purposes. The operation of these transfer pricing rules have considerable impact on the amount of profits that will be taxed by the foreign country versus the U.S. or other related entity's domiciliary country.

b. Special Rules in Setting Up Foreign Subsidiaries

In establishing a foreign subsidiary, note should be taken of special rules that apply when transferring appreciated assets and intangible property to a foreign corporation in a nonrecog-

[889] Reg. §1.987-7(c)(1), Reg. §1.987-7(c)(2). Application of the provisions listed in Reg. §1.987-7(c)(2) is subject to modifications under Reg. §1.987-7(c)(3) and Reg. §1.987-7(d) (suspended §987 loss). Reg. §1.987-7(c)(2). *See also* Reg. §1.987-7(g)(1), *Ex.* 1 (example illustrating aggregate approach to §987 and application of loss suspension rule), Reg. §1.987-7(g)(2), *Ex.* 2 (example illustrating entity approach to §987).

[890] T.D. 10016, 89 Fed. Reg. 100,138 (Dec. 11, 2024) (finalizing Prop. Reg. §1.987-14 as Reg. §1.987-15), REG-132422-17, 88 Fed. Reg. 78,134 (Nov. 14, 2023).

[891] Reg. §1.987-15(c). *See also* Reg. §1.987-1(h) (specifying which regulation sections are included in 2016 and 2019 final regulations).

[892] *See* IV.C.4., below.

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nition transaction such as a reorganization or an incorporation under §351.[893]

Section 367(a)(1) generally taxes an exchange of appreciated property by a U.S. person to a foreign corporation (an outbound transfer) by turning off the recipients' status as a corporation solely for purposes of applying the gain nonrecognition rules under the enumerated provisions (e.g., §332, §351, §354, §356, or §361). Thus, on the outbound transfer of business assets in a §351 exchange or an otherwise tax-free asset reorganization, gain is recognized on all appreciated assets transferred but losses continue to be subject to nonrecognition. Additionally, §367(b) may cause exchanging domestic shareholders of the foreign corporation to include a pro rata share of the foreign corporation's earnings in income in certain circumstances. In PLR 9331018, the IRS ruled that inbound transfer of a foreign corporation's assets to an S corporation in a D reorganization would be subject to §367(b). There are many exceptions to these general rules, a discussion of which is outside the scope of this Portfolio.[894]

In the case of outbound transfers of intangibles, the transfer may be recharacterized as the equivalent of a royalty arrangement, in which case the S corporation shareholders would be treated as receiving a continuous flow of royalty payments commensurate with the income generated by the intangibles over the life of the intangible rather than a lump-sum payment.[895] In addition, the deemed royalty payments received by the S corporation's shareholders may be treated as income from sources within the United States, which may have the effect of reducing the amount of foreign tax credits that the shareholders are able to use. The definition of intangibles for this purpose includes virtually every item that was attributable to neither tangible property nor the services of individuals, including goodwill and going concern value.[896]

Proposed regulations would, among other things, terminate the application of §367(d) if the foreign corporation repatriates the intangible property to a qualified domestic person and certain reporting requirements are satisfied.[897] A qualified domestic person includes the U.S. transferor that initially transferred the intangible property subject to §367(d) and certain successor U.S. transferors; however, the successor U.S. transferors cannot include S corporations.[898]

c. U.S. Taxation of Foreign Subsidiary Earnings

An S corporation parent using a foreign per se corporation to conduct its foreign operations could prove to be expensive from a tax perspective. A corporation is foreign if it is organized outside of the U.S.[899] If an S corporation were to adopt a foreign, per se corporation subsidiary structure, §1363(b) requires the S corporation to compute its income as an individual, which would deny any dividends received deduction to the S corporation and its shareholders with respect to distributions attributable to the subsidiaries' foreign earnings that, when earned, were not subject to U.S. taxation. In using this structure, foreign earnings would be taxed first in the foreign country where earned and again when distributed to the S corporation parent and its shareholders. Thus, the earnings would be taxed twice — once in the local country and again in the U.S. at the S corporation shareholder level.[900]

The end result is not dissimilar to the worldwide system of taxation, which used the former §902 deemed dividends paid credit as a way for C corporations to avoid double taxation on repatriating earnings. But §1363(b) presented the same issue then as now — no deemed dividends paid credit was available for individual taxpayers, including S corporations and their shareholders.

(1) Participation Exemption System and Transitional Rule

With respect to domestic corporations (including S corporations with foreign subsidiaries), there is a participation exemption system of taxing foreign income earned by foreign subsidiaries.

Subpart F applies to a controlled foreign corporation, i.e., a foreign corporation that is owned (directly, indirectly or through special constructive stock ownership rules) more than 50% (by vote or value) by U.S. shareholders.[901] The definition of U.S. shareholder in §951(b) includes each U.S. person who owns (directly, indirectly or through special constructive stock ownership rules) 10% or more of the voting stock of all classes of stock entitled to vote of the relevant foreign corporation, or each U.S. person who so owns at least 10% of the value of all classes of stock of the foreign corporation.[902] The definition of U.S. shareholder could include an S corporation owning stock in a foreign corporation.[903]

The participation exemption system is intended to simulate a territorial tax approach to the taxation of foreign earnings of foreign subsidiaries, but only foreign subsidiaries of C corporations. With the participation exemption system, foreign earnings are taxed in the country earned, but when those earnings are distributed back to the foreign corporations' 10% U.S. C corporation shareholders, no U.S. tax is imposed by virtue of the 100% dividends received deduction under §245A.[904] No

[893] *See* §367.

[894] For a detailed discussion, see 6100 T.M., *U.S.-to-Foreign Transfers Under Section 367(a)* (Foreign Income Series), and 920 T.M., *Other Transfers Subject to Section 367* (Foreign Income Series).

[895] *See* §367(d).

[896] §367(d)(4).

[897] Prop. Reg. §1.367(d)-1(f)(4); 88 Fed. Reg. 27,819 (May 3, 2023).

[898] Prop. Reg. §1.367(d)-1(f)(4)(iii).

[899] §7701(a)(5).

[900] S corporation shareholders may be able to elect under §962 to be treated as a corporation with respect to earnings that are deemed distributed currently to the S corporation under subpart F, §951–§964. In that case, they would receive a foreign tax credit with respect to those earnings but would still not receive a foreign tax credit with respect to other earnings of the subsidiary.

[901] §957(a).

[902] §951(b) (adding the 10%-value element of the definition and providing that the definition of U.S. shareholder applies for purposes of title 26 and effective for taxable years of foreign corporations beginning after 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end).

[903] For a detailed discussion, see 6200 T.M., *CFCs — General Overview* (Foreign Income Series) and 6820 T.M., *CFCs — Sections 959–965 and 1248* (Foreign Income Series).

[904] Section 245A provides a 100% dividend received deduction for the foreign-source portion of any dividend received by a domestic corporation that is a 10% U.S. shareholder in a specified 10-percent owned foreign corporation. §245A(a). Because an S corporation must compute its taxable income as an individual under §1363(b), there is no §245A dividends received deduction for S corporation shareholders of foreign corporations. For a detailed discussion of

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deemed paid foreign tax credit is available with respect to the foreign taxes paid by the foreign subsidiaries to the extent their foreign earnings are not taxed in the U.S.[905] However, an S corporation owning stock in foreign corporations must include in income dividends received from all such corporations, including dividends from CFCs in which it is a 10%-or-greater shareholder. This is because §1363(b) requires the S corporation to compute its taxable income as an individual, precluding it from claiming an offsetting §245A deduction, which is available only to domestic corporations. The absence of a §245A deduction for an S corporation parent, along with the inability to take a deemed paid foreign tax credit for foreign income taxes paid by foreign subsidiaries, makes the holding of a separate foreign subsidiary relatively expensive compared to a similarly situated C corporation.

A transitional rule required all deferred foreign income corporations (DFICs) to increase their subpart F income for the last taxable year of the DFIC beginning before 2018 by its deferred foreign income as of a specified measurement date.[906] A DFIC includes a CFC with any U.S. shareholders and post-1986 noneffectively connected, untaxed, earnings and profits (E&P) greater than zero as of the measurement date.[907] U.S. shareholders of the DFIC had to include their pro rata share of the increased amount of subpart F income in gross income in the year of increase, although there was an election available to U.S. shareholders to pay the net tax liability under §956 over an eight-year period, which, as discussed below, could have been extended in the case of S corporations and their shareholders. While the participation exemption regime implemented by the §245A dividends received deduction for post-2017 dividends is available only to U.S. corporate shareholders, the mandatory inclusion in gross income of a DFIC's post-1986 deferred foreign income applied to all U.S. shareholders, corporate or not.

The inclusion of deferred foreign income under §965 applied at special lower effective rates. To implement this, §965(c)(1) provided a deduction for the taxable year of a U.S. shareholder in which the §965(a) inclusion amount was included in the gross income equal to an amount that would produce a 15.5% tax rate on the relevant shareholder's aggregate share of the cash (and other current or liquid assets) held by all the shareholder's specified foreign corporations (including all DFICs and CFCs in which it is a 10% shareholder) up to the §965(a) inclusion amount, and an 8% tax rate on any remaining portion of the DFICs' pre-2018 earnings included in the §965(a) inclusion amount.

However, calculation of these deduction amounts as a result of the §965(a) inclusion was based on the highest rate of tax applicable to corporations (§11) in the taxable year of inclusion, even if the U.S. shareholder was an individual. Thus, for individuals, the §965 inclusion amounts were potentially taxed at the 37% highest individual marginal tax rate while the §965(c) offsetting deduction was based on a 21% corporate rate. To compensate for this discrepancy in rates, individual U.S. shareholders could elect to apply the corporate income tax rate to their inclusion amounts under §962.[908]

In addition, the increase in income that was not taxed by reason of the partial dividends-received deduction (§965(c)) was treated as tax-exempt income tax for purposes of determining the stock basis of S corporation shareholders.[909] Accordingly, this amount — in addition to any additional amount of the §965(a) inclusion — increased stock basis under §1367. However, for purposes of computing the S corporation's accumulated adjustments account (AAA), which is ordinarily not adjusted for tax-exempt income and related expenses, the portion of the §965(a) inclusion not taxed by reason of §965(c) was treated as income that was not tax exempt and could therefore give rise to a positive AAA adjustment.[910]

Although, as noted above, as a general rule 10% U.S. shareholders of DFICs could elect to pay the tax on the inclusion of DFIC earnings over 8 years, a more generous deferral rule applied to S corporation shareholders. Section 965(i) permitted an S corporation shareholder to make an election to defer payment of the tax liability until the shareholder's taxable year that includes the triggering event with respect to the liability[911] That triggering event is defined as whichever of the following occurs first:[912]

- the S corporation ceases to be an S corporation;
- a liquidation or sale of substantially all the assets of the S corporation (including in a title 11 or similar case);
- a cessation of business by the S corporation;
- the S corporation ceases to exist;
- any circumstance similar to the cessation of the S corporation's business or its existence; or
- a transfer of any share of stock in the S corporation by the taxpayer (partial transfers of stock trigger an alloca-

§245A, see 6130 T.M., *Participation Exemption Regime Under Section 245A* (Foreign Income Series).

[905] §960.

[906] §965, effective Dec. 22, 2017. Rev. Proc. 2018-17, issued under §965(o) to prevent the avoidance of the purposes of §965 through changes in the taxable years of certain specified foreign corporations (SFCs), modifies Rev. Proc. 2002-39 and Rev. Proc. 2006-45 to preclude an SFC with one or more U.S. shareholders that must include an amount in gross income under §951(a)(1) by reason of §965(a) from changing its taxable year. *See also* Reg. §1.965-4, T.D. 9846, 84 Fed. Reg. 1838 (Feb. 5, 2019), *corrected by* 84 Fed. Reg. 14,260 (Apr. 10, 2019). For a detailed discussion, see 6820 T.M., *CFCs — Sections 959–965 and 1248* (Foreign Income Series).

[907] §965(d).

[908] Reg. §1.962-2(a), T.D. 9846 (clarifying that an individual includes an individual who is a U.S. shareholder because, by reason of §958(b), they are considered to own stock of a foreign corporation owned by a domestic pass-through entity). *See* Elections & Compliance Statements: Individual: CFC Income Subject to Tax at Corporate Rates (§962(b)).

[909] Reg. §1.965-3(f)(2)(i).

[910] Reg. §1.965-3(f)(2)(ii), (iii); H.R. Rep. No. 115-466, 620 (2017) (Conf. Rep.).

[911] *See* Elections & Compliance Statements: S Corporation Shareholder's Election to Defer § 965 Tax Until Triggering Event (§ 965(i)). Reg. §1.965-7(c)(2)(ii) provides that the 965(i) election had to be made no later than the due date (taking into account any extensions) for the shareholder's return for each taxable year that included the last day of the taxable year of the S corporation in which the S corporation had a §965(a) inclusion to which the shareholder's section 965(i) net tax liability was attributable. No relief is available under Reg. §301.9100-2 or Reg. §301.9100-3 to make a late election.

[912] §965(i)(2); Reg. §1.965-7(c)(3)(ii). The regulations broadened the potential triggering events by referring to "[a] liquidation, sale, *exchange*, or other disposition of substantially all of the assets of the S corporation." (emphasis added). The reference to an exchange could mean, for example, that tax-free exchanges might also trigger the deferred liability.

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ble amount of the deferred tax). This includes transfers by death.

Under §965(i)(2)(C), if a transferee of the relevant S corporation stock agrees with the IRS to be liable for the tax in the same manner as if such transferee were the taxpayer, the immediate trigger is avoided.[913]

In the case of a triggering event where the transferee exception is either not available or otherwise not used, the shareholder may make an election under §965(h) to pay the net tax liability in installments over eight years.[914] If the triggering event is a liquidation, sale, exchange or other disposition of stock of the S corporation, the §965(h) election may be made by the S corporation shareholder only with the consent of the IRS.[915] In order to obtain the IRS's consent, the shareholder must file a consent agreement with the IRS.[916]

A §965(h) election made following a §965(i) triggering event generally must be made no later than the due date (taking into account any extensions) for the shareholder's return for the taxable year in which the triggering event with respect to the S corporation occurs.[917] In the case of a triggering event described in Reg. §1.965-7(c)(3)(ii)(B), the taxpayer must request consent of the Commissioner to make a §965(h) election within 30 days of the triggering event.[918] No relief is available under Reg. §301.9100-2 or Reg. §301.9100-3 to make a late election.[919]

Comment: Practical complications may arise where one or more S corporation shareholders make a §965(h) election following a §965(i) triggering event but other shareholders do not. Specifically, the nonelecting shareholders may need larger tax distributions from the corporation to pay their accelerated liabilities, requiring the corporation to make payments to the electing shareholders in order to maintain pro rata distributions with respect to all the corporation's shares. Depending on the particular facts and circumstances, there may be alternatives available for the corporation to get cash to shareholders with an accelerated §965(i) net tax liability without exhausting the corporation's available cash or violating the single class of stock requirement.

(2) Pre-Distribution Inclusion of CFC Income: Subpart F Income and Net CFC Tested Income (f/k/a Global Intangible Low-Taxed Income)

The result of the U.S. and foreign taxation of an S corporation with a foreign subsidiary is double taxation of the foreign income: by the foreign country as the income is earned, and by the United States at the shareholder level (taking into account any withholding tax imposed on distributions by the foreign country, with a residual U.S. tax after a credit is given under §901 for the foreign withholding taxes) when the foreign corporation's profits are distributed as dividends.

Section 951(a)(1) requires U.S. shareholders of a CFC to include in gross income their pro rata share of the CFC's subpart F income. For purposes of subpart F, S corporations and their shareholders are treated like partnerships and their partners, respectively.[920] Under prior rules, an S corporation that was a U.S. shareholder of a CFC included in gross income its §951 inclusion and each shareholder had a distributive share of the S corporation's §951 inclusion, regardless of whether the shareholder was a U.S. shareholder. The final regulations adopt aggregate treatment (matching the GILTI inclusion rule, discussed below) for purposes of determining the subpart F inclusion of an S corporation shareholder.[921] For purposes of §951, stock of a foreign corporation owned by an S corporation is generally treated in the same manner as stock of a foreign corporation owned by a foreign partnership under §958(a)(2) and Reg. §1.958-1(b), i.e., the subpart F inclusion under §951 is determined at the shareholder level, subjecting a shareholder to a subpart F income inclusion only if the shareholder is a U.S. shareholder of the underlying CFC.[922] Therefore, a shareholder that is not a U.S. shareholder of the underlying CFC will not have a subpart F inclusion.[923] The final regulations do not affect existing rules for determining whether a U.S. person is a U.S. shareholder, whether a U.S. shareholder is a controlling domestic shareholder, whether a foreign corporation is a CFC, applying §1248, or defining U.S. property for purposes of §956, including for purposes of pledges and guarantees.[924] Proposed regulations would allow certain S corporations with transition accumulated E&P to elect entity, rather than aggregate, treatment for purposes of §951 and §956(a) inclusions.[925] The election is temporary, and aggregate treatment would apply begin-

[913] Reg. §1.965-7(c)(3)(iv); *see* Elections & Compliance Statements: S Corporation Shareholder's Transfer Agreement for Exception to Triggering Event (§965(i)).

[914] §965(i)(4); Reg. §1.965-7(c)(3)(iv)(C).

[915] §965(i)(4)(D); Reg. §1.965-7(c)(3)(v)(D)(1).

[916] Reg. §1.965-7(c)(3)(v)(D)(2), (4); *see* Elections & Compliance Statements: S Corporation Shareholder's Consent Agreement to Make 965(h) Election (§ 965(i)(4)) and Foreign Deferred Income Election to Pay Tax in Installments (§965(h)).

[917] Reg. §1.965-7(c)(3)(v)(B).

[918] Reg. §1.965-7(c)(3)(v)(D).

[919] Reg. §1.965-7(c)(3)(v)(B), §1.965-7(c)(3)(v)(D)(2).

[920] §1373(a).

[921] T.D. 9960, 87 Fed. Reg. 3648 (Jan. 25, 2022) (finalizing portions of REG-101828-19, 84 Fed. Reg. 29,114 (June 21, 2019), that treat domestic partnerships as aggregates of their partners for purposes of determining income inclusions under §951 and §951A). Note that the final regulations clarify that the aggregate treatment of domestic partnerships also applies for purposes of §956(a) and any provisions that specifically apply to it by reference. *See* Reg. §1.958-1(d)(1); Preamble to T.D. 9960.

[922] *See* Reg. §1.958-1(d)(1).

[923] Reg. §1.958-1(d)(1). The final regulations apply to tax years of foreign corporations beginning on or after January 25, 2022, and to tax years of U.S. persons in which or with which such tax years of foreign corporations end. An S corporation may also apply the final regulations to prior tax years of a foreign corporation beginning after 2017, and to tax years of the S corporation in which or with which such tax years of the foreign corporation end, provided that the S corporation, its shareholders who are U.S. shareholders of the CFC, and other related entities and U.S. shareholders consistently apply the rule to all of the foreign corporations in which the S corporation owns stock under §958(a). Reg. §1.958-1(d)(4).

[924] *See* Reg. §1.958-1(d)(2).

[925] Prop. Reg. §1.958-1(e) (adopting approach from Notice 2020-69), REG-118250-20, 87 Fed. Reg. 3890 (Jan. 25, 2022). Transition accumulated E&P means the amount of accumulated E&P calculated as of September 1, 2020, reduced by distributions. Prop. Reg. §1.958-1(e)(3). Prop. Reg. §1.958-1(e) would apply to S corporations' tax years ending on or after September 1, 2020. However, taxpayers could apply the rules to S corporations' tax years ending on or after June 22, 2019, if they are applied consistently for all CFCs. Prop. Reg. §1.958-1(e)(6). For a detailed discussion of the proposed rules, see 6215 T.M., *Global Intangible Low-Taxed Income (GILTI)* (Foreign Income Series).

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ning with the first tax year in which the S corporation has no transition accumulated E&P as of the first day of that year.[926]

Although a detailed discussion of subpart F income is beyond the scope of this Portfolio,[927] subpart F income consists of several different types of income earned by CFCs, including (i) foreign personal holding company income,[928] which includes most investment income, including gain from the sale of stock and other investment property; (ii) foreign base company sales income;[929] (iii) foreign base company services income;[930] (iv) and insurance income of CFCs (specially defined for this purpose).[931] In addition, U.S. shareholders of CFCs are taxable on the portion of their CFCs' previously untaxed earnings that are considered to be invested in certain United States property on the last day of the CFC year,[932] including by way of purchasing stock in U.S. affiliates and by lending to or providing credit support for U.S. affiliates. Section 960(a) provides a deemed paid foreign tax credit to certain domestic C corporations for foreign income taxes paid by their CFCs on the earnings giving rise to subpart F inclusions, but individual S corporation shareholders must elect under §962 to be taxed as domestic corporations and therefore subject to double taxation in order to be eligible for such credit.[933]

On top of the above potential inclusions of CFC earnings in the income of 10% U.S. shareholders, §951A requires each U.S. shareholder of a CFC to also include in gross income the U.S. shareholder's net CFC tested income (NCTI) (formerly known as global intangible low-taxed income (GILTI)) for the taxable year.[934] Like the mandatory inclusion in income under §965, §951A applies to all U.S. shareholders. Generally, §951A is intended to impose a minimum U.S. tax on what Congress considers to be high-yield, low-taxed assets. NCTI/GILTI is calculated annually for each U.S. shareholder.[935] With respect to any U.S. shareholder of one or more CFCs, NCTI is defined as all of the shareholder's pro rata share of such CFC's aggregate income,[936] whereas GILTI is the shareholder's pro rata share of such CFCs' aggregate net income in excess of 10% of the shareholder's pro rata share of those CFCs' depreciable tangible property basis.[937] Thus, any reasonably profitable CFC is likely to generate income that could be taxable under §951A to its 10% shareholders, including the shareholders of S corporations that own such CFCs.

The 2019 GILTI final regulations adopted aggregate treatment for purposes of determining the GILTI inclusion of an S corporation shareholder.[938] For purposes of §951A, an S corporation is treated as a foreign partnership under §958(a)(2) when determining the persons that own stock of the foreign corporation under §958(a).[939] Therefore, a shareholder is treated as owning proportionally the stock of CFCs owned by the S corporation, and if the shareholder is not also a U.S. shareholder, the shareholder does not have a GILTI inclusion.[940] Proposed regulations would allow certain S corporations with transition accumulated E&P to elect entity, rather than aggregate, treatment for purposes of §951 and §956(a) inclusions.[941] The election is temporary, and aggregate treatment would apply beginning with the first tax year in which the S corporation has no transition accumulated E&P as of the first day of that year.[942]

Note: Treasury is likely to revise the §951A regulations to reflect the legislative changes made to §951A and related Code sections by the OBBBA.

In tax years beginning between 2018 through 2025, domestic C corporations are permitted a deduction for any taxable years in an amount equal to 50% of: (1) any GILTI included in the gross income of the domestic corporation under §951A for that taxable year; plus (2) the §78 amount attributable to the §951 inclusion.[943] As a result, GILTI has an effective tax rate of 10.5% (21% x 50%) if it is included by a U.S. shareholder that is a C corporation. In tax years beginning after 2025, the deduction is reduced to 40% of: (1) any NCTI included in the gross income of the domestic corporation under §951A; plus (2) the §78 amount attributable to the §951A inclusion.[944] As a result,

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[926] Prop. Reg. §1.958-1(e)(4).

[927] For a more detailed discussion of subpart F income, see 6200 T.M., *CFCs — General Overview* (Foreign Income Series), 6820 T.M., *CFCs — Sections 959–965 and 1248* (Foreign Income Series), 6220 T.M., *CFCs — Foreign Personal Holding Company Income* (Foreign Income Series), 6240 T.M., *CFCs — Foreign Base Company Income (Other than FPHCI)* (Foreign Income Series), 6260 T.M., *CFCs — Investment of Earnings in United States Property* (Foreign Income Series), and 6300 T.M., *PFICs* (Foreign Income Series).

[928] §954(a)(1), §954(c).

[929] §954(a)(2), §954(d).

[930] §954(a)(3), §954(e).

[931] §952(a)(1), §953.

[932] §951(a)(1)(B), as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70354(a). *See* §956.

[933] §962(a)(1) (tax on §951(a) inclusions at corporate rate); §962(d) (income inclusion with respect to distributions from foreign corporation to the extent E&P of the foreign corporation attributable to the §951(a) inclusions is distributed and exceeds the amount of tax paid on the amounts to which the election applied).

[934] For tax years beginning after 2025, the OBBBA renames GILTI as NCTI and revises the calculation. For further discussion of NCTI and GILTI, see 6215 T.M., *Global Intangible Low-Taxed Income (GILTI)* (Foreign Income Series).

[935] §951A(a), as amended by the OBBBA, Pub. L. No. 119-21, §70323(a)(1). For a discussion of the §951A calculation, see 6000 T.M., *Foundations of U.S. International Taxation* (Foreign Income Series).

[936] §951A(b), as amended by the OBBBA, Pub. L. No. 119-21, §70354.

[937] Pre-OBBBA §951A(b). Although losses of a shareholder's CFCs are taken into account in determining the relevant aggregate income, the depreciable asset bases of such loss CFCs are not taken into account in calculating the floor on the shareholder's GILTI income.

[938] Reg. §1.951A-1(e); T.D. 9866, 84 Fed. Reg. 29,288, 29,315 (June 21, 2019).

[939] Former Reg. §1.958-1(d)(1), §1.951A-1(e). This rule does not apply for purposes of determining whether any person is a U.S. shareholder, whether any U.S. shareholder is a controlling domestic shareholder, whether any foreign corporation is a CFC, applying §1248, or defining U.S. property for purposes of §956, including for purposes of pledges and guarantees. Former Reg. §1.951A-1(e). *See* former Reg. §1.958-1(d)(2).

[940] *See* Preamble to T.D. 9866, 84 Fed. Reg. at 29,315.

[941] Prop. Reg. §1.958-1(e) (adopting approach from Notice 2020-69), REG-118250-20, 87 Fed. Reg. 3890 (Jan. 25, 2022). Transition accumulated E&P means the amount of accumulated E&P calculated as of September 1, 2020, reduced by distributions. Prop. Reg. §1.958-1(e)(3). Prop. Reg. §1.958-1(e) would apply to S corporations' tax years ending on or after September 1, 2020. However, taxpayers could apply the rules to S corporations' tax years ending on or after June 22, 2019, if they are applied consistently for all CFCs. Prop. Reg. §1.958-1(e)(6). For a detailed discussion of the proposed rules, see 6215 T.M., *Global Intangible Low-Taxed Income (GILTI)* (Foreign Income Series).

[942] Prop. Reg. §1.958-1(e)(4).

[943] Pre-OBBBA §250(a)(1)(B); Reg. §1.250(a)-1(b)(1), T.D. 9901, 85 Fed. Reg. 43,042 (July 15, 2020).

[944] §250(a)(1)(B), as amended by the OBBBA, Pub. L. No. 119-21, §70321.

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NCTI has an effective tax rate of 12.6% (21% x 60%) if it is included by a C corporation U.S. shareholder.

In tax years beginning between 2018 through 2025, a deemed paid foreign tax credit is available to certain domestic corporations for foreign income taxes paid by their CFCs on earnings attributable to the §951A GILTI inclusions, but limits the amount of the deemed paid foreign tax credit to 80% of the domestic corporation's inclusion percentage.[945] The deemed paid foreign tax credit limitation is increased from 80% to 90% of the domestic corporation's inclusion percentage for tax years beginning after 2025.[946] Moreover, individual 10% shareholders, including shareholders of S corporations that are 10% shareholders in such CFCs, must make an election under §962 to be taxed twice on the inclusion amount in order to obtain any credit for such foreign income taxes attributable to the GILTI inclusion (for pre-2026 years) or NCTI inclusion (for post-2025 years).

While mandatory inclusion under §951A applies to all U.S. shareholders, both the deduction under §250 and the deemed paid credit under §960 apply solely to C corporations that are U.S. shareholders.[947] An S corporation shareholder may make an election under §962(b) to be treated as a C corporation for purposes of §960 in order to take advantage of the deemed paid credit and for purposes of any inclusions under §951(a), §951A, and §78.[948] However, the §962 election also causes an income inclusion under §962(d) to the extent a foreign corporation distributes E&P attributable to these inclusions in excess of the amount of tax paid with respect to the inclusions. Although the Code does not provide a comparable election for §250. However, the regulations under §250 provide that an individual, including a shareholder of an S corporation, making a §962 election may offset their NCTI/GILTI inclusion by the §250(a)(1)(B) amount.[949]

Comment: The regulation permitting an S corporation shareholder a deduction under §250(a)(1)(B) if a §962 election is made reduces the incentive for the S corporation to conduct its foreign operations in a tiered, holding company structure. Under such a structure, the S corporation parent would form a holding company as a C corporation (no QSub election), then the holding company would own the stock of the CFC. The holding company would ameliorate the high-tax incidence on the CFC income if the S corporation held the CFC's stock directly, but this structure may be economically costly to implement without a general economic benefit.[950]

Although earnings of a foreign corporation that are not connected with a U.S. business and are not subject to either the subpart F or the NCTI/GILTI provisions are, in theory, not subject to U.S. taxation until repatriated to U.S. shareholders as dividends, the passive foreign investment corporation (PFIC) provisions also require current inclusion in the income of even less-than 10% U.S. shareholders of certain types of income earned by foreign corporations with predominantly passive income or passive assets, or, in lieu of such inclusion, impose an interest charge on the deferral.[951]

It should also be noted that special rules govern the taxation of gain on the sale of stock in CFCs. Section 1248, which is based on subpart F principles, converts capital gain to dividend income, based on certain remaining E&P in a CFC upon the tax disposition of stock of the CFC. Section 1248 is gain and E&P limited. Such deemed dividend income is eligible for the §245A 100% dividends received deduction with respect to 10% U.S. shareholders that are C corporations, but, as noted above, §245A does not apply to non-C corporation taxpayers, including the shareholders of S corporations that sell stock in CFCs.

Unlike many of the code sections discussed throughout this chapter, the base erosion and anti-abuse tax (BEAT) favors S corporations over C corporations.[952] The BEAT is effectively a minimum tax on the income of large U.S. corporations (average gross receipts of $500 million or more) making a certain level of deductible payments to foreign related parties. The tax is imposed in addition to a U.S. corporation's regularly calculated federal income tax liability.[953] Neither S corporations nor their shareholders are subject to the BEAT.[954] For a detailed analysis of the BEAT, see 6125 T.M., *Base Erosion and Anti-Abuse Tax (BEAT).*

(3) Foreign Tax Credit

U.S. taxpayers are generally permitted to elect to credit foreign income taxes against their U.S. tax liability. A direct credit for foreign tax paid or accrued by any U.S. person is allowed under §901. The deemed paid foreign tax credit in §960 has been discussed above. The credits for direct and deemed paid foreign taxes are both limited by §904, which limits, with certain carryback and carryforward rules, the total amount of credit allowable to the product of the taxpayer's total U.S. tax (determined prior to the calculation of the credit) and a fraction, the numerator of which is its foreign source taxable income and the denominator of which is its worldwide taxable income. Thus, in general, the greater a taxpayer's foreign source net income, the greater its foreign tax credit limitation.

Generally, absent a §962 election discussed above, no foreign tax credit is available to an S corporation's shareholders for foreign taxes paid by a foreign subsidiary of the S corporation. Foreign tax credits reduce the E&P of the foreign corpo-

[945] Pre-OBBBA §960(d)(1).

[946] §960(d)(1), as amended by the OBBBA, Pub. L. No. 119-21, §70312(a).

[947] §960(a). *See also Eaton Corp. v. Commissioner*, 164 T.C. No. 4 (2025) (holding that §960(a) did not apply where a domestic partnership, rather than a domestic corporation, held the §951 inclusions, and thus, the U.S. parent was not entitled to deemed-paid foreign tax credits for taxes paid by lower-tier CFCs).

[948] Reg. §1.962-1(a), (b), (c), *Ex.* For a sample, see Individual: CFC Income Subject to Tax at Corporate Rates (§962(b)), in the Bloomberg Tax Election & Compliance Statements Library.

[949] Reg. §1.962-1(b)(1)(i)(B)(3). This rule is applicable to tax years of foreign corporations ending after March 4, 2019, and tax years of U.S. persons for the tax year in which or with which such tax year of the foreign corporation ends. However, taxpayers may apply this rule to tax years of foreign corporations beginning after 2017 and tax years of U.S. Persons for the tax year in which or with which such tax year of the foreign corporation ends. Reg. §1.962-1(d). Note that the regulations have not been amended to reflect the changes made by the OBBBA to §250. Pub. L. No. 119-21.

[950] *See* Preamble to T.D. 9901, 85 Fed. Reg. at 43,076–77.

[951] *See* §1291–§1297 (the PFIC provisions, which apply to foreign investment companies regardless of the level of U.S. ownership).

[952] *See* §59A.

[953] §59A(a).

[954] §59A(e)(1)(A).

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ration and thus potentially reduce the dividend income received by the S corporation on distributions from the subsidiary. The shareholders may, however, obtain a foreign tax credit for foreign withholding tax imposed on dividends paid by the foreign subsidiary to the S corporation because such tax is treated as a tax imposed directly on the shareholders.[955]

(4) Holding Company Structure

S corporations with foreign operations should consider a holding company structure for operations involving CFCs and the enactment of dividends received deductions not available to S corporations (§245 and §245A), at least if conducted through foreign corporations. For existing S corporations, their foreign operations would be contributed to a domestic C corporation as a holding company of the foreign operations (likely per se foreign corporations). This affiliated group structure would not affect the parent's S corporation status.[956] S corporations are allowed to own 80% or more of a foreign corporation.[957]

There may be other reasons to form a holding company structure. Under the terms of certain income tax treaties, the foreign withholding tax rate on dividends paid to a U.S. parent corporation may be lower for dividends paid to a corporation that owns all the shares of the subsidiary.[958] In such cases, a U.S. holding company can be created to own 100% of the foreign subsidiary.

Use of a U.S. holding company would theoretically subject the earnings of a foreign subsidiary to triple taxation — when the income is earned, when it is distributed to the holding company, and when it is distributed to the S corporation. However, the holding company will generally receive a deemed paid credit under §960 with respect to subpart F and NCTI/GILTI inclusions for foreign taxes paid by the foreign subsidiary, as well as a foreign tax credit for foreign withholding tax on the dividends. Because taxpayers other than corporations generally cannot claim the indirect foreign tax credit, the credit is not an item that may be passed through to S corporation shareholders.[959] Further, taxpayers other than C corporations are not eligible for the 100% dividends received deduction in §245A, or the deduction for foreign-derived deduction eligible income (FDDEI) (formerly known as foreign-derived intangible income (FDII)) in §250.[960] Additional U.S. tax with respect to income flows under the U.S. holding company structure would be due only if the combined corporate and withholding rates are lower than the effective U.S. corporate income tax rate. If the holding company is itself an S corporation, on the other hand, it would pass the dividend income and any direct foreign tax credits (withholding) through to its shareholders, but again, they generally will not be able to claim a credit or deduction for any other foreign taxes paid by the foreign subsidiary.

[955] §901, §903. For a detailed discussion of the foreign tax credit rules, see 6020 T.M., *The Creditability of Foreign Taxes* (Foreign Income Series).

[956] §1361(b)(2).

[957] Pub. L. No. 104-188, §1308(a).

[958] *See* U.S.-Switzerland Income Tax Treaty, Art. VI.

[959] §1363.

[960] For further discussion of FDDEI/FDII, see IV.B.3., below.

3. Foreign Sales Corporations, Domestic International Sales Corporations, Extraterritorial Income Exclusion, and Repeal of Extraterritorial Income Exclusion

There has been a long-running dispute between the U.S. and the European Union (EU) over the U.S. tax breaks with regard to export income. The U.S. initially provided for a tax deferral under its regime for domestic international sales corporations (DISCs). After DISCs were held to be an illegal export subsidy by a panel under the General Agreement on Tariffs and Trade in 1976, the U.S. introduced the Foreign Sales Corporation (FSC).[961] Subsequently, in February 2000, the World Trade Organization (WTO) ruled against the FSC, holding that the FSC was an export subsidy inconsistent with the U.S. obligations under international trade agreements. In 2000, Congress replaced the FSC regime with the extraterritorial income exclusion regime (ETI) under which certain income realized by U.S. persons from foreign trading activities was excluded from gross income.[962] In January 2002, the WTO ruled that ETI was a prohibited export subsidy and then subsequently raised tariffs on certain imports, effective March 1, 2004. In October 2004, the U.S. repealed ETI in the 2004 American Jobs Creation Act (2004 AJCA).[963] Section 199 was added in place of ETI, but was repealed by the TCJA for tax years beginning after 2017. Former §199 provided a deduction from taxable income for a percentage of the taxpayer's income derived from certain production or manufacturing activity occurring in the U.S. (qualifying production activities income).[964]

A DISC is not subject to income tax;[965] rather, its shareholders are taxed on its income when the income is distributed or is deemed distributed.[966] The benefit of the DISC provisions is therefore deferral of U.S. tax on export earnings — at the price of an interest charge for the deferred taxes.[967] For a C corporation, this is advantageous because of the lag time in calculating the interest and because the interest rate is generally lower than the corporation's normal cost of funds. However, this interest is not deductible to S corporation shareholders, and it is thus more advantageous for them to structure borrowings in a manner in which an interest deduction can be obtained.[968]

The FSC provisions, former §921–§927 and accompanying regulations, were repealed by the 2000 FSC Repeal and Extraterritorial Income Exclusion Act.[969] The FSC regime operat-

[961] Pub. L. No. 98-369, §801.

[962] Pub. L. No. 106-519, §2, §3.

[963] Pub. L. No. 108-357, §101.

[964] Pub. L. No. 115-97, §13305(a). For a detailed discussion of the ETI regime, its repeal, and the §199 deduction, see 510 T.M., *Section 199: Deduction Relating to Income Attributable to Domestic Production Activities. See also* Atkinson, *Assembling the Pieces of the Domestic Manufacturers' Deduction*, 215 Daily Tax Rpt. J-1 (Nov. 8, 2004).

[965] §991.

[966] §995. Under Prop. Reg. §1.995(f)-1(h)(2), DISC income is attributed to each S corporation shareholder in proportion to the shareholder's pro rata share of the S corporation's income or loss.

[967] *See* §995(f).

[968] See Reg. §1.163-9T(b)(2) (providing that interest on underpayments of tax, including interest paid by an S corporation or its shareholders, is nondeductible personal interest). *See also Miller v. United States*, 65 F.3d 687 (8th Cir. 1995), *aff'g* 95-1 USTC ¶ 50,068 (D.N.D. 1994).

[969] Pub. L. No. 106-519.

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ed primarily by exempting a portion (usually 70%) of the FSC income (generally approximately 23% of the taxable income from the sales or services) from U.S. tax. The FSC shareholders were able to obtain the untaxed FSC income as a distribution which was also untaxed because of the 100% dividends received deduction.[970] Thus, approximately 16% of qualifying export income (23% x 70%) was exempt from U.S. tax. In an S corporation context, the use of a FSC was not beneficial because S corporations are not eligible for a divided received deduction.[971]

The tax incentive FDDEI (formerly known as FDII) is not available to S corporations and, in addition, S corporations may be subject to some of the same E.U. and WTO objections applicable to the DISC, FSC, and ETI regimes described above. Under §250, for tax years beginning before 2026, C corporations — but not RICs, REITs, or S corporations[972] — may deduct 37.5% of the amount of their FDII, resulting in an effective federal income tax rate of 13.125% on such income.[973] For tax years beginning after 2025, such corporations may deduct 33.34% of the amount of their FDDEI, resulting in an effective tax rate of 14%.[974] The potential availability of this benefit to C corporations, but not S corporations, could be a factor in determining whether to make an S election.

C. Other Issues Affecting Foreign Operations of S Corporations

1. The Look-Through Rule of §1373

Under §1373(a), an S corporation is treated as a partnership, and its shareholders as partners, for purposes of the foreign tax credit rules (§901–§908), the controlled foreign corporation provisions (§951–§965), and the international boycott provision (§999). Foreign income taxes paid by an S corporation thus flow through to the shareholders who either claim a credit (subject to the applicable limitations) or a deduction for these taxes.[975] Because the foreign tax credit reduces U.S. taxes dollar-for-dollar, it is generally more beneficial than a deduction for foreign taxes.

Prior to its repeal,[976] §902 treated a portion of taxes paid by a foreign corporation as paid by a domestic corporation that owned 10% or more of the foreign corporation's voting stock. Shareholders of an S corporation with a foreign corporate subsidiary were generally not eligible for this §902 indirect (deemed paid) credit for taxes paid by the subsidiary. However, they might have been able to elect under §962 to be treated as domestic corporations and thus obtain an indirect credit with respect to income that was deemed distributed by the foreign subsidiary under §951(a). Note, however, that the Office of Chief Counsel has advised that the basis limitation of §1366(d)(1) applies to limit the amount of the S corporation shareholder's deduction or credit for its pro rata share of the S corporation's creditable foreign income taxes to the shareholder's basis in its stock at the end of its taxable year.[977] So, to the extent an S corporation shareholder could have obtained a §902 indirect credit, the use of such credit would presumably have also been subject to the basis limitation.

2. Effect of Electing or Terminating S Corporation Status on Foreign Losses (§1373(b))

A C corporation with international operations may consider making an S election in order to eliminate double taxation of earnings. In addition to considering the built-in gains tax in §1374, the corporation must also consider the immediate impact of the election on any unrecovered foreign losses generated as a C corporation. S corporations contemplating a termination of S status have similar considerations.

In that regard, under §1373(b), the conversion to and termination of S corporation status is treated as a disposition of the business for purposes of §904(f) and causes recognition of gain on property that was used predominantly in a trade or business outside the United States. Because the purpose of §904(f) is to recapture foreign losses that had the effect of reducing U.S. tax, the amount recognized under §904(f)(3) is limited to the amount of foreign losses not previously recaptured. The foreign loss recapture computation probably must be made on a shareholder-by-shareholder basis, with each shareholder considered to have disposed of their pro rata share of the foreign assets determined as of the date of the termination (and not on a per-share, per-day basis). The legislative history to the 1982 Subchapter S Revision Act indicates that, in the case of a corporation electing out of S corporation status which has passed foreign losses through to its shareholders, rules concerning the source of income (including the capital gains source rule of §904(b)) and the amount of creditable taxes will apply at the shareholder level.[978]

Comment: Shareholders to whom foreign losses have been passed through may no longer be shareholders of the corporation, or they may have reduced their stockholdings substantially. There may also be new shareholders to whom no foreign losses were ever passed through. It is not clear how the recapture of foreign losses will affect these shareholders.

3. Corporate Indebtedness to Shareholders

In general, corporate-level indebtedness (other than indebtedness to shareholders) does not generate shareholder basis in the S corporation. Thus, the corporation's operating losses will be available to use at the shareholder level only to the ex-

[970] *See* former §245(c)(1)(A).

[971] *See* §1363(b); *Naporano v. United States*, 834 F. Supp. 694 (D.N.J. 1993).

[972] Reg. §1.250(a)-1(c)(1); H.R. Rep. 115-466, at 498 (2017) (Conf. Rep.).

[973] Pre-OBBBA §250(a)(1), §250(a)(3).

[974] §250(a)(1), as amended by the OBBBA, Pub. L. No. 119-21, §70323(b). For a detailed discussion of FDDEI/FDII, see 6360 T.M., *Export Tax Incentives* (Foreign Income Series).

[975] S. Rep. No. 97-640, 16 (1982). *See also* PLR 9612017 (since office or fixed place of business of a partnership is considered to be the office or fixed place of business of each of its partners, and since an S corporation is treated as a partnership pursuant to §1373(a), the sole office or fixed place of business of an S corporation, located in country in which all of its assets were located, is deemed to be that of its shareholders, and, assuming the foreign country imposes an effective rate of tax of at least 10% on such gain, gain from sale of corporation's stock is foreign source income under §865(e)(1)). *Sale of Stock in S Corporation with Foreign Operations to Foreign Corporation Generates Foreign Source Income*, 37 Tax Mgmt. Memo. 123 (Apr. 29, 1996).

[976] Section 902 was repealed for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

[977] CCA 201429025.

[978] S. Rep. No. 97-640, 16 (1982). The amount of creditable taxes would include, for example, the oil and gas foreign tax credit of §907.

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tent the shareholders have stock basis and basis in indebtedness to the shareholders.[979] In a foreign context, some jurisdictions will scrutinize shareholder loans closely and may disallow interest expense.[980] However, where the indebtedness to shareholders is recognized, funding foreign operations this way may be preferable to capital contributions because the resulting interest deduction may help reduce foreign income taxes.[981] For S corporations with average annual gross receipts in excess of a base statutory amount of $25 million (for inflation-adjusted amounts, see footnote) for the prior three-taxable-year period, this must be balanced against the potential deferral or loss of deductions if their total interest expense exceeds the limitation under §163(j).[982] Interest payments made by the foreign corporation may be subject to withholding by the foreign jurisdiction.

4. Arm's-Length Pricing Requirement of §482

S corporations doing business abroad through a foreign subsidiary need to pay particular attention to pricing of transactions between the S corporation and the related foreign entity. Under §482, the IRS has the authority to allocate income, deductions, and other items between two or more businesses owned or controlled by the same interests in order to prevent evasion of taxes or to reflect clearly the income of the businesses. Overlapping ownership will generally subject two entities to §482 with respect to their transactions with each other, if the same group has effective control of the two entities.

Under §6662, the IRS may impose penalties based on the underpayment in tax resulting from §482 adjustments.

5. Foreign Tax Credit Splitting Events

Section 909 was added to the Code to address foreign tax credit splitter arrangements, i.e., arrangements where the payer of the tax, for U.S. tax purposes, is not the earner of the income, and there is a mismatch in taking the foreign tax credit into account before the income.[983] Section 909(a) and (b) do not allow any foreign tax credit until the related income is taken into account for U.S. income tax purposes. Section 909(c) provides that foreign tax splitter rule will apply at the owner-beneficiary level for any taxes paid by any pass-through entity. Reg. §1.909-1(b) provides that foreign taxes paid by an S corporation will be treated as if actually paid by the S corporation shareholders. If the foreign taxes would be treated as split taxes had they actually been paid by the S corporation shareholder, then they will be treated as split taxes at the S corporation shareholder level even though paid at the corporate level. This means the split taxes will be suspended at the S corporation level until a matching of the related income occurs.

D. Foreign Investment in S Corporation Business

1. Restrictions on Foreign Shareholders

Section 1361(b)(1)(C) prohibits an S corporation from having any foreign shareholders (except resident aliens).

An individual is a nonresident alien if they are neither a citizen of the United States nor a resident of the United States within the meaning of §7701(b)(1)(A).[984] Under §7701(b)(1)(A), an individual is considered to be a resident of the United States if they have lawfully been granted the privilege of residing in the United States (i.e., holds a green card), meets the substantial presence test of §7701(b)(3), or makes an election pursuant to §7701(b)(4) to be treated as a resident alien.

An individual who holds a green card may decide to leave the United States to live elsewhere. Provided the individual retains their green card, they may continue to be an S corporation shareholder.[985] A nonresident alien who is citizen of a country with which the United States has an income tax treaty that contains a nondiscrimination article may choose to argue that the prohibition against nonresident alien shareholders in §1361 is in conflict with the treaty. In such a case, the nonresident alien could argue that the treaty overrides §1361 and the nonresident should therefore be permitted to own shares in an S corporation. However, this interpretation has not been recognized by the IRS and, therefore, presents substantial risk of terminating a valid S corporation election.[986]

Comment: Although this argument on its surface may seem supportable, allowing a nonresident to hold stock directly in an S corporation is very risky. This approach is not recommended.

In some cases, it may be desirable to attract foreign capital to an S corporation's business while retaining the benefits of a single level of tax for existing shareholders. Two choices are available: structuring the business operations as a partnership with the nonresident alien individual entering into a partnership with the S corporation to conduct the business at the partnership level, or structuring the foreign investment in the form of convertible debt or debt issued with warrants.

While foreign persons are not eligible to own stock in an S corporation, a dual resident may be able to. A dual resident claiming treaty benefits can be an eligible S corporation shareholder if the S corporation and shareholder comply with certain provisions. Specifically, Prop. Reg. §301.7701(b)-7(a)(4)(iv) provides a special rule and conditions that permit a dual resident taxpayer to be treated as United States resident for purposes of §1361(a)(1) even if the taxpayer claims treaty benefits. The special exception will apply if a dual resident S corporation

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[979] §1366(d).

[980] *See* Alter & Bissell, *International Tax Planning with S Corporations After the Tax Reform Act of 1986*, 16 Tax Mgmt. Int'l J. 447 (Dec. 12, 1986).

[981] Interest expense of the corporation will need to be allocated under Reg. §1.861-9 through Reg. §1.861-12 and Reg. §1.861-9T through Reg. §1.861-13T. The rules are not clear whether shareholder-level interest expense is incurred on borrowed proceeds reloaned to the corporation.

[982] *See* §163(j)(3) (small business exemption; reference to §448(c)). For inflation-adjusted amounts, see Tables, Charts & Lists, *Gross Receipts Test Limit by Year under §448(c)*. For further discussion of the §163(j) limitation, see I.G., above.

[983] The Education, Jobs and Medicaid Assistance Act of 2010, Pub. L. No. 111-126, §211(a), added §909.

[984] §7701(b)(1)(B).

[985] PLR 9018045 (resident alien's move to foreign country would not affect eligible shareholder status as long as green card retained). *Compare* PLR 201640001 (S corporation termination waived by IRS when a resident alien permanently moved to a foreign country and became a nonresident alien).

[986] *See Langer Letter to Treasury International Tax Counsel*, 34 Tax Notes 1004 (Mar. 9, 1987). In his letter, the writer suggests that the nondiscrimination articles in recent U.S. income tax treaties might override the prohibition against a nonresident alien being a shareholder of an S corporation. For example, *see* 2016 U.S. Model Income Tax Treaty, Art. 24(5).

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shareholder and the S corporation enter into an agreement to be subject to tax and withholding as if the dual resident were a nonresident alien partner in a partnership.

The character and source of the S corporation items included in the dual resident shareholder's income will be determined as if realized directly by the shareholder. The dual resident shareholder will be considered as carrying on a business within the United States through a permanent establishment if the S corporation carries on such a business. A dual resident shareholder of an S corporation that was a C corporation, or a successor to a C corporation or a successor to an S corporation that itself was a successor (directly or indirectly) to a C corporation is not eligible for the exception.[987]

Although not permitted to own stock of an S corporation directly, a nonresident alien can be an eligible beneficiary of an electing small business trust (ESBT) following amendments.[988] Generally, in determining whether a corporation is eligible to be an S corporation, including limitations on eligible shareholders, each potential current beneficiary of an ESBT is treated as a shareholder.[989] Effective January 1, 2018, that rule does not apply in determining whether an S corporation has a nonresident alien as a shareholder.

Regulations confirm that a nonresident alien is both an eligible ESBT beneficiary and an eligible potential current beneficiary of an ESBT and does not violate the requirement that an S corporation cannot have a nonresident alien shareholder.[990] A potential current beneficiary that is a nonresident alien does, however, count toward the 100-shareholder limit in §1361(b)(1)(A).[991] Consideration should be given to corresponding amendments made to the regulations addressing the taxation of ESBTs, which provide that for ESBTs that are grantor trusts and have a nonresident alien deemed owner, the items of income, deduction, and credit must be reallocated from the grantor portion to the S portion of the ESBT.[992]

2. *Foreign Investment in S Corporation Operations Through a Partnership*

It is possible to accommodate a foreign investment in an S corporation's operations through the use of a partnership.[993]

The S corporation can contribute some, or potentially all, of its operating assets to the partnership, while the foreign investor contributes its own assets or cash. Thus, the partnership would conduct at least part of the S corporation's former business and the business would have an infusion of capital. A business purpose is required for this transaction or, otherwise, the partnership could be viewed as a mere subterfuge to avoid the S corporation eligibility rules.

Comment: Such a partnership should be cautious of disproportionate distributions to the S corporation partner shortly after the partnership's creation. Under §707(a), such distributions may constitute disguised sales resulting in a deemed taxable event for the S corporation.[994]

Under §875, if a partnership is engaged in a trade or business within the United States, its foreign partners are also considered to be engaged in a trade or business in the United States. This results, through §871(b), in the imposition of tax on the foreign investors to the extent that the partnership has taxable income that is effectively connected with the conduct of a trade or business within the United States. Section 1446 requires that the partnership withhold and pay over tax on foreign partners' distributive shares of such effectively connected income, even if not distributed. To the extent that such gain is attributable to appreciation on partnership assets, including goodwill, that are used in the partnership's U.S. trade or business, any gain realized by a foreign partner on a sale or redemption of an interest in a partnership is subject to tax under §864(c)(8) and to a withholding tax under §1446(f).[995]

3. *Foreign Investment Through Convertible Debt or Debt with Warrants*

A foreign investor can also invest in an S corporation through convertible debt or debt issued with warrants.[996] Convertible debt and warrants can be structured so they are not considered stock in a company, and therefore, their ownership is not limited by the ineligible shareholder provisions of §1361(b)(1).[997] The convertible debt and warrant approach to allowing foreign investors to enjoy appreciation in an S corporation may only be temporary. If the debt is converted to equity or the warrants exercised, the foreign investors will become stockholders and terminate S corporation status. Care should also be taken to ensure the terms of the convertible debt or warrants are structured so as not to run afoul of the single class of stock rules.[998]

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[987] *See* Prop. Reg. §301.7701(b)-7(a)(4)(iv), IL-121-90, 57 Fed. Reg. 15,272 (Apr. 27, 1992).

[988] Pub. L. No. 115-97, §13541(a).

[989] §1361(c)(2)(B)(v). If there is no potential current beneficiary for any period, then the ESBT is treated as the shareholder during such period.

[990] Reg. §1.1361-1(m)(1)(ii)(D), (m)(2)(ii)(E)(2), (m)(4)(i).

[991] Reg. §1.1361-1(m)(4)(i).

[992] Reg. §1.641(c)-1(b).

[993] *See* Rev. Rul. 94-43. The use of a partnership to allow a nonresident alien to invest in the operations of an S corporation is not an abusive use of subchapter K. *See* Reg. §1.701-2(d) *Ex*. 2.

[994] For a complete discussion of the disguised sale rules, see 711 T.M., *Partnerships — Formation and Contributions of Property or Services.*

[995] Even if such a partnership did not earn any income effectively connected with a U.S. trade or business, foreign members of such a partnership would still be taxed on their shares of certain partnership investment income that is sourced in the United States. Such a partnership may be liable for withholding taxes on such income. Section 871(a) and §1441, with respect to nonresident alien individuals, and §881(a) and §1442, with respect to foreign corporations, ensure that a 30% gross basis withholding tax is paid on U.S. source fixed, determinable, annual, or periodic (FDAP) income, which includes non-portfolio interest, dividends, royalties, and non-business rents — but not most capital gain income.

[996] Issuance of debt with warrants may also bring into effect the original issue discount rules of §1272 through §1275.

[997] Reg. §1.1361-1(l)(4); *see* Rev. Rul. 67-269, *obsoleted by* Rev. Rul. 95-71 (due to issuance of final regulations).

[998] Reg. §1.1361-1(l)(3), §1.1361-1(l)(4). For a complete discussion, see 730 T.M., *S Corporations: Formation and Termination.*

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V. Other Issues

A. *S Corporations and Partnerships*

Although S corporations may provide certain corporate benefits (e.g., the ability to partake in corporate reorganizations and the income allocable to shareholders not being subject to self-employment taxes and), the partnership and limited liability company forms of business can offer their owners certain advantages and flexibility unavailable to S corporation shareholders (i.e., multiple classes of investment, special allocations, and no restriction on investor types). To take advantage of the benefits of both types of entities, S corporations frequently invest in partnerships.

1. *S Corporations as Partners*

A popular scenario that often results in an S corporation becoming a partner in a partnership involves the introduction of an ineligible shareholder.

> *Example:* An S corporation wishes to engage in a new trade or business along with a nonresident alien. If the nonresident alien were to receive an interest in the S corporation in exchange for their investment, S status would terminate.[999] In order to achieve the desired result without terminating S status, the S corporation and the nonresident alien form a partnership to operate the new trade or business.

In 1994, the IRS ruled that the use of a partnership owned by S corporations in order to circumvent the limitations imposed on S corporations was not abusive.[1000] Rev. Rul. 94-43 revoked Rev. Rul. 77-220,[1001] which ruled that the formation of three separate S corporations (with 10 shareholders each, the maximum number permitted in 1977) to operate a partnership while avoiding the shareholder limitation provision for S corporations was abusive and that the three corporations must be combined for purposes of analyzing the shareholder limitation provision. Such a combination produced excessive shareholders, thereby creating ineligibility. In revoking the 1977 ruling, the IRS stated that the reason the number of shareholders is restricted is for simplicity in the administration of the corporation's tax affairs. In this context, administrative simplicity is not affected by the corporation's participation in a partnership with other S corporation partners, nor should a shareholder of one S corporation be considered a shareholder of another S corporation simply because the S corporations are partners in a partnership.

In addition to avoiding shareholder limitations, partnerships may be used to achieve special allocations that would be unavailable in S status. In PLR 8804015, an S corporation that owned and leased real estate sought to form a limited partnership. The S corporation was to act as the limited partner while a C corporation would serve as a general partner. Both corporations were to contribute cash to the partnership, with the S corporation receiving a special allocation of partnership profits, losses, and distributions. The IRS ruled that the not-yet-revoked Rev. Rul. 77-220 and its approach of combining corporate partners was inapplicable, as the S corporation had activities outside of the partnership. In addition, it concluded that the special allocation did not cause the S corporation to have a prohibited second class of stock because it represented the partners' diverse economic interests.

Reg. §1.701-2(d) *Ex.* 2 deals head-on with the question of whether an S corporation participating in a partnership can use the partnership to ameliorate some of the strictures of subchapter S eligibility. In the example, an S corporation and a nonresident alien form a partnership to avoid terminating S status by making the nonresident alien a direct shareholder. The regulation example concludes that the formation of the partnership is consistent with the intent of subchapter K and that the partnership transaction cannot be recast by the IRS under the partnership anti-abuse regulations as a direct investment of the nonresident alien in the S corporation, thereby terminating its status. Rev. Rul. 94-43 and Reg. §1.701-2(d) provide significant support to S corporation and partnership transactions, which have the effect of side-stepping some of the strictures imposed on S corporations.

Comment: It seems reasonable to conclude under current IRS guidance that proper planning with S corporations investing in partnership-type entities, along with other investors who cannot invest directly into the S corporation without terminating its status, can be used to avoid some of the subchapter S eligibility constraints.

2. *Partnership Incorporations*

Occasionally partnerships decide to convert to corporate status. There are five ways to do so:[1002]

- the partnership contributes its assets to a corporation in return for the corporation's stock, and the stock is then distributed to the partners in liquidation of the partnership;
- the partnership distributes its assets to the partners in liquidation of the partnership, and the partners then contribute the assets to the new corporation tax free under §351;
- the partners form a new corporation and transfer their partnership interests to the corporation in return for stock (such a contribution terminates the partnership and gives

[999] Section 1361(b)(1)(C) prohibits a nonresident alien from being a shareholder in an S corporation.

[1000] Rev. Rul. 94-43; *see* PLR 201544020 (applying Rev. Rul. 94-43 where an S corporation nearing the 100-shareholder limit reorganized into a partnership owned by two S corporations with the shareholders of the former corporation split between them).

[1001] The General Counsel's Office issued GCM 36966 which agreed with Rev. Rul. 77-220 but was revoked after the IRS issued Rev. Rul. 94-43. *See* GCM 39886 (Sept. 23, 1994). For additional rulings prior to Rev. Rul. 94-43, *see* PLR 9017057, PLR 8950066, PLR 8823023, PLR 8819040, and PLR 8711020.

[1002] See Rev. Rul. 70-239, which discusses the first three methods of partnership incorporation and provides that regardless of the method employed, the IRS will treat the transaction as a transfer of partnership assets to the corporation in exchange for stock, followed by a liquidation of the partnership. However, *see* Rev. Rul. 84-111, which revokes Rev. Rul. 70-239 and states that these three methods may produce different tax consequences. For a general discussion, *see* Blau, Lemons, & Glover, *Partnership Incorporations and the S Election,* 47 Tax Notes 719, 725–26 (May 7, 1990). *See also* PLR 9316027, PLR 9316028, and PLR 9316029.

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the corporation outright ownership of the underlying partnership property);

- the partners make an entity classification election (a so-called check-the-box election) to be treated as an association;[1003] or
- the partners convert their partnership-type entity into a corporation under local law.[1004]

For a detailed discussion on the conversion of a partnership to an S corporation and the related subchapter S issues, see 730 T.M., *S Corporations: Formation and Terminations.*

B. Below-Market Loans

In an S corporation setting, loans are frequently made between the corporation and its shareholders. For example, shareholders often borrow money from the corporation as an alternative to receiving distributions, or loan money to the corporation to fund operations or increase their basis in the S corporation.[1005] In these situations, it is essential that the corporation and its shareholders be aware of the special rules that apply to indebtedness in order to avoid unexpected tax consequences.

Under §7872, loans are evaluated to determine if the interest payable on the loan is at a below-market rate, i.e., there is inadequate interest or no interest charged. If so, the statute provides that these below-market loans be recharacterized as arm's-length transactions, thereby resulting in income and/or gift tax consequences to both the lender and borrower. Specifically, §7872(e) defines a below-market loan as one of the following:

- a demand loan, the interest on which is payable at a rate less than the applicable federal rate (AFR); or
- a term loan, if the amount loaned exceeds the present value of all principal and interest payments due under the loan.[1006]

In general, the existence of a below-market loan means that lenders are deemed to have received interest income, and borrowers are deemed to have incurred interest expense to the extent of the difference between the specified statutory rate and the actual interest charged on the loan. When a below-market demand loan is made, the difference between the interest that would have been paid using the AFR rate over the interest that was actually payable on the loan is treated as if the lender transferred the foregone interest to the borrower, which the borrower then used to meet the debt service on the loan.[1007]

In the case of a below-market term loan, the lender is deemed to have transferred to the borrower an amount of money equal to the excess of the amount loaned over the present value of all payments to be made on the loan.[1008] This foregone interest is then treated as original issue discount (OID) and is amortized over the life of the loan.[1009]

The tax treatment of the transfer by the lender to the borrower will be determined based upon the classification of the below-market loan. There are five general types of below-market loans: gift loans, compensation-related loans, corporation-shareholder loans, tax avoidance loans, and certain significant tax effect loans.[1010]

Two of these types of loans commonly occur in the S corporation context: corporate-shareholder loans and compensation-related loans. However, there is a de minimis exception to the deemed interest treatment, where under §7872(c)(3), the rules of §7872 do not apply on any day that the aggregate amount of loans between the borrower and the lender do not exceed $10,000. The impact of these rules on S corporations and their shareholders can be quite different than on C corporations and may create unexpected tax consequences. These consequences are discussed below.

1. Loans from an S Corporation to Its Shareholders

a. Corporation-Shareholder Loans

If an S corporation makes a below-market loan to a shareholder, §7872 will generally treat the transaction as a corporate-shareholder loan. However, if the shareholder is also an employee of the S corporation, the loan may be treated as a compensation-related loan.

In the case of a corporate-shareholder demand loan, the S corporation will be treated as making a deemed distribution to the shareholder in the amount of the imputed interest, i.e., the difference between the interest that is payable and the interest that would have been due using the AFR rate on a demand loan. Under Prop. Reg. §1.7872-4(d)(1), the deemed transfer of money is treated as a distribution under §1368. The deemed distribution will decrease both the shareholder's stock basis as well as the corporation's AAA. The shareholder will then be deemed to have made an interest payment for the same amount to the corporation.[1011] The corporation will recognize interest income that will be allocated proportionately to all shareholders, resulting in increases to stock basis for each shareholder as well as the corporation's AAA.

[1003] Under Reg. §301.7701-3(g)(1)(i), checking the box to treat a partnership as an association is treated as if the partnership contributes all its assets to a new association in exchange for stock of the new corporation and distributes the stock to its partners in liquidation of the partnership. Note that, under Reg. §301.7701-3(c)(1)(v), an S corporation election made by an entity eligible not already treated as a corporation for U.S. federal tax purposes is also treated as an election for the entity to be classified as an association under Reg. §301.7701-3, provided that all other requirements to qualify as a small business corporation under §1361(b) are satisfied. *See also* Rev. Rul. 2009-15, Situation 1 (noting that the deemed transactions arising from the check-the-box election occur immediately before the close of day before the S election is effective, so that the partnership will not be deemed to own the stock of the association during any part of the association's new tax year and the association can be treated as an S election beginning on the effective date of the election).

[1004] Rev. Rul. 2004-59 (formless conversion under local law of partnership into corporation treated in same manner as making a check-the-box election to be treated as an association); Rev. Rul. 2009-15, Situation 2 (same result as in Situation 1 for a state law conversion to a corporation).

[1005] *See* §1366(d)(1)(B), which allows direct indebtedness to the S corporation from the shareholder to increase the shareholder's basis for loss deduction purposes.

[1006] Present value is computed using the AFR.

[1007] §7872(a)(1). Under §7872(a)(2), this transfer is deemed to be made on the last day of the calendar year.

[1008] §7872(b)(1).

[1009] §7872(b)(2).

[1010] Prop. Reg. §1.7872-4(a).

[1011] The interest payment from the shareholder to the corporation may be deductible depending upon the expenditures made by the shareholder with the debt proceeds. Reg. §1.163-8T.

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Where the S corporation is owned by a single shareholder or where the loans are made equally and ratably among all shareholders, this deemed transaction might have no tax effect to the extent the deemed interest income is offset by deemed interest expense, and deemed distributions from the AAA are offset by the increase in the AAA resulting from the deemed interest income. In these cases, §7872 may be inapplicable given that §7872(c)(1)(E) states that only those interest arrangements that have a significant tax effect will be subject to the rules of §7872.[1012]

Comment: If the S corporation has a negative AAA at the end of the year and prior C corporation E&P, the borrowing shareholder will have both interest income and dividend income (of the same amount in a sole shareholder scenario) from the S corporation. In addition, the interest expense at the shareholder level may be classified as personal interest and therefore nondeductible.

Where loans are not made ratably among all shareholders, the deemed transfer will mean that the shareholders not participating in the below-market loan are recognizing income without receiving any current economic benefit. In contrast, the shareholder-debtor is receiving the benefit of a below-market interest rate, while only picking up offsetting interest income to the extent of that shareholder's distributive share. In addition, it is possible that the deemed distribution will create a taxable dividend to the debtor-shareholder, assuming the deemed distributions are in excess of the AAA.

> *Example:* XYZ, an S corporation, is owned equally by B and C. At the beginning of the year, XYZ has a deficit AAA balance of ($2,000), and $1,000 in E&P from its prior C corporation existence. During the year, B took out a demand loan from XYZ that did not provide for interest. Under §7872, the foregone interest on the loan was $200 (assumed). XYZ's earnings for that year were $600 including the deemed interest income under §7872. Under these facts, B and C will share the deemed $200 interest income passthrough from XYZ, which will also increase XYZ's AAA balance. B will recognize interest expense of $200. In addition, because the corporation had an insufficient AAA after the year's earnings to support the deemed distribution of the foregone interest, B must recognize dividend income of $200.

In the case of a term loan, the chances of a deemed distribution sourced from E&P are increased. For term loans, the amount deemed distributed is the difference between the loan amount and the discounted payment stream. The distribution is deemed to occur on the date the loan was made; however, the amount treated as interest income is imputed on an annual basis over the term of the loan. As a result, for term loans, the deemed distribution is not offset by an equal amount of interest income in the year of the loan increasing the chances of a taxable dividend or a capital gain to the borrowing shareholder under §1368(b) and §1368(c).

> *Example:* On January 1, Year 1, XYZ, an S corporation, is wholly owned by B. At the beginning of the year, XYZ has a balance in the AAA of $0, and $1,000 in E&P from its prior C corporation existence. During the year, B took out a $1,000 term loan from XYZ that did not provide for interest. Under §7872, the present value of the payments on the loan was $800 (assumed). As a result, the foregone interest, and thus the deemed distribution, is $200. However, under the OID rules, the foregone interest is to be amortized over the loan's life, equaling $50 for that year (assumed). For that year, assume that the corporation recognized income of $300, not including the interest income under §7872, all of which was distributed during the year.
>
> Under these facts, B recognizes $350 of passthrough income from XYZ, which also increases XYZ's AAA balance. B recognizes interest expense of $50. B also recognizes a $150 dividend, because XYZ's AAA will not support the deemed distribution ($0 beginning AAA + $300 in income – $300 in distributions + $50 in imputed income leaves $50 of the $200 deemed distribution to be sourced from AAA, with the remainder sourced from E&P).

Comment: In general, the interest income that is deemed to flow through to the shareholder is investment income for purposes of the §163(d) investment interest limitation. Problems can arise, however, with matching deemed interest income and deductions if the S corporation uses a fiscal year or the shareholder is subject to the alternative minimum tax.

Although the deemed distribution is specific to the borrowing shareholder, and therefore disproportionate in the case of an S corporation with multiple shareholders, Reg. §1.1361-1(l)(2)(vi) *Ex.* 5 states that the deemed distribution will not create a second class of stock if the facts and circumstances do not reflect that a principal purpose of the below-market loan is to circumvent the single class of stock requirement of §1361(b)(1)(D).

b. Compensation-Related Loans

In the case of a compensation-related loan, the corporation is deemed to have made a compensation payment in the amount of the understated interest.[1013] This creates a compensation deduction at the corporate level, which reduces stock basis and the AAA. The shareholder has compensation income and is treated as making a deemed interest payment to the corporation. The corporation's deemed interest income flows through to all shareholders, increasing or restoring stock basis and the corporation's AAA. At the shareholder level, the shareholder has compensation income and passthrough interest income, along with offsetting passthrough compensation expense as well as an interest expense deduction. As in the case of corporation-shareholder loans, there may be problems with matching the deemed income with the deemed deduction unless there are loans to all shareholders proportionate to their ownership interests.

[1012] *See* Reg. §1.7872-5T(c)(3).

[1013] *See* Reg. §1.7872-4(c).

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2. Shareholder Loans to S Corporations

If a shareholder makes a below-market loan to an S corporation, the underpayment of interest is first treated as a contribution to capital by the shareholder, which increases the shareholder's basis.[1014] The corporation is then treated as making a deemed interest payment to the shareholder which reduces the AAA.[1015] The shareholder has interest income and an offsetting interest deduction based on the shareholder's allocable portion of ownership passed through from the corporation which decreases the shareholder's basis. As a result, the effect is similar to that discussed above, with the exception that the income and expense flow is reversed. The problems of the deemed distribution are avoided (i.e., a taxable dividend) reducing the potential adverse effects of the transaction. Finally, as in the case of loans from an S corporation to its sole shareholder, loans to an S corporation from its sole shareholder may fall within the no-significant-tax-effect rule of §7872(c)(1)(E) and thus avoid the §7872 deemed interest treatment.

3. Administrative Matters

If §7872 operates to create deemed interest, the S corporation and its shareholders must meet certain administrative requirements. For example, Prop. Reg. §1.7872-11(g) requires that the lender and borrower attach statements to their personal tax returns containing information relating to the transaction. In addition, any deemed dividends should be reported on Form 1099-DIV and on Schedule K (Form 1120-S). To the extent the deemed distribution is from the AAA, it should be reported on Form 1120-S and each shareholder's Schedule K-1. For compensation-related loans, each shareholder's Form W-2 should report the foregone interest. However, no withholding is required for deemed interest amounts under §7872.[1016]

Under Prop. Reg. §1.7872-2(a)(3), each extension of credit or transfer of money by a lender to a borrower is treated as a separate loan. Taxpayers in *Cutts v. Commissioner*,[1017] however, were able to net loans from their S corporation against loans to their S corporation for purposes of determining the amount of deemed distribution.

C. Oil and Gas Considerations

1. Depletion Allowance

Under the former subchapter S rules, one of the major drawbacks to conducting oil and gas operations as a subchapter S corporation was that depletion was calculated using the cost method for computing corporate earnings and profits, while the percentage method was generally used for tax purposes. As a result, current earnings and profits frequently exceeded taxable income, making distributions to the shareholders taxable as dividends.

However, S corporations are now treated in the same manner as partnerships for purposes of oil and gas depletion. Under §613A(c)(11), the allowance for depletion with respect to oil or gas property is computed by each shareholder, rather than by the corporation.[1018] Therefore, depletion under either the cost or percentage method is computed separately by each shareholder, based upon the allocation of the S corporation's adjusted basis in oil or gas property to the shareholder.[1019] As a result, each shareholder must do the following:

- separately keep records of their share of the adjusted basis in each of the S corporation's oil and gas properties;
- adjust their share of the basis for any depletion taken on the property; and
- use such adjusted basis in computing their cost depletion or gain or loss on the disposition of the property by the S corporation.[1020]

If there is a distribution of any oil and gas property by the S corporation to its shareholders, the corporation's adjusted basis is "an amount equal to the sum of the shareholders' adjusted bases in" the property.[1021]

This allocation provision introduced the concept of inside basis and outside basis to S corporations, since each shareholder is required to keep records of their pro rata share of the S corporation's adjusted basis in each oil or gas property. This adjusted outside basis is used each year to compute and track the depletion allowance or the gain or loss on the disposition of the property by the corporation, and it is comparable to that imposed on partners with respect to their respective shares in partnership oil and gas properties.[1022]

In addition, because depletion is an outside item, a shareholder's deductibility of such amounts is apparently not conditioned on the shareholder having basis in the S corporation. Therefore, depletion deductions could apparently be taken, even though S corporation losses that pass through are suspended under §1366(d)(2) as a result of insufficient basis. This does not mean that basis is unaffected by these deductions, however. To create parity between the corporation's basis in the oil and gas property and the shareholder's stock bases, §1367(a)(2)(E) requires that the shareholder reduce its basis in the S corporation's stock or debt by the amount of the shareholder's depletion deduction attributable to S corporation oil and gas property to the extent the depletion does not exceed the proportionate share of the adjusted basis of the property attributable to that shareholder.

Comment: Where shareholders join the S corporation after the S corporation has acquired oil and gas property, it appears that such new shareholders may not be entitled to any cost depletion with respect to such properties. This occurs because §613A(c)(11)(B) permits the basis of property subject to deple-

[1014] Reg. §1.7872-4(d)(1).

[1015] §7872(a)(1).

[1016] §7872(f)(9). *See* Announcement 2003-55, for updated requirements for printing Form 1099-DIV in compliance with the 2003 Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27.

[1017] T.C. Summ. Op. 2004-8 (Jan. 29, 2004).

[1018] Section 1363(b)(2) provides that §703(a)(2) deductions are not allowed to S corporations. Section 703(a)(2)(F) addresses the deduction for depletion under §611 with respect to oil and gas wells.

[1019] This rule is generally effective for taxable years beginning after December 31, 1982. For former subchapter S corporations holding oil or gas property on December 31, 1982, their adjusted basis in such property was to be allocated ratably to the shareholders of the corporation on January 1, 1983. Any property acquired by the corporation on or after January 1, 1983 is to be allocated as of the date of acquisition.

[1020] §613A(c)(11)(B).

[1021] §613A(c)(11)(B).

[1022] §613A(c)(7)(D).

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tion to be allocated only to those shareholders as of the date of the property's acquisition.[1023]

Under §1367(a)(1)(C), a shareholder's basis in S corporation stock is to be increased to the extent of "the excess of the deduction for depletion over the basis of the property subject to depletion."[1024] While this rule might seem to apply to oil and gas properties, it appears to be limited to non-oil and gas depletion situations. This conclusion may be drawn from the language in §1367(a)(2)(E), which deals with the shareholder-level deduction for oil and gas depletion. On the other hand, §1367(a)(1) appears to apply to deductions taken at the corporate level. From a practical perspective, this would allow the shareholder a deduction for depletion while at the same time receiving a basis increase. Therefore, it seems inappropriate to consider §1367(a)(1)(C) as applicable to oil and gas situations.[1025]

2. Intangible Drilling Costs

Under §263(c), S corporations that own the operating rights to oil and gas properties may elect to deduct intangible drilling costs on such properties, provided the properties are located in the United States.[1026] If the intangible drilling costs are not deducted currently, they may be capitalized and recovered as depletion by adding the costs to the cost basis for depletion.[1027] Dry hole intangible drilling costs may be deducted currently to the extent the capitalized costs have yet to be deducted.[1028] If the properties are not located in the United States, the intangible drilling costs may either be added to the basis for depletion or amortized over a 10-year straight-line period.[1029]

3. Transfers of Proven Oil and Gas Properties — Pre-1990

For transfers before October 12, 1990, S corporations were treated like partnerships for purposes of the so-called anti-transfer rules applicable to oil and gas properties eligible for percentage depletion.[1030] As a result, the transfer of proven property by an individual to an S corporation before this date limited the percentage depletion allowance to the transferring individual's percentage interest in the S corporation.[1031]

a. Conversions from C Corporations to S Corporations

Under pre-1990 RRA §613A(c)(13)(C)(ii), when a C corporation elected S corporation status, the election was treated as a disqualifying transfer and the use of percentage depletion was denied. The disqualification is effective as of the date of the election. However, this rule was repealed in the 1990 RRA and applies only to conversions from C to S status before October 12, 1990.

b. Conversions from S Corporations to C Corporations

Under pre-1990 RRA §613A(c)(13)(D), if a corporation terminated S status, each shareholder was deemed to have transferred its share of the S corporation's assets to the C corporation. As a result, the C corporation was unable to utilize percentage depletion and would take as its basis in the properties the carryover basis from the shareholders. This rule was also repealed by the 1990 RRA, effective for transfers after October 11, 1990.

4. Passive Loss Limitations

Under §469(c)(3), a working interest in oil and gas property is not a passive activity, provided that the taxpayer holds the interest directly or through an entity that does not limit liability. An oil and gas interest owned by an S corporation that has a legal form that limits the liability of its owners can be a passive activity with respect to its shareholders. Whether a legal entity limits liability is a question of state law; however, entities such as corporations, limited liability companies, and limited partnerships generally limit the liability of their owners, while an entity like a general partnership may not limit liability.

5. Recapture Potential

Under §1254(a)(1), intangible drilling costs and depletion deductions that reduce the property's basis may both be subject to recapture as ordinary income upon the disposition of oil and gas property. Under §1254(b)(2), this recapture may also apply if an S corporation shareholder sells its stock in the S corporation, recharacterizing capital gain into ordinary income.

Regulations provide rules for applying §1254 to S corporations and their shareholders upon the disposition by an S corporation (or a former S corporation) of natural resource recapture property[1032] and upon the disposition by a shareholder of stock of an S corporation that holds natural resource recapture property.[1033]

For detailed discussions of §1254 recapture, see 501 T.M., *Gross Income: Overview and Conceptual Aspects*; 605 T.M., *Oil and Gas Transactions*; and 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation.*

a. Disposition of Natural Resource Recapture Property

The regulations adopt an aggregate approach by providing that, upon a disposition of natural resource recapture property by an S corporation, the amount of gain treated as ordinary income under §1254 is determined at the shareholder level.[1034]

Each shareholder must recognize, as ordinary income, the lesser of:

- the shareholder's §1254 costs with respect to the property disposed of; or
- the shareholder's share of the amount, if any, by which the amount realized on the sale, exchange, or involuntary

[1023] See §1367(a)(2)(E), which refers to §613A(c)(11)(B).

[1024] This rule is similar to the treatment for partners in a partnership under §705(a)(1)(C).

[1025] For additional discussion on this problem and the general issue of depletion in an S corporation, *see* Lemons, Blau & Rohman, *Depletion Problems for S Corporations and Partnerships*, 69 J. Tax'n 176 (Mar. 1988).

[1026] §263(i). See §7701 for definition of United States.

[1027] Reg. §1.612-4(b)(1).

[1028] Reg. §1.612-4(b)(4).

[1029] §263(i)(2).

[1030] Pre-1990 RRA §613A(c)(13)(C)(i). The anti-transfer rules were repealed by 1990 RRA, §11521(a).

[1031] *See* Reg. §1.613A-3(i)(2). *See also* PLR 8350088, PLR 8510054, PLR 8937033, and PLR 9014024 (partnership rules applied to transfers to S corporations).

[1032] *See* Reg. §1.1254-1(b)(2) for definition.

[1033] Reg. §1.1254-4(a).

[1034] Reg. §1.1254-4(b)(1).

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conversion, or the fair market value of the property upon any other disposition (including a distribution), exceeds the adjusted basis of the property.[1035]

The following example illustrates this rule in the case of a disposition of oil and gas property, the adjusted basis of which is allocated to the shareholders under §613A(c)(11):

Example: C and D are equal shareholders in Y, an S corporation. On January 1 of Year 1, Y acquires for $150,000 undeveloped oil and gas property, its sole property. During Year 1, Y expends in developing the property $40,000 in intangible drilling costs which it elects to expense under §263(c). On January 15 of Year 2, Y sells the property for $200,000. C and D's share of the $200,000 amount realized on the sale is $100,000 each. C and D each have a basis of $75,000 in the property and $20,000 of §1254 costs with respect to the property. Under these circumstances, C and D each are required to recognize $20,000 of the $25,000 gain on the sale of the property as ordinary income under §1254.[1036]

Computation at the shareholder level is consistent with the treatment of oil and gas properties under §613A(c)(11) (disposition gain and depletion are computed at the shareholder level) and with the fact that the determination of §1254 costs can be affected by shareholder elections and characteristics.[1037]

b. Sale or Exchange of S Corporation Stock

(1) In General

Rules relating to the recognition of ordinary income under §1254 upon a sale or exchange of S corporation stock are also contained in the regulations. Pursuant to §1254(b)(2),[1038] the regulations provide that, as a general rule, a shareholder must treat any gain recognized on a sale or exchange of S corporation stock as ordinary income to the extent of the shareholder's §1254 costs with respect to the shares sold or exchanged.[1039]

(2) Exceptions

The regulations provide two exceptions to the general rule. First, the general rule does not apply to the extent that the shareholder establishes that the gain is not attributable to the §1254 costs. The portion of the gain recognized that is not attributable to §1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under §1254 (with respect to the shares sold or exchanged) if, immediately before the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would have resulted in the recognition by the shareholder of ordinary income under §1254.[1040] To qualify for this exception, the shareholder must attach to their tax return a statement detailing their share of the fair market value and basis and their §1254 costs for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.[1041]

The second exception to the general rule applies to cases in which there is a contribution of property to the S corporation before a sale or exchange of stock pursuant to a plan, a principal purpose of which is to avoid the recognition of ordinary income under §1254.[1042] In such cases, the selling or exchanging shareholder must recognize as ordinary income the amount of ordinary income the shareholder would have recognized under §1254 (with respect to the shares sold or exchanged) had the S corporation sold all of its natural resource recapture property the disposition of which would have resulted in ordinary income under §1254.[1043]

c. Section 1254 Costs

(1) In General

Rules for determining an S corporation shareholder's §1254 costs are also provided by the regulations. In general, a shareholder's §1254 costs with respect to any natural resource recapture property held by an S corporation include all of the shareholder's §1254 costs with respect to the property while in the hands of the corporation.[1044]

(2) Acquiring Shareholder After Certain Acquisitions

In the case of a person who acquires stock from a shareholder, the regulations provide that the acquiring shareholder's §1254 costs are zero on the acquisition date if the acquiring shareholder's basis for the stock acquired is determined solely by reference to its cost (within the meaning of §1012)[1045] or solely by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in §2032 (relating to alternate valuation date).[1046] The regulations further provide, however, that an acquiring shareholder's §1254 costs include any §1254 costs paid or incurred before the decedent's death, to the extent that the basis of the stock is reduced under §1014(b)(9) (relating to adjustments to basis if the property is acquired from a decedent before death).[1047]

If stock is acquired in a transfer that is a gift, in a transfer that is part sale or exchange and part gift, in a transfer described in §1041 (marital and divorce transfers), or in a transfer at death where the basis of property in the hands of the transferee is determined under §1022, the acquiring shareholder generally acquires the §1254 costs of the transferor but reduces the §1254

[1035] Reg. §1.1254-4(b)(1).

[1036] Reg. §1.1254-4(b)(2) *Ex.* 2.

[1037] *See, e.g.*, §59(e)(4)(C), §1363(c)(2)(A). *See also* PS-7-89, 60 Fed. Reg. 66,238 (Dec. 21, 1995).

[1038] Section 1254(b)(2) provides that rules similar to the rules of §751 are to be applied to that portion of the excess of the amount realized over the adjusted basis of the stock that is attributable to §1254 costs.

[1039] Reg. §1.1254-4(c)(1).

[1040] Reg. §1.1254-4(c)(2)(i)(A). This exception is illustrated by Reg. §1.1254-4(c)(3) *Ex.* 2.

[1041] Reg. §1.1254-4(c)(2)(i)(B).

[1042] Reg. §1.1254-4(c)(2)(ii).

[1043] Reg. §1.1254-4(c)(2)(ii). The amount recognized as ordinary income reduces the amount realized on the sale or exchange of the stock and this reduced amount realized is used in determining any gain or loss on the sale or exchange. Reg. §1.1254-4(c)(2)(ii). This exception is illustrated by Reg. §1.1254-4(c)(3) *Ex.* 3.

[1044] Reg. §1.1254-4(d).

[1045] Reg. §1.1254-4(e)(1).

[1046] Reg. §1.1254-4(e)(2).

[1047] Reg. §1.1254-4(e)(3).

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costs by the amount of any gain treated as ordinary income under §1254 by the transferor on the transfer.[1048]

(3) Former C Corporation

In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, the regulations provide that each shareholder's §1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a pro rata share of the §1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.[1049]

(4) Former S Corporation

If an S corporation becomes a C corporation, the C corporation's §1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' §1254 costs with respect to the property as of the close of the last taxable year for which the corporation was an S corporation. In an S termination year, as defined in §1362(e)(4), the shareholders' §1254 costs are determined as of the close of the S short year as defined in §1362(e)(1)(A).[1050]

(5) Certain Stock Transactions Require §1254 Cost Reallocation

Section 1254 costs must be reallocated to reflect the effects of certain stock transactions that change the allocation to the shareholders of gain or amount realized from the natural resource recapture property if the S corporation disposes of it after these transactions. Transactions requiring reallocation of the §1254 costs are transactions involving the issuance of stock by an S corporation in a reorganization or otherwise[1051] (excluding transactions in which stock is issued in exchange for stock of the same S corporation, e.g., in a §368(a)(1)(E) reorganization or a §1036 exchange)[1052] and transfers of natural resource recapture property to the S corporation in exchange for stock of the S corporation (e.g., in a §351 transaction or in a reorganization under §368).[1053]

S corporations must determine the aggregate of their shareholders' §1254 costs in applying the rules for former S corporations and for allocating §1254 costs upon certain transfers. An S corporation may determine a shareholder's §1254 costs by using written data provided by the shareholder or by applying certain assumptions outlined in the regulations.[1054]

6. Alternative Minimum Tax Consequences for Individual Shareholders

The corporate alternative minimum tax (CAMT), applicable to tax years beginning after 2022, does not apply to S corporations.[1055] However, because the S corporation's shareholders are likely to be individuals, the S corporation must provide its shareholders with the necessary information so that they can comply with the individual §55 AMT at the shareholder level.

Under §57(a)(1), a preference item results to the extent depletion deductions exceed the adjusted basis of the oil and gas property at the end of the year (determined without regard to the depletion deduction for the taxable year). In addition, §57(a)(2) provides that a tax preference item results to the extent that the amount of the excess intangible drilling costs in a taxable year are greater than 65% of a taxpayer's net income from all properties for the year. Under §57(a)(2)(C), the net income of a taxpayer from oil and gas properties is the excess of the aggregate gross income the taxpayer received from all such properties over the amount of any deductions allocable to such properties reduced by excess intangible drilling costs. Excess intangible drilling costs are the excess of the intangible drilling costs incurred over the amount that would have been allowable had the taxpayer elected to amortize the intangible drilling costs.[1056] Therefore, if the shareholders elect to deduct intangible drilling costs currently, a tax preference generally results. However, if they elect to capitalize and amortize intangible drilling costs over 10 years under §59(e)(1), there is no tax preference item.[1057]

D. Accounting Method Changes

1. Adoption and Changes

In general, a taxpayer does not need to secure prior permission from the IRS to change a method of accounting until a method of accounting has been adopted. A taxpayer adopts a method of accounting when the first tax return is filed or when an item is reported for the first time.[1058] Once a method of accounting has been adopted, the taxpayer must secure permission from the IRS to change that method of accounting. However, certain changes in business form may allow taxpayers to adopt new methods of accounting. Although neither an election by a C corporation to be treated as an S corporation[1059] nor the termination of an S election allows the taxpayer to adopt new methods of accounting, a new corporation formed as a result of the termination of a qualified subchapter S subsidiary (QSub) election is permitted to adopt new accounting methods.[1060]

As noted above, a taxpayer wishing to change its method of accounting must secure permission from the IRS. Some requests to change a method of accounting must receive prior consent,[1061] while others are automatic.[1062]

Other special rules apply to corporations making an election to be treated as an S corporation when the corporation also elects to discontinue the use of a LIFO method. Rev. Proc.

[1048] Reg. §1.1254-4(e)(4). *See* T.D. 9811, 82 Fed. Reg. 6235 (Jan. 1, 2017).
[1049] Reg. §1.1254-4(f).
[1050] Reg. §1.1254-4(f)(3).
[1051] Reg. §1.1254-4(g)(1).
[1052] Reg. §1.1254-4(g)(4).
[1053] Reg. §1.1254-4(g)(2).
[1054] Reg. §1.1254-4(g)(5).
[1055] §1363(a), §1363(b); *see also* §55(b)(2), §59(k)(1)(A) (excluding S corporations from CAMT's scope), added and amended by the Inflation Reduction Act of 2022, Pub. L. No. 117-169, §10101. For a detailed discussion of the post-2022 CAMT, see 752 T.M., *Corporate Alternative Minimum Tax*, at IX.
[1056] §57(a)(2)(B).
[1057] §59(e)(6). Under §59(e)(5)(A), any amounts treated as a deduction during the amortization period are treated as current deductions.
[1058] Reg. §1.446-1(e)(1).
[1059] *See Leonhart v. Commissioner*, 414 F.2d 749 (4th Cir. 1969), *aff'g per curiam*, 27 T.C. Memo 1968-98.
[1060] *See* §1361(b)(3).
[1061] The fundamental prior consent revenue procedure is Rev. Proc. 2015-13.
[1062] The automatic consent revenue procedure is Rev. Proc. 2025-23.

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2015-13, §7.03(4)(b) provides that if a taxpayer elects to be treated as an S corporation in the same year as a request to change from the LIFO method is filed, the taxpayer must include the LIFO recapture amount in gross income in the last taxable year as a C corporation and include a corresponding adjustment to the basis of the taxpayer's inventory as of the end of the taxable year preceding the year of change.[1063] Any increase in tax as a result of the inclusion of the LIFO recapture amount is payable in four equal installments, beginning with the taxpayer's last taxable year as a C corporation.[1064] Any corresponding basis adjustment is taken into account in computing the §481(a) adjustment that results upon the discontinuance of the LIFO method by the corporation.

Rev. Proc. 2015-13, §7.03(4)(c) further provides that if a C corporation elects to be treated as an S corporation for a taxable year after the taxable year in which it discontinued use of the LIFO inventory method, the remaining balance of any positive §481(a) adjustment must be included in its gross income in its last taxable year as a C corporation. If this inclusion results in an increase in tax for the last taxable year as a C corporation, this increase in tax is generally payable in four equal installments, beginning with the taxpayer's last taxable year as a C corporation.[1065]

2. *Section 481 Adjustments*

When a taxpayer changes its method of accounting (either voluntarily or involuntarily), §481(a) requires adjustments to prevent duplication or omission of amounts in the taxable year of the change. In general, positive §481(a) adjustments (i.e., adjustments unfavorable to the taxpayer because they increase income) resulting from a voluntary request to change a method of accounting must be taken into account over four taxable years. The §481(a) adjustment period is one year for negative adjustments (i.e., adjustments in the taxpayer's favor because it reduces income).[1066] Once a taxpayer requests permission to change its method of accounting, the taxpayer generally has audit protection for the item being changed. Audit protection assures the taxpayer that the IRS will not require the taxpayer to change its method of accounting for the same item for a taxable year before the year of change.

If a taxpayer does not change an erroneous method of accounting voluntarily, the IRS has the ability to change the taxpayer's method of accounting during the course of an examination (i.e., an involuntary change). When an involuntary change in method of accounting occurs, the IRS generally requires the taxpayer to take the entire §481(a) adjustment into account in the earliest open year under exam.[1067]

Comment: The voluntary change is advantageous because it generally precludes an IRS change to an earlier year.[1068]

Comment: If a C corporation is able to take into account §481(a) adjustments for voluntary changes in accounting method (other than the discontinuation of the LIFO method, discussed above) over a period of time — e.g., four-year adjustment periods — the S election does not affect the acceleration of any income subject to the adjustment period. The S corporation election is merely a change in the entity's tax status.[1069] On the other hand, if an S corporation terminates its status midyear, the short S and short C years created by §1362(e) effectively accelerate two years of a §481(a) adjustment period into the S termination year.[1070]

To avoid the negative tax effect that results from accelerating §481(a) adjustments into income in a single year, the Code limits tax liability when an involuntary change is made and the adjustment under §481(a) results in an increase in taxable income greater than $3,000.[1071]

Comment: These provisions affect only the computation of tax, not the year of inclusion of the §481(a) adjustment. Unless there is a specific agreement with the IRS to provide for a spread of the adjustment and the applicable tax, the entire tax attributable to the §481(a) adjustment from the involuntary change is paid in the year of change.

Comment: In the case of an S corporation, the limitations on tax provided by §481(b) are computed at the shareholder level.[1072]

In limited situations, eligible terminated S corporations that converted to C corporation status would take into account any §481(a) adjustments due to the conversion (e.g., cash to accrual) over a six-year period rather than the standard four-year spread.[1073] This provision applied to S corporations that revoked their status during the two-year period beginning on December 22, 2017, and had the same owners on both the enactment date and the revocation date.[1074]

3. *Cash vs. Accrual Method of Accounting*

Under §448, C corporations, partnerships with C corporation partners, and tax shelters must use the accrual method of accounting. One of the exceptions to the general rule allows corporations and partnerships with three-taxable-year average annual gross receipts of a base statutory amount of $25,000,000 or less (for inflation-adjusted amounts, see footnote) to use the cash method.[1075] Because §448 is primarily directed to C cor-

[1063] *See also* §1363(d).

[1064] §1363(d)(2).

[1065] §1363(d)(2).

[1066] Rev. Proc. 2015-13, §7.03.

[1067] Rev. Proc. 2015-13, §2.09. *See Starer v. Commissioner*, T.C. Memo 2022-124 (IRS correctly recharacterized transfers of real property as sales rather than loans, constituting change in method of accounting resulting in §481 adjustment to recognize income received).

[1068] Rev. Proc. 2015-13, §8.01.

[1069] Rev. Proc. 2015-13, §§7.03(4)(a) (acceleration of §481(a) adjustment period if taxpayer ceases to engage in trade or business), §3.04(3) (conversion to or from S corporation status not considered a cessation of trade or business that accelerates §481(a) adjustment period); PLR 9226011 (S corporation election does not trigger inclusion of anything in its §447 suspense account); PLR 9117055 (§447(i) suspense account under the farm price method not affected by S corporation election). Section 447(i) was repealed, effective for tax years beginning after December 31, 2017, except with respect to any suspense account established before December 22, 2017. Pub. L. No. 115-97, §13102(a)(5)(C)(i).

[1070] *See* Rev. Proc. 2015-13, §7.03(2); Rev. Rul. 78-165 (short taxable year resulting from acquisition of consolidated group member treated as separate taxable year).

[1071] §481(b).

[1072] Reg. §1.481-2(c)(5)(ii).

[1073] §481(d)(1). For a detailed discussion, see 730 T.M., *S Corporations: Formation and Termination.*

[1074] §481(d)(2).

[1075] §448(b)(3). *See* §448(c). The average gross receipts test is indexed for inflation for tax years beginning after 2018. For inflation-adjusted amounts,

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porations, an S corporation may generally continue to use the cash method of accounting for its service operations even if its receipts exceed the threshold.

However, an S corporation classified as a tax shelter must use the accrual method of accounting.

Under §448(d)(3), a tax shelter is defined by reference to §461(i)(3) and, thus, includes:

- any enterprise (other than a C corporation) if at any time interests in the enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale;
- any syndicate (within the meaning of §1256(e)(3)(B));
- any tax shelter (within the meaning of §6662(d)(2)(C)(ii)); and
- any farming syndicate (within the meaning of §461(k)).

An S corporation is not treated as a tax shelter under the public offering definition merely because it is required to file a notice of exemption from registration with a state agency that has the authority to regulate the offering of securities for sale.[1076]

Under §1256(e)(3)(B), a syndicate is defined as any partnership or other entity (other than a corporation that is not an S corporation), if more than 35% of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs.[1077] Limited entrepreneurs are persons who have an interest in an enterprise other than as a limited partner and do not actively participate in the management of the enterprise.[1078] Thus, an S corporation could fall unexpectedly into the definition of a syndicate under the regulations if 35% of actual losses are allocated to shareholders that are limited entrepreneurs.[1079]

Effective for taxable years beginning after December 31, 2017, any change in method of accounting made *pursuant* to §448 is treated as a voluntary change made by the taxpayer with the consent of the IRS.[1080] For tax years beginning before 2018, any change in method of accounting *required* by §448 was treated as voluntary with the consent of the IRS.[1081] Thus, prior to 2018, an accrual method C corporation that elected S corporation status had to continue to use the accrual method unless it received IRS prior approval to change to the cash method.

> *Example:* XYZ is a C corporation that started business in 2012 and, under pre-2018 §448, was required to use the accrual method of accounting. In 2015, XYZ elected S status. Section 448 does not require S corporations to use the accrual method; thus, for tax years prior to 2018, XYZ was required to seek IRS approval prior to changing to the cash method. Post-2018, if XYZ meets the gross receipts test of §448(c), it may elect to change to the cash method of accounting without pre-approval from the IRS.

Accrual method taxpayers eligible to change to the cash method under §448 may do so, pursuant to the automatic change procedures of Rev. Proc. 2025-23.

An S corporation with average annual gross receipts for the prior three-year period in excess of a base statutory amount of $25,000,000 (for inflation-adjusted amounts, see footnote) that revokes or loses its S corporation status is required to change to the accrual method of accounting, given that a C corporation is required to use the accrual method under §448(a).[1082]

E. Accounting Periods

1. Automatic Change Procedures

Rev. Proc. 2006-46[1083] outlines the procedures under which certain flowthrough entities (including an S corporation or an electing S corporation)[1084] within the scope of the revenue procedure may automatically adopt, change, or retain an annual accounting period under §441 and §442.[1085] Taxpayers within the scope of Rev. Proc. 2006-46 are deemed to have established a business purpose and obtained the consent of the Commissioner to make the change in accounting period.[1086]

Rev. Proc. 2006-46 provides automatic consent for an S corporation or an electing S corporation to change to its required taxable year, or to a 52–53-week taxable year ending with reference to such taxable year.[1087] In addition, an S corporation or electing S corporation that wants to change to or retain a natural business year that satisfies the 25% gross receipts test may do so automatically under Rev. Proc. 2006-46.[1088] However, an S corporation or electing S corporation is precluded

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see Tables, Charts & Lists, Gross Receipts Test Limit by Year under §448(c). For tax years beginning before January 1, 2018, corporations and partnerships with C corporation partners were permitted to use the cash method if three-taxable-year average annual gross receipts were $5,000,000 or less. *See* pre-2018 §448(b)(3).

[1076] §448(d)(3).

[1077] Regulations under §448 define the term syndicate based on the definition in §1256(e)(3)(B) but using the term allocated instead of allocable. Reg. §1.448-1T(b)(3). Reg. §1.1256(e)-2(a), T.D. 9943, 86 Fed. Reg. 5496 (Jan. 19, 2021). In addition, losses are determined without regard to §163(j). Reg. §1.1256(e)-2(b).

[1078] §461(k)(4).

[1079] Under §1256(e)(3)(C)(ii), an interest in an entity is not treated as held by a limited partner or a limited entrepreneur for any period during which the interest is held by the spouse, children, grandchildren, or parents of an individual who actively participates in the management of the activity.

[1080] *See* §448(d)(7).

[1081] *See* pre-2018 §448(d)(7).

[1082] *See* §448(c) (indexed for inflation for tax years beginning after 2018). For inflation-adjusted amounts, see Tables, Charts & Lists, Gross Receipts Test Limit by Year under §448(c).

[1083] PLR 202016014 (granting relief for an untimely Form 1128, Application to Adopt, Retain or Change a Tax Year, filed under Rev. Proc. 2006-46); *but see* PLR 202314015 (ruling that taxpayer that filed an untimely Form 1128, Application to Adopt, Retain or Change a Tax Year, was ineligible for an automatic change under Rev. Proc. 2006-46 but could file for relief under Rev. Proc. 2002-39, which requires prior approval of the IRS). Rev. Proc. 2002-38, §5.05 was effective for earlier periods.

[1084] An electing S corporation is defined in Rev. Proc. 2006-46, §5.03, as a corporation attempting to make an S election for the short period beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year.

[1085] For a discussion regarding selection of a permissible taxable year that can be used by an S corporation, see 730 T.M., *S Corporations: Formation and Termination*.

[1086] Rev. Proc. 2006-46, §1.

[1087] Rev. Proc. 2006-46, §4.01(1).

[1088] Rev. Proc. 2006-46, §4.01(2).

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from using Rev. Proc. 2006-46 to change to, or retain, a natural business year if the S corporation or electing S corporation has changed its annual accounting period at any time within the most recent 48-month period ending with the last month of the requested taxable year.[1089]

Rev. Proc. 2006-46 also provides automatic consent for an S corporation or electing S corporation that wants to adopt, change to, or retain its ownership taxable year[1090] or a 52–53-week taxable year ending with reference to such taxable year.[1091] Finally, an S corporation or electing S corporation that wants to change from a 52–53-week taxable year that references a particular calendar month to a non-52–53-week taxable year that references the last day of the same calendar month, and vice versa, may do so automatically.[1092]

Comment: Rev. Proc. 2006-45, §4.02(6), allows an existing C corporation to automatically change to a permitted S corporation year, and then to make an S corporation election following the short C year. *See* 730 T.M., *S Corporations: Formation and Termination.*

2. Nonautomatic Change Procedures

Taxpayers that are unable to use the automatic consent procedures provided under Rev. Proc. 2006-46 or that are requesting to change to a taxable year other than a taxable year provided in Rev. Proc. 2006-46 must request permission to change the taxable year in accordance with Rev. Proc. 2002-39,[1093] which sets forth the procedures under which a taxpayer must establish a business purpose and request the prior approval of the Commissioner to adopt, change, or retain an annual accounting period.

Rev. Proc. 2002-39 provides that a taxpayer will generally be granted consent to change its annual accounting period to the extent that the taxpayer establishes a business purpose for the change and agrees to the Commissioner's prescribed terms, conditions, and adjustments under which the adoption, change, or retention will be effected.[1094] A taxpayer requesting to change to its natural business year is treated as having established a business purpose.[1095] A taxpayer may also establish a business purpose based on all relevant facts and circumstances; however, Rev. Proc. 2002-39 notes that only in rare and unusual circumstances will permission be granted based on the relevant facts and circumstances.[1096]

F. Affordable Care Act and Qualified Small Employer Health Reimbursement Arrangements (QSEHRA)

The Affordable Care Act (ACA) of 2010[1097] requires certain market reforms for group health plans. Notice 2013-54 concluded that employer payment plans will fail to comply with the ACA market reforms. Employer payment plans are group health plans under which an employer reimburses an employee for some or all of the premium expenses incurred for an individual health insurance policy, or directly pays a premium for an individual health insurance policy covering the employee.[1098]

Notice 2015-17 provided transition relief from the assessment of an excise tax under §4980D for failure to satisfy the ACA market reforms. The tax is equal to $100 per day of noncompliance with respect to each individual to whom the failure relates. For example, an employer with 24 employees whose group health plan is noncompliant would incur a $2,400 excise tax for each day until the plan becomes compliant.

Congress decided to change the policy regarding employer payment plans and their co-existence with the ACA. The 21st Century Cures Act (Cures Act),[1099] was enacted on December 13, 2016. Section 18001 of the Cures Act amends ERISA to permit an eligible employer to provide a Qualified Small Employer Health Reimbursement Arrangements (QSEHRA) to its eligible employees.

An employer may sponsor a QSEHRA if the employer had fewer than 50 full-time (and full-time equivalent) employees in the previous year and does not offer any group health plan to any of its employees.[1100] An eligible employer is defined for QSEHRA purposes as an employer that is not an applicable large employer (ALE) under the employer shared responsibility payment rules (ACA employer mandate); thus, employer aggregation rules apply in determining employer eligibility.[1101] If an employer that provides a non-calendar year QSEHRA increases in size and becomes an ALE, it is not an eligible employer as of January 1 of the year it becomes an ALE. The employer may no longer provide the QSEHRA as of the date it becomes an ALE, regardless of whether the QSEHRA has a non-calendar plan year.[1102]

If an employer offers a group health plan to its employees that would provide coverage on any day of the month, the employer may not provide a QSEHRA for that month.[1103] If any employer that is part of group of employers that are treated as a single employer under §414(b), §414(c), §414(m), or §414(o) offers its employees a group health plan, no employer in the

[1089] Rev. Proc. 2006-46, §4.02(5). The following changes will not be considered prior changes in annual accounting period for this purpose: (a) a change to a required taxable year or ownership taxable year; (b) a change from a 52–53-week taxable year to a non-52–53-week taxable year that ends with reference to the same calendar month, and vice versa; or (c) a change in accounting period by an S corporation, electing S corporation, or PSC, in order to comply with the common taxable year requirements of Reg. §1.1502-75(d)(3)(v) and Reg. §1.1502-76(a).

[1090] Rev. Proc. 2006-46, §5.08, defines ownership taxable year for an S corporation or electing S corporation as "the taxable year (if any) that, as of the first day of the first effective year, constitutes the taxable year of one or more shareholders (including any shareholder that concurrently changes to such taxable year) holding more than 50% of the corporation's issued and outstanding shares of stock."

[1091] Rev. Proc. 2006-46, §4.01(3).

[1092] Rev. Proc. 2006-46, §4.01(4).

[1093] Rev. Proc. 2002-39, *modified by* Rev. Proc. 2003-79.

[1094] Rev. Proc. 2002-39, §5.01(1).

[1095] Rev. Proc. 2002-39, §5.02(1)(a).

[1096] Rev. Proc. 2002-39, §5.02(1)(b). For a more detailed discussion of the nonautomatic change procedures, see 574 T.M., *Accounting Periods.*

[1097] Pub. L. No. 111-148.

[1098] This definition includes reimbursement arrangements described in Rev. Rul. 61-146.

[1099] Pub. L. No. 114-255.

[1100] §9831(d)(3)(B).

[1101] §9831(d)(3)(B)(i). *See* §4980H(c)(2). For discussion of applicable large employer (ALE) status, see 332 T.M., *Employer Shared Responsibility.*

[1102] Notice 2017-67, Q&A-7. A QSEHRA may have a run-out period for submitting claims for medical expenses incurred during the months of the prior year during which the QSEHRA was provided.

[1103] §9831(d)(3)(B)(ii); Notice 2017-67, Q&A-4.

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group may provide a QSEHRA.[1104] For purposes of determining an employer's eligibility to provide a QSEHRA, the following are group health plans: a health reimbursement arrangement (HRA); a health flexible spending arrangement (FSA); a plan that provides only excepted benefits described in §9831(c) (such as a vision plan or dental health plan that qualifies as an excepted benefit); or a particular policy, form, or issuer of individual health insurance endorsed by the employer.[1105]

An S corporation does not fail to be an eligible employer because it reimburses the health insurance policy premiums of a 2% shareholder who is an employee.[1106]

For a more detailed discussion, see 330 T.M., *Tax and ERISA Implications of Employer-Provided Medical and Disability Payments.*

[1104] Notice 2017-67, Q&A-5.

[1105] Notice 2017-67.

[1106] Notice 2017-67, Q&A-3. *See* §1372(b) (defining 2% shareholder). However, a more-than-2% shareholder is not considered to be an eligible employee under §1372(b). Notice 2017-67, Q&A9. Also in Notice 2008-1, the IRS stated that S corporation reimbursements of individual health insurance coverage for more-than 2% shareholders under §1372(b) would be includible in shareholder income, but the shareholder-employee would be permitted to deduct the amount of premiums under §162(l) provided that all other eligibility criteria under §162(l) are satisfied. In order for a 2% shareholder to deduct the amount of accident and health insurance premiums: (i) the S corporation must report the accident and health insurance premiums paid or reimbursed as wages on the shareholder-employee's Form W-2 in that same tax year; and (ii) the shareholder-employee must report the premium payments or reimbursements from the S corporation as gross income on their Form 1040. *See also* CCA 201912001.

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