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Termination of S Corporations and of S Shareholder Interests

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TERMINATION OF S CORPORATIONS
AND OF S SHAREHOLDER INTERESTS

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TABLE OF CONTENTS

	<u>Page</u>
I. Introduction	1
II. Fundamental Rules Governing S Corporations	1
A. Eligibility	1
B. Electing "S" Status	2
C. Terminating S Corporation Status	2
1. In General	2
2. Revocation	2
a. Consent	2
b. Timing of Revocation	2
3. Automatic Terminating Events	3
4. Year of Termination -- Two Taxable Years	3
5. Election of "S" Status After Termination.	4
D. Taxation of S Corporations and Their Shareholders.	4
1. In General	4
2. Shareholder Consequences	4
a. Losses and Deductions	5
b. Basis	5
3. Payments to Family Members	5
4. Fringe Benefits	5
5. Deductible Payments to Shareholders.	5
E. Distributions to Shareholders	6
1. Corporations Without Earnings and Profits	6
2. Corporations With Earnings and Profits	6
a. Tax-free Distributions	6
b. Accumulated Adjustments Account ("AAA")	6
c. Dividend Distribution	7
d. Additional Distributions	7
e. Election to Distribute Earnings and Profits	7
3. Recognition of Gain on Appreciated Property	8

	<u>Page</u>
F. Basis Adjustments	8
(1) Increase in Stock Basis	8
(2) Decrease in Stock Basis	8
(3) Basis in Debt.	9
(4) Adjustments to Basis in "Debt"	9
(5) Repayment of Debt.	9
G. Post-termination Distributions.	10
1. General	10
2. Election to Treat as Taxable Dividends	10
H. Post-Termination Period -- Carryover of Losses	10
III. Sale or Transfer of Stock by Shareholder to Third Party.	11
A. Effect on Shareholder	11
1. Computation of Gain or Loss on Sale	11
2. Allocation of Income and Losses During Year of Sale or Other Transfer	11
a. General Pro-Rata Rule	11
b. Election to Close the Taxable Year.	11
c. Examples.	12
3. Effect of Corporation's "AAA".	12
4. Effect of Basis Adjustments	12
5. Recapture of Investment Tax Credit	13
6. Unused Corporate Losses.	13
B. Effect on Corporation	13
IV. Redemption by Corporation of Shareholder's Stock	13
A. Effect on Shareholder	13
1. Computation of Gain or Loss	13
2. Allocation of Income and Computation of Basis	13
3. Timing	14
4. Investment Tax Credit.	14
B. Effect on Corporation	14
1. Cash v. Property	14
2. Effect on "AAA".	14
V. Liquidation of S Corporations.	15
A. Effect on the Shareholders	15
1. Gain or Loss	15
2. Basis	15
B. Effect on Corporation - Gain and Loss on Liquidating Sales and Other Distributions (Repeal of <u>General Utilities</u>)	15
1. Background	15
2. Statutory Principles of Prior (Pre-1987) Law	15
(a) Section 311 - nonliquidating distributions	15

	<u>Page</u>
(b) Section 336 - liquidating distributions	16
(c) Section 337 - liquidating sales	16
3. No Corporate Gain On Liquidation of S Corporation	16
4. Coordination with Subchapter C	16
5. Old §1374	16
a. "Grandfather" of Old §1374.	17
6. Current Law (After 1986)	17
a. General	17
b. New §1374	17
c. Effective Date.	18
d. Transition Rule for "Small" Corporations.	18
e. LIFO Recapture.	19
f. Effective Dates and Transition Rules.	19
VI. Sale of Assets by S Corporation Without Liquidation.	19
A. Effect on Shareholders.	19
1. Gain or Loss	19
2. Basis	19
B. Effect on Corporation	20
1. Corporate Level Taxes.	20
(a) Passive Investment Income	20
(b) Section 1374 Gain	20
2. Termination of "S" Status.	20
VII. Tax-Free Reorganizations	20
A. General	20
B. Mergers (§368(a)(1)(A))	21
1. Merger of S Corporation into C Corporation	21
a. Status of S Corporation	21
b. Effect on "AAA"	21
2. Merger of C Corporation into S Corporation	21
a. Status of S Corporation	21
b. Effect on "AAA"	21
3. Merger of S Corporation into S Corporation	22
a. Status of S Corporation	22
b. Effect on "AAA"	22
C. Corporate Divisions (§368(a)(1)(D) and 355).	22
1. In General	22
2. Availability of "S" Election to "Split-off," "Split-up" or "Spin-off" Corporation	22
3. Effect of Transitory Ownership of Subsidiary (Before "Split-off," "Split-up" or "Spin-off") Corporation.	22

	<u>Page</u>
D. Other Reorganizations (§368(a)(1)(B) and (C)) . . .	23
1. "B" Reorganization	23
2. "C" Reorganization	23
VIII. Buy-sell Arrangements	23
A. General	23
B. Making the Election	23
C. Terminating the Election.	24
D. Allocation of Income.	24

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I. Introduction. The termination of a shareholder's interest in an S corporation can involve any one of several types of transactions, each having its own distinctive tax consequences. A typical transaction resulting in the termination of an "S" shareholder's interest is the direct sale or transfer of stock by the "S" shareholder to a third party. This can involve the transfer by one, several or all of the corporation's shareholders. Other transactions resulting in the termination of a shareholder's interest involve the redemption of the shareholder's interest by the corporation and the complete liquidation of the corporation. Various types of tax-free reorganizations, including divisive reorganizations, can also result in the termination of a shareholder's interest. In addition, certain of these transactions will not only terminate the shareholder's interest but will also result in the termination of the corporation's "S" status.

To adequately evaluate the tax consequences of the different types of transactions which result in the termination of a shareholder's interest in an S corporation and, in some cases, the termination of the "S" election, it is necessary to review certain of the rules governing S corporations and their shareholders which are contained primarily in §§1361-1378 of the Code. It is also necessary to understand the rules governing the tax consequences of operating as an S corporation (to the corporation and to the shareholders) to evaluate the planning options involved in the termination of an "S" shareholder's interest and the "S" status of the corporation.

II. Fundamental Rules Governing S Corporations.

A. Eligibility. For a corporation to be eligible to elect "S" status under §1362, it must be a "small business corporation," defined in §1361(b) as a domestic corporation (excluding certain corporations) which:

(1) is not a member of an "affiliated group" under §1504, i.e., does not own 80% or more of stock in another corporation;

(2) has no more than 35 shareholders (spouses count as one shareholder) who are individuals (other than nonresident aliens), decedent's estates, bankruptcy estates or certain trusts;

(3) has only one class of stock (different voting rights alone do not create a second class).

B. Electing "S" Status. An eligible corporation can elect "S" status under §1362 for its full taxable year if the election is made and consents obtained from all shareholders on or before the 15th day of the third month of such taxable year. If the requirements are not met by this date, the election is effective for the following taxable year. §1362(b)(3). Once a proper election has been made, it remains effective until a terminating event occurs. §1362(c).

C. Terminating S Corporation Status.

1. In General. The termination of "S" status can occur by any one of the following:

(a) revocation under §1362(d)(1),

(b) by the corporation's failure to maintain its qualification as a "small business corporation" (as defined in §1362(b)) under §1362(d)(2), or

(c) by the corporation (if it has subchapter C earnings and profits) earning excessive "passive investment income" (more than 25% of the corporation's gross receipts) for three consecutive years under §1362(d)(3).

2. Revocation.

a. Consent. An "S" election can be terminated by revocation only if the shareholders of the corporation owning more than one-half of the shares of its stock (including non-voting shares) on the date of revocation consent to the revocation. §1362(d)(1)(B) and Reg. §18.1362-3.

b. Timing of Revocation. The revocation can be made prospectively or retroactively. If made before the 15th day of the third month of the corporation's taxable year, a revocation can be effective for the entire taxable year. If made thereafter, the revocation can be effective as of the first day of the following taxable year, or any earlier date which is on or after the date of revocation. §1362(d)(1)(C) and (D). There is

no prohibition against revoking the "S" election in the first year for which the election is made if the revocation is filed prior to the 15th day of the third month of the taxable year. For example, if Widget, Inc. elects "S" status in December of 1988 for its taxable year beginning January 1, 1989, Widget, Inc. can revoke its election effective for all of 1989 if it files its revocation prior to March 15, 1989. The fact that revocations can be made by specifying any prospective termination date during its taxable year can lead to planning opportunities if it can be determined in advance when termination will be most beneficial. §1362(d)(1)(D). The timing of a revocation by a calendar year S corporation is illustrated as follows:

(1) If the revocation is filed on March 14, 1989, it can be effective for the entire year, retroactive to January 1st, or on any date during the year specified in the revocation.

(2) If the revocation is filed on March 16, 1989, it can be effective for the following year beginning January 1, 1990, or on any specified date from March 16 through the end of the year.

3. Automatic Terminating Events. Termination of "S" status will automatically occur under the following circumstances:

(a) If the corporation ceases to meet the eligibility requirements of §1361, its "S" status will terminate on the date of the terminating event, e.g., the date of issuance of a second class of stock or the sale or gift of stock to a non-resident alien or other ineligible shareholder. §1362(d)(2).

(b) If the corporation has "C" earnings and profits and "passive investment income" (gross receipts from royalties, rents, dividends, interest, annuities and the sale or exchange of securities) in excess of 25% of its total gross receipts for three (3) consecutive taxable years, the corporation's "S" status will terminate on the first day of the taxable year following such third year. §1362(d)(3).

4. Year of Termination -- Two Taxable Years. If termination (or revocation) of the corporation's "S" status occurs on a date other than the last day of the corporation's taxable year (the "S termination year"), the corporation's taxable year will be a split taxable year consisting of an "S short year" and a "C short year." §1362(e)(1). Unless an election is made to the contrary, items of income and losses for the entire "S termination year" will be allocated pro-rata between the "S short year" and the "C short year" on a daily basis. The corporation can elect to apply its normal method of accounting ("close its books" at the end of the "S short year")

in allocating its income or losses for the "S termination year" between the two short years if all shareholders who were shareholders at any time during the "S short year" and on the first day of the "C short year" consent to the election. §1362(e)(3). No election is necessary to prevent the pro-rata allocation rule from applying (so that the corporation will "close its books" at the end of the "S" short Year) if there has been a sale or exchange of at least 50% of the stock in such corporation during the "S termination year." §1362(e)(6)(D).

5. Election of "S" Status After Termination. If an "S" election is terminated, the corporation, and any successor corporation, may not again elect "S" status without the Commissioner's consent until the fifth (5th) taxable year following the first taxable year for which the termination is effective. §1362(g). This five-year prohibition period has been held not to apply where the corporation never received the benefit of the "S" election. See Ltr. Rul. 8828050, where a corporation filed a revocation prior to the effective date of the "S" election, and the Service later permitted an "S" election for the next year since the corporation had never operated as an S corporation. Also, if there has been an inadvertent termination of the S election, the Commissioner can, under the conditions set forth in §1362(f), permit the retroactive reinstatement of the election. See Ltr. Ruls. 8830020 and 8830032.

D. Taxation of S Corporations and Their Shareholders.

1. In General. An S corporation is generally not taxed on income at the corporate level (whether or not the corporation makes distributions to shareholders) and items of income, gain, loss, deduction and credit pass directly through to the shareholders. §§1363 and 1366. The corporation will, however, be subject to tax under certain circumstances on "built-in gains" under §1374 and will be taxed on excess "net passive income" if the corporation has earnings and profits carried over from its years as a C corporation (often called the "sting tax") under §1375.

2. Shareholder Consequences. Shareholders of S corporations must take into account their pro-rata share of separately computed items of income, loss, deduction and credits and non-separately computed income or loss. §1366(a)(1). The allocation of each item is generally computed on a per share, per day basis. §1377(a)(1). Corporate distributions do not affect the amount of the passthrough except for the distribution of appreciated property under §1363(d). Under §1363(d), the shareholders are attributed with the S corporation's gain on property distributed to them as a dividend (as if the property had been sold) and the shareholders would have a stepped-up basis in the property.

a. Losses and Deductions. Losses and deductions of the corporation are passed through to a shareholder only to the extent of the shareholder's basis in his stock and in any indebtedness owed by the corporation to such shareholder. §1366(d)(1). It should also be noted that any loss of the corporation for a taxable year which is disallowed to the shareholder because of his insufficient basis in stock and debt can be carried forward indefinitely for the shareholder's (but not his successor's) benefit. §1366(d)(2).

b. Basis. Income items increase the shareholder's basis before the deduction limitation applies thereby creating some planning possibilities. §1367(a)(1). A shareholder can increase his basis by purchasing additional shares of stock, by making contributions to the capital of the corporation or by making loans to the corporation. It should be noted that debts of the corporation to non-shareholders (unlike partnership debt) do not increase the shareholder's basis. Also, guaranties of corporate obligations by shareholders do not increase stock basis. See Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983); Blalock v. United States, _____ F.Supp. _____, 1988-2 U.S.T.C. ¶9495 (N.D. Miss. 1988). §1366(d)(2).

3. Payments to Family Members. To insure that reasonable compensation for services and capital are paid to family members, the Secretary is given the power to adjust items to reflect the value of such services or capital. §1366(e). Therefore, an S corporation must pay reasonable salaries, rents and interest to its shareholders and their families who provide services and the use of capital assets to the corporation.

4. Fringe Benefits. Under §1372, two percent (2%) or greater shareholders are treated as "partners" with respect to "employee fringe benefits." Therefore, corporate expenditures for such benefits will not be excluded from the income of the shareholder-employee receiving such benefits. "Fringe benefits" include (a) the \$5,000 death benefit exclusion under §101; (b) the exclusion from income of amounts paid under corporate sponsored accident and health plans under §105(b), (c) and (d) and §106(b); (c) the exclusion from income of the cost of up to \$50,000 of group term life insurance under §79; and (d) the exclusion from income of meals and lodging furnished for the convenience of employers under §119. The amounts paid can be deductible by the corporation under §162 if the expenditures are in the nature of compensation and are not unreasonable. Cf. §707(c).

5. Deductible Payments to Shareholders. An S corporation must use the "cash basis" for purposes of deducting interest and business expenses paid to a shareholder or related person using the cash method. §267(a)(2) and (e). Therefore, if deductible expenditures are paid to a shareholder or related

persons, no deduction will be allowed to the corporation until the amount is includible in the income of the recipient. For example, an S corporation may not accrue a deduction for salary due a cash basis shareholder in 1988, if the salary will not be paid until 1989.

E. Distributions to Shareholders. It is typical for S corporations to make distributions to their shareholders since shareholders are taxed on all S corporation income and generally need funds to pay the taxes on the attributed income. Distributions to shareholders will have different tax consequences depending on the earnings and tax history of the S corporation, and whether or not the corporation has accumulated earnings and profits at the time of the distribution. §1368(a).

1. Corporations Without Earnings and Profits. Distributions by S corporations without earnings and profits are tax free to the shareholders to the extent the distributions do not exceed the shareholder's basis in stock of the corporation. §1368(b)(1). (The shareholder's basis in indebtedness is not considered.) If the distribution exceeds the shareholder's stock basis, the excess is treated as gain from the sale or exchange of property. §1368(b)(2). A tax-free distribution causes a reduction in the shareholder's stock basis under §1367(a)(2). Basis adjustments for the current taxable year are taken into account before determining the tax consequences of a distribution; therefore, distributions are treated as if made at the end of the corporation's taxable year irrespective of when actually made. See §1368(d) and S. Rep. No. 640, 97th Cong., 2nd Sess. (1982) at 18.

2. Corporations With Earnings and Profits. Post-1982 operations of an S corporation will not generate earnings and profits. §1371(c)(1). However, an S corporation can have earnings and profits attributable to prior taxable years when it was a C corporation or pre-1983 taxable years when an S election was in effect. See Bravenec, "Unwanted E & P of Subchapter S Corporation," 57 Taxes 66 (January 1979).

a. Tax-free Distributions. A distribution by an S corporation with accumulated earnings and profits will be treated the same as if made by an S corporation without earnings and profits up to the amount of its "accumulated adjustment account" ("AAA"), i.e., tax free to the extent of the corporation's "AAA" if the distribution is not in excess of the shareholder's basis in his stock. §1368(c)(1).

b. Accumulated Adjustments Account ("AAA"). The corporation's "AAA" is essentially equivalent to the net amount of the corporation's undistributed income that has been attributed and taxed to its shareholders for taxable years beginning after January 1, 1983, i.e., net profits of the corporation less

prior distributions. §1368(e)(1); H.R. No. 432 (Part II), 98th Cong., 1st Sess. (1984). It should be noted that the "AAA" is a corporate level account and not personal to each shareholder. Accordingly, a transferee of stock in an S corporation will be entitled to receive tax-free distributions to the extent of the corporation's "AAA" notwithstanding he was not a shareholder at the time the corporation earned the profits (taxed to the previous shareholders) which resulted in the creation of the "AAA." The "AAA" is adjusted in the same manner as a shareholder's basis in his stock with the following differences:

i. No adjustment is made for tax-exempt interest income of the S corporation or for nondeductible expenditures not chargeable to capital. §1368(e)(1)(A).

ii. An adjustment is made for a redemption under §302(a) or §303(a). §1368(e)(1)(B).

iii. Adjustments to "AAA" can result in a negative "AAA". §1368(e)(1)(A); H.R. No. 432 (Part II), 98th Cong., 1st Sess. (1984) at 1645.

c. Dividend Distribution. A distribution in excess of the corporation's "AAA" will be treated as a dividend up to the amount of the corporation's accumulated earnings and profits. §1368(c)(2).

d. Additional Distributions. Distributions in excess of the corporation's earnings and profits will be applied against the shareholder's basis in his stock, i.e., received tax free, with any further distributed amounts generally producing a capital gain. §1368(c)(3).

e. Election to Distribute Earnings and Profits. During any taxable year, an S corporation may, with the consent of all of its shareholders, elect to treat distributions (that otherwise would be tax free to the extent of the corporation's "AAA") as first coming out of the corporation's accumulated earnings and profits. §1368(e)(3). The election remains in effect only for the year of the election and applies to all distributions made during that year. §1368(e)(3). This election may be advantageous to a shareholder in a year in which he has substantial losses from other sources if the taxable distribution can be used to offset his unrelated losses. In the year of the election, the "AAA" will remain intact, thus allowing a tax-free distribution in a subsequent year. In making this determination, the "passive activity loss" rules of §469 must be evaluated. In addition, the election also enables the corporation to eliminate its earnings and profits to avoid the problems of disqualification and taxability under the "passive income" rules of §§1362(d)(3) and 1375(a) which are applicable only to S

corporations having Subchapter C earnings and profits at the close of its taxable year. §1362(d)(3) and §1375(a)(1).

3. Recognition of Gain on Appreciated Property. Except in a tax-free reorganization, S corporations will recognize gain under §1363(d) on distributions of appreciated property to its shareholders with respect to its stock (e.g., dividend distributions) in the same manner as if it had sold the property to the shareholders. The distribution does not result in a corporate level tax as the gain at the corporate level is passed through to the shareholders under §1366(a) and the shareholders receive a stepped-up basis in the property under §1367(a)(1). In addition, the distribution of appreciated stock of another corporation could result in "passive investment income" under §1375.

F. Basis Adjustments. Basis plays an important role in S corporation planning because a shareholder can deduct corporate losses only up to his basis in his stock and in any debt owed to him by the corporation. The adjusted basis of his stock (but not debt) also affects the treatment of distributions. §1367(a)(1). An "S" shareholder's basis in stock is computed in a manner similar to the computation of basis of a partner's partnership interest except for indebtedness of the S corporation. §1367(a). A shareholder's basis is adjusted each year as follows:

(1) Increase in Stock Basis. A shareholder's basis in his stock is increased by the following items under §1367(a)(1):

(a) Items of income that are separately stated and passed through to the shareholder;

(b) The shareholder's allocated portion of any nonseparately computed income; and

(c) The shareholder's allocated portion of depletion deductions over the basis of the depletable property.

(2) Decrease in Stock Basis. A shareholder's basis in his stock is decreased (but not below zero) by the following items under §1367(a)(2):

(a) Distributions by the corporation which are not taxed to the shareholder under §1368;

(b) Items of loss and deduction that are separately stated and passed through to the shareholder;

(c) The shareholder's allocated portion of any nonseparately computed loss;

(d) The shareholder's allocated portion of any nondeductible expense not chargeable to the capital account;

(e) The shareholder's allocated portion of any oil and gas depletion deduction.

(3) Basis in Debt. An "S" shareholder has a basis in debts of the corporation only to the extent of the amount loaned by such shareholder to the corporation. §1012 and §108(d)(7). Debts of the corporation to third parties (contrary to the "basis" rules for partnerships) do not create basis for shareholders. Nor will a guaranty of corporate indebtedness by a shareholder be considered as "debt" for purposes of the basis rules except to the extent the shareholder actually makes payment under the guaranty. See Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983); Blalock v. United States, ___ F.Supp. ___, 1988-2 U.S.T.C. ¶9495 (N.D. Miss. 1988); Perry v. Commissioner, 47 T.C. 159 (1968), aff'd 392 F.2d 458 (8th Cir. 1968); Rev. Rul. 80-236, 1980-2 C.B. 240; Rev. Rul. 71-288, 1971-2 C.B. 319 and Rev. Rul. 70-50, 1970-1 C.B. 178. But see Selge v. United States, 778 F.2d 769 (11th Cir. 1985) (loan to corporation guaranteed by shareholder can be recharacterized as a direct loan to shareholder followed by an advance of the funds to the corporation).

(4) Adjustments to Basis in "Debt." Items described in §1367(a)(2) which reduce a shareholder's basis are first applied to reduce the shareholder's stock basis to zero, with any excess (excluding tax-free distributions under §1367(a)(2)(A)) applied to reduce the shareholder's basis in any debt owed to him by the corporation. §1367(b)(2)(A). Neither basis in stock nor basis in debt can be reduced below zero. If a shareholder's basis in debt is reduced, any subsequent increases in basis is first applied to restore the basis in the debt before being applied to increase the basis in his stock. §1367(b)(2)(B). The order of restoration is sometimes important because basis in debt cannot be used to obtain tax-free distributions. In contrast to the partnership basis rules, only debt of the corporation to the shareholder can be used to provide basis for the purpose of passing through losses and deductions to the shareholder. §1366(d)(1)(B).

(5) Repayment of Debt. If the S corporation repays its debt to a shareholder, the basis of which has previously been reduced, the shareholder will recognize gain. If the debt is evidenced by a note, any gain will be capital gain if the note is a capital asset in the hands of the shareholder. §1221; Rev. Rul. 68-537, 1968-2 C.B. 304. In the absence of a note the gain will be ordinary income. See Cornelius v. Commissioner, 53 T.C. 417 (1972), aff'd 494 F.2d 465 (5th Cir. 1974).

G. Post-termination Distributions.

1. General. During a "post-termination transition period," generally, the one-year period beginning with the date of termination of an "S" election, distributions of cash by the former S corporation are tax free to the shareholders (and are applied to reduce the basis of their stock) to the extent of the corporation's "AAA." §1371(e)(1). These tax-free post-termination distributions can prevent the "lock-in" (and the double taxation) of income previously taxed to the shareholders during the "S" years. However, if "AAA" remains undistributed following the post-termination transition period, the shareholders will be unable thereafter to use the "AAA" to obtain tax-free distributions since there is no provision for reestablishing the "AAA" if the corporation thereafter reelects "S" status. It should be noted that only distributions of money will qualify for the special treatment, thus cases under prior law involving loan-back schemes, uncashed checks, etc. will remain relevant. See Fountain v. Commissioner, 59 T.C. 696 (1973) (checks with insufficient funds); Clark v. Commissioner, 58 T.C. 94 (1972) (promissory notes). It should also be noted that distributions in redemption of stock under §302 or §303 may not qualify under §1371(e) since they are payments in "exchange" for stock, not distributions "with respect to" stock. See discussion in J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations, (Warren, Gorham and Lamont, Inc., 2d ed. 1985) §9.05(2).

2. Election to Treat as Taxable Dividends. The corporation may elect under §1371(e)(2) to treat distributions of money made during the "post-transition period" as taxable dividends to the extent of the corporation's earnings and profits. This will allow a corporation to pay dividends to avoid the accumulated earnings tax or the personal holding company tax. Temp. Reg. 18.1371-1; H. Rep. No. 861, 98th Cong., 1st Sess. (1984) at 1644. The election can be made only with the consent of each shareholder to whom the corporation makes a distribution during the post-transition period.

H. Post-Termination Period -- Carryover of Losses. If losses of the corporation (including disallowed losses carried forward from prior years under §1366(d)(2)) are or continue to be disallowed to a shareholder in the last "S" corporation year because of the shareholder's insufficient basis in his stock and debt under §1366(d)(1), the disallowed losses are taken into account by the shareholder on the last day of the "post-termination transition period." §1366(d)(3)(A). However, such losses may not be used to the extent they exceed the shareholder's stock basis (not his basis in debt) as of the close of the "post-termination transition period." §1366(d)(3)(B). The losses that are allowed pursuant to this provision will reduce the shareholder's basis in the stock. §1366(d)(3)(C).

III. Sale or Other Transfer of Stock by Shareholder to Third Party.

A. Effect on Shareholder.

1. Computation of Gain or Loss on Sale. Upon the sale of S corporation stock, gain or loss to the shareholder is computed on the difference between the amount realized and the shareholder's adjusted basis in the stock. §1001(a). Gain on the sale will be treated as capital gain under §1222 unless the collapsible corporation rules of §341 apply.

2. Allocation of Income and Losses During Year of Sale or Other Transfer. Income and losses of an S corporation for its taxable year in which a shareholder sells or transfers his entire stock interest will be allocated pro-rata to the shareholders on a per-share, per-day basis. However, all of the shareholders who owned shares at any time during such taxable year can elect under §1377(a)(2) to treat the taxable year as two short taxable years under §1377(a)(2), i.e., "close the books" on the date the shareholder terminates his interest. It should be noted that if there has been a change of 50% or more in stock ownership during the year in which the "S" election is terminated, the books of the corporation will automatically be "closed" in allocating income or loss to the shareholder for the "S termination year." §1362(e)(6)(D).

a. General Pro-Rata Rule. If the general per-share, per-day rule of §1377(a)(1) applies, the tax effect of the corporation's operations upon a terminated shareholder will not be determined until the end of the corporation's taxable year. Therefore, if the price of a selling shareholder's stock reflects only the profit or loss only up to the date of transfer, a shareholders' agreement may be appropriate to provide for an adjustment in price if the profit or loss actually allocated to the terminated shareholder differs from the amount taken into account in setting the price. If the election to "close" the corporation's taxable year has not been made under §1377(a)(2), the buyer could accelerate income into the year of sale, thus causing the selling shareholder to be taxed on a portion of the corporation's income without his being entitled to receive it. Therefore, if the risk of such acceleration of income exists, the seller should attempt to negotiate an agreement to close the taxable year pursuant to §1377(a)(2) in order to eliminate the risk.

b. Election to Close the Taxable Year. If the election is desired, it is advisable to have an agreement among the shareholders prior to a sale or transfer of stock that the corporation will elect to close its taxable year as of the sale or transfer of stock and that all the shareholders who were shareholders during the taxable year will consent to the

election. §1377(a)(2). The procedure for making the election and handling the shareholders' consents is described in Temp. Reg. §1377-1. By electing to "close" the books at the end of the short taxable year which ends on the date of sale or transfer, the seller or transferor avoids having to include income earned by the corporation after the sale or transfer. The buyer or donee of the stock may also want an agreement to "close the books" to assure that any losses of the corporation occurring after his purchase or receipt of stock can be taken into account.

c. Examples. The two options under §1377(a) are illustrated in the following example:

Facts: Widget, Inc., an S corporation on a calendar-year basis, has a net operating loss of \$100,000 for the six-month period January 1 - June 30, 1988, and breaks even during the six months ending December 31, 1988, thus showing a net loss for the entire year of \$100,000. On January 1, 1988, the stock of Widget, Inc. is owned equally by A and B. On July 1st, A transfers all of his stock interest in Widget, Inc. to C.

General pro-rata rule of §1377(a)(1). The \$100,000 NOL for 1988 would be allocated equally to each day of the corporation's taxable year so that \$50,000 of the loss would be allocated to the first half of the year. Since A owned 50% of the stock of the corporation during this period, he would be allowed \$25,000 of the loss on his individual tax return for 1988. B would be allocated \$50,000 of the loss, and C would be allocated \$25,000 of the loss.

Two taxable-year rule of §1377(a)(2). The \$100,000 NOL for 1988 would be allocated entirely to the short taxable year ending June 30, 1988. Accordingly, A and B would each be entitled to \$50,000 of the loss. Since Widget, Inc.'s short taxable year, July 1 through December 31, 1988, is a break-even year, A and C would be attributed with no income or loss from the corporation for this period.

3. Effect of Corporation's "AAA." A purchaser of an S corporation's stock which has accumulated earnings and profits should be aware of the size and amount of the corporation's "AAA." The amount of "AAA" will determine how future distributions will be treated by the purchasing shareholder. See Section II, Par. E, supra.

4. Effect of Basis Adjustments. The buyer and seller should both take into account the fact that adjustments in the basis of an "S" shareholder's stock and debt are made at the end of the year. §1367. The basis of the selling shareholder will increase or decrease depending on the income or loss of the corporation in the year of sale. §1367(a). The selection of the

"per-day per-share" or the "closed taxable year" methods under §1377(a) in allocating the income or loss of the corporation to the shareholders in the year of sale will, in addition to affecting the amount of income or loss attributed to the shareholders, affect the basis of the selling shareholder and, therefore, the amount of gain or loss which he recognizes on the sale. §§1366, 1367 and 1377(a).

5. Recapture of Investment Tax Credit. The sale or other transfer by a shareholder of his stock in an S corporation will result in the recapture of investment tax credit by the corporation if the shareholder's stock interest is reduced to less than two-thirds of the interest he held at the time the property was placed in service by the corporation. Reg. §1.47-4(a).

6. Unused Corporate Losses. Corporate losses that cannot be used by a shareholder because of the shareholder's inadequate basis in stock and debt can be carried forward indefinitely. However, upon sale or transfer of his shares, the shareholder automatically loses his right to benefit from the previously disallowed losses. §1366(d)(2). For discussion regarding the carry forward of unused losses to the end of the "post-termination transition period" under §1366(d)(3) after termination of the "S" election under §1366(d)(3), see Section II, Par. H, supra at p. 10.

B. Effect on Corporation. The sale or transfer of S corporation stock will have no direct effect on the corporation except for a possible recapture of investment tax credits as discussed in Paragraph 5 above. A §338 basis step-up only applies with respect to a corporate shareholder, and a corporation is not a permissible S corporation shareholder.

IV. Redemption by Corporation of Shareholder's Stock.

A. Effect on Shareholder.

1. Computation of Gain or Loss. If the redemption qualifies under §302(a), gain or loss is computed based on the difference between the amount received by the shareholder and his adjusted basis in his stock. §1001(a).

2. Allocation of Income and Computation of Basis. The consideration involved in determining the allocation of the corporation's income to the redeemed and remaining shareholders in the year of the redemption and in the determination of the redeemed shareholder's basis are the same considerations discussed in connection with a shareholder's sale or transfer of stock to a third party. See Section III, Par. A, supra at p. 11.

3. Timing. If the payments to the redeemed shareholder by the corporation are made in installments, the redeemed shareholder may benefit from a distribution under §1368 in the year in which the redemption occurs. The distribution by the corporation will be "tax free" to the shareholder under §1368(b) up to the amount of his stock basis if the corporation has no earnings and profits or to the extent of the corporation's "AAA" under §1368(c)(1) if the corporation has earnings and profits. The §1368 distribution allows the shareholder to receive a portion of the "redemption price" tax free. See Section II, Par. E, supra at pp. 6-8.

4. Investment Tax Credit. The redemption of more than one-third of an "S" shareholder's stock will result in the recapture by the redeemed shareholder of a proportionate part of the investment tax credit to the extent the credit was previously claimed by that shareholder. Reg. §1.47-4(a)(2). See Section III, A, Par. A. 5., supra at p. 13.

B. Effect on Corporation.

1. Cash v. Property. A corporation's distribution of cash to the redeemed shareholder will not affect the corporation's taxable income or loss. However, a distribution of appreciated property to a redeemed shareholder will result in gain recognition by the corporation as if it had sold the appreciated property to the shareholder at its fair market value. Any such gain is passed through to the shareholders on a "per-share, per-day" basis for the entire year unless an election is made by the shareholders to "close the books" of the corporation as of the date of the redemption. §1377(a). In that case, the redeemed shareholder will recognize a larger share of such gain. See discussion at D. Schenk, Federal Taxation of S Corporations at 12-18 (Law Journal Seminars-Press, 1985). In case of a converted S corporation with earnings and profits, a corporate level tax may also be imposed on the distribution of appreciated property if the distribution would cause a recognition of "built-in gain" under §1374 or "excess passive income" under §1375. See Section II, Pars. D, E, and F, supra at pp. 4-9. Section 106(f)(8) of the Technical Corrections Act of 1988 ("TCA-88") repealed the distribution of appreciated property rule of §1363(d) as "deadwood" because of the repeal of General Utilities and the adoption of new §§311(b) and 336(a).

2. Effect on "AAA." A redemption under §302 or §303 will cause a reduction in the corporation's "AAA" based on the ratio of the number of shares redeemed to the total number of shares immediately prior to the redemption. §1368(e)(1)(B).

V. Liquidation of S Corporations.

A. Effect on the Shareholders.

1. Gain or Loss. Upon complete liquidation of an S corporation pursuant to §331, gain or loss is based on the difference between the fair market value of the amount received by the shareholder in the liquidation and the adjusted basis of his stock (which will be adjusted in the year of liquidation under §1367). §1001(a). See Reg. §1.331-1(b).

2. Basis. The basis of the shareholder's stock will reflect the income and losses of the corporation and the distributions by the corporation during all "S" status years, including the income, losses and distributions during the year of liquidation. §1367. The basis of the distributed assets received by the liquidated shareholder will equal their fair market value at the time of distribution. §334(a).

B. Effect on Corporation - Gain and Loss on Liquidating Sales and Other Distributions (Repeal of General Utilities).

1. Background. The principle of General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), granted non-recognition of gain to corporations for certain distributions of appreciated property to shareholders, and certain liquidating sales of property. The distributed property escaped tax at the corporate level even though the shareholder received a fair market value basis in the property (usually "stepped up") upon receipt. Although the shareholder paid tax on the transaction, either as a dividend or as a capital gain, it was felt by some that the unrecognized gain at the corporate level was an inappropriate "windfall." But see §1363(d).

2. Statutory Principles of Prior (Pre-1987) Law. The 1954 Code reflected the General Utilities doctrine in the following sections, each of which provided for non-recognition of gain or loss to the distributing corporation:

(a) Section 311 - nonliquidating distributions (dividends and redemptions). Exceptions to non-recognition were:

- (1) distributions of LIFO inventory (§311(b))
- (2) distribution of property with respect to which a liability exceeded the corporation's basis in the property (§311(c))
- (3) dividend and redemption distributions other than

- (i) partial liquidations or dividend distributions to noncorporate shareholders of business property, involving "qualified stock" as defined in §311(e)(1);
- (ii) distributions of stock or obligations of certain controlled corporations (§311(e)(2));
- (iii) Section 303 redemptions;
- (iv) redemption distributions to private foundations of "excess business holdings";
- (v) distributions by regulated investment companies made upon shareholder demand.

(b) Section 336 - liquidating distributions.
Exceptions to non-recognition were distributions of installment obligations or LIFO inventory.

(c) Section 337 - liquidating sales.
Exceptions to non-recognition were sales involving collapsible corporations, stock in trade, LIFO inventory, and liquidations governed by §332 or §333.

3. No Corporate Gain on Liquidation of S Corporation.
Prior to TRA-86, §1363(e) of the Code provided that the corporate level recognition of gain on distributions of appreciated property as provided for in §1363(d) did not apply in a complete liquidation of an S corporation. §1371(a)(1) and old §336(a).

4. Coordination with Subchapter C. Section 1371(a)(1) provided (and continues to provide) that Subchapter C shall apply to an S corporation and its shareholders except as otherwise provided in Subchapter S.

5. Old §1374. Prior to TRA-86, §1374 subjected an S corporation with "C" earnings and profits to a corporate level tax on the "net capital gain" of the corporation if during the year the gain exceeded \$25,000 and 50% of the taxable income and if the taxable income exceeded \$25,000. However, the S corporation was not subject to this corporate level tax if the "S" election had been in effect for the three immediately preceding taxable years. Old §1374(c). The corporate level tax could be avoided under old §1374 by delaying the transaction until after the three-year period or by making an installment sale so that the payments during the three-year period were below \$25,000 or

50% of taxable income. Further, prior to the repeal of General Utilities, a liquidating sale under §337 would prevent the recognition of the corporate level tax under §1374 even during the three-year period. See Rev. Rul. 78-89, 1978-1 C.B. 272. See also, J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations, (Warren, Gorham and Lamont, Inc., 2d ed. 1985) ¶13.02(2)(c).

a. "Grandfather" of Old §1374. Old §1374 will continue to apply to S corporations that elected "S" status prior to 1987 and, subject to limitations, to certain small corporations which elect "S" status prior to 1989. See Section V, Par. B. 6. d. and e., infra at pp. 18-19.

6. Current Law (After 1986). TRA-86 repealed sections 336 and 337 and the General Utilities doctrine. New §336, adopted by TRA-86, now requires a liquidating corporation to recognize gain or loss upon distribution of property in complete liquidation as if the property were sold to the shareholder at fair market value. Therefore, gain or loss will be recognized in most cases by a "C" corporation making a liquidating distribution or sale. §336(a). If the recipient shareholder comes under the tax-free reorganization provisions of §§351-368, then §336 will not apply with respect to the distribution.

a. General. Even after the repeal of General Utilities, it would appear that an "S" election could eliminate the "double tax." However, to prevent this result, a new §1374 was adopted in TRA-86 which imposes a corporate level tax on the "built-in gain" of S corporations which are converted from C corporations after 1986.

b. New §1374. New §1374 imposes a tax at the corporate level on any "built-in gain" which is recognized within a period of ten (10) years following the "S" election. Generally, "built-in gain" refers to the excess of the fair market value of the assets of the corporation over their adjusted basis at the beginning of the first "S" year, i.e., the appreciation above basis which occurred prior to the conversion to "S" status. §1374(d). In contrast, under old §1374 (applicable to "C" corporations converting to "S" status prior to 1987), the corporation is subject to a corporate level tax only on net capital gains in excess of \$25,000 and 50% of the corporation's taxable income and, further, the potential for double taxation exists only for a period of three (3) years following the date of conversion. For example, a calendar year S corporation which elected "S" status in 1986 (effective January 1, 1987) will be able to avoid corporate level tax on a gain transaction after the three-year period, i.e., after 1989.

It must be kept in mind that the "built-in gains" tax of new §1374 applies only to converted S corporations and to the unrealized appreciation in the value of the assets owned at the beginning of the first taxable year for which the "S" election is in effect so that the total recognized gain under new §1374 is limited to the aggregate net "built-in gain" of the corporation at the time of conversion to "S" status.

The tax imposed by new §1374 utilizes the highest corporate tax rate provided for in §11(b). The tax rate is multiplied by the lesser of the "built-in gains" recognized for the taxable year or the corporation's taxable income calculated as if such corporation were a C corporation. §1374(b)(1)(B) and (d)(4).

c. Effective Date. The rules of new §1374 apply to "S" elections made after December 31, 1986. For S corporations which made the election before the end of 1986, the prior version, i.e., old §1374 (imposing a tax only on capital gains in excess of \$25,000 and 50% of taxable income) is applicable. TRA-86 §633(d)(8).

d. Transition Rule for "Small" Corporations.

(i) Relief from the results caused by the repeal of General Utilities was granted to certain small corporations, defined as "qualified corporations," that completely liquidate prior to January 1, 1989. Under the transition rule, the nonrecognition provisions of old §§336 and 337 (prior to TRA-86) will apply with regard to the liquidation, thus eliminating the tax at the corporate level. The transition rule does not, however, apply with respect to any gain under §453B on the disposition of an installment obligation, any ordinary gain or loss, or any short term capital gain or loss. TRA-86 §633(d)(2).

The corporations that qualify for this transition rule are corporations which, as of August 1, 1986, and at all times thereafter prior to complete liquidation, have more than 50% of the value of its stock held by ten (10) or fewer "qualified persons." TRA-86 §633(d)(5). A "qualified person" is defined as an individual, estate, and certain qualified "S" corporation trusts described in §1361(c)(2)(A)(ii) or (iii). TRA-86 §633(d)(6)(A). If the "applicable value" (the fair market value of the "qualified corporation" on the date of adoption of the plan of liquidation) is less than \$5,000,000, the transition rules basically provide that the new rules of TRA-86, which repeal old §§336 and 337, shall not apply to such liquidation. The TRA-86 amendments, however, will fully apply to such qualified corporations with an "applicable value" of \$10,000,000 or more and will ratably apply to those corporations with values between \$5,000,000 and \$10,000,000.

Unless the transition rule with regard to certain small corporations are applicable, a double tax will be imposed on the complete liquidation of a "C" corporation.

(ii) The transition rules set forth in TRA-86 §633(d) also apply to permit the "old" version of §1374 to apply to certain small converted "S" corporations which meet the same criteria as to value and number of shareholders. TRA-86 §633(d)(8). For old §1374 to apply, the "S" election must be made before January 1, 1989, and the value of the corporation (to determine if the valuation test is met) is the value on August 1, 1986 or the date of the "S" election, whichever date results in the greater value. Rev. Rul. 86-141 1986-2, C.B. 152. TCA-88 clarified the time for making the "S" election as set forth in TRA-86 §633(d)(8).

e. Effective Dates and Transition Rules. The repeal of the General Utilities doctrine is generally effective for liquidating sales and distributions after July 31, 1986. However, "grandfathered" transactions will continue to qualify if all liquidating sales or distributions are completed before January 1, 1989. Old §1374 which will continue to apply where the S election was made prior to 1987 and will continue to apply to qualifying "small" corporations if the election is made prior to 1989 except for ordinary income items and short term capital gains. TRA-86 §633(d)(2).

f. LIFO Recapture. Upon a C corporation electing "S" status after December 17, 1987, it will be taxed on any LIFO recapture amount. Section 1363(f), added by the Revenue Act of 1987, provides that the LIFO recapture amount (the excess of the inventory amount under the FIFO method over the amount under the LIFO method) shall be included in income of the S corporation in its first taxable year after the election.

VI. Sale of Assets by S Corporation Without Liquidation.

A. Effect on Shareholders.

1. Gain or Loss. The gain or loss on the sale of S corporation assets will pass through to the S shareholders on a pro-rata basis under §1366. If such assets, however, are sold by the S corporation on an installment basis, then the shareholders should be permitted to report such transaction on the installment basis.

2. Basis. Income items increase the shareholder's basis and loss items decrease the shareholder's basis pursuant to §1367(a).

B. Effect on Corporation.

1. Corporate Level Taxes. The sale of assets by an S corporation may trigger a corporate level tax, as a result of either excess "passive investment income" under §1375, the recognition of "built-in gain" under new §1374 or excess capital gain under old §1374.

(a) Passive Investment Income. Section 1375 imposes a tax on S corporations with Subchapter C earnings and profits if more than 25% of the corporation's "gross receipts" are considered "passive investment income." Generally, "passive investment income" includes rents, dividends and interest and certain capital gains. §1362(d)(3). The tax is imposed on the "excess passive income," which is an amount that bears the same ratio to "net passive income" (rents, dividends and other passive investment income reduced by allowable deductions directly connected with the production of such income) as the "passive investment income" in excess of 25% of the corporation's "gross receipts" bears to the total "passive investment income" for that year. §1375(b).

(b) Section 1374 Gain. If the S corporation has ever been a C corporation, then either new or old §1374 may impose a tax on certain gains. If old §1374 applies, the corporate level tax applies only if the "S" election has not been in effect for the three (3) immediately preceding years, and if the "net capital gain" for the year exceeds \$25,000 and 50% of the corporation's taxable income which must also exceed \$25,000. Old §1374(a), (c)(1). New §1374, on the other hand, imposes a tax on "built-in gain" recognized within ten (10) years of the "S" election. See Section V, Par. B, 5, supra at p. 16.

2. Termination of "S" Status. The sale of corporate assets without a liquidation may also result in the termination of "S" status for S corporations with Subchapter C earnings and profits. §1362(d)(3). Termination occurs if "passive investment income" is more than 25% of gross profits for three consecutive taxable years and the corporation has C earnings and profits during such period. §1362(d)(3)(A)(i).

VII. Tax-Free Reorganizations.

A. General. Unlike a partnership, an S corporation can take advantage of the tax-free reorganization provisions available to corporations under §368 and related provisions of Subchapter C of the Code. The following discussion of the different types of corporate reorganizations will focus on the particular concerns of S corporations and their shareholders and the ability of the corporations to maintain "S" status.

B. Mergers (§368(a)(1)(A)).

1. Merger of S Corporation into C Corporation.

a. Status of S Corporation. Since the S corporation ceases to exist, the "S" election is lost. The surviving C corporation does not receive "S" status from the merger, but could, of course, elect "S" status following (or before) the merger if all requirements are met. The surviving corporation would not be subject to the five year rule under §1362(g) since the termination of the "S" election as a result of the merger does not fall within the prohibitions of §1362(d). See Rev. Rul. 70-232, 1977-1 C.B. 177; Ltr. Rul. 8007089.

b. Effect on "AAA." The accumulated adjustments account, "AAA," of the disappearing S corporation would not carry over to the surviving C corporation. In order to take advantage of a tax-free distribution from an S corporation's "AAA," the distribution must be made by the corporation "with respect to its stock." §1368(a). The "AAA" is preserved during the "post-termination period" (generally a period of one year from the end of the last taxable year of the S corporation) and, therefore, a distribution by the surviving C corporation to the former "S" shareholders would qualify as a tax-free distribution. §1377(b)(1)(A). See discussion of post-merger distributions in S. Starr, 60-7th T.M., S Corporations at A-112 (1986).

2. Merger of C Corporation into S Corporation.

a. Status of S Corporation. The "S" status of the acquiring corporation does not automatically terminate unless one of the "S" requirements is no longer met. Rev. Rul. 69-566, 1969-2 C.B. 165. For example, if the S corporation after the merger had more than 35 shareholders, it would lose its "S" status. The "built-in gain" in the assets of the former C corporation will be carried over to the S corporation, and will be taken into account for a period of ten years commencing with the date of the merger. See §1374 and Announcement 86-128, 1986-2 C.B. 151.

b. Effect on "AAA." If the surviving S corporation maintains its "S" status, its "AAA" will also be maintained. The former C corporation shareholders (as would any new shareholder) will be entitled to participate in the benefits of the "AAA" upon a subsequent distribution under §1368(b)(1) to the extent of such shareholder's basis in his stock. See Section II, Par. E, 2, supra at p. 6.

3. Merger of S Corporation into S Corporation.

a. Status of S Corporation. The "S" status of the acquiring corporation will continue provided it continues to satisfy the "S" requirements, such as the limitation upon the number of shareholders or the prohibition of corporate shareholders. Rev. Rul. 69-566, 1969-2 C.B. 165; Ltr. Rul. 8502082. If the acquired corporation was subject to the ten-year "built-in gain" treatment of new §1374, such condition would be carried over to the acquiring corporation. See Announcement 86-128, 1986-2 C.B. 151.

b. Effect on "AAA." The "AAA" of the surviving S corporation will remain intact, and it appears that the "AAA" of the disappearing S corporation will be added to the surviving corporation's "AAA." See H.R. Rep. No. 826, 97th Cong., 2d Session 19, 1982-2 C.B. 730, 738.

C. Corporate Divisions (§§368(a)(1)(D) and 355).

1. In General. A divisive "D" reorganization, either as a "split-off," "split-up" or "spin-off," involves a transfer of assets by a corporation to either an existing or newly created corporation followed by a distribution of the transferee corporation's stock to the transferor's shareholders. §§368(a)(1)(D) and 355. A corporate division can also occur without a "D" reorganization, where stock in a controlled corporation is issued by its corporate shareholder to its shareholders. However, since an S corporation cannot have a corporate shareholder, and cannot be a member of an "affiliated group," a corporate division involving an S corporation would necessarily involve a "D" reorganization.

2. Availability of "S" Election to "Split-off," "Split-up" or "Spin-off" Corporation. Since an "S" election by a corporation is not permitted if it has a corporate shareholder on any day of its taxable year, it would appear that a "split-off," "split-up" or "spin-off" corporation must wait until the next taxable year before electing S status. However, the Service has ruled privately that a "split-off" corporation could elect "S" status from its inception. See Ltr. Rul. 8736014.

3. Effect of Transitory Ownership of Subsidiary (Before "Split-off," "Split-up" or "Spin-off") for an S Corporation. Although the ownership by an S corporation of 80% or more of the stock in a subsidiary will result in the termination of its "S" status because of the "affiliated group" prohibition, the Service has for several years permitted the transitory ownership of a subsidiary by an S corporation. See Rev. Rul. 72-230, 1972-1 C.B. 270; Ltr. Ruls. 8002073 and 8529037.

D. Other Reorganizations (§1368(a)(1)(B) and (C)).

1. "B" Reorganization. Since a "B" reorganization involves one corporation transferring its voting stock in exchange for at least 80% of the stock of another corporation (which would result, if the S corporation is the acquired corporation, in it being a corporate shareholder, or if the S corporation is the acquiring corporation, in it being a member of an affiliated group), a "B" reorganization is generally not a viable alternative if it is desirable to maintain the "S" election. §386(a)(1)(B). However, if the S corporation is the acquiring corporation and thereafter immediately liquidates the subsidiary, its "S" status may be maintained. See Rev. Rul. 73-496, 1973-2 C.B. 312; Rev. Rul. 72-230, 1972-1 C.B. 270. Such transaction may, however, be collapsed and recharacterized as an asset acquisition, perhaps as a "C" reorganization. See D. Schenk, Federal Taxation of S Corporations at 14-12 (Law Journal Seminars-Press 1985); S. Starr, 60-7th T.M., S Corporations at A-112 (1986).

2. "C" Reorganization. A "C" reorganization, which involves the acquisition by one corporation of substantially all the assets of another corporation in exchange for all or part of its voting stock, is another type of reorganization that will not typically be utilized with an S corporation if a paramount consideration is the retention of an "S" election. §368(a)(1)(C). An "S" corporation could not be the acquiring corporation in a C reorganization because the transfer of its voting stock would create a corporate shareholder. If the S corporation is the acquired corporation, then unless it is part of an affiliated group, as an 80% or more shareholder, the S election is maintained. The "transitory control" argument may also save the "S" election in a "C" reorganization. See D. Schenk, Federal Taxation of S Corporations at 14-15 (Law Journal Seminars-Press 1985); S. Starr, 60-7th T.M., S Corporations at A-112 (1986).

VIII. Buy-sell Arrangements.

A. General. Shareholder agreements do not create a second class of stock and therefore can (and should) be used to deal with particular problems and requirements of S corporations. See Rev. Rul. 85-161, 1985-2 C.B. 191.

B. Making the Election. If the shareholders intend the corporation to qualify under Subchapter S from its inception, an agreement setting forth the intention and binding the parties to make the election and satisfy the election requirements is desirable. For the corporation that does not initially elect "S" status, the shareholder agreement can make a future election easier by requiring consent of less than all shareholders and

possibly giving dissenting shareholders the right to have their stock purchased.

C. Terminating the Election. S corporation status may be revoked by a vote of more than one-half of the shares as provided for in §1362(d). However, a shareholder agreement may change this requirement to a greater number, i.e., the agreement could provide that the shareholders will not revoke the S status of the corporation unless all of its shareholders agree to do so. In addition, the agreement could restrict a transfer of shares to non-eligible parties so as to avoid an inadvertent termination of the election, or restrict transfer if create more than 35 shareholders. The agreement could also require that a transferee agree not to revoke the "S" election as a condition to the transfer.

D. Allocation of Income. The agreement could provide that in the event a shareholder disposes of his stock, the transfer would be made on the condition that the acquiring shareholder consent to an election under §1377(a)(2) to have the corporation's income calculated as if the taxable year of the S corporation consisted of two taxable years.