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Federal Income Tax Considerations of Acquisitions Involving S Corporations

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FEDERAL INCOME TAX CONSIDERATIONS OF ACQUISITIONS INVOLVING S CORPORATIONS

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FEDERAL INCOME TAX CONSIDERATIONS
OF
ACQUISITIONS INVOLVING S CORPORATIONS

Mary L. Harmon 1/

I. Introduction

Acquisitions of stock or assets involving an S corporation purchaser ("S purchaser") or an S corporation target ("S target") are necessarily complicated by the various detailed S corporation rules, including the rules regarding (1) qualification as an S corporation; (2) coordination between Subchapter S and Subchapter C; (3) the consequences of a termination of an S election; (4) basis for stock and shareholder-held debt; and (5) allocations of income, gain, loss and deduction. This outline will describe some of the more common structures for acquisitions involving S corporations and the consequences that follow from those transactions. 2/

Part II of this outline describes briefly the relevant law under Subchapters S and C that apply to these acquisitions. Part III describes the typical acquisition structures utilized in transactions involving S purchasers or S targets. Parts IV and V describe taxable acquisitions involving S corporations and the related tax consequences. Part VI describes tax-free acquisitions involving S corporations and the related consequences.

1/ The author wishes to thank David A. Winter, Esq. for his excellent assistance in the development of this outline.

II.  **Technical Background - Interaction Between Subchapter S and Subchapter C**

This Part briefly summarizes those provisions of Subchapters S and C that are directly relevant in determining the tax treatment of an acquisition structure involving an S corporation (and their interaction with each other).

A.  **Subchapter S Provisions 3/**

1.  **Eligibility - Section 1361.** Pursuant to section 1361, only a small business corporation is eligible to elect to be taxed as an S corporation. Generally, a small business corporation is a domestic corporation that:

   (i) does not have more than 35 shareholders (husbands and wives treated as one);

   (ii) has only one class of stock;

   (iii) has only individuals, estates and certain trusts as shareholders;

   (iv) does not have a nonresident alien shareholder; and

   (v) is not an "ineligible" corporation.

An ineligible corporation is (i) a corporation that is a member of an affiliated group; (ii) a financial institution for which a bad debt deduction is allowed under §§ 585 or 593; (iii) an insurance company subject to tax under Subchapter L; (iv) a § 936 (possessions) corporation; or (v) a DISC or former DISC.

2.  **Termination of S Election - Section 1362.** Pursuant to section 1362, the election by a corporation to be treated as an S corporation will be terminated under three circumstances. Once a corporation's S election is terminated, it must wait five years before making a new S election. Section 1362(g).

(a) **By Revocation.** An S election may be revoked by the shareholders of the corporation.

(b) **By E&P and Passive Investment Income.** An S election will terminate if an S corporate (i) has Subchapter C earnings and profits or E&P and (ii) has passive investment income in excess of 25% of its gross receipts for 3 consecutive taxable years.

(c) **By Ceasing to be Small Business Corporation.** An S election will terminate whenever an S corporation ceases to be a small business corporation.

(d) **Effect of Termination Rules.** As a result of the Section 1362 termination rules, an S corporation's election will terminate if, pursuant to a transaction, any of the eligibility requirements are not satisfied. Although each of the requirements should be considered when structuring an acquisition involving an S corporation, the two requirements that create the most fundamental problems in structuring acquisitions are that an S corporation is prohibited from (i) having a corporate shareholder or (ii) being a member of an affiliated group.

(e) **Momentary Affiliation Exception.** The Service, however, has carved out an important exception to these termination rules. It has consistently ruled that momentary affiliation in connection with an acquisition or spin-off does not terminate the S election. Rev. Ruls. 73-496, 1973-2 C.B. 312; 72-320, 1972-1 C.B. 270; TAM 9245004. Moreover, the Service has ruled that the momentary ownership of an S target by an ineligible shareholder (a corporation) prior to a spin-off would not terminate the S target's S election. See, e.g., PLRs 8801025; 8739010. The Service has taken the position that the subsidiary can be in existence for at least 30 days. Rev. Rul. 73-496, supra; but see Haley Bros. Construction Corp. v. C.I.R. 87 T.C. 498 (1986) (in which the tax court indicated that the Service's liberal position regarding momentary affiliation might be invalid). See also GMC 39768 where the service indicated both momentary affiliation and a momentary ineligible shareholder could be ignored.

3. **Section 1371(a).** Section 1371(a)(1) provides, "Except as otherwise provided in this title, and except to the extent inconsistent with this Subchapter, Subchapter C shall apply to an S corporation and its shareholders." Section 1371(a)(2) provides, however, that "[f]or purposes of Subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual."
B. Interaction Between the Provisions of Subchapters S and C Where S Corporation is Purchaser (Non-Reorganization)

1. Liquidations - Sections 332, 334 and 337. Amounts received by a shareholder in a distribution in complete liquidation of a corporation are treated as full payment in exchange for the stock under section 331, and the distributee takes a fair market value basis. § 334. Under section 332, however, no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of a subsidiary corporation if the distributee corporation owns sufficient stock in the liquidating corporation to meet the affiliation requirements under section 1504(a)(2) on the date of adoption of the plan of liquidation and at all times until the receipt of the property. Further, section 337(a) provides that the distributing corporation will not recognize gain if the transaction falls within section 332. In such a case, the distributee corporation takes a carryover basis in the distributed property. Section 334(b).

2. Regular Section 338 Election. Pursuant to section 338 of the Code, generally, a corporation that purchases at least 80% of the stock of another corporation can elect to treat the acquisition as an asset purchase (paying corporate-level tax on the deemed asset sale) and take a stepped-up basis in the assets of the acquired corporation.

3. Interaction between Sections 332, 337 and 338, and Sections 1371(a)(2) and 1362

(a) A Literal Reading. Sections 332 and 337 require a corporate distributee that owns more than 80% of the distributing corporation and section 338 requires a corporate purchaser. As described above, section 1371(a) generally provides that (i) the Subchapter C rules apply to S corporations unless inconsistent with the rules of Subchapter S and (ii) an S corporation that owns shares in another corporation is treated as an individual for purposes of Subchapter C. Consequently, a literal reading of section 1371 would prohibit an S purchaser from making an election under section 338 and from qualifying for the beneficial treatment of sections 332 and 337. A further complication is that an S election will terminate if the S corporation is affiliated with (i.e., owns 80% or more) of a subsidiary. In PLR 8818049, the Service, based on a literal reading of section 1371(a)(2), ruled that an S corporation purchasing the stock of another corporation could not make a section 338 election. In that ruling, an S corporation purchased all of the stock of another S corporation, followed by an upstream merger of the target into the purchaser two days later. Citing Rev. Rul. 73-496, PLR 8818049 held that the purchaser was ineligible to make a section 338 election if it retained its S status, on the ground that section 1371(a)(2) would treat the purchaser as an individual for purposes of section 338. The ruling, thus, indicated that sections 332 and 337 were inapplicable to the merger of the target into the
purchaser. For a thorough analysis of PLR 8818049, see Sheldon M. Bonovitz, S Corporations and Section 332, 58 Tax Notes 1545 (Sept. 17, 1990).

(b) New Rulings Based on Policy Interpretation. In TAM 9245004, however, the Service reversed itself and held that an S corporation could make a § 338 election and that the S corporation could immediately liquidate the target under § 332 and invoke the benefits of section 337. Reviewing the legislative history of section 1371(a)(2) of the Code, the Service concluded that section 1371(a)(2) of the Code was not intended to prevent S corporations from making qualified stock purchases under section 338 of the Code. See Jerald David August, Taxable Stock Acquisition by S Corporations: Technical Advice Memorandum 9245004 Permits Use of Section 332 and 338, 5 J. of S Corp. Tax'n 203 (1994). See also ABA Section of Taxation, Task Force Report on Taxable and Tax-Free Acquisitions Involving S Corporations; reprinted in 45 Tax Lawyer 435 (1992) (which urged the Service to interpret § 1371 in the manner applied in TAM 9245004). In PLR 9325006, the Service ruled that it would apply TAM 9245004 retroactively.

C. Interaction Between the Provisions of Subchapters S and C Where S Corporation is Target (Non-Reorganization)

1. Eligibility. Transactions involving S targets are often structured so that the S target is momentarily affiliated with another corporation and/or has a corporate shareholder prior to a liquidation, merger or spin-off of the S target. The Service's positions, therefore, regarding momentary affiliation and momentary ineligible shareholders, described above in paragraph A.2.(d) of this Part II, provide needed flexibility in structuring the acquisition of an S target.

2. Joint Section 338(h)(10) Election. An additional special election, under section 338(h)(10), is provided for cases in which the target is a member of a consolidated group. Pursuant to this election, target's stock is purchased from its shareholders, but target is treated as if it sold its assets and completely liquidated in a tax-free liquidation under section 332. Prior to final Treasury regulations under section 338, an election under section 338(h)(10) was available only in instances where the target was a member of a consolidated group. The final 338 regulations, however, provided a pleasant surprise by providing that an election under section 338(h)(10) is allowed with respect to acquisitions of the stock of S corporations. See Part V.B. for a more detailed description.

D. Interaction Between the Provisions of Subchapters S and C in Tax-Free Transactions

1. Section 368 - General Rules. Section 368 generally provides nonrecognition of gain or loss if the property or stock of one corporation is exchanged for the stock of another corporation in a transaction that meets the specific requirements of section 368. For a transaction to qualify under section 368,
it must also meet the judicially created requirements of (i) business purposes; (ii) continuity of proprietary interest; and (iii) continuity of business enterprise. If interpreted literally, section 1371(a)(2), which requires an S corporation holding shares in another corporation to be treated as an individual, would prohibit S corporations from being able to engage in tax-free reorganizations. In addition, the prohibition against S corporations having corporate shareholders or being members of an affiliated group would cause S corporations not to be able to engage in the tax-free reorganizations.

2. **S Target — GCM 39768.** In GCM 39768, the Service indicated that an S corporation could engage in a tax-free reorganization notwithstanding section 1371(a)(2), the prohibition against a corporate shareholder and the prohibition against affiliation. The GCM indicates that transferor S corporations may engage in reorganizations that qualify as "A," "C," "D," or "F" reorganizations. The Service cited with approval Rev. Rul. 72-320, 1972-1 C.B. 270, which held that a corporation's momentary ownership of stock of another corporation in connection with a divisive "D" reorganization did not terminate the S election under the predecessor to section 1361(d)(2)(A).

3. **S Purchaser.** S corporations may also engage in tax-free reorganizations as the purchasing corporation. See Rev. Rul. 69-566, 1969-2 C.B. 165 (acquisition by S corporation of stock of C corporation target by means of statutory merger with S corporation surviving constitutes a valid type "A" reorganization). GCM 39768 indicated that the momentary existence of an ineligible shareholder (a corporation) should be ignored in the same manner that momentary affiliation is ignored. S corporation purchasers, under current law, would not engage in a type "B" reorganization or a forward or reverse subsidiary merger under section 358(a)(2)(D) or (E) because the S corporation would then have an affiliated subsidiary which would terminate the S election. If the S corporation immediately liquidated the subsidiary in order to take advantage of the Service's position regarding momentary affiliation, the transaction would most likely be characterized as a type "C" reorganization.

4. **Divisive "D" Reorganizations and Section 355.** S corporations may engage in spin-offs, split-offs, and split-ups under section 355 of the Code. Rulings have indicated that the momentary affiliation between the distributing S corporation and a controlled corporation does not terminate the S election. See, e.g., PLR 9424039; PLR 9414016; and PLR 9403031. This outline does not detail the issues raised by or consequences of a divisive "D" reorganization. For excellent discussions of this topic, see August -- Philadelphia Conference, at 57; and Eustice & Kuntz, at ¶ 12.10.

5. **Section 351.** S corporations may also structure an acquisition of stock or assets of a target utilizing a section 351 structure. The eligibility requirements must be watched closely to ensure that the target
shareholders receiving S purchaser stock are eligible and that the total number of shareholders does not exceed 35.

E. Pending Legislation

Many of the issues created by the interaction between the provisions of Subchapter C and S may be affected by two pieces of legislation now pending before Congress: the Subchapter S Revision Act of 1993 (S. 1690) introduced by Senators David Pryor (D-Ark) and John Danforth (R-Mo) (the "Pryor/Danforth Bill") and the Tax Simplification and Technical Correction Act of 1993 (H.R. 3419) (the "Tax Simplification Act") which passed the House on May 17, 1994. Though the Pryor/Danforth Bill is more ambitious, both pieces of legislation would, if enacted, amend important provisions of Subchapter S providing increased flexibility for transactions involving S corporations.

1. Affiliated Groups. Both the Pryor/Danforth Bill and the Tax Simplification Act would permit an S corporation to own 80% of another corporation's stock and thereby be a member in an affiliated group.

2. Eligible Shareholders. Both the Pryor/Danforth Bill and the Tax Simplification Act would expand the definition of a small business corporation so that an "electing small business trust" would qualify as an eligible shareholder. The Pryor/Danforth Bill would go further to increase the number of permitted shareholders from thirty-five to fifty, allow a tax-exempt organization described in section 501(c)(3) of the Code or a qualified retirement trust under section 401(a) of the Code to be an eligible shareholder, and repeal the limitation on nonresident alien ownership of stock.

3. Section 1371(a)(2). Both the Pryor/Danforth Bill and the Tax Simplification Act would repeal section 1371(a)(2), which provides that as a shareholder in a C corporation, and S corporation is treated as an "individual."

4. Elections and Terminations. The Pryor/Danforth Bill, in an effort to reduce problems associated with obtaining the required consents to end a taxable year after a shareholder's interest has been terminated, the Pryor/Danforth Bill provides generally that only the terminating shareholder and any "affected" shareholder (e.g., a purchaser of the terminating shareholder's stock) are required to consent to the election. It also repeals the rule terminating a corporation's S election for excess passive investment income.
III. Acquisition Structures in General

A. Taxable Acquisition Structures

1. Taxable Acquisition of Stock – Carryover Basis in Target's Assets. A transaction will be treated as a taxable stock acquisition, with a purchaser obtaining a carryover basis in a target’s assets if:

   (a) the purchaser acquires the target's stock directly and immediately liquidates the target or merges itself and target; or

   (b) the transaction is structured as a taxable reverse subsidiary merger (pursuant to which the purchaser's transitory subsidiary is merged into the target) followed by an immediate liquidation of the target (or a merger of the purchaser and target). For a reverse subsidiary merger being treated as a stock purchase, see Rev. Rul. 90-95, 1990-2 C.B. 67 and Rev. Rul. 79-273, 1979-2 C.B. 125.

2. Taxable Acquisition of Assets – Cost Basis in Target’s Assets. A transaction will provide a purchaser with a cost basis in a target’s assets (generally, the sum of the amount paid, liabilities assumed and certain transaction costs) if:

   (a) the purchaser acquires directly the target's assets;

   (b) the transaction is structured as a forward cash merger (pursuant to which the target merges into the purchaser with the target shareholder's receiving cash or other consideration for their stock) (Rev. Rul. 69-6, 1969-1 C.B. 104); or

   (c) the purchaser acquires the target's stock (directly or via a reverse subsidiary cash merger) and a regular section 338 election or a joint election under section 338(h)(10) is made.

3. Taxable Shareholder-Level Purchases. Variations on these structures involve transactions in which the shareholders of a purchaser acquire some or all of the stock of a target and either (i) merge the purchaser and target or (ii) continue to hold the target as a "joint" subsidiary. In addition, S corporations may utilize a partnership in order to provide a preferred return to one of the parties.

B. Tax-Free Acquisition Structures

Generally, the corporate reorganization rules of section 368 apply to the acquisitions by or of S corporations if the parties comply with the reorganization requirements. Asset acquisitions typically are accomplished under
section 368(a)(1)(A) (statutory merger or consolidation), (C) (acquisition of substantially all of target's assets in exchange for stock) or (D) (either merger or "C" type acquisition where transaction results in target shareholders owning control of purchaser). Stock acquisitions generally follow the rules under section 368(a)(1)(B) (stock for stock), (a)(2)(D) (forward subsidiary merger) or (a)(2)(E) (reverse subsidiary merger). For reasons discussed in Part VI below, acquisitions structured under this latter set of sections are not attractive if one of the parties is an S corporation that wants to avoid termination of its S election.

IV. **Taxable Acquisitions – S Purchaser**

A. **Taxable Stock Acquisitions – Carryover Basis in Assets**

As indicated in Part III, a taxable acquisition of stock of another corporation may be structured as a direct acquisition of the stock from the shareholders or as a reverse subsidiary merger, which would be treated as a direct acquisition of stock.

1. **Momentary Affiliation.** The S purchaser should immediately liquidate the acquired corporation in order to avoid a termination of the S election because of the prohibition against affiliation. The S purchaser should be allowed to take advantage of sections 332 and 337 for the liquidation of a greater than 80%-owned subsidiary and receive a carry over basis in target's assets under section 334. In addition, section 381 should apply so that the attributes of the target carry over to the S purchaser. It is possible that the immediate liquidation of the target could result in the transaction being stepped together as a purchase of assets. The Service, however, in Rev. Rul. 90-95, 1990-2 C.B. 67, ruled that section 338 superseded the prior step transaction line of cases. Consequently, the S purchaser should be treated as having made a qualified stock purchase followed by a liquidation rather than as having made an asset acquisition.

2. **Built-in Gain Tax - Section 1374.** Since the liquidation of the target should be taxed under sections 332 and 337, the built-in-gain of a C corporation target's assets would not be recognized upon the liquidation. Section 1374, however, would apply to impose a corporate-level tax on that built-in-gain if it is recognized at any time in the succeeding ten-year period. Section 1374(d)(8). Generally, section 1374 tax is imposed only on the built-in-gain existing at the time of an acquisition. The S purchaser, therefore, should obtain an appraisal of the assets at time of the acquisition. If, subsequent to the acquisition, the assets appreciate in value and no appraisal was done, the S corporation will have the burden or proving that the extra appreciation did not exist at the time of the acquisition.

3. **Subchapter C Earnings and Profits.** The E&P of a C corporation target will carry over to the S purchaser. If the S purchaser has not
traditionally maintained its accumulated adjustments account ("AAA"), it will have to go back and calculate this account. Distributions made by S purchaser, to the extent of the AAA, will not be taxed as section 301 dividends attributable to the Subchapter C earnings and profits. An election is available to distribute the E&P even if the AAA has a positive balance. Treas. Reg. section 1.1368-1(f).

4. **An Alternative.** An alternative to liquidating the subsidiary in a reverse subsidiary merger transaction that has been blessed by private rulings is to have the S purchaser merge into the subsidiary immediately after acquisition. See PLR 8810045. See also PLR 8739010.

5. **Lack of Precedential Authority.** Note that the Service has only privately ruled that sections 332 and 337 apply on these facts. While the Service provides a very thoughtful analysis of section 1371 and its legislative history in TAM 9245004 which is consistent with the apparent underlying policy of section 1371, until published guidance is available, practitioners should be cautious.

6. **Effect on S Election.** Typically, a stock acquisition will terminate S purchaser's S election only if the momentary affiliation rule is not applicable.

7. **Allocations.** If the S election does terminate, typically, items of income and loss of S purchaser will be allocated between the S short year and the C short year on a pro rata basis under section 1362(e)(2), unless an election is made to close the books under section 1362(e)(3). If 50% or more of the stock of S purchaser is sold (maybe used as part of the consideration), the S corporation must close its books. Section 1362(e)(6). In such a situation, the short S year ends before the day that the termination is effective, and the short C year begins on the day that the termination is effective. If the transaction results in new shareholders, but no termination, the general rule is pro rata allocation, but an election may be made by all affected shareholders to close the books if (i) at least one shareholder's interest is completely terminated (section 1377(a)(2)); (ii) a shareholder disposes of 20% or more of S purchaser stock through sale or redemption (section 1.1368-1(g)(2)) or (iii) S purchaser issues new stock equaling at least 25% of its former outstanding stock (Treas. Reg. section 1.1368-1(g)(2)).

8. **Post-Termination Distributions.** If the S election is terminated, section 1371(e) provides that S purchaser may distribute money tax free to the extent of the lesser of the adjusted basis in the stock or the AAA. The section 1371(e) applies in a post-termination transition. Of course, if the S election is not terminated, post-acquisition distributions will be taxed under the general rules of section 1368.
9. Keeping Target Alive. The Service has blessed, in private rulings, a structure whereby S purchaser acquired less than 80% of target and S purchaser's shareholders acquired the remainder. Target was not liquidated. PLRs 8635012 and 8451049. In these rulings, the Service applied the 80% vote and value test literally. It is important to remember, however, that private letter rulings may only be relied on by the taxpayer who received them.

B. Taxable Asset Acquisitions and Other Cost Basis Acquisitions

1. Direct Acquisition of Assets or Forward Merger. In a direct asset acquisition or a forward merger (with S purchaser surviving), the S purchaser will take a cost basis in the assets of the target (typically, the sum of price paid, liabilities assumed and certain acquisition costs) and the target's tax attributes will not be carried over under section 381. Consequently, no section 1374 taint comes with the assets and no Subchapter C earnings and profits carry over to the S purchaser.

2. Section 338 Election. As explained above, in TAM 9245004, the Service interpreted section 1371 and its legislative history to allow an S corporation to make a section 338 election if the S purchaser makes a qualified stock purchase of the target. If the section 338 election is made, S purchaser will take a cost basis in the assets of the target (generally the same basis that the S purchaser would take if the assets were acquired directly) and the tax attributes of the target do not carry over to the S purchaser. Thus, even in the case of a C corporation target, no section 1374 taint carries over on the assets and no corporate-level earnings and profits carry over from the target. On the other hand, since the repeal of General Utilities, situations in which the target is a C corporation and a 338 election is beneficial to the purchaser are rare. If the S purchaser acquires target's stock and makes a 338 election, a corporate-level tax is imposed upon the deemed sale of the target's assets, which is in addition to the selling shareholder's tax on the gain on the stock sale. Some authorities believe, however, that, in the case of an S purchaser and S target, if the S target is liquidated immediately and S purchaser makes a section 338 election, the gain recognized on the deemed sale of the assets flows through to the S purchaser's shareholders. See Ginsburg and Levin, at p. 735. If this characterization is correct, the S target shareholders would be taxed on their stock sale and the S purchaser shareholders would be taxed on the deemed asset sale. The tax cost of the election, thus, would most likely outweigh the stepped-up basis unless the S purchaser or its shareholders have losses available to offset the gain.

3. Section 338(h)(10) Election. If the target is an affiliate in a consolidated group or, since the issuance of the new section 338(h)(10) final regulations, an S corporation, the parties may make a joint section 338(h)(10) election. In this case, the target would be treated as having sold its assets to the S
purchaser and immediately liquidating under section 332. The actual sale of stock by target shareholders is ignored. The section 338(h)(10) election is more attractive than the regular 338 election because only one level of tax is imposed -- on the built-in-gain in the assets -- and it is paid by the selling shareholders.

4. **Effect on S Election.** None of the structures described in this Part IV.B. should affect the S purchaser's S election unless the assets of target include the stock of a greater-than 80% owned subsidiary. Even in that case, S purchaser should be able to liquidate the subsidiary immediately to avoid a termination.

5. **Allocations.** Since S purchaser is merely acquiring assets and the S election should not be terminated, its income and loss allocations should continue to be made pro rata under the general rules of sections 1366 and 1377.

C. **Financing the Acquisition**

Regardless of whether an acquisition is structured as a taxable asset acquisition or a taxable stock acquisition, the shareholders of an S purchaser should attempt to finance the acquisition in a manner that provides them with the maximum basis in their stock or in debt of the S corporation. Stock and debt basis allow losses to flow through to the shareholders from the corporation. In addition, stock basis will allow distributions to be made without triggering gain.

1. **Capital Contributions.** Direct contributions from the shareholders will increase their basis in the stock. The contribution of a shareholder's note to an S corporation, however, will not create basis. Rev. Rul. 81-187, 1981-2 C.B. 167.

2. **Shareholder Loans to S Purchaser.** A shareholder may lend needed funds to an S corporation and obtain basis in the note. As indicated above, losses will flow through to the extent of the shareholder's basis in the note.

3. **Third-Party Borrowing.** The debt of an S corporation to a third-party lender will not create basis for a shareholder. This will be the case even if the shareholder guarantees the debt. If feasible, therefore, third-party lending should be structured so that the third-party lends to the shareholder who then contributes or lends to the S corporation. Even if, on that shareholder borrowing, the lender requires a pledge of the shareholder's S corporation stock as security, the shareholder's basis in the loan should not be affected. If, however, the lender requires that the corporate assets secure the loan to the shareholder, the loan may be treated as being made to the S corporation and not to the shareholder. See Harrington v. United States 605 F. Supp. 53 (Dist. Ct. Del. 1985).
4. **Shareholder Guarantees.** Shareholder guarantees of S corporation debt typically will not provide the shareholder with basis. If, however, the facts and circumstances indicate that the lender was actually looking to the shareholder for repayment and not the S corporation, the structure may be characterized as a loan from the third party to the shareholder and a contribution to the capital of the corporation. See *Selke v. U.S.*, 778 F.2d 769 (11th Cir. 1985); *Plantation Patterns, Inc. v. C.I.R.*, 462 F.2d 712 (5th Cir. 1972).

5. **Preferred Returns.** The investor putting up the cash for the acquisition may want a preferred return. Unlike C corporations or partnerships, S corporations do not have the flexibility to provide priority allocations or distributions. One way to accomplish the preferred return is by the investor lending the money to the S corporation rather than contributing to its capital. Another more elaborate structure is to organize a second S corporation and have the two S corporations form a partnership to acquire the assets of the target. Revenue Ruling 94-43, 1994-27 IRB-8 (revoking Rev. Rul. 77-220) holds that S corporations may join together in a partnership to avoid the 35-shareholder limit on S corporation eligibility. In light of this ruling, the risk that the Service will treat the two corporations as one in determining whether the S election is available has decreased significantly. If the two S corporations are treated as one, however, the S election would be unavailable because the corporation would probably be considered to have a second class of stock.

6. **One Class of Stock Restriction.** If the acquisition is financed by S purchaser issuing stock or debt, the parties should carefully consider the rules in Treas. Reg. 1.1361-1(l) to avoid the instrument being considered a second class of stock. Generally, any stock with different rights to distributions or liquidation proceeds will be considered a second class of stock and the S election will terminate. An instrument issued as debt, however, will only be considered a second class of stock if (1) the obligation constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law and (2) the obligation is used to circumvent the rights conferred by the corporation's outstanding stock with regard to distribution or liquidation proceeds or to circumvent the limitation on eligible shareholders. Treas. Reg. section 1.1361-1(l)(4)(ii). Shareholder debt generally should be respected as debt if (i) the S purchaser is reasonably capitalized; (ii) the debt is not held pro rata by the shareholders; (ii) it is reasonably expected that S purchaser will make payments when due; and (iv) the parties treat the instrument as debt. Alternatively, the money could be borrowed within the boundaries of the "straight debt" safe harbor of Treas. Reg. section 1.1361-1(l)(5).
V. **Taxable Acquisitions - S Target**

A. **Taxable Stock Sales**

1. **Reasons for Stock Sales.** A taxable sale of the stock of an S corporation can be structured in one of two ways: (i) the stock can be sold to a purchaser directly; or (ii) the stock can be acquired through a reverse subsidiary merger in which a subsidiary of a purchaser merges into an S target, and the S target survives. Though S target shareholders will often be indifferent regarding whether they sell their stock or the assets of the S corporation, there are several situations in which they will prefer a stock sale.

   (a) **Section 1374 Application.** In cases in which section 1374 is applicable, S target shareholders will prefer a stock sale to an asset sale. In such a case, an asset sale would result in a corporate level tax on the section 1374 built-in-gain to be borne by the S target shareholders. No such tax would result from a stock sale.

   (b) **High Stock Basis.** In certain circumstances, S target shareholders will have higher basis in their stock than in the assets of the S corporation. For example, this will likely be the case where the stock of an S corporation has been purchased at fair market value or has been received through an estate with a stepped-up basis. In these and other similar situations, the S target shareholders will recognize less gain in a stock sale than in an asset sale.

   (c) **S Target Owns Ordinary Income Assets.** S corporation shareholders, typically, will recognize capital gain upon a stock sale. Because the character of any gain recognized by an S corporation on an asset sale will flow through to the shareholders, if the S corporation has ordinary assets, such an asset sale may trigger ordinary income to the shareholders. This result could be further exacerbated in a situation where (i) the shareholder has a high outside stock basis; (ii) the sale of S target's assets produces ordinary income; and (iii) upon complete liquidation of S target, the shareholder recognizes a capital loss.

2. **Effect on S Election.** A sale of S target stock (or a reverse subsidiary merger where S target survives) should only terminate the S election if the sale results in S target having (i) an ineligible shareholder; (ii) more than 35 shareholders; or (iii) becomes affiliated with the purchaser. Therefore, a purchase by a corporation of S target would terminate the election because (i) a corporation is an ineligible shareholder or (ii) they would be affiliated. If, however, an ineligible shareholder (the corporation) immediately disposes of the stock (via liquidation, merger or spin-off), the ineligible shareholder's ownership may be ignored. In addition, the Service's position regarding momentary affiliation should protect S target's S election in such cases. See Rev. Rul. 73-496, 1973-2 C.B. 312;
72-320, 1972-1 C.B. 270; TAM 9245004. An important benefit of avoiding S election termination is that such avoidance renders the 5-year waiting period for re-electing S status inapplicable. See PLRs 8801025 and 8739010.

3. Allocations. If the S election is terminated and less than 50% of the stock is sold, income or loss will be allocated pro rata between the S and C short years; the C short year begins on the day the termination is effective, and the S short year ends before that day. If 50% or more of the stock is sold, the S corporation must close its books. Section 1362(e)(6). Also, the S corporation may elect to close its books even if less than 50% of the stock is sold. Section 1362(e)(3)(A). If the S election is not terminated, the general rule is pro rata allocation, but an election may be made by all affected shareholders to close the books if (i) at least one shareholder's interest is completely terminated (section 1377(a)(2)); (ii) a shareholder disposes of 20% or more of S target stock through sale or redemption (section 1.1368-1(g)(2)) or (iii) S target issues new stock equaling at least 25% of its former outstanding stock (Treas. Reg. section 1.1368-1(g)(2)).

4. Post-Termination Distributions. If the S election is terminated, section 1371(e) provides that S target may distribute money tax free to the extent of the lesser of the adjusted basis in the stock or the AAA. The rules of section 1371(e) applies in a post-termination transition. Of course, if the S election is not terminated, post-acquisition distributions will be taxed under the general rules of section 1368.

5. Pre-Sale Distributions. S target shareholders may be able to receive a distribution tax-free, to the extent of their stock basis (unless attributable to C E&P), from S target prior to the sale under section 1368. If the money for the distribution comes from the purchaser, the distribution could be recharacterized as disguised purchase price. See Waterman Steamship Corp. v. C.I.R., 430 F.2d 1185 (5th Cir. 1970). If section 1368 applies and the distribution is tax-free, the shareholders may then be able to sell the stock at a lower price to the purchasers on the installment basis.

6. Installment Sales. If parties do not make a joint section 338(h)(10) election, the parties may engage in an installment sale of S target stock. Installment sales, however, are not as advantageous as they traditionally were. First, if the deferred payments under the installment method exceed $5 million (based on aggregating the face amount of installment receivables arising from all such sales during the year), the seller's deferred tax liability will have an interest charge imposed on it. Second, if the sales price exceeds $150,000 and the seller pledges the installment receivables as security for a loan, the seller's deferred gain will be triggered. Finally, there is some question regarding whether an S target shareholder may use the installment sale when selling stock. Section 453A(e)(2) authorizes Treasury to issue regulations as may be necessary to carry out the purposes of this section, including regulations providing that the sale of an interest
in a pass-through entity will be treated as a sale of the proportionate share of the assets of the entity. Section 453A(e)(2) appears to need regulations in order to be effective. The Service, however, may interpret it differently, but has issued no guidance to indicate their interpretation. For a much more detailed discussion of section 453 and S corporations, see Ginsburg and Levin, Chapter XI.

7. **QSST Sellers.** In Rev. Rul. 92-84, the Service ruled that the beneficiary of a QSST is taxed on gain on the sale of the underlying S target stock. Beneficiaries of QSSTs should therefore be careful to ensure that upon a sale of the S target stock held by the QSST, cash would be available to them to pay the taxes. It is unclear whether an installment note received by the QSST will pass through installment reporting treatment to the beneficiary, however, the pass-through treatment seems unlikely. See Ginsburg and Levin, p. 766.

8. **Other Consequences to S Target Shareholders.** As mentioned above, S target shareholders, typically, will recognize capital gain on the stock sale. Any losses that have been suspended under 1366(d)(2) will likely be lost because the shareholders no longer own the stock.

9. **Regular Section 338 Election.** The purchaser may wish to acquire the stock from S target shareholders, then make a section 338 election. The interaction of section 1368(e)(1)(B) and section 338(a)(1) make such a structure inadvisable. S target would be considered a C corporation on the date of the acquisition (the date that S target's election terminates) and would recognize the deemed sale gain (under the 338 election) on that same day. S target shareholders would have been taxed on any gain inherent in the sale of their stock and, thus, the transaction would result in a double level of taxation. For the possibility of a different result if the purchaser is an S corporation, see Ginsburg & Levin, at 735. In light of the availability of the section 338(h)(10) election, described below, a regular 338 election seems unlikely.

10. **Joint Section 338(h)(10) Election.** Since the sale of stock in a joint section 338(h)(10) election has substantially the same effect as an asset sale by S target, this structure will be discussed in Part B below.

**B. Taxable Asset Sales**

1. **Asset Sale Structures.** S target may sell its assets by exchanging them directly for cash, notes or other property or by entering into a forward merger whereby S target merges into the purchaser. Rev. Rul. 69-6, 1969-1 C.B. 104. Further, the S target shareholders may be taxed in substantially the same manner as an asset sale in a case in which the purchaser acquires S target stock in a qualified stock purchase and the S target shareholders and purchasers make a joint 338(h)(10) election.
2. Reasons for Asset Sales. The S target shareholders should be indifferent as to whether S target sells its assets or they sell their stock if (i) the outside stock basis and inside asset basis is substantially the same; (ii) substantially all of the gain that would be recognized by S target on a sale of its assets would be capital gain from the sale; and (iii) section 1374 does not apply to S target. If the stock basis is lower than the inside asset basis or a sale of S target's assets would produce ordinary loss (instead of the capital loss that might be triggered by a sale of S target's stock), the shareholders might prefer that S target sell its assets.

3. Effect on S Election. An asset sale by S target (or a forward merger) should not terminate S target's S election. The election would cease when S target goes out of existence pursuant to an actual or, in the case of a forward merger, a deemed liquidation. If S target stays in existence, however, and S target has prior Subchapter C earnings and profits, passive investment income (defined in section 1362) received upon the investment of the cash proceeds from the sale or the interest income received from an installment note obtained in the exchange could result in a termination of the S election under section 1362(d). Generally, the S election will terminate under section 1362(d) if for 3 (three) consecutive years, (i) S target has Subchapter C earnings and profits and (ii) passive investment income exceeds 25% of S target's total gross receipts.

4. Corporate-Level Income

(a) Section 1374. If S target was subject to section 1374 (generally converted from, merged or otherwise combined with a C corporation in a carryover basis transaction since December 31, 1986), the sale of the assets will trigger any section 1374 gain.

(b) Section 1375. If S target stays in existence and if it has C corporation E&P and the gross receipts from passive investment income is equal to or exceeds 25% of its total gross receipts, the S target will have a corporate-level tax imposed on its income. Section 1375(a).

An installment note received in exchange for the sale of assets may then be distributed to the shareholders in a liquidation (or deemed liquidation in the case of a forward merger) without triggering the gain in the installment note. Sections 453B(h) and 453(h)(1). The shareholder's stock basis, however, must be allocated between the note and other property received in the liquidation for purposes of calculating gain under section 331. If assets are sold directly and S target stays in existence, as mentioned above, the interest on the note could trigger tax under section 1375 or a termination under section 1362(d) (if S target has C corporation E&P). For a more detailed description, see August -- Philadelphia Conference, at 48.
6. **Allocations.** In a direct asset sale where S target stays alive, section 1362(e) (regarding allocations in a termination year) would not be applicable. Further, the transaction would most likely not result in any new shareholders, so the elections under sections 1377 and 1368 would be irrelevant. The general rules for allocating income or loss under sections 1366(a) and 1377(a) would continue to apply. In the case of a taxable forward merger, the income or loss items should also be allocable under the general rules of sections 1366 and 1377, but if the S corporation has gone out of existence, some income could be accelerated.

7. **Joint 338(h)(10) Election.** As explained in Part II, final Treasury regulations under section 338(h)(10) were issued on January 20, 1994, which allowed the selling shareholders and purchasers of S targets to make a joint 338(h)(10) election. The S target shareholder's determination of whether to join in this election should take into account the same factors considered in determining whether to sell assets or stock: (i) the relative inside and outside basis; (ii) the character of S target's assets; and (iii) possibly, whether section 1374 applies (but see paragraph (e) below).

   (a) **Eligibility to Make Election.** The purchasing corporation must acquire 80% or more of the voting power and value of the S corporation target's stock. § 1.338(h)(10)-1(c)(2). Note that since the target must be an S corporation on the acquisition date, the purchasing corporation may not own any of the target's stock before the acquisition date (no corporate shareholders allowed).

   (b) **Election.** The election must be made jointly on IRS Form 8023 by the purchasing corporation and the S corporation's shareholders not later than the 15th day of the 9th month beginning after the acquisition. Treas. Reg. section 1.338(h)(10)-1(d)(3)(2).

   (c) **Tax Consequences.** The tax consequences of a 338(h)(10) election to the target S corporation are as follows: the S corporation is treated as if it (i) sold all of its assets to the acquiring corporation and (ii) distributed the proceeds to its shareholders in a taxable liquidation under section 331 of the Code. The actual stock sale is ignored. The shareholders of the S corporation will pay tax on the gain upon the deemed sale that flows through to them, and will be taxed under section 331 to the extent the value of the assets deemed distributed exceeds their stock basis. No double tax should be recognized, however, because the gain from the asset sale should cause an increase in their stock basis under section 1367.

   (d) **Purchaser's Basis.** The deemed sales price for the assets is the sum of (i) the stock sales price; (ii) any target liabilities assumed; and (iii) certain other relevant items (such as reductions for purchaser's acquisition
costs). The purchaser takes a basis in the assets equal to the deemed sales price plus its acquisition costs.

(e) **Section 1374.** Treasury regulation section 1.338(h)(10)-1(e)(5) appears to provide that, if any section 1374 tax is imposed on the deemed asset sale, the section 1374 tax is imposed on and remains with S target, rather than being taxed to the selling shareholders. Which party bears that tax could, of course, be a negotiated issue.

(f) **Benefit.** The availability of the 338(h)(10) election provides a great opportunity for purchasers to obtain a fair market value basis in the assets of a target S corporation without the attendant hassles of obtaining the necessary consents to transfer licenses or contracts or dealing with property transfer issues unless a change in control requires such consents or filings.

(g) **Effective Date.** The election is available for acquisitions occurring after January 20, 1994, but may be made retroactively for acquisitions occurring after January 14, 1992. No companion extension of the time for making an election was provided, but see Treas. Reg. section 301.9100-1(a) and Rev. Proc. 92-85, 1992-2 C.B. 490 regarding making late elections. See also PLR 9417844 where the Service allowed a belated section 338(h)(10) election.

VI. **Tax-Free Acquisitions Involving S Purchaser or S Target**

As indicated above, S corporations may engage in reorganizations under section 368, but will accomplish the goal of tax-free treatment only if all of the relevant statutory, regulatory and judicial requirements are met. See GCM 39768 issued on December 1, 1988 which analyzes the interaction of the reorganization rules and the post-1982 Subchapter S rules and holds that an S transferor corporation may engage in "A," "C," "D," and "F" reorganizations qualifying under section 368 as well as in spin-off transactions qualifying under section 355. The GCM favorably cites several pre-1982 revenue rulings allowing transferor S corporations to engage in tax-free reorganizations and Rev. Rul. 69-566, 1969-2 C.B. 165, allowing an S purchaser to engage in an "A" reorganization. See also ABA Task Force Report on Taxable and Tax-Free Acquisitions Involving S Corporations, reprinted at 45 Tax Lawyer 435, 452-468 for a thoughtful discussion of the authorities regarding S corporations involved in reorganizations. The ABA Task Force requested that GCM 39768 be published as a Revenue Ruling. Unfortunately, the Service has not yet done so.

A. **Tax-Free Stock Acquisitions**

1. "B" Reorganizations and Tax-Free Forward and Reverse Subsidiary Mergers. If S purchaser or S target engages in a
reorganization transaction described in one of sections 368(a)(1)(B), (a)(2)(D), or (a)(2)(E), its S election will most likely terminate. Each of these three reorganizations requires that the purchasing corporation acquire control of the target. Thus, S purchaser or S target, whichever the case may be, would most likely become a member of an affiliated group which would terminate their S election. For the possibility of structuring the transaction so that S purchaser owns 80% of the vote, but not 80% of the value of a target's stock, see Ginsburg and Levin, at p. 743.

(a) **Effect on S Election.** As indicated above, a reorganization under one of these sections involving an S purchaser would probably terminate the S election.

(b) **Allocations.** In the case of a termination of the S status of S purchaser, pursuant to a tax-free stock reorganization, S purchaser's income should be allocated between the S and C short years on a pro rata basis unless (i) 50% or more of S purchaser's stock was exchanged in the transaction or (ii) S purchaser elects to close its books. Section 1362(e). Under section 1362(e), the C short year begins on the day the termination is effective and the S short year ends before that day. If S target engaged in one of these reorganizations and its S election terminated, section 1362(e) should apply to require that S target close its books in the S termination year.

(c) **Post-Termination Distributions.** In the post-termination transition period, the S corporation is allowed to make tax-free distributions to the extent of the lesser of the adjusted basis the shareholders have in S purchaser stock or the corporation's AAA. Section 1371(e).

(d) **Suspended Losses.** If an S corporation engages in a "B" reorganization and terminates its S election, S purchaser shareholders will be able to recognize suspended losses in the post-termination transition period under section 1366(d)(3). It is unclear whether the same rule would apply to S target shareholders since they now own stock in an S purchaser.

2. **Section 351.** S Purchaser may acquire target stock in exchange for S purchaser's stock in a transaction qualifying under section 351 so long as the amount of S purchaser stock issued in exchange for target stock constitutes control (as defined in section 368(c)).

(a) **Effect on S Election.** The section 351 transaction should not terminate the S election of S purchaser unless either (i) target shareholders who receive S purchaser stock are not all qualified S corporation shareholders; (ii) after the transaction, S purchaser has more than 35 shareholders; or (iii) S purchaser holds more than 80% of the stock of target.
(b) **Allocations.** Under Treas. Reg. 1.1368-1(g), the shareholders of an S corporation that issues stock constituting at least 25% of the formerly outstanding stock in one taxable year may elect to close the books of the S corporation at the time of the stock sale. If such an election is not made, allocations of income and loss will be made on a pro rata basis under the general rules of section 1366.

**B. Tax-Free Asset Acquisitions**

An S purchaser or an S target may engage in a tax-free asset acquisition without causing a termination of its S election by way of several different structures. S purchaser or S target, whichever the case may be, could engage in a transaction qualifying under one of sections 358(a)(1)(A), (a)(1)(C), or (a)(1)(D).

1. **Structures.**

   (a) **"A" Reorganizations.** An "A" reorganization would be structured as a statutory merger of target into purchaser with at least some of target shareholders receiving stock of purchaser. The Service has issued several rulings blessing such a transaction as an "A" reorganization in the case of either an S purchaser or S target. The rulings have provided that no termination of the S election occurred. Rev. Rul. 69-566, 1969-2 C.B. 165; PLRs 9410022; 9206011 and 9115059 (all regarding S purchasers who survive the merger); Rev. Rul. 64-94, 1964-1 C.B. 317 and PLR 8502082 (both regarding S targets that merge into purchasers); and Rev. Rul. 70-232, 1970-1, C.B. 177 (regarding a consolidation of two S corporations, neither of whose election terminates). For the relevance of S target's S election not terminating, see paragraph 3.(a) below.

   (b) **"C" Reorganizations.** In a "C" reorganization, generally, a purchaser acquires substantially all of a target's assets in exchange for the purchaser's voting stock, and the target completely liquidates. There appears to be no published or private ruling blessing a transaction in which S purchaser acquires target's assets in a "C" reorganization in exchange for S purchaser's stock. In other contexts, however, the Service has privately ruled that target's momentary holding of S purchaser's stock will not cause a termination. PLRs 8942052, 8736014, and 8518034. See GCM 39768 where the Service stated that a momentary ineligible shareholder should not terminate an S election in the course of any reorganization. It is clear that an S target can exchange its assets in a "C" reorganization without terminating its election, although the S target will cease existence upon the required liquidation. See Rev. Rul. 71-266, 1971-1 C.B. 262; GCM 39768. For the relevance of S target's S election not terminating, see paragraph 3.(a) below.
(c) "D" Reorganizations. To qualify as a "D" reorganization in a transaction similar either to a "C" reorganization or an "A" reorganization, purchaser may acquire target's assets in exchange for purchaser's stock, target must liquidate and 50% of target's shareholders must own S purchaser's stock immediately after the transaction. The analysis applied above to "A" or "C" reorganizations should apply equally to an acquisitive "D" reorganization.

2. Considerations for S Purchasers Engaging in Tax-Free Asset Acquisitions

(a) Effect on S Election

(i) 80% Affiliate. If one of the assets of target is a more than 80% owned subsidiary, S purchaser's S election will terminate unless the subsidiary is promptly liquidated.

(ii) Ineligible Shareholders. If S purchaser's stock is transferred to a target shareholder who is an ineligible shareholder, S purchaser's election may terminate.

(iii) 35 Shareholders. If the transaction results in S purchaser having greater than 35 shareholders, S purchaser's S election will terminate.

(iv) Second Class of Stock. Stock of S purchaser issued in the reorganization must have the same rights to distributions and liquidations as S purchaser's other stock to avoid termination attributable to having a second class of stock.

(b) Allocations. If S purchaser's election is not terminated, allocations of income and loss will be made under the pro rata, per-share, per-day rules of sections 1366 and 1377. The shareholders, however, may elect to close the books if S purchaser issues stock totaling more than 25% of its stock outstanding prior to the transaction. Treas. Reg. 1.1368-1(g). If the S election does terminate, section 1362(e) would provide for a pro rata allocation of income between the short S and short C year unless (i) the shareholders elect to close the books under section 1362(e)(3) or (ii) if there is a sale or exchange of 50% or more of S purchaser's stock. The short S year ends on the day preceding the termination event.

(c) Attribute Carryover. Generally, the target's attributes would carry over to S purchaser. Section 381. S purchaser would receive a carry over basis in target's assets, and thus, section 1374 would apply to the built-in-gain in target's assets. Moreover, the LIFO recapture rules of section 1363(d) would apply. Treas. Reg. 1.1363-2(a)(2). On the other hand, target's NOLs and
credits will not be carried forward or back to S purchaser. Section 1371(b)(1). The C corporation target's NOLs, however, may be used to offset gain subject to section 1374 tax. Section 1374(b)(2).


(e) Post-Acquisition Distributions. Distributions made by S purchaser after a tax-free asset acquisition should be governed by section 1368. For a detailed analysis of how section 1368 will apply in different fact scenarios, see Silverman and Keyes, at p. 662.

(f) Distributions Made Pursuant to the Acquisition. It is unclear whether distributions made by S purchaser pursuant to a tax-free asset acquisition will be treated under section 1368 or section 356. Under section 356, boot distributions would be taxed to the extent of gain. Under section 1368, boot distributions would be tax-free unless E&P is present and the AAA is not sufficient. For arguments that section 1368 should control, see August-Philadelphia Conference, at 56; and Silverman and Keyes, at 664.

3. Considerations for S Targets Engaging in Tax-Free Asset Acquisition

(a) Effect on S Election. The S election of an S target in an "A," "C," or "D" reorganization does not terminate. Rev. Rul. 79-52, 1979-1 C.B. 283; Rev. Rul. 72-320, 1972-1 C.B. 270; Rev. Rul. 71-266, 1971-1 C.B. 262, Rev. Rul. 70-232, 1970-1 C.B. 177; Rev. Rul. 64-94, 1964-1 C.B. 317. See also analysis in GCM 39768. The S corporation ceases to exist, however, upon the transaction in the case of a merger or upon complete liquidation in cases in which the transaction is not a merger. The importance of the lack of a terminating event is that the purchaser may elect S status without waiting for the five-year period required by section 1362(g) in the case of terminations.

(b) Allocations. Since the S corporation's election does not terminate under section 1362 but S target ceases to exist, the short S year will include the day of the reorganization. The income and loss allocations would be made on a pro rata, per-share, per-day basis under sections 1366 and 1377.

(c) Attribute Carryover. Generally, S target's attributes would carry over to purchaser under section 381. Section 381, which enumerates the attributes to be carried over, does not specify S corporation items such as AAA or suspended losses. The Service has taken the position, however, that if purchaser is an S corporation, the two corporations' respective AAAs will merge. Treas. Reg. section 1.1368-2(d)(2). S target's AAA presumably will not
carry over to a C corporation purchaser because section 1368 only applies to S corporations. It remains unclear whether losses suspended under section 1366(d)(2) will carry over.

(d) Pre-Acquisition Distributions. Generally, distributions made by S target before a tax-free asset acquisition should be governed by section 1368. See Rev. Rul. 71-266, 1971-1 C.B. 262.

(e) Post-Acquisition Distributions. Distributions made by an acquiring corporation after a tax-free acquisition of the assets of an S target will be treated according to whether the purchaser is an S corporation or a C corporation. If the purchaser is a C corporation, the provisions of Subchapter C will control. If the purchaser is an S corporation, then (i) section 1368 should apply and (ii) the purchaser will succeed to the AAA of the S target. Treas. Reg. section 1.1368-2(d)(2).

(f) Distributions Made Pursuant to the Acquisition. It is unclear whether distributions made by S target pursuant to a tax-free asset acquisition will be treated under section 1368 or section 356. Under section 356, boot distributions would be taxed to the extent of gain. Under section 1368, boot distributions would be tax-free unless E&P were present and the AAA were not sufficient. For arguments that section 1368 should control, see August - Philadelphia Conference, at 56; and Silverman and Keyes, at 664.