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Now You See it, Now You Don't: The Comings and Goings of Disregarded Entities

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Now You See It, Now You Don't: The Comings and Goings of Disregarded Entities

MARTIN J. MCMAHON, JR.*

I. Introduction

A. *Limited Liability Companies*

A business may be conducted through a limited liability company (LLC), organized under state law, rather than through a partnership, corporation, or through direct ownership by an individual as a sole proprietor. While state law recognizes an LLC as a distinct type of entity, the Code does not recognize an LLC as a distinct entity. Rather, for federal income tax purposes, an LLC that is regarded as an entity separate and distinct from its owners will be treated as either a corporation or a partnership, and it will be taxed accordingly. In some circumstances, however, an LLC will simply be disregarded for purposes of federal income taxation.

Under the rules governing the classification of unincorporated business entities for income tax purposes, an LLC with two or more members (owners) is treated as an entity separate and distinct from its members and is taxed either as a corporation or a partnership.¹ It is taxed as a corporation only if it affirmatively elects to be treated as a corporation for federal tax purposes.² Otherwise, it will be treated as a partnership for purposes of federal income taxation.³

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¹Reg. § 301.7701-2(a).

²Reg. § 301.7701-3(a).

³Reg. §§ 301.7701-2(c)(2), -3(b)(1)(i).

An LLC with a single owner—whether the owner is an individual, corporation, or partnership—may affirmatively elect to be taxed as a corporation,⁴ but if it does not so elect, it will be disregarded as an entity separate from its owner.⁵ When an LLC is disregarded as an entity, its assets, liabilities, income items, and deduction items will be treated as owned, owed, received, and incurred directly by its owner.⁶ Thus, for example, if an individual is the sole owner of a domestic LLC that has not elected to be taxed as a corporation, the business conducted by the LLC will be treated as a sole proprietorship, the income of which is reportable directly on the individual taxpayer's income tax return. In practice, LLCs rarely elect to be taxed as corporations unless they also elect S corporation status to operate under a pass-through tax regime.⁷ Virtually every LLC that does not make these two elections is either treated as a partnership or is disregarded for federal tax purposes.

B. Corporations

Unlike partnerships, which are not taxpaying entities but generally are treated as an aggregate of the partners who pay tax on their shares of the partnership's income, corporations are taxpaying entities that are separate and distinct from their shareholders. However, certain corporations are eligible to elect under Subchapter S to treat the corporation as a pass-through entity with gains and losses being reported on the shareholders' individual returns.⁸ Corporations that do not make an election under Subchapter S are called "C corporations"; corporations that make the election are called "S corporations." Approximately 60% of corporations elect to be treated as S corporations.⁹

⁴Reg. § 301.7701-3(a). An election—made on Form 8832—is effective on the date specified in the election, which cannot be more than 75 days prior to the date the election is filed or more than 12 months after the date the election is filed. Reg. § 301.7701-3(c)(1)(iii). The election is made by the entity, and Form 8832 must be signed by either (1) each member of the electing entity who is an owner at the time, or (2) any officer, manager, or member of the electing entity who is authorized under local law or the organizational documents to make the election and who under penalties of perjury must represent having such authorization to make the election. Reg. § 301.7701-3(c)(2); see INTERNAL REVENUE SERVICE FORM 8832 (2011). For retroactive elections, everyone who was an owner between the effective date and the date of the election, but who is not an owner at the time the election is filed, also must sign the election. Reg. § 301.7701-3(c)(2)(ii).

⁵Reg. § 301.7701-3(b)(1)(ii). For a discussion of miscellaneous issues regarding single member LLCs, see Carter G. Bishop, *Through the Looking Glass: Status Liability and the Single Member LLC Perspective*, 42 SUFFOLK U. L. REV. 459 (2009).

⁶See Reg. § 301.7701-2(a).

⁷This is not a tax strategy but is a strategy followed to invoke application of state law LLC governance rules rather than corporate statute governance rules, while obtaining limited liability under state law pass-through taxation. See Stephen R. Looney & Ronald A. Levitt, *Operating as an S Corporation Through a State Law Limited Liability Company*, 66 N.Y.U. ANN. INST. FED. TAX'N § 17.03 (2008).

⁸See I.R.C. §§ 1361–1379.

⁹See 29 STATISTICS OF INCOME BULLETIN No. 4, 180 tbl.13 (2010).

C. *Qualified Subchapter S Subsidiaries*

An S corporation may own the stock of a subsidiary that is a C corporation. Such a C corporation subsidiary may elect to join in the filing of a consolidated return with its affiliated C corporations—chains of controlled corporations of which the subsidiary is the common parent—but the S corporation parent is not allowed to join in the consolidated return.¹⁰ On the other hand, a subsidiary of another corporation may not be an S corporation, because a corporation that has another corporation as a shareholder is not eligible to make an S election.¹¹ However, section 1361(b)(3) provides a special rule for “qualified Subchapter S subsidiaries” (QSubs).

A qualified Subchapter S subsidiary (QSub) is any domestic corporation that (1) is not an ineligible corporation, (2) is wholly owned by an S corporation, and (3) is one that the parent S corporation elects to treat as a QSub.¹² A corporation for which a QSub election is made is not treated as a separate corporation. The existence of the stock of a QSub is ignored for tax purposes.¹³ All assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation.¹⁴ Transactions between the S corporation parent and the QSub are not taken into account for tax purposes.¹⁵

D. *The Comings and Goings of Disregarded Entities*

Both single-member LLCs and QSubs are “disregarded entities” for income tax purposes. This Article discusses the income tax consequences of a number of events in the life of a domestic disregarded entity, focusing principally on transitions between disregarded entity status and regarded entity status, as well as acquisitions and dispositions.¹⁶ Part II discusses LLCs, and Part III discusses QSubs.

Because the transition of an LLC from a disregarded entity to a partnership and the transition of an LLC from a partnership to a disregarded entity involve all of the issues that arise with respect to the formation and liquidation of partnerships, including the complex rules for allocating built-in gains and losses with respect to contributed property after the formation of a partnership and the complex rules governing distributions from partnerships, this Article does not attempt to provide a detailed description of the answers to all the questions. It merely identifies the issues and highlights the governing provisions of the Code and Treasury Regulations that must be applied to the

¹⁰ See I.R.C. § 1504(b)(8).

¹¹ I.R.C. § 1361(b)(1)(B).

¹² I.R.C. § 1361(b)(3)(B).

¹³ Reg. § 1.1361-4(a)(4).

¹⁴ Reg. § 1.1361-4(a)(1).

¹⁵ See *id.*

¹⁶ There are a number of employment tax and excise tax issues raised by the existence of disregarded entities and the transition between being a disregarded entity and a regarded entity. Those issues are beyond the scope of this Article.

transactions discussed in this Article. An attempt to answer all of the questions would require a treatise on partnership taxation.¹⁷

Likewise, elections and revocations of QSub status involve all of the provisions dealing with the formation and liquidation of corporations, as well as many other provisions of Subchapter C of the Code that generally govern corporate taxation along with provisions of Subchapter S. Again, this Article does not attempt to provide a detailed description of the answers to all the questions but merely identifies the issues and highlights the governing provisions of the Code and Treasury Regulations that must be applied to the transactions discussed in this Article.¹⁸

II. Single-Member Limited Liability Companies

A. Counting Members

There are no general attribution rules that apply for purposes of determining the number of members of an entity under the check-the-box rules. Thus, for example, if two family members both own interests in an LLC, the LLC has two members and it is a partnership, not a disregarded entity.

However, section 761(f) provides that a husband and wife who operate a qualified joint venture may elect not to treat the joint venture as a partnership.¹⁹ A qualified joint venture is one conducted by a husband and wife, both of whom are material participants and who file a joint return. Each spouse is required to report the spouse's share of income and expense items on a separate schedule C.²⁰

Revenue Procedure 2002-69 deals with the classification of partnerships, including LLCs taxed as partnerships, that are wholly owned by a husband and wife as community property in community property law states.²¹ If the husband and wife treat the entity as a disregarded entity with a single owner under Regulation sections 301.7701-1(a)(4) and -2(a), the Service will accept the position that the entity is a disregarded entity for federal tax purposes. On the other hand, if the husband, wife, and the entity treat the entity as a partnership for federal tax purposes and file appropriate partnership returns, the Service will accept the position that the entity is a partnership for federal tax purposes. A change in reporting position will be treated as a conversion of the entity for federal tax purposes.

Revenue Procedure 2002-69 provides broader relief than section 761(f)

¹⁷For detailed discussion of any of the partnership taxation issues raised in this Article, refer to the appropriate sections of WILLIAM S. MCKEE, ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (2011).

¹⁸For detailed discussion of any of the corporate taxation issues raised in this Article, refer to the appropriate sections of BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (2011).

¹⁹I.R.C. § 761(f).

²⁰I.R.C. § 761(f)(1)(C). Each spouse is individually assessed self-employment tax; *see also* I.R.C. § 1402(a)(17).

²¹Rev. Proc. 2002-69, 2002-2 C.B. 831.

does, because, among other things, it applies even if one spouse does not materially participate in the venture.²² Nevertheless, nothing in the Revenue Procedure allows husbands and wives who own all of the interests in an LLC or partnership in a common law property state to avoid entity characterization under Regulation section 301.7701-2(a) unless section 761(f) applies.

If two subsidiaries of a single parent corporation own all of the interests in an LLC, the LLC is a partnership, not a disregarded entity,²³ even if the corporations file a consolidated return.²⁴

B. Formation or Liquidation of a Single-Member LLC

1. Formation of a Single-Member LLC

For federal income tax purposes, the formation of a single-member LLC that does not affirmatively elect to be treated as a corporation simply is a non-event. Even though ownership of the assets transferred to the LLC is effective for state law purposes, all of the assets continue to be owned by the transferor member of the LLC for federal income tax purposes.²⁵ The assets' bases and sections 167, 168, and 197 cost recovery periods are unaffected.²⁶

All of the LLC's income and deductions will be reported directly on the member's tax return.²⁷ This is true whether the single owner is an individual, partnership, or corporation (including an S corporation). Of course, if the owner is a partnership or S corporation, the LLC's items ultimately flow through to the partners or shareholder(s), after aggregation with the member pass-through entity's other income and deduction items under the rules of either Subchapter K or Subchapter S, as appropriate.

The assumption of the transferor's debts by the LLC has no tax effect, even if the debts assumed exceed the transferor member's basis in the transferred

²² Compare I.R.C. § 761(f) (requiring both spouses materially participate in a business to be a qualified joint venture), with Rev. Proc. 2002-69, 2002-2 C.B. 831.

²³ See T.D. 8697, 1997-1 C.B. 215 ("The fact that some or all of the owners of an organization are under common control does not require the common parent to be treated as the sole owner."); Rev. Rul. 1983-156, 1983-2 C.B. 66 (recognizing as a partnership an entity owned by a first tier and second tier subsidiary); Michael Hirschfeld & Richard P. Wild, *LLCs Provide Broad Tax Planning Possibilities For Corporate Groups in Both Domestic and Cross-Border Transactions*, 18 J. TAX'N INVESTMENTS 3, 8 (2000).

²⁴ See, e.g., P.L.R. 1999-04-039 (Oct. 1, 1998) (recognizing a partnership between two affiliated corporations filing a consolidated return).

²⁵ See Reg. § 301.7701-3.

²⁶ For cost recovery periods for depreciable assets and amortizable section 197 intangibles generally, see BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS*, ¶¶ 14.04, 14.07-14.08, 14.10 (3d ed. 2003).

²⁷ Many states follow the federal classification of LLCs, but some impose excise taxes or fees. See Bruce P. Ely, et al., *State Tax Treatment of Limited Liability Companies and Limited Liability Partnerships*, 104 TAX NOTES 1059, 1068, n.5 (Sept. 6, 2004); Michael W. McLoughlin & Bruce P. Ely, *Series LLCs: Many State Tax Questions Are Raised but Few Answers Are Yet Available*, 9 J. BUS. ENT. 36 (2007).

assets.²⁸ The rule of Regulation section 1.1001-2, which requires recognition of gain when an asset is transferred to a transferor who assumes a debt (or in the case of a nonrecourse debt, takes subject to an encumbering debt) that exceeds the basis of the transferred property, does not apply because there has been neither a transfer of property nor an assumption of the debt for federal income tax purposes.²⁹ For federal income tax purposes, all of the LLC's debts are treated as direct obligations of the single owner.

Because the owner of a single-member LLC is treated as directly owning all of the assets of the LLC and as the debtor with respect to all of the LLC's debts,³⁰ the member does not have a basis in the LLC units themselves.

If an LLC has two or more members that include only a particular taxpayer, whether an individual or a regarded entity (such as a partnership or corporation) and one or more upper-tier LLCs that are disregarded entities which also are wholly-owned by the same taxpayer that directly owns an interest in the lower-tier LLC, the lower-tier LLC is a disregarded entity under the default rule of Regulation section 301.7701-3(b)(1) because the upper-tier LLCs are disregarded entities.³¹

2. Liquidation of a Single-Member LLC

The liquidation of a single-member LLC that has not checked-the-box, like the formation of a single-member LLC, simply is not an event cognizable by the federal income tax, regardless of whether the sole owner is an individual, partnership, or corporation (including an S corporation). This conclusion flows from the fundamental premise of disregarded entity status: for federal income tax purposes, at all times the sole member of the LLC is treated as (1) directly owning the LLC's assets and having an adjusted basis in each of those assets, and (2) directly owing all of the LLC's debts, with all of the tax consequences that flow from incurring, paying, and being relieved of debts.

C. Checking the Box

1. Section 351 Tax-Free Corporate Formation

a. *Generally.* If a single-member LLC elects under Regulation section 301.7701-3(a) to be taxed as a corporation,³² the election is treated as

²⁸ See *id.*

²⁹ See *id.*; Reg. § 1.1001-2.

³⁰ However, the LLC's obligation to pay employment taxes is not treated as a direct liability of the single member. A disregarded entity is treated as a separate entity—essentially in the same manner as a wholly-owned corporation—for purposes of employment tax reporting and liability. Reg. § 301.7701-2(c)(2)(iv). Nevertheless, if the LLC fails to pay its employment taxes, the owner likely will be liable for them under section 6672 as a “responsible person.” For a discussion of section 6672, see BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 50.07[1] (3d ed. 2003).

³¹ Rev. Rul. 2004-77, 2004-2 C.B. 119.

³² For election procedures, see *supra* note 4; for limitations on elections, see *infra* Part II.C.3.

the transfer of all of the LLC's assets to a new corporation, which assumes all of the LLC's liabilities, even though the entity remains an LLC for state law purposes.³³ Since there is only one continuing owner, the formation of the corporation is subject to the rules of sections 351, 357, 358, and 362. Since there is only one owner, the control requirement to qualify for nonrecognition under section 351 is automatically met. This deemed transaction occurs on the day before the effective date of the election.³⁴ Thus, for example, if a check-the-box election is effective on July 1, the deemed incorporation transaction occurs on June 30.

Except in the limited circumstances described below, no gain or loss will be recognized by the LLC member, who by virtue of the election for federal income tax purposes becomes a shareholder.³⁵ For purposes of determining gain or loss on a subsequent sale of the LLC units, which are now treated as shares of stock, section 358 provides that the basis of the stock received is the same as the basis of property transferred to the corporation. However, section 358(d) requires a reduction in the member's basis by an amount equal to the LLC's liabilities, excluding (1) cash method accounts payable and (2) liabilities of an accrual method taxpayer the deduction for which has been deferred under the economic performance rules of section 461(h).³⁶

To the extent the LLC's assets are capital or section 1231 assets, section 1223(1) provides a holding period for the LLC units, which are now treated as stock, that includes the period that the LLC held the capital or section 1231 assets while it was a disregarded entity. If the LLC, as is most likely, holds a mix of assets only some of which qualify for a tacked holding period under section 1223(1), a proportionate number of units (shares), by value,

³³Reg. § 301.7701-3(g)(1)(iv). For rules regarding the order in which the transactions are deemed to occur if elections are made for two or more tiered entities, see Reg. § 301.7701-3(f)(3)(iii).

³⁴Reg. § 301.7701-3(g)(3)(i).

³⁵Because a simple check-the-box election will not result in the LLC member receiving any money or other property from the LLC, section 351(b) should not cause any gain to be recognized.

³⁶See Rev. Rul. 1995-74, 1995-2 C.B. 36 (applying section 357(c) to unpaid accrual method liabilities subject to section 461(h) economic performance rules). If the basis of the stock otherwise would exceed its fair market value, section 358(h) requires that the basis of the stock be reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any section 357(c) liability that was assumed by the corporation. For this purpose, "liability" is broadly defined to include "any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of [the income tax]." Under this definition, a liability that is not cognizable under section 357—for example, a cash method account payable, a contingent liability, or an obligation of an accrual method taxpayer that is not yet deductible because of the operation of the economic performance rules of section 461(h)—nevertheless will be taken into account under section 358(h) to reduce the stock basis. Section 358(h) does not apply, however, if "the trade or business with which the liability is associated is transferred to the person assuming the liability." I.R.C. § 358(h)(3). Thus, section 358(h) will not apply to a check-the-box election unless the LLC does not conduct a business. See Reg. § 1.358-5.

are assigned a tacked holding period, and the remaining shares take a holding period beginning with the exchange.³⁷

Section 1032 and the Regulations thereunder³⁸ provide that the corporation, which the LLC becomes for federal income tax purposes by virtue of the election, does not recognize gain or loss on the issuance of stock, which the LLC membership unit becomes for federal income tax purposes by virtue of election.

As long as an LLC continues to conduct business after “checking the box,” no “business purpose” should be required for recognizing the election, even if the sole purpose of making the election is to secure tax benefits.³⁹ A corporation that actually conducts business will be recognized as a taxpayer separate and distinct from its owner(s) under the *Moline Properties* doctrine.⁴⁰

If the LLC is taxed as a C corporation, its taxable income is subject to the section 11 corporate tax (under which there is no capital gains preferential rate). Capital losses are allowed only to the extent of capital gains,⁴¹ subject to a three-year carryback.⁴² Net operating losses are subject to the carryover rules of section 172.

b. *LLC's Asset Basis and Holding Period.* Section 362(a) generally provides the corporation with a basis in the transferred property equal to the transferor's basis for purposes of determining the corporation's (1) gain or loss on a subsequent sale and (2) depreciation and amortization deductions.⁴³ Thus, the LLC takes a basis in its assets equal to the sole member's basis in the LLC's assets prior to the election.

However, if the aggregate basis of the LLC's property exceeds the aggregate fair market value of that property, the aggregate basis of the property must be reduced to its fair market value.⁴⁴ If the LLC holds both depreciated prop-

³⁷ See *Runkle v. Commissioner*, 39 B.T.A. 458 (1939).

³⁸ Reg. § 1.1032-1.

³⁹ See Rev. Rul. 2003-125, 2003-2 C.B. 1243. This Ruling held that an election to change the classification of an entity from a corporation to a disregarded entity resulted in the allowance of a section 165(g)(3) worthless security deduction to the corporation that was the sole-owner of the entity where the fair market value of the entity's assets did not exceed its liabilities. The Ruling reasoned that in the deemed liquidation of the entity, the shareholder received no distribution on its stock. The Ruling acknowledged that the entity continued to operate as it had in the past, that the election had no effect apart from securing benefits under the tax law, and was silent regarding any business purpose for the election.

⁴⁰ See *Moline Properties v. Commissioner*, 319 U.S. 436, 436 (1943); *Weekend Warrior Trailers, Inc. v. Commissioner*, 101 T.C.M. (CCH) 1506, 1519, 2011 T.C.M. (RIA) ¶ 2011-105, at 748 (“Even if a corporation was not formed for a valid business purpose, it nevertheless must be respected for tax purposes if it actually engaged in business activity.”); *Rogers v. Commissioner*, 34 T.C.M. (CCH) 1254, T.C.M. (P-H) ¶ 83,420 (1975) (“*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity. . . . Business purpose or business activity are alternative requirements.”).

⁴¹ I.R.C. § 1211(a).

⁴² I.R.C. § 1212(a).

⁴³ See I.R.C. § 362(a).

⁴⁴ See I.R.C. § 362(e)(2).

erty and appreciated property, section 362(e)(2) does not necessarily result in the basis of every item of loss property being reduced to its fair market value. Section 362(e)(2)(A) requires that the aggregate basis of the transferred property be reduced by the excess of the aggregate basis over the aggregate fair market value, and section 362(e)(2)(B) requires that the aggregate basis reduction be allocated among the transferred properties in proportion to the built-in losses in the properties before taking into account section 362(e)(2).

Section 1223(2) provides that the LLC's holding period for any capital asset or section 1231 asset received in a section 351 exchange includes the period for which the transferor shareholder held the capital or section 1231 asset.

2. *Gain Recognition When Liabilities Exceed Asset Basis*

If the LLC's aggregate liabilities exceed the aggregate basis of its property, section 357(c) requires the recognition of gain by the LLC member to the extent of such excess.⁴⁵ This will be true even if the sole member has personally guaranteed the debts with respect to which the LLC is the primary obligor.⁴⁶ In making this determination, section 357(c)(3)(A) excludes a liability the payment of which would give rise to a deduction. Typically, these liabilities are cash method accounts receivable and liabilities of an accrual method taxpayer the deduction for which has been deferred under the economic performance rules of section 461(h).

If gain is recognized, it is treated as being realized with respect to each asset, pro rata to the assets' relative fair market values.⁴⁷ The character of the gain—ordinary including section 1245 recapture or other recapture income, section 1231, or capital including “unrecaptured section 1250 gain”—depends on the character of the assets.

If the LLC member recognizes gain pursuant to section 357(c), the LLC, now taxed as a corporation, increases the aggregate basis of its assets by the amount of the gain recognized.⁴⁸ Neither the Code nor the Regulations, nor any other authority, provide any specific guidance on the method for allocating this basis increase among the assets.

⁴⁵If the LLC itself is the debtor, then the conditions of section 357(d), which apply to determine whether or not a transferor-shareholder's debts have been assumed by the transferee corporation for purposes of applying section 357, as well as the basis rules in sections 358 and 362, ordinarily will have been met.

⁴⁶See *Seggerman Farms v. Commissioner*, 308 F.3d 803, 804 (7th Cir. 2002) (holding that section 357(c) requires gain recognition when the liabilities assumed by the corporation exceed the transferor shareholder's basis in the property even if the transferor remains liable as a guarantor).

⁴⁷See Reg. § 1.357-2(b), Exs. (1)–(2).

⁴⁸I.R.C. § 362(a).

3. *Limitation on Future Elections*

If an LLC, other than a newly formed LLC, elects to change its classification from disregarded entity to corporation, it cannot elect to change its classification to disregarded entity again during the 60 months succeeding the effective date of the election to be taxed as a corporation.⁴⁹ However, the Service may allow such a change within the 60-month period if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of LLC's prior election.⁵⁰

For these purposes, an election by a newly formed LLC to be taxed as a corporation that is effective on the date of formation is not considered a change.⁵¹ Thus, the 60-month limitation does not apply. An LLC that elects to be taxed as a corporation effective upon its formation is free, therefore, to make its first election to be disregarded at any time after its formation. Likewise, an LLC that does not initially elect to be taxed as a corporation—thus remaining a disregarded entity—is free to make its first election to be taxed as a corporation at any time after its formation.

D. *“Check-and-Elect”—The Subchapter S LLC*

A single-member LLC that has elected to be treated as a corporation for federal tax purposes and that is owned by an individual U.S. resident (or other eligible shareholder) can also elect Subchapter S status, thereby avoiding the section 11 corporate income tax.⁵² The election may be made effective for the LLC's first taxable year as a corporation, and it will not be deemed to have an intervening short taxable year as a C corporation.⁵³ The treatment of a single-member LLC that elected to be taxed as a corporation and also elected Subchapter S status is no different from any other S corporation.

It is important to remember that even though a “check-and-elect” strategy keeps the LLC in a single tax regime, very different rules apply to Subchapter S corporations than to LLCs that are disregarded for federal tax purposes. First, for computing gain and loss, the LLC membershareholder has an independent basis in the LLC units that are treated as S corporation stock, and the S corporation's indebtedness is not reflected in that stock basis. Second, passed-through losses are limited to the basis of the stock (and losses reduce

⁴⁹Reg. § 301.7701-3(c)(1)(iv).

⁵⁰*Id.*

⁵¹*Id.*

⁵²As noted previously, this is not a tax strategy but a strategy followed to invoke application of state law LLC governance rules rather than state corporate statute governance rules while obtaining limited liability under state law pass-through taxation. *See supra* text accompanying note 7.

⁵³Rev. Rul. 2009-15, 2009-21 C.B. 1035.

that basis⁵⁴) even if the shareholder guarantees the S corporation's indebtedness.⁵⁵ Third, distributions of property from the LLC treated as an S corporation to the member result in the recognition of gain—but not loss—by the LLC under section 311, with that gain being taken in to account in the income passed through to the member under section 1366. Fourth, the liquidation of an LLC treated as an S corporation results in recognition of gain and loss to the LLC under section 336, with that gain or loss being passed through to the member under section 1366, followed by recognition of gain or loss by the member (as a shareholder for federal income tax purposes) under section 331 with respect to the liquidating distribution (after taking into account any adjustments to the basis of the membership units (treated as stock) under section 1367 resulting from the section 1366 gain or loss passed through to the member under section 1366.

E. Check-and-Sell

In *Dover Corp. v. Commissioner*,⁵⁶ the taxpayer corporation had complete ownership of a business entity organized under the laws of a foreign jurisdiction. Under Regulation section 301.7701-3, the entity was taxable as a corporation unless it elected to be a disregarded entity.⁵⁷ The taxpayer sold the subsidiary entity to another party and, solely for the purpose of reducing the taxes on the sale, elected to treat the subsidiary entity as a disregarded entity effective immediately before the sale.⁵⁸

As a result, the subsidiary corporation was treated as having been liquidated in a transaction to which section 332 applied to provide nonrecognition.⁵⁹ The transaction was thus transmuted from a stock sale and purchase to an asset sale and purchase. The Tax Court upheld the taxpayer's treatment of the sale as an asset sale rather than a stock sale.⁶⁰ The proposition that a nontax business purpose is not a prerequisite for a check-the-box election was implicit in the Tax Court's holding.

Applying *Dover* in the domestic context, the owner of an LLC that is a disregarded entity has the last-minute option of structuring the sale of the entity's business as either an asset sale and purchase, by simply selling the membership units of the LLC, or as a stock sale and purchase by first electing to treat the LLC as a corporation. The owner could then sell the LLC mem-

⁵⁴However, section 1366(d)(1) allows a shareholder to claim passed-through losses in excess of the basis of the shareholder's stock to the extent of the shareholder's basis in any indebtedness of the S corporation to the shareholder.

⁵⁵See I.R.C. § 1366(d)(1)(B).

⁵⁶122 T.C. 324 (2004).

⁵⁷*Id.* at 327. For certain foreign entities with limited liability that are not per se corporations, the default rule is that the entity is a corporation unless it elects to be a disregarded entity—the opposite of the rule for domestic entities.

⁵⁸*Dover Corp.*, 122 T.C. at 327.

⁵⁹*Id.* at 347–48.

⁶⁰*Id.* at 353.

bership units, which are treated as stock as a result of the election.

If respected, such a strategy could convert ordinary income into capital gain to the extent the LLC holds assets the gain on the sale of which would be ordinary income. However, the portion of LLC membership units attributable to the value of ordinary income assets would take a holding period commencing on the day after the effective date of the election. Any gain recognized on the sale of these LLC membership units within a year of the election would be short term capital gain.⁶¹

There is a possibility that the Service would challenge the application of section 351 to a "check-and-sell" strategy in certain circumstances, particularly if the sale was prearranged. For an incorporation to be tax-free under section 351, the shareholder(s) transferring property to the corporation in exchange for stock must be in control of the corporation "immediately after the exchange."⁶² Revenue Ruling 70-140 held that section 351 did not apply to the transfer of assets of a sole proprietorship to a controlled corporation followed immediately by a prearranged exchange of the stock of the controlled corporation for the stock of another corporation "in an integrated transaction."⁶³ Because of the integrated nature of the two transactions, the original transferor was not in control of the transferee "immediately after the exchange," as required by section 351.⁶⁴

Courts have held that the control requirement of section 351 is not satisfied where, pursuant to a binding agreement entered into by the transferor prior to the transfer of property to the corporation in exchange for stock, the transferor loses control of the corporation by a taxable sale of all or part of that stock to a third party who does not also transfer property to the corporation in exchange for stock.⁶⁵

⁶¹For the holding period of stock acquired in a section 351 transaction, see *supra* Part II.C.1.a.

⁶²See I.R.C. § 351. Through a cross reference in section 351(c), "control" is defined in section 368(c) as (1) 80% of the combined voting power of all classes of voting stock and (2) 80% of the number of shares of *each* class of nonvoting stock. See Rev. Rul. 1959-259, 1959-2 C.B. 115.

⁶³Rev. Rul. 1970-140, 1970-1 C.B. 73; see also Rev. Rul. 1979-70, 1979-1 C.B. 144 (finding section 351(a) control requirement not satisfied where a corporation transferred property to a newly organized corporation in exchange for all of its stock and, pursuant to a prearranged binding agreement that was an integral part of the incorporation, sold 40% of such stock to another corporation, which also purchased securities for cash from the new corporation); Rev. Rul. 1979-194, 1979-1 C.B. 145 (control requirement of section 351(a) was not met where one-half of the 99% stock interest in a newly organized corporation acquired by a transferor in exchange for property was sold, pursuant to an agreement, to others who had acquired the other 1% stock interest for property transferred to the corporation).

⁶⁴Rev. Rul. 1970-140, 1970-1 C.B. 73.

⁶⁵See, e.g., *S. Klein on the Square, Inc. v. Commissioner*, 188 F.2d 127, 128-31 (2d Cir. 1951); *Hazeltine Corp. v. Commissioner*, 89 F.2d 513, 518 (3d Cir. 1937); *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025, 1029-31 (1976).

In *May Broadcasting Co. v. United States*, the owner of a radio station agreed to sell a one-quarter interest for \$100,000.⁶⁶ Pursuant to a contract, the sale was effected through the transfer of the radio station to a newly formed corporation for its stock, following which the original incorporators sold one-quarter of the stock to the purchaser. The purchaser also contributed \$25,000 to the corporation, but received no additional stock. The court held that the original transfer was not a section 351 exchange because the sale was pursuant to a contract existing at the time of incorporation, although the requirement of Federal Communications Commission approval delayed the sale until nine months after the transfer of the assets to the corporation by the seller.⁶⁷ The court reasoned as follows:

It is . . . clear that the transfer of the assets to the corporation and the issuance of the corporate stock were merely steps taken pursuant to and in accordance with the sale agreement There was no evidence that the [transferor] had any intention or interest to merely effect a transformation of its radio station property into a corporate stock holding. The sole transaction of substance between the parties that had anything to do with possible gain or loss to either of them was the sale of the interest for \$100,000—the divesting of the [transferor's] “control” as defined by the statute and conferring a substantial ownership and voice in the operation on the [purchaser].⁶⁸

On its particular facts, the vitality of *May Broadcasting* as a precedent might be vitiated somewhat by Revenue Ruling 79-194,⁶⁹ but the general principle expressed in the essential reasoning of *May Broadcasting* cannot be ignored.

In Revenue Ruling 79-194, the Service concluded that under certain circumstances a pre-arranged sale between two transferors of property for stock did not affect the control requirement.⁷⁰ In Situation (1) of the Ruling, Z Corporation transferred property to Newco for 80% of Newco stock. A group of investors transferred property for 20% of Newco stock. Following the transfers to Newco, Z sold stock to the investors. After the sale, Z owned 49% of the Newco stock. The Ruling held that because Z and the investors were transferors, the persons transferring property to Newco in exchange for Newco stock owned 100% of Newco stock immediately after the exchange. In contrast, in Situation (2) the investor group transferred property in exchange for only 1% of the Newco stock, with Z Corporation receiving 99%. The investors' stock ownership received directly from Newco in exchange for property was insufficient to qualify them as transferors of property. Thus, the control requirement was not satisfied because of the subsequent sale of stock by Z to the investors.

⁶⁶*May Broadcasting Co. v. United States*, 200 F.2d 852, 854 (8th Cir. 1953).

⁶⁷*Id.* at 855-56.

⁶⁸*Id.*

⁶⁹Rev. Rul. 1979-194, 1979-1 C.B. 145.

⁷⁰Rev. Rul. 1979-194, 1979-1 C.B. 145.

In *Intermountain Lumber Co. v. Commissioner*, the Tax Court held that the requisite control immediately after the exchange was not present where, as part of the incorporation transaction, the transferor was obligated under an agreement of sale to sell almost half of the shares of the corporation to a third party.⁷¹ The court formulated the control requirement of section 351 as follows:

A determination of "ownership," as that term is used in section 368(c) and for purposes of control under section 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired it from the corporation. . . . If the [stockholder], as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of section 351. By contrast, if there are no restrictions upon freedom of action at the time he acquires the shares, it is immaterial how soon thereafter the [stockholder] elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding obligation.⁷²

Because the stockholder in *Intermountain Lumber Co.* was under an obligation to sell the shares, section 351 was not applicable and the corporate transferee obtained a stepped-up basis in the property involved in the transaction.⁷³ However, the last sentence of the court's reasoning quoted above—although dictum—suggests that, if the LLC member is not under a binding obligation to sell LLC membership units at the time of the check-the-box election, a subsequent sale, even if pre-negotiated, will not affect the application of section 351.⁷⁴

The issue here also can be viewed as a variation on the *Court Holding Co.* issue. In *Commissioner v. Court Holding Co.*,⁷⁵ the taxpayer corporation owned a rental building that was its only operating asset. The taxpayer and a purchaser had an oral agreement for the sale and purchase of the building, and the potential purchaser paid a cash deposit.⁷⁶ At a meeting of the parties where the agreement was to be reduced to writing, the taxpayer's lawyer advised the parties that the transaction should not be consummated as proposed because the corporation would incur taxes on the sale and that the execution of the contract should be delayed. The following day, the corporation was liquidated and the building conveyed to the corporation's two shareholders, who then executed a purchase and sale contract with the potential purchaser. Three days

⁷¹*Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025, 1033–34 (1976).

⁷²*Id.* at 1031–32.

⁷³*Id.* at 1033–34.

⁷⁴*Id.* at 1031–32.

⁷⁵324 U.S. 331, 332 (1945).

⁷⁶*Id.* at 333.

later the contract was closed and the property was transferred.⁷⁷

On these facts, the Tax Court held that the corporation never had abandoned the sale.⁷⁸ Rather the various steps by which the transaction was consummated “were mere formalities designed ‘to make the transaction appear to be other than what it was.’”⁷⁹ After the Court of Appeals reversed the Tax Court, the Supreme Court, in turn, reversed the Court of Appeals and held that there were sufficient facts to support the Tax Court’s decision.⁸⁰ The Court observed as follows:

[T]he transaction must be viewed as a whole, and each step from the commencement of negotiations to the consummation of the sale is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.⁸¹

As a result, the transaction was taxed as a sale of the building by the corporation followed by the liquidation of the corporation, and two levels of tax were imposed.⁸²

Over the next five years, the courts applied these principles unevenly. Some courts applied an almost automatic “sale-by-the-corporation rule,”⁸³ while others held that as long as the shareholder—officers negotiated and contracted with the buyer in their capacity as shareholders who held the reasonable prospect of obtaining title to the corporation’s assets prior to the closing of the purchase and sale, the sale was not attributed to the corporation.⁸⁴

⁷⁷The liquidation predated the enactment of sections 311(b) and 336, which tax corporations on the distribution of appreciated property to shareholders. At that time, under the principles of *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935)—the *General Utilities* doctrine—corporations did not recognize gain or loss on the distribution of property to shareholders, whether the distribution was as a dividend in a stock redemption or in liquidation of the corporation.

⁷⁸*Court Holding Co.*, 324 U.S. at 333–34.

⁷⁹*Id.* at 333.

⁸⁰*Id.* at 334.

⁸¹*Id.*

⁸²*Id.* at 333.

⁸³*See, e.g., Guinness v. United States*, 73 F. Supp. 119, 131 (Ct. Cl. 1947) (“[I]n order to minimize taxes, the formalities of a transfer from the [corporation] to the [shareholder], which did not want the [property] and did not intend to keep it, except momentarily and for the purpose of satisfying the order of procedure decided upon, were gone through. Then the [stockholder], in turn, made its prearranged move and transferred the [property] to the person who was at all times intended to have it. We think that the intermediate move, useless and without any purpose except to reduce taxes, ought to be disregarded.”).

⁸⁴*Howell Turpentine Co. v. Commissioner*, 162 F.2d 319 (5th Cir. 1947); *see Kaufman v. Commissioner*, 175 F.2d 28 (3d Cir. 1949) (finding sale attributable to corporation); *Beaty & Co. v. Commissioner*, 145 T.C. 52 (1950) (finding sale not attributable to corporation).

Five years after deciding *Court Holding Co.*, the Supreme Court clarified the doctrine in *United States v. Cumberland Public Service Co.*⁸⁵ The taxpayer was a closely held corporation in the business of generating and distributing electric power in three Kentucky counties. In 1936 a local cooperative began to distribute Tennessee Valley Authority (TVA) power in the area served by the taxpayer. It became obvious to the taxpayer and its shareholders that its diesel-generated power could not compete with TVA power, which the taxpayer had not been able to obtain.

The shareholders offered to sell all their stock to the cooperative. The cooperative refused to buy the stock, but countered with an offer to buy the corporation's transmission and distribution equipment. The corporation rejected the offer because of the corporate income tax that would result from the sale, but at the same time the shareholders offered to acquire the transmission and distribution equipment and then sell to the cooperative. The cooperative accepted. The corporation transferred the transmission and distribution systems to its shareholders in partial liquidation. The shareholders then completed the pre-arranged sale to the cooperative. The corporation's remaining assets were sold and the corporation dissolved.

The Service asserted that under *Court Holding Co.*, the corporation should be taxed on the sale of the transmission and distribution equipment, but the Court of Claims held that the sale was made by the shareholders.⁸⁶ The Supreme Court affirmed, distinguishing *Court Holding Co.*:

Our *Court Holding Co.* decision rested on findings of fact by the Tax Court that a sale had been made and gains realized by the taxpayer corporation. There the corporation had negotiated for sale of its assets and had reached an oral agreement of sale. When the tax consequences of the corporate sale were belatedly recognized, the corporation purported to "call off" the sale at the last minute and distributed the physical properties in kind to the stockholders. They promptly conveyed these properties to the same persons who had negotiated with the corporation. The terms of purchase were substantially those of the previous oral agreement. . . . Discussing the evidence which supported the findings of fact, we went on to say that "the incidence of taxation depends upon the substance of a transaction" regardless of mere "formalisms," and that taxes on a corporate sale cannot be avoided by using the shareholders as a "conduit through which to pass title."

This language does not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution. . . .

Here, on the basis of adequate subsidiary findings, the Court of Claims has found that the sale in question was made by the stockholders rather than the corporation. The Government's argument that the shareholders acted as a mere "conduit" for a sale by respondent corporation must fall before

⁸⁵*United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 452 (1950).

⁸⁶*Id.* at 453.

this finding. The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.⁸⁷

In other words, sometimes formalism does not work, but other times formalism does work, and it all depends on the facts. *Cumberland Public Service Co.* provides an instruction manual for avoiding the *Court Holding Co.* result. Although not noted by the Supreme Court in its opinion, the persons who were the corporate officers negotiating on behalf of the corporation were the shareholders.⁸⁸

After *Cumberland Public Service Co.*, the courts generally did not attribute the asset sale to the corporation even though negotiations were conducted by shareholder-officers, as long as the shareholders and not the corporation entered into the purchase and sale contract.⁸⁹ But where the corporation entered into the purchase and sale contract and transferred the property to the shareholders before the closing of the contract, the sale was attributed to the corporation.⁹⁰

The *Court Holding Co.—Cumberland Public Service Co.* dichotomy depends to a large extent on the simultaneous existence of two different legal statuses for one person—shareholder and corporate officer—who, wearing different hats, can engage in two separate and distinct negotiations—an asset sale by the corporation or a stock sale by the shareholder—or choose not to engage in one or the other of the negotiations.⁹¹ A check-and-sell transaction, however, does not entail the simultaneous existence of two different legal statuses for one person at the time the fact pattern begins to unfold, but rather such a transaction entails the metamorphosis of the status of one person from asset owner for federal income tax purposes to a stockholder for federal income tax purposes. Thus, an application of the *Court Holding Co.—Cumberland Public Service Co.* dichotomy in the context of a check-and-sell transaction might simply be reduced to the dichotomy described in *Intermountain Lumber Co. v. Commissioner*⁹² and the application of Revenue Ruling 70-140.⁹³ As long as

⁸⁷ *Id.* at 454–55.

⁸⁸ See *Cumberland Pub. Serv. Co. v. United States*, 83 F. Supp. 843 (Ct. Cl. 1949).

⁸⁹ See, e.g., *Gensinger v. Commissioner*, 208 F.2d 576 (9th Cir. 1953); *St. Louis Union Trust Co. v. Finnegan*, 197 F.2d 565 (8th Cir. 1952); *Merka Holding Co. v. Commissioner*, 27 T.C. 82 (1956).

⁹⁰ *Donner v. Commissioner*, 227 F.2d 381 (2d Cir. 1955).

⁹¹ In a slightly different context, *Court Holding Co.* has been applied to tax a shareholder of an existing controlled corporation on the sale of an asset by the corporation promptly after the contribution of the property to the corporation. See, e.g., *Stewart v. Commissioner*, 714 F.2d 977 (9th Cir. 1983); *Hallowell v. Commissioner*, 56 T.C. 600 (1971).

⁹² *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976).

⁹³ Rev. Rul. 1970-140, 1970-1 C.B. 73.

there is no binding agreement to sell the stock at the time of the check-the-box election, it ought to be respected.⁹⁴

F. *Unchecking-the-Box—A Corporate Liquidation*

1. *Generally*

If a single-member LLC has elected to be taxed as a corporation and subsequently revokes that election,⁹⁵ the revocation of the election is treated as a corporate liquidation for purposes of federal income taxation, even though the LLC entity continues to exist under state law and none of its assets were actually transferred to the member.⁹⁶ As a result, if the LLC is owned by an individual or partnership, the LLC recognizes gain or loss pursuant to section 336, except to the extent that section 336(d) disallows the loss with respect to certain recently contributed property.⁹⁷ This deemed liquidation occurs on the day before the effective date of the election.⁹⁸ Thus, for example, if the election to be a disregarded entity is effective on January 1, the deemed liquidation occurs on December 31.

If the sole LLC member is an individual or a partnership, the member recognizes capital gain or loss on the liquidating distribution pursuant to section 331 and takes a fair market value basis in each asset under section 334(a), even though the LLC continues to own the assets under state law.⁹⁹ Thereafter the LLC will be treated in the same manner as if it had never elected to be taxed as a corporation—its assets, liabilities, income items, and deduction items will be treated as owned, owed, received, and incurred directly by its owner.

If the sole LLC member is a corporation—whether a C corporation or an S corporation—under section 332 the corporate LLC owner recognizes no gain or loss on the liquidation; for federal income tax purposes, the liquidation is treated as the liquidation of a subsidiary corporation into its parent

⁹⁴ Cf. *Cent. Tablet Mfg. Co. v. Commissioner*, 417 U.S. 673 (1974).

⁹⁵ For election procedures, see *supra* note 4; for limitations on elections, see *supra* Part II.C.3.

⁹⁶ For special rules regarding the order in which the transactions are deemed to occur if elections are made for two or more tiered entities, see Reg. § 301.7701-3(f)(3)(iii).

⁹⁷ See I.R.C. § 336(d).

⁹⁸ Reg. § 301.7701-3(g)(3)(i). For a different rule that applies where the election follows a qualified stock purchase as defined in section 338(d), see *infra* Part F.2.

⁹⁹ See I.R.C. §§ 331, 334(a).

corporation.¹⁰⁰ In that case, section 337 provides a general exception to the basic rule of section 336 that a liquidating corporation recognizes gain or loss on liquidating distributions; the LLC is treated as a corporate subsidiary liquidating into its parent, which does not recognize any gain or loss pursuant to section 337.

Pursuant to section 334(b), the basis of the LLC's assets is unchanged; the corporate member of the LLC, which now is treated as directly owning the LLC's assets, takes a transferred basis. Cost recovery periods and depreciation and amortization methods remain unchanged.¹⁰¹ Likewise, accounting methods and inventory methods remain unchanged.¹⁰²

If section 332 applies to the constructive liquidation of the LLC, section 381(a) provides that the corporate tax attributes that the LLC possessed as a C corporation carry over to the corporate owner of the LLC.¹⁰³ The most notable of these attributes are net operating loss carryovers, capital loss carryovers, and the earnings and profits accumulations or deficits.¹⁰⁴ If either the LLC, when it was taxed as a corporation, or the corporate owner of the LLC has a deficit in its earnings and profits accounts, the corporate owner of the

¹⁰⁰Section 332 applies when any parent corporation completely liquidates a subsidiary corporation that it controls pursuant to a plan of liquidation, as long as there is some distribution made with respect to the common stock. Regulation section 301.7701-3(g)(2)(ii) provides the election to treat as a disregarded entity the LLC that previously had elected to be taxed as a corporation is the adoption of the required plan for purposes of section 332. "Control" is defined in section 332(b)(1), through a cross reference to section 1504(a)(2), as holding both (1) 80% or more of the voting power, and (2) 80% or more of the total value of all stock of the corporation, except that pursuant to section 1504(a)(4), nonparticipating, nonconvertible, nonvoting preferred stock is not taken into account. Since the LLC is postulated to be solely-owned, this requirement is met.

If there is no distribution on the common stock, either because the net value of the corporation's assets does not exceed the liquidation preference of any outstanding preferred stock, *see* H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986), or the corporation is insolvent, then section 332 does not apply. If section 332 does not apply, as long as the transaction is not a section 368 reorganization, the parent recognizes gain or loss—usually loss. Thus, unchecking-the-box with respect to an insolvent LLC that is wholly-owned by a corporation could be a taxable transaction, which often would result in an ordinary loss under section 165(g)(3). *See* *Textron, Inc. v. United States*, 561 F.2d 1023 (1st Cir. 1977); *Commissioner v. Spaulding Bakeries Inc.*, 252 F.2d 693 (2d Cir. 1958); *Northern Coal & Dock Co. v. Commissioner*, 12 T.C. 42 (1949). However, if the parent corporation receives a distribution on at least one class of stock—for example, preferred stock—the transaction likely would be treated as an upstream section 368(a)(1)(C) tax-free reorganization. *See* Reg. § 1.368-2(d)(4)(i); Prop. Reg. § 1.332-2(b), (e), Ex. (2), 2007-2 C.B. 548; T.D. 9475, 74 Fed. Reg. 67,055 (Dec. 18, 2009) (“[A] subsidiary liquidation not subject to section 332 can qualify as a section 368(a)(1)(C) reorganization by effectively treating old and cold subsidiary stock that the parent holds as exchanged for hypothetical parent voting stock issued in exchange for the subsidiary's assets.”).

¹⁰¹*See* I.R.C. § 381(c)(6); Reg. § 1.381(c)(6)-1.

¹⁰²*See* I.R.C. § 381(c)(4)-(5).

¹⁰³If section 332 does not apply, *see supra* note 100, unless the transaction is a section 368 reorganization, there is no carryover of the tax attributes of the subsidiary under section 381. Rev. Rul. 1968-359, 1968-2 C.B. 161; Rev. Rul. 1959-296, 1959-2 C.B. 87.

¹⁰⁴*See generally* I.R.C. § 381(c).

LLC must maintain separate earnings and profits accounts after a section 332 liquidation; the deficit of one cannot be used to offset the surplus in the earnings and profits account of the other.¹⁰⁵ Earnings and profits accumulated by the parent after the liquidation are used to exhaust the deficit account before the accumulated earnings and profits account of the parent is increased.¹⁰⁶

If an LLC that has elected to be taxed as a corporation is insolvent—that is, the LLC has liabilities that exceed its assets, at the time the election is revoked—Revenue Ruling 2003-125 allows a section 165(g) worthless security deduction.¹⁰⁷ Although the Ruling itself dealt with a U.S. corporate parent of a foreign entity eligible to make a check-the-box election, the same principle ought to apply to domestic single-member LLCs, regardless of ownership.

If an LLC that previously had elected to be taxed as a corporation subsequently elects to change its classification to a disregarded entity, it cannot elect to change its classification to be a corporation again during the 60 months succeeding the effective date of the “uncheck-the-box” election.¹⁰⁸ However, the Service may allow such a change within that 60-month period if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of LLC’s prior election.¹⁰⁹ This limitation will not apply if the election to be taxed as a corporation was made when the LLC was formed.¹¹⁰

2. *Unchecking-the-Box Following a Qualified Stock Purchase*

If a corporation purchases all of the interests in an LLC taxed as a corporation and has purchased at least 80% of the interests within a 12-month period, the acquisition will meet the definition of a “qualified stock purchase” in section 338(d).¹¹¹ As a result, the purchasing corporation may both (1) make a section 338 election and (2) elect to “uncheck the box.” In such a case, if

¹⁰⁵I.R.C. § 381(c)(2); *Luckman v. Commissioner*, 56 T.C. 1216 (1971).

¹⁰⁶Reg. § 1.312-11(b)(2), -11(c).

¹⁰⁷Rev. Rul. 2003-125, 2003-2 C.B. 1243.

¹⁰⁸Reg. § 301.7701-3(c)(1)(iv).

¹⁰⁹*Id.*

¹¹⁰*Id.*

¹¹¹A “qualified stock purchase” is defined in section 338(d)(3), through a cross reference to section 1504(a)(2), as the acquisition by purchase within a 12-month period of 80% or more of the voting stock and 80% or more of the total value of all stock of the corporation, excluding nonvoting stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Stock of the target corporation already owned by the acquiring corporation is not counted toward the 80% requirement. A purchase under section 338(h)(3) includes any acquisition other than acquisitions of (1) stock the basis of which is determined in whole or in part with reference to the transferor’s basis, i.e., transferred basis stock, and stock acquired from a decedent; (2) stock acquired in certain nonrecognition transactions, including section 351 transactions and corporate reorganizations; and (3) stock acquired from a person from whom it would be attributed to the purchaser under section 318.

the “uncheck-the-box” election with respect to the acquired LLC is effective at the earliest possible date, which is the day immediately following the date on which stock sufficient to qualify as a “qualified stock purchase” has been acquired,¹¹² the deemed sale and purchase of the target’s assets occurs immediately after the deemed asset purchase by the new target corporation under section 338.¹¹³

Generally speaking, the result is that the acquired LLC recognizes the gain and loss on the deemed sale of its assets while it is still taxed as a C corporation, and it must file a final return as a C corporation reflecting the deemed sale.¹¹⁴ The bases of the LLC’s assets, which are deemed to have been transferred to the acquiring corporation pursuant to section 334(b) in a deemed section 332 liquidation, is then determined under section 338(b) and the Regulations thereunder with reference to the purchase price of the LLC units and the LLC’s liabilities, which, unless the section 338 election is a section 338(h)(10) election, will include the tax liability on the deemed asset sale.¹¹⁵

G. Conversion of a Single-Member Disregarded Entity LLC into a Partnership

A single-member LLC that is treated as a disregarded entity automatically becomes a partnership when it obtains an additional member.¹¹⁶ However, if the LLC elects to be treated as a corporation effective at the same time as a second member (or more) is added, the election to be taxed as a corporation takes precedence over the reclassification as a partnership.¹¹⁷

1. Sale of a Membership Unit by the Original LLC Member

Revenue Ruling 99-5 addresses the sale of an interest in a single-member LLC to another person.¹¹⁸ The Ruling treats the transaction as if the selling member sells a partial interest in each of the LLC’s assets to the purchasing member followed immediately by a contribution of the assets to a partnership.

The selling member recognizes gain on the asset sale. The gain or loss recognized on the sale of the assets will be (1) ordinary, (2) section 1231 gain

¹¹²Reg. § 301.7701-3(c)(1)(iii).

¹¹³Reg. § 301.7701-3(g)(3)(ii).

¹¹⁴See Reg. § 1.338-10(a).

¹¹⁵I.R.C. § 338(b); Reg. § 1.338-5. Section 338(h)(10) allows a joint election by an acquiring corporation and the former consolidated (or affiliated) group of the target corporation under which, instead of the seller recognizing gain or loss on the stock sale, the seller recognizes the gain and loss on the assets under section 338(a)(1). As a result, the seller bears the tax liability for any gain recognized with respect to the section 338 election. If a section 338(h)(10) election is made, the tax attributes of the target corporation are transferred to the selling parent corporation. Reg. § 1.338(h)(10)-1(d)(4)(i).

¹¹⁶Reg. § 301.7701-3(f)(2). A change in classification caused by a change in the number of LLC members does not result in the creation of a new entity for purposes of the 60-month limitation on elections under Reg. § 301.7701-3(c)(1)(iv), discussed *supra* text accompanying notes 100–108. See Reg. § 301.7701-3(f)(3).

¹¹⁷Reg. § 301.7701-3(f)(2), -3(g).

¹¹⁸Rev. Rul. 1999-5, 1999-1 C.B. 434.

or loss, (3) section 1245 (or some other ordinary recapture income), or (4) capital gain—including “unrecaptured section 1250 gain”—or loss, under generally applicable characterization rules.¹¹⁹ If the selling member receives a promissory note, section 453 installment reporting will be available for eligible assets.

Pursuant to section 721, no gain or loss is recognized on the subsequent deemed contribution of a portion of the LLC’s assets by either the seller or the purchaser of the interest.¹²⁰ The purchasing member’s basis in the LLC membership interest will be the same as the purchase price of the assets deemed to have been contributed.¹²¹ The selling member’s basis in the LLC membership interest will be the same as the member’s basis in the contributed portion of the LLC’s assets.¹²²

As a result of the difference in the basis of the assets to the seller and the purchaser—the seller’s basis being unchanged and the purchaser’s basis being fair market value—and the assets being booked to fair market value under Regulation section 1.704-2(b), there will be a book–tax disparity. This results in the rules of section 704(c) being applied to allocations of gain and loss and depreciation with respect to the LLC’s assets.¹²³ Generally speaking, any built-in gain or loss—measured as of the purchase and sale date—subsequently recognized by the LLC, which now is taxed as a partnership, with respect to the portion of the assets treated as having been contributed by the original LLC member will be allocated only to that member.¹²⁴ Any depreciation or section 197 amortization will be allocated first to the purchasing member of the LLC in an amount equal to that member’s share of book depreciation or amortization, with any remaining depreciation or amortization allocated to the selling member of the LLC.¹²⁵

With respect to section 197 amortization, however, the anti-churning rules of section 197(f)(9) generally deny any amortization deduction at the partnership level, even with respect to the buyer’s purchased one-half interest (which under section 704(c) otherwise would be allocated to the seller), unless the intangible was an amortizable section 197 intangible in the seller’s (the LLC’s) hands before the sale.¹²⁶ Amortization is allowed, however, if the buyer elects to recognize gain on the entire intangible.¹²⁷

The seller and buyer will have different holding periods for their LLC membership interests, which are treated as partnership interests. Under section

¹¹⁹ See, e.g., I.R.C. §§ 1(h)(6), 64, 1231, 1245.

¹²⁰ See I.R.C. § 721(a).

¹²¹ I.R.C. §§ 722, 1012.

¹²² I.R.C. § 722.

¹²³ See Reg. § 1.704-3.

¹²⁴ See *id.*

¹²⁵ The remaining depreciation may be either more or less than the remaining book depreciation or amortization.

¹²⁶ Reg. § 1.197-2(g)(2).

¹²⁷ Reg. § 1.197-2(h)(9); see also Reg. § 1.197-2(k), Ex. 18.

1223(1), to the extent the LLC's assets are section 1231 or capital assets, the seller's holding period includes the period for which the LLC held the assets. To the extent LLC's assets are ordinary income assets or cash, the seller's holding period commences the day after the sale.¹²⁸ For this purpose, potential depreciation recapture with respect to a section 1231 asset is treated as a separate ordinary income asset.¹²⁹

If the contribution consists of a mix of assets with different holding periods or some holding periods that do not tack, such as inventory, the interest is comminuted for purposes of determining the owner's holding period.¹³⁰ The portion of the interest that takes a holding period with respect to any particular item of property or amount of cash that was contributed to the LLC generally is the fraction that is equal to the fair market value of the item of property or cash divided by the fair market value of the entire interest.¹³¹ Subsequently, any capital gain or loss realized with respect to the sale of the interest, or with respect to a distribution, is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.¹³²

Under general principles of tax law, the buyer's holding period in the entire LLC interest will begin the day after his purchase of the LLC interest.

2. *Issuance of a New Membership Unit by the LLC*

If, rather than purchasing an interest in a single-member LLC from the sole owner, the new member contributes cash to the LLC—that is, purchases the interest directly from the LLC—Revenue Ruling 99-5 treats the transaction as the formation of a new partnership by both the continuing member and the new member.¹³³ The continuing member is deemed to contribute all of the assets of the existing LLC, and the new member contributes cash. The contributions are nonrecognition transactions under section 721, with transferred and exchange basis under sections 722 and 723. This treatment results in section 704(c) controlling post-sale allocations of built-in gain and loss and depreciation.

Under section 704(c), generally speaking, any built-in gain or loss subsequently recognized by the LLC with respect to its assets held on the date it changed to a partnership will be allocable only to the original member of the LLC.¹³⁴ Any depreciation or section 197 amortization will be allocated

¹²⁸ See BORIS I. BITTKER, MARTIN J. McMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 32.07[2] (3d ed. 2003).

¹²⁹ Reg. § 1.1223-3(b)(4).

¹³⁰ Reg. § 1.1223-3(a), -3(b).

¹³¹ See Reg. § 1.1223-3(b).

¹³² See Reg. § 1.1223-3(c).

¹³³ Rev. Rul. 1999-5, 1999-1 C.B. 434.

¹³⁴ See I.R.C. § 704(c). Built-in gain or loss is measured as of the date the LLC changes from a disregarded entity into a partnership for tax purposes.

first to the new member(s) of the LLC in an amount equal to the member's share of book depreciation or amortization, with any remaining depreciation or amortization, which may be either more or less than the remaining book depreciation or amortization, allocated to the original member of the LLC.¹³⁵

H. *Simultaneous Conversion from Disregarded Single-Member LLC to Check-the-Box Corporation with Two Shareholders*

As noted previously, a single-member LLC that was a disregarded entity is treated as a partnership for tax purposes when it obtains an additional member, unless it elects to be treated as a corporation effective at the same time as a second member is added.¹³⁶ If the original LLC member sells one or more units to another person or persons, the transaction is recharacterized as the formation of a new wholly owned corporation by the seller followed by the sale of stock—rather than a pro rata share of the LLC's assets—to the purchaser of the LLC unit.¹³⁷ The purchaser takes a cost basis in the LLC unit, which is treated as stock.¹³⁸ The selling LLC member is treated as contributing all of the LLC's assets to the new corporation, which is treated as assuming all of the LLC's liabilities on the day before the purchase, before the effective date of the election.¹³⁹

Unless the seller retains at least 80% of the voting power in the LLC and at least 80% of the economic rights of each class of nonvoting membership units, section 351 will not apply to provide nonrecognition to the seller on the deemed transfer.¹⁴⁰ Thus, the seller would recognize gain with respect to all of the LLC's assets under general tax principles and, under section 1012, would take a cost basis in the LLC interest—now treated as corporate stock for tax purposes—equal to its fair market value.¹⁴¹ The LLC takes a cost basis in the asset, which in this case is the fair market value of the LLC membership interest, not the fair market value of the assets.¹⁴² The seller should not realize any additional gain from the deemed stock sale.¹⁴³

The Treasury Regulations do not clearly address the consequences of a check-the-box election effective at the same time that a second member is added through a contribution to the LLC. If the paradigm in the Regulations

¹³⁵ See Reg. § 1.704-3.

¹³⁶ Reg. § 301.7701-3(f)(2).

¹³⁷ Reg. § 301.7701-3(f)(4), Ex. 1.

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ See I.R.C. §§ 351, 358(c). Section 351 nonrecognition is available only if immediately after the transfer of property to the corporation, the transferor controls the corporation within the meaning of section 368(c).

¹⁴¹ See *Phila. Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

¹⁴² Reg. § 1.1032-1(d); Rev. Rul. 1956-100, 1956-1 C.B. 624 (the basis of property acquired by a corporation in a taxable exchange for its stock is the fair market value of the stock, not the fair market value of the underlying property).

¹⁴³ Reg. § 301.7701-3(f)(4), Ex. 1.

example addressing the consequences of a check-the-box election at the same time a second member purchases LLC units from the sole owner is followed,¹⁴⁴ the transaction would be recharacterized as the formation of a new wholly-owned corporation by the seller, followed by the contribution of property or money to the LLC by the purchaser of the LLC unit. However, if the step transaction principle reflected in Regulation section 1.351-1 applies,¹⁴⁵ the contributions by both the original member and the new member(s) would be accorded nonrecognition under section 351. Thus, the LLC members' basis in the LLC units—now treated as stock—would be an exchanged basis under section 358, determined with reference to the basis of the assets each member is deemed to have contributed to the corporation. The LLC—now treated as a corporation—takes a transferred basis in the assets under section 362(a), subject to any required adjustments.¹⁴⁶

If, alternatively, the contribution of assets to the LLC is treated as a post-incorporation contribution of assets in exchange for stock, the results should not differ for the original sole owner but would differ for the new member, who is treated as contributing assets to a corporation in exchange for stock. Unless the new member (or members taken as a group under the Regulation section 1.351-1 step-transaction analysis) obtains 80% control of the LLC, the new member is treated as exchanging assets for stock in a taxable transaction, and gain or loss will be recognized under section 1001.¹⁴⁷ The new member would take a cost basis in the LLC units, which are treated as stock.¹⁴⁸ The LLC would take a transferred basis in its original assets and a cost basis—that is, a basis equal to the fair market value of the units issued to the new member—in the assets transferred by the new member.¹⁴⁹

¹⁴⁴ *Id.*

¹⁴⁵ This principle treats all transferors pursuant to a prearranged plan that proceeds expeditiously as members of the 80% controlling group of transferors required for nonrecognition. Reg. § 1.351-1(a)(1) provides in relevant part: "The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure."

¹⁴⁶ If the liabilities of the LLC exceed the basis of its assets and gain is recognized by the original owner pursuant to section 357, the LLC's basis for the assets is increased by that amount. I.R.C. § 362(a). If either the assets of the LLC or the assets contributed by the new member have an aggregate basis in excess of their aggregate fair market value, section 362(e) requires a somewhat complicated-to-compute downward adjustment to the basis of any assets that otherwise would have a basis in excess of fair market value.

¹⁴⁷ See Reg. § 1.351-1(a)(2), Ex. (2).

¹⁴⁸ See *Phila. Park Amusement Co. v. United States*, 126 F. Supp. 184, 188 (Ct. Cl. 1954).

¹⁴⁹ Reg. § 1.1032-1(d); Rev. Rul. 1956-100, 1956-1 C.B. 624.

I. *Conversion of an LLC Taxed as a Partnership into a Single-Member Disregarded Entity LLC*

An LLC that is treated as a partnership automatically becomes a disregarded entity for federal income tax purposes when its ownership is reduced to a single member.¹⁵⁰

1. *Sale and Purchase of Interests*

a. *Seller's Treatment.* When an LLC is treated as partnership for tax purposes and all of the other members of the LLC sell their interests to a single member, Revenue Ruling 99-6 treats the sellers as selling their partnership interests.¹⁵¹ A selling LLC member recognizes gain or loss on the sale of the deemed partnership interest pursuant to section 741. That gain or loss will be capital gain or loss, except to the extent, which generally is very likely, that section 751(a) characterizes a portion of the gain, or sometimes loss, as ordinary.¹⁵² Ordinary income treatment results whenever the LLC owns property subject to section 1245 depreciation recapture, has cash method accounts receivable, or has inventory, even if the overall result of the transaction is a loss.¹⁵³

b. *Purchaser's Treatment.* Because the LLC now has only a single member, the deemed partnership terminates pursuant to section 708(b)(1)(A). Upon the deemed termination of the partnership, under Revenue Ruling 99-6, the purchasing member—now the sole member—of the LLC is considered to receive a distribution of those assets attributable to the purchasing member's interest in the LLC when it was taxed as a partnership.¹⁵⁴ The continuing LLC member must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required by section 731(a).¹⁵⁵ As a result, the continuing LLC member will recognize gain to the extent that any cash deemed to have been distributed exceeds the adjusted basis of the LLC interest immediately before the transaction.¹⁵⁶

Loss can be recognized by the continuing LLC member only if (1) a distribution consists solely of cash that is less than the distributee's basis for the LLC interest or (2) the distributee LLC member (a) receives only cash, unrealized receivables,¹⁵⁷ and inventory, and (b) the sum of the cash and the

¹⁵⁰ Reg. § 301.7701-3(f)(2).

¹⁵¹ Rev. Rul. 1999-6, 1999-1 C.B. 432; *see also* Reg. § 1.741-1(b).

¹⁵² *See* I.R.C. § 741.

¹⁵³ *See* I.R.C. §§ 751(a), 1245.

¹⁵⁴ Rev. Rul. 1999-6, 1999-1 C.B. 432.

¹⁵⁵ *Id.*

¹⁵⁶ *See* I.R.C. § 731(a)(1).

¹⁵⁷ In general, unrealized receivables include payments to be received for goods and services. In addition, recapture of depreciation and other capital recovery deductions are treated as an unrealized receivable. I.R.C. § 751(c); Reg. § 1.751-1(c)(4)(iii). For purposes of section 751, the amount of potential recapture income is treated as an unrealized receivable with a basis of zero. Reg. § 1.751-1(c)(4), -1(c)(5).

distributee's section 732(a)(2) basis for the unrealized receivables and inventory—which cannot exceed the LLC's basis in those assets—is less than the member's basis for the LLC interest.

Revenue Ruling 99-6 has another implication. Technically, the Ruling not only treats the continuing LLC member as receiving the continuing member's share of the LLC's assets as a liquidating distribution from the partnership and purchasing the withdrawing member's share of the LLC's assets but also treats the LLC as having distributed the withdrawing member's share of the LLC's assets to the withdrawing member immediately before the sale of the assets to the continuing LLC member.

Under this construct, a seemingly anomalous result occurs if the continuing LLC member has contributed property to the LLC within the seven prior years. Section 704(c)(1)(B) requires the contributing partner to recognize gain or loss upon the distribution of property by the partnership to another partner within seven years of the date the property was contributed. Because the Revenue Ruling 99-6 construct treats the withdrawing LLC member as receiving a distribution of that member's share of the LLC's assets,¹⁵⁸ the continuing LLC member appears to be required to recognize a portion of the remaining built-in gain—or allowed to recognize a portion of the remaining built-in loss—with respect to any property that the continuing member contributed within the prior seven years.¹⁵⁹ It is also possible that the continuing LLC member might recognize gain under section 737 if the withdrawing member had contributed property to the LLC within the prior seven years.¹⁶⁰

c. *Basis of the LLC's Assets.* The determination of the basis of the LLC's assets, which are treated as being owned directly by the sole continuing member of the LLC, is complicated. A portion of each asset is treated as having been acquired by purchase from each selling member of the LLC, and a portion is treated as having been received by the sole continuing member of the LLC in a liquidating distribution from the LLC, which theretofore had been taxed as a partnership.

From the purchasing member's perspective, Revenue Ruling 99-6 applies *McCauslen v. Commissioner*¹⁶¹ and Revenue Ruling 67-65¹⁶² for assets that are deemed to have been purchased.¹⁶³ Both *McCauslen* and Revenue Ruling 67-65 held that when one partner in a two person partnership purchases the other partner's entire interest, the purchaser is treated as having acquired by

¹⁵⁸This share is presumably a pro rata share of every asset, including the assets contributed by the continuing member, although this is not entirely clear.

¹⁵⁹See generally NEW YORK STATE BAR ASS'N TAX SECTION REPORT ON REVENUE RULING 99-6, N.Y. St. B. Ass'n, 40-45, available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1240Rpt.pdf>.

¹⁶⁰See *id.*

¹⁶¹45 T.C. 588 (1966).

¹⁶²Rev. Rul. 1967-65, 1967-1 C.B. 168.

¹⁶³Rev. Rul. 1999-6, 1999-1 C.B. 432.

direct purchase the portion of partnership assets attributable to the acquired partnership interest, even though Regulation section 1.741-1(b) provides that the selling partner is treated as selling his partnership interest.

Thus, solely from the purchasing LLC member's perspective, the transaction is treated as a liquidating distribution to the selling LLC member followed by the purchase of the selling member's interest in the assets deemed to have been distributed to that member. The purchasing member is deemed to receive the remaining portion of the LLC's assets in a liquidating distribution with respect to that member's interest. The purchasing member would, therefore, recognize gain under section 731(a) with respect to the deemed liquidating distribution of the purchasing member's interest in the LLC-taxed-as-a-partnership interest if there is a deemed distribution of cash in excess of the purchasing member's basis in the membership interest.

As in *McCauslen*, the purchasing LLC member, who for tax purposes now is treated as directly owning all of the LLC's assets, takes a section 1012 purchase price basis in the newly acquired portion of the LLC's assets. This occurs without resort to the basis adjustment rules in sections 734(b) and 755, for which a section 754 election generally is required.

The same rules apply whenever all of the interests in an LLC theretofore taxed as a partnership are purchased by one unrelated purchaser in an integrated transaction. Revenue Ruling 99-6 holds that the sale of membership interests by both members of a two-member LLC to a single purchaser will be treated as the sale of their partnership interests, which is governed by sections 741 and 751(a) with respect to each of the selling members. The purchaser, however, is treated as acquiring all of the LLC's assets directly. The purchaser's basis in the LLC's assets, all of which the purchaser is deemed to own, should be determined by allocating the aggregate purchase price of all of the LLC units among the LLC's assets under section 1060 and the Treasury Regulations thereunder.¹⁶⁴

For the continuing LLC member, its basis in its "original share" of the LLC's assets, which were treated as having been received in the deemed liquidation of the member's partnership interest, is determined under section 732(b). Section 732(b) provides the continuing LLC member with an exchanged basis in the LLC's property deemed to have been received in the liquidating distribution equal to the taxed-as-a-partnership LLC interest basis, less any cash received.¹⁶⁵

This exchanged basis is allocated among the distributed assets in a multi-step process prescribed in section 732(c). Generally speaking, each asset first is assigned a transferred basis equal to its basis in the hands of the partnership. The bases of the various assets are then adjusted either upwards or downwards,

¹⁶⁴ See Reg. § 1.1060-1.

¹⁶⁵ If cash received in a liquidating distribution exceeds the redeemed partner's basis for the partnership interest and the redeemed partner recognizes gain under section 731, any property received in the distribution will take a zero basis.

depending on whether the member's exchanged basis exceeds or is less than the aggregate transferred basis. If the exchanged basis is less than the aggregate transferred basis, negative basis adjustments are made.¹⁶⁶ If the exchanged basis exceeds the aggregate transferred basis, positive basis adjustments are made.¹⁶⁷ In no event, however, may inventory or unrealized receivables take a basis in the hands of the continuing LLC member that is greater than their basis in the hands of the taxed-as-a-partnership LLC.¹⁶⁸

If the continuing LLC member's basis for the taxed-as-a-partnership LLC interest exceeds the LLC's basis for the property received in the deemed liquidating distribution, the basis increase must be allocated among the assets. First, inventory and accounts receivable are allocated a basis equal to their bases in the hands of the taxed-as-a-partnership LLC.¹⁶⁹ If any basis remains after the allocation to inventory and accounts receivable, the remaining basis is allocated among all other assets.¹⁷⁰ Each such asset is tentatively allocated a transferred basis in the continuing LLC member's hands equal to the taxed-as-a-partnership LLC's basis for the asset.¹⁷¹ Then the basis of any such property with a fair market value greater than its basis to the partnership is increased in proportion to the relative built-in appreciation.¹⁷² The basis increase in this step cannot increase an asset's basis above its fair market value.

If the required basis increase exceeds the appreciation inherent in the distributed appreciated assets, a portion of the aggregate basis increase cannot be allocated in proportion to relative appreciation. In such a case, the remaining portion of the increase is allocated among all of the properties, other than inventory and unrealized receivables, received in the distribution relative to their fair market values.¹⁷³

Under section 735(b), the continuing LLC owner's holding period for the assets attributable to his or her interest in the LLC includes the LLC's holding period for such assets, except for purposes of section 735(a)(2).¹⁷⁴ What this means, in essence, is that with respect to an aliquot share of each asset attributable to the member's original percentage interest in the LLC, the member's holding period began the day after the LLC acquired the asset. The continuing LLC owner's holding period in the newly acquired portion of the former partnership's assets begins on the day immediately following the date of the purchase.¹⁷⁵

¹⁶⁶I.R.C. § 732(c)(3).

¹⁶⁷I.R.C. § 732(c)(2).

¹⁶⁸I.R.C. § 732(c)(1).

¹⁶⁹Any section 734(b) or section 743(b) basis adjustments previously made with respect to the partner's basis for those assets are taken into account in determining the partnership basis for its assets. Reg. § 1.732-2.

¹⁷⁰*Id.*

¹⁷¹I.R.C. § 732(c)(1)(B).

¹⁷²I.R.C. § 732(c)(2)(A).

¹⁷³I.R.C. § 732(c)(2)(B).

¹⁷⁴See I.R.C. §§ 735(b), 1223(2).

¹⁷⁵Rev. Rul. 1999-6, 1999-1 C.B. 432.

After the purchase of all of the membership units in the LLC, which results in the sole remaining member being treated as directly owning all of the LLC's assets, each asset has what is in effect a "split" basis, part of which is determined under section 1012 and part of which is determined under section 732. Furthermore, the portion of the asset basis determined under section 732 may itself have two components—the portion of the basis transferred from the partnership and the portion attributable to a positive adjustment if the sole remaining LLC member's basis in the partnership interest exceeded the partnership's basis in the portion of its assets underlying that interest. This split basis affects subsequent depreciation and amortization deductions.

To the extent that the LLC's assets take a section 1012 cost basis, sections 167 and 168 depreciation and MACRS cost recovery and section 197 amortization of intangibles are computed as if the assets were newly purchased assets. However, to the extent that the LLC's assets reflect a transferred basis under section 732, the continuing LLC member steps into the shoes of the former partnership LLC with respect to sections 167–168 depreciation and section 197 amortization of intangibles.¹⁷⁶ For assets other than amortizable intangibles, any basis increase under section 732 is depreciated as if it were the basis of newly acquired property.¹⁷⁷ However, to the extent of any basis increase under section 732 in an intangible deemed to have been distributed to the continuing LLC member, the anti-churning rules of section 197(f)(9)(A) appear to apply to disallow any amortization.

2. Redemption of Interests of All but One LLC Member

The redemption of the interests of all but one of the members of an LLC that is treated as a partnership terminates the partnership.¹⁷⁸

The deemed liquidation of an LLC taxed as a partnership is governed by the same provisions that govern liquidation of a partner's interest, except that section 736 usually is inapplicable. This is because, other than in very narrow circumstances, there is no continuing partnership, even though for purposes other than federal taxation, the LLC has not been liquidated and continues to exist.¹⁷⁹

Generally speaking, the tax consequences of the complete liquidation of a partnership are the sum of the consequences to the individual partners. A redeemed LLC member does not recognize any gain unless he receives a cash

¹⁷⁶ See I.R.C. §§ 168(i)(7), 197(f)(2).

¹⁷⁷ See I.R.C. § 167(c)(1).

¹⁷⁸ I.R.C. § 708(b)(1)(A); Reg. § 1.708-1(b)(1).

¹⁷⁹ Section 736(a) can apply to the termination of a partnership in which one or more of the redeemed partners receive payments from the sole continuing member over a period of years. If any of these payments are classified under section 736(a), the partnership continues in existence as long as such payments are due. Reg. §§ 1.708-1(b)(1)(i)(b), 1.736-1(a)(1)(ii), -6. This situation most frequently occurs where all but one member of a professional practice retires and the partner who continues the practice as a sole proprietor makes continuing payments of either a fixed amount or a share of profits from the practice to the redeemed partners.

distribution—including net debt relief under sections 752(a) and 752(b) if the other LLC members assume a disproportionate share of the partnership's liabilities—in excess of the LLC member's basis for the partnership interest.¹⁸⁰ Any gain that is recognized is a capital gain under section 741, except to the extent that section 751(b) applies to create ordinary income treatment.¹⁸¹ None of the capital gain is treated as unrecovered section 1250 gain; all of the gain is "adjusted net capital gain."¹⁸²

Any property received in the deemed liquidation generally will take an exchanged basis equal to the member's basis for the taxed-as-a-partnership LLC interest less any cash received.¹⁸³ The exchanged basis is then allocated among the distributed assets according to the formula of section 732(c).

An LLC member may recognize a loss upon deemed liquidation of the taxed-as-a-partnership LLC if (1) a distribution consists solely of cash that is less than the member's basis for the LLC interest or (2) the member receives only cash, unrealized receivables, and inventory, and the sum of the cash and the member's basis under section 732(a)(2) for the unrealized receivables and inventory deemed to have been distributed¹⁸⁴ is less than the member's basis for the interest in the taxed-as-a-partnership LLC.¹⁸⁵ Any loss recognized under section 731(a) is a capital loss under section 741.

In actuality, the preceding discussion is an oversimplification. Under section 751(b), if a partner reduces the partner's interest in unrealized receivables¹⁸⁶ and substantially appreciated inventory¹⁸⁷ and increases an interest in other property, the partner is treated as exchanging an interest in the inventory and receivables for the other property in a taxable exchange.¹⁸⁸ On

¹⁸⁰I.R.C. § 731(a)(1).

¹⁸¹*Yourman v. United States*, 277 F. Supp. 818, 819 (S.D. Cal. 1967), held that section 751(b) was applicable to a non-pro rata distribution of assets on the dissolution of a partnership. Rev. Rul. 1977-412, 1977-2 C.B. 223, it to the same effect, holding that each partner can be treated as a distributee partner in determining gain or loss recognized under section 751(b), and in the case of a two person partnership, the other partner can be treated as the continuing partnership. See also *Wolcott v. Commissioner*, 39 T.C. 538, 546-47 (1962).

¹⁸²Reg. § 1.1(h)-1(b)(2)(ii).

¹⁸³I.R.C. § 732(b).

¹⁸⁴Basis under section 732(a)(2) for the unrealized receivables and inventory deemed to have been distributed cannot exceed the taxed-as-a-partnership LLC's basis for those assets.

¹⁸⁵I.R.C. § 731(a)(2).

¹⁸⁶In general, unrealized receivables include payments to be received for goods and services. In addition, recapture of depreciation and other capital recovery deductions are treated as an unrealized receivable. I.R.C. § 751(c); Reg. § 1.751-1(c). Inclusion of recapture income in the definition of unrealized receivables is significant because it results in the potential applicability of section 751(b) to every conversion to a disregarded entity of an LLC that had been taxed as a partnership until the interests of every member but one had been redeemed if the LLC holds depreciable personalty, such as machinery, equipment, and amortizable section 197 intangible assets, even though the LLC uses the accrual method of reporting and thus has no unrealized accounts receivable.

¹⁸⁷Inventory is "substantially appreciated" if the fair market value of inventory held by the partnership exceeds 120% of the partnership's basis in inventory. I.R.C. § 751(b)(3)(A).

¹⁸⁸See I.R.C. § 751(b)(1)(B).

the other side of the exchange, the partnership is treated as purchasing an increased interest in the unrealized receivables and inventory in exchange for the partner's increased interest in the other property.¹⁸⁹ Similarly, if a partner increases an interest in unrealized receivables and substantially appreciated inventory, the partner is treated as selling an interest in other property in a taxable exchange for the inventory and receivables.¹⁹⁰ The partnership is treated as selling the interest in unrealized receivables and inventory in exchange for an increased interest in the other property.¹⁹¹

Section 751(b) applies if the distribution of one class of property is "in exchange for" the partner's interest in the other class of property. Whether a non-pro rata distribution is to be considered "in exchange for" an interest in other property depends upon the effect of the distribution on the partners' interests in particular partnership assets.¹⁹² Section 751(b) will apply to any redemption of LLC interests that converts the LLC into a disregarded entity in which the members of the LLC¹⁹³ receive distributions that are disproportionate as to unrealized receivables and substantially appreciated inventory, even though the distributions are of like amounts.¹⁹⁴

Thus, under the rules of section 751(b), if the LLC holds unrealized receivables or substantially appreciated inventory, which can be expected of most LLCs engaged in any sort of business activity, the redeemed LLC members will be forced to recognize some amount of ordinary income before the rules of sections 731 and 732 are applied. The sole continuing member of the LLC will likely recognize some amount of section 1231 or capital gain. The actual results, however, are fact specific.

As a general rule, section 734(a) provides that the basis of the LLC's remaining property is not affected by the redemption distributions. However, if a section 754 election was in effect with respect to the partnership, or is made in connection with the redemption section 734(b) allows a basis increase for the LLC's assets that inures to the benefit of the continuing LLC member.¹⁹⁵ This increase is allowed to the extent any of the redeemed LLC members (1) recognize gain under section 731(a) with respect to their liquidating distributions, or (2) take an aggregate basis in assets received in the redemption distribution under section 732 that is less than the partnership's basis in those assets.

Conversely, the LLC's basis for its remaining assets must be decreased by any section 731(a)(2) loss recognized by any redeemed LLC member and by any excess of the basis of distributed assets to any redeemed LLC mem-

¹⁸⁹ *Id.*

¹⁹⁰ See I.R.C. § 751(b)(1)(A).

¹⁹¹ *Id.*

¹⁹² See *Yourman v. United States*, 277 F. Supp. 818, 820 (S.D. Cal. 1967).

¹⁹³ This includes the redeemed members and the continuing member, who receives a "distribution" of the LLC's remaining assets.

¹⁹⁴ See *Yourman*, 277 F. Supp. at 820.

¹⁹⁵ See I.R.C. § 734(b)(1).

ber over the taxed-as-a-partnership LLC's basis for the distributed assets.¹⁹⁶ Furthermore, section 734(d) requires negative section 734(b) adjustments to the basis of the LLC's remaining assets if an aggregate basis reduction in excess of \$250,000 results, even though no section 754 election has been made.¹⁹⁷

If the basis of the LLC's depreciable property is increased under section 734(b), the increased portion of the basis must be depreciated as if it were newly-purchased property placed in service on the date the distribution occurred.¹⁹⁸ The taxed-as-a-partnership LLC's original basis in the property continues to be depreciated as before the distribution, as if there had been no basis increase. If section 734(b) requires a decrease in the basis of the LLC's depreciable property, the decrease in basis must be taken into account over the remaining recovery period of the property beginning with the recovery period in which the basis is decreased.¹⁹⁹

Again, the application of section 751(b) will complicate the above described basis consequences. Section 751(b) may result in a deemed exchange between the redeemed members and the sole remaining member of the LLC in which the redeemed members exchange their interests in unrealized receivables and substantially appreciated inventory for some combination of cash, section 1231 assets, and capital assets. If so, generally speaking, before the above described basis consequences occur, the LLC's basis for the unrealized receivables and substantially appreciated inventory will increase by some amount.²⁰⁰ As with the computation of gain under section 751(b), the actual results are fact specific. It is worth noting, however, that for many LLCs the most significant unrealized receivables are not cash method accounts receivables but section 1245 depreciation recapture and contract rights.²⁰¹ Thus, as a result of the application of section 751(b), there is a basis increase for section 1231 assets, such as machinery and equipment, purchased intangibles, and contract rights.

J. *Merger of a Single-Member LLC into Another LLC or Partnership*

If, as the result of the merger under state law of a single-member LLC into another LLC or partnership, the surviving LLC or partnership has two or more members, the transaction is treated as contribution of the LLC's assets to a partnership in a transaction generally governed by sections 721–723.

The member of the disappearing, merged, single-member LLC generally

¹⁹⁶ See I.R.C. § 734(b)(2).

¹⁹⁷ See I.R.C. § 734(d).

¹⁹⁸ Reg. § 1.734-1(e)(1).

¹⁹⁹ See Reg. § 1.734-1(e)(2).

²⁰⁰ See, e.g., Reg. § 1.751-1(g), Ex. (2).

²⁰¹ See I.R.C. § 751(c); *Ledoux v. Commissioner*, 77 T.C. 293, 303 (1981), *aff'd per curiam*, 695 F.2d 1320 (11th Cir. 1983) (holding that the term "unrealized receivables" includes any contractual or other right to payment for goods delivered or to be delivered or services rendered or to be rendered); Reg. § 1.751-1(c) (defining "unrealized receivables").

recognizes no gain or loss and takes a basis in the new LLC (or partnership) equal to the sum of the adjusted basis of the disappearing—single-member LLC's property and its cash. Pursuant to sections 751(a) and 751(b), this tentative basis is adjusted to take into account the liabilities of the merged LLC and the surviving LLC (or partnership).²⁰² Generally speaking, the member's basis in the surviving LLC is reduced by the amount of the merged LLC's debts and is then increased by the member's share of the surviving LLC's debts.²⁰³

The member's share of the liabilities of the surviving LLC (or partnership) is determined under Regulation section 1.752-2 for recourse liabilities and under Regulation section 1.752-3 for nonrecourse liabilities.²⁰⁴ A "recourse liability" is any liability "to the extent . . . that any partner or related person bears the economic risk of loss for that liability."²⁰⁵ An LLC (or partnership) indebtedness is nonrecourse debt only to the extent that no member, partner, or any person related to a member or partner under Regulation section 1.752-4(b), bears the economic risk of loss on the liability.²⁰⁶

Recourse liabilities are allocated to members (partners) in proportion to the liabilities for which each member (partner) bears the ultimate economic risk of loss.²⁰⁷ A partner bears the economic risk of loss with respect to a partnership liability—even if the liability is nonrecourse as to the LLC or partnership—if upon a hypothetical liquidation of the partnership in which all of its assets are treated as worthless, the partner or a related person "would be obligated to make a payment to any person (or a contribution to the partnership) . . . and the partner or related person would not be entitled to reimbursement from another partner [or person related to that partner]."²⁰⁸

In very general terms, debts for which no partner bears a risk of loss—nonrecourse debts—are allocated to the partners in accord with their share of gain attributable to encumbered property—including gain allocable to a partner under section 704(c)—or their shares of partnership profit.²⁰⁹

Because the continuing LLC or partnership generally will book the merged LLC's assets to fair market value to comply with Regulation section 1.704-2(b), a book-tax disparity will arise. As a result, section 704(c) will apply with respect to allocations of gain and loss and depreciation attributable to the merged LLC's assets. Generally speaking, any built-in gain or loss—measured as of the merger date—recognized by the continuing LLC with respect to the assets will be allocable only to the member of the merged LLC. Any depreciation or section 197 amortization will be allocated first to the other

²⁰² See I.R.C. § 751(a)–(b).

²⁰³ *Id.*

²⁰⁴ Reg. §§ 1.752-2, -3.

²⁰⁵ Reg. § 1.752-1(a)(1).

²⁰⁶ Reg. § 1.752-1(a)(2).

²⁰⁷ Reg. § 1.752-2(a).

²⁰⁸ Reg. § 1.752-2(b)(i).

²⁰⁹ See Reg. § 1.752-3(a).

members of the continuing LLC in an amount equal to their shares of book depreciation or amortization. Any remaining depreciation or amortization—which may be either more or less than the remaining book depreciation or amortization—is allocated to the member of the merged LLC.²¹⁰

K. *Merger of Single-Member LLC into a Corporation*

If a single-member LLC merges into a corporation pursuant to state law merger statutes, the “merger” is treated as the LLC member selling of all of the separate assets of the LLC,²¹¹ unless the member controls the corporation within the meaning of section 368(c). The amount realized is the aggregate value of the stock and any other consideration received. This amount is allocated among the assets pursuant to section 1060 and the Regulations thereunder.²¹² The character of the gain—ordinary, including recapture, section 1231, or capital, including “unrecaptured section 1250 gain”—is determined asset-by-asset.²¹³

Dover Corp. v. Commissioner raises the question of whether a single-member LLC’s check-the-box election in anticipation of an acquisition structured as a section 368 tax-free reorganization will be respected.²¹⁴ The proposition that a nontax business purpose is not a prerequisite for a check-the-box election was implicit in the Tax Court’s holding in *Dover*. At least one commentator has suggested that the strategy of checking-the-box to convert a single-member LLC into a corporation in anticipation of a tax-free reorganization works, arguing that no business purpose is necessary for a check-the-box election.²¹⁵

The preamble to the 1997 proposed check-the-box Regulations explained that Regulation section 301.7701-3(g)(2) “is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations.”²¹⁶ The 1999 Proposed Regulations regarding classification of foreign entities had a limited anti-abuse provision that generally provided that if an “extraordinary transaction,” as defined in the Proposed Regulations, occurred either one day before or within 12 months after the date a foreign entity changed its classification to disregarded-entity status, then the entity would not be treated as a disregarded entity but instead would be classified as an association taxable as a corporation for all purposes.²¹⁷

²¹⁰ See I.R.C. § 704(c).

²¹¹ See Reg. § 1.368-2(b)(1)(iii), Ex. (6) (providing that a merger of a disregarded entity into a corporation cannot qualify as a reorganization under section 368).

²¹² See I.R.C. §§ 1001(b), 1060.

²¹³ See, e.g., I.R.C. §§ 1(h)(6), 64, 1231, 1245.

²¹⁴ *Dover Corp. v. Commissioner*, 122 T.C. 324, 325 (2004); see also *supra* Part II.E.

²¹⁵ Joseph M. Percopo, *The Check-and-Merge: A Viable Answer to Cross Entity Merger?*, 85 FLA. BAR J. 40, 44 (2011).

²¹⁶ Treatment of Changes in Elective Entity Classification, 62 Fed. Reg. 55,768–69 (Oct. 28, 1997).

²¹⁷ Prop. Reg. § 301.7701-3(h)(2)(C), 64 Fed. Reg. 66,591 (1999).

That provision, however, was withdrawn and does not appear in the Treasury Regulations.²¹⁸ Nevertheless, in Notice 2003-46, the Service expressed its concern over tax-avoidance motivated check-the-box elections:

The Service and Treasury remain concerned about cases in which a taxpayer, seeking to dispose of an entity, makes an election to disregard it merely to alter the tax consequences of the disposition. The IRS will continue to pursue the application of other principles of existing law (such as the substance over form doctrine) to determine the proper tax consequences in such cases. As the Supreme Court has noted: "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945).²¹⁹

From this statement, one reasonably should conclude that the Service very well might limit *Dover Corp.* to the international tax, foreign-entity classification context in which that case arose.²²⁰ Thus, pre-*Dover Corp.* case law regarding business purpose, the step transaction doctrine, substance over form, and *Court Holding Co.* principles should continue to be relevant in the context of domestic LLCs. Notice 2003-46 stands as a warning that *Court Holding Co.* principles could be applied to treat the transaction as a taxable sale of the LLC's assets for stock of the acquiring corporation. This possibility should be seriously considered before attempting a check-and-sell strategy.²²¹

It generally is taken as axiomatic that no business purpose is required as a prerequisite to recognizing the taxpayer's choice to operate a business in the corporate form for tax purposes.²²² Nevertheless, incorporating assets, which is the result of a single-member LLC electing to be taxed as a corporation, solely for the purpose of executing a tax-free reorganization might be attacked by the Service, resulting in the overall transaction being recharacterized as a

²¹⁸ See Notice 2003-46, 2003-2 C.B. 53.

²¹⁹ *Id.*

²²⁰ For a discussion of the proposed extraordinary transaction regulation and its withdrawal, see generally David L. Click, *Treasury Withdraws Extraordinary Check-the-Box Regulations*, 101 TAX NOTES 95 (Oct. 6, 2003).

²²¹ See *supra* text accompanying notes 75-94 for a discussion of *Court Holding Co.* and related cases.

²²² See STAFF OF THE J. COMM. ON TAX'N, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT," No. JCX-18-10, at 152-53 (2010) (stating that the economic substance doctrine does not apply to the choice to enter a transaction or series of transactions that constitute a corporate organization under subchapter C); see also *Weekend Warrior Trailers, Inc. v. Commissioner*, T.C.M. (CCH) 1506, 1519, 2011 T.C.M. (RIA) ¶ 2011-105, at 748 ("Even if a corporation was not formed for a valid business purpose, it nevertheless must be respected for tax purposes if it actually engaged in business activity."); *Rogers v. Commissioner*, T.C. Memo. 1975-289 ("*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity. . . . Business purpose or business activity are alternative requirements.").

taxable asset sale and purchase.²²³

In *West Coast Marketing Corp. v. Commissioner*,²²⁴ West Coast Marketing owned an interest in a tract of land, and its sole shareholder owned an interest in two adjacent tracts. At a time when a taxable exchange of the lands for stock in a publicly-held corporation was imminent, West Coast Marketing and its shareholder organized another corporation, Manatee, and transferred their interests in the land to Manatee in exchange for stock of Manatee. Soon thereafter, all of the stock of Manatee was transferred to a publicly held corporation, Universal, in exchange for Universal stock in a transaction that was tax-free under sections 354 and 368(a)(1)(B).²²⁵ Shortly thereafter, Manatee was liquidated and its assets transferred to Universal in a tax-free transaction under section 332.²²⁶ The Tax Court held that Manatee was not organized or used for any bona fide business purpose and that the substance of the transaction was a taxable exchange of interest in land for stock of Universal.²²⁷

A business purpose requirement as a prerequisite for obtaining section 351 nonrecognition was also imposed in *Estate of Kluener v. Commissioner*.²²⁸ In that case, Kluener owned all of the stock of APECO, which had more than \$4 million of net operating loss carryovers and was in financial straits. Kluener also directly owned highly leveraged real estate and thoroughbred horses, both of which activities were losing substantial amounts of money. Kluener was deeply in debt. To help stem his losses, he decided to sell some horses. On the advice of his accountants, Kluener transferred the horses to APECO to shelter the gains—approximately \$1.2 million—with APECO's net operating loss carryovers. Kluener hid the transfer from APECO's directors and did not use the \$2.5 million sales proceeds to alleviate APECO's financial straits. Instead, Kluener caused the corporation to distribute most of the funds to himself for personal use—mostly repayment of personal debts—shortly after the sale. The Sixth Circuit affirmed the Tax Court's holding that the transfer to APECO lacked a business purpose.²²⁹ Accordingly, the transfer to APECO was not respected for tax purposes, and the gain was taxed directly to Kluener because Kluener himself was the true seller of the horses.²³⁰

Perhaps *Kluener* is distinguishable because of its unusual facts, but it never-

²²³Rev. Rul. 1970-140, 1970-1 C.B. 73, held that section 351 did not apply to the transfer of assets of a sole proprietorship to a controlled corporation followed immediately by a prearranged exchange of the stock of the controlled corporation for the stock of another corporation "in an integrated transaction." See also Martin J. McMahon, Jr., *Living With the Codified Economic Substance Doctrine*, 128 TAX NOTES 731, 741 (Aug. 16, 2010) ("However, read literally, the second prong of the [section 7701(o)] codified economic substance doctrine could, in some instances, be read to require recasting the transaction as an asset sale.").

²²⁴46 T.C. 32 (1966).

²²⁵*Id.* at 39-40.

²²⁶*Id.* at 39.

²²⁷*Id.* at 40-41.

²²⁸154 F.3d 630, 634 (6th Cir. 1998).

²²⁹*Id.* at 636.

²³⁰*Id.*

theless stands for the proposition that a business purpose can be imposed as a prerequisite for obtaining section 351 treatment in certain circumstances. Resolving the conflicting principles underlying the analysis in *Dover* and *West Coast Marketing Corp.* is difficult. One might conclude that *West Coast Marketing Corp.* was overruled *sub silentio* by *Dover*, but that conclusion should not be lightly reached. *Dover* involved a check-the-box election that gave rise to a deemed section 332 liquidation, and all the principal authorities cited by the court in *Dover* involved liquidations—mostly section 332 liquidations, in which form controls over substance.²³¹ None of the cited authorities involved section 351 transactions. Thus, *Dover* should be applied with caution in this context.

Furthermore, even if *Dover* were to be applicable, and the business purpose requirement was held not to apply to the check-the-box election generally, the deemed incorporation could still fail to satisfy a section 351 requirement. For example, if the check-the-box election and the subsequent acquisition were part of an integrated plan, the deemed incorporation would not be tax-free under section 351 because it would fail the “control immediately after the transfer requirement.”²³² As discussed above, Revenue Ruling 70-140 held that section 351 did not apply to the transfer of a sole proprietorship’s assets to a controlled corporation followed immediately by a prearranged exchange of the stock of the first corporation for the stock of another corporation “in an integrated transaction.”²³³ Courts have reached the same result.²³⁴ Because of the integrated nature of the two transactions, the original transferor was not in control of the transferee.

L. *Merger of a Corporation into a Single-Member LLC Owned by the Sole Shareholder*

The merger of a corporation into a single-member LLC owned by the sole shareholder of the corporation generally is not a tax-free reorganization as defined in section 368,²³⁵ even though the merger of two corporations owned by the same shareholder is a tax-free reorganization under both sections 368(a)(1)(A) and 368(a)(1)(D). The same is true with respect to the conversion of a corporation into an LLC under a state law statute that permits such a conversion without a merger or asset transfer.²³⁶ Rather, the merger

²³¹ See *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956). See generally Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 197–200 (2001).

²³² See *supra* Part II.C.1.a.

²³³ Rev. Rul. 1970-140, 1970-1 C.B. 73; see also *supra* Part II.E.

²³⁴ See *supra* text accompanying notes 75–94.

²³⁵ See Reg. § 1.368-2(b)(1)(iii), Ex. 7 (merger of corporation into a disregarded entity in exchange for interests in the disregarded entity does not qualify as a reorganization under section 368(a)(1)(A)).

²³⁶ Reg. § 1.368-2(b)(1)(iii), Ex. 9.

or conversion is treated as a liquidation of the corporation.²³⁷ As such, it is governed by the rules generally applicable to liquidations and will be a taxable transaction if the LLC owner—sole shareholder is a partnership or individual, or as a tax-free corporate liquidation if the LLC owner—sole shareholder is a domestic corporation.²³⁸

There is one exception to the above description of the tax consequences of the merger of a corporation into a single-member LLC, and the exception applies regardless of the ownership of the corporation. If the single-member LLC is owned by a corporation and in the merger the shareholders of the merging corporation receive either stock of the corporation that owns the LLC or stock of the parent of the corporation that owns the LLC, the merger will be a tax-free reorganization under either section 368(a)(1)(A) or section 368(a)(2)(D),²³⁹ assuming that all other requirements for qualifying as a tax-free reorganization have been met. This is true regardless of whether the merging corporation is a shareholder of the corporation that directly or indirectly owns the LLC and issues its stock in the merger.

III. Qualified Subchapter S Subsidiaries

A. Generally

A QSub is any domestic corporation that (1) is not an ineligible corporation under section 1361(b)(2) (principally excluding certain financial institutions, insurance companies, and certain Puerto Rican corporations), (2) is wholly owned by an S corporation, and (3) the parent S corporation elects to treat as a QSub.²⁴⁰ QSub elections can be made for a subsidiary of a QSub, as well as for lower-tier subsidiaries, as long as there is an unbroken chain of eligible subsidiaries for which QSub elections have been made.²⁴¹

A QSub is not treated as a separate corporation. The existence of the stock of a QSub is ignored for tax purposes.²⁴² All assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation.²⁴³

²³⁷ *Id.*

²³⁸ For the treatment of corporate liquidations generally, see *supra* Part II.E.

²³⁹ See Reg. § 1.368-2(b)(1)(iii), Ex. 2 (merger qualifying under section 368(a)(1)(A)), -2(b)(1)(iii), Ex. 4 (merger qualifying under section 368(a)(2)(D)).

²⁴⁰ I.R.C. § 1361(b)(3)(B).

²⁴¹ See Reg. § 1.1361-4(b) (dealing with elections in situations involving tiered subsidiaries).

²⁴² Reg. § 1.1361-4(a)(4). A QSub nevertheless is treated as a separate corporation for purposes of (1) federal tax liabilities of the QSub with respect to any taxable period for which the QSub was treated as a separate corporation, (2) federal tax liabilities of any other entity for which the QSub is liable, and (3) federal tax refunds or credits. Reg. § 1.1361-4(a)(6). A QSub also is a separate corporation for purposes of employment taxes, Reg. § 1.1361-4(a)(7), and certain excise taxes, Reg. § 1.1361-4(a)(8).

²⁴³ Reg. § 1.1361-4(a)(1).

Transactions between the S corporation parent and the QSub are not taken into account for tax purposes.

B. *Elections and Revocations*

Election procedures are described in the Treasury Regulations.²⁴⁴ Regulation section 1.1361-3(a)(4) allows the effective date of a QSub election to be any specified date within two months and 15 days prior to, or not more than 12 months after, the date the election is made.²⁴⁵ Unlike an S election, a QSub election does not have to be made within two months and 15 days of the beginning of a taxable year to be retroactive; although if the election is made more than two months and 15 days after the beginning of a taxable year, it cannot be retroactive for the entire year. A QSub election may be revoked as of any specified date within two months and 15 days prior to, or not more than 12 months after, the date of the revocation.²⁴⁶

A QSub whose election has terminated may not have a QSub election made with respect to it—or, if its stock is acquired by eligible shareholders, make an S election itself—before its fifth taxable year that begins after the first taxable year for which the termination is effective without the Service's consent.²⁴⁷ If a QSub election is terminated by reason of the disposition of the stock of the subsidiary by the parent, the new owners, if eligible, may make an immediate S election, without the consent of the Service, provided that there has been no intervening period in which the corporation was a C corporation.²⁴⁸

Section 1362(f) permits the Service to grant relief from inadvertently invalid QSub elections and inadvertent terminations of QSub elections. Revenue Procedure 2003-43²⁴⁹ provides a simplified procedure for relief from late QSub elections. Relief is available if the request is filed within 24 months of the original due date of the election and there is a showing that the late election was due to reasonable cause.²⁵⁰ The application for relief must be filed no later than six months after the due date of a tax return for the year of the election, and all shareholders must report their taxes consistent with a valid election.²⁵¹

²⁴⁴ Reg. § 1.1361-3(a).

²⁴⁵ Reg. § 1.1361-3(a)(4).

²⁴⁶ Reg. § 1.1361-3(b)(2).

²⁴⁷ I.R.C. § 1361(b)(3)(D); Reg. § 1.1361-5(c).

²⁴⁸ Reg. § 1.1361-5(c)(2).

²⁴⁹ Rev. Proc. 2003-43, 2003-1 C.B. 998, *supplemented by* Rev. Proc. 2007-62, 2007-2 C.B. 786.

²⁵⁰ *Id.*

²⁵¹ *Id.*

C. Treatment of the Formation of and the Transition to a QSub

1. Newly Formed QSub

If a QSub election is made for a newly formed subsidiary, the subsidiary is treated as a QSub from its inception—the parent and subsidiary both are treated as if the subsidiary never had been formed.²⁵² It is a disregarded entity. Just as in the case of the formation of a single-member LLC, the formation of new QSub is a nonevent. Even though ownership of the assets transfers to the new QSub for state law purposes, all of the assets continue to be owned by the parent S corporation for federal income tax purposes. The basis and section 167–168 and 197 cost recovery periods for the assets are unaffected.

The assumption by the QSub of the parent S corporation's debts in connection with the transfer of assets to the QSub has no tax effect, even if the debts assumed exceed the S corporation's basis in the transferred assets. Because the QSub is disregarded, section 357(c) does not apply.

Because the parent S corporation is treated as directly owning all of the assets of the QSub and as the debtor with respect to all of the QSub's debts, the parent S corporation does not have a basis in the shares of the QSub that it owns. A sale of all of the QSub's stock is treated as a sale of the QSub's assets. Thus, the amount realized—the aggregate value of the consideration received—is allocated among the assets pursuant to section 1060 and the Regulations thereunder.²⁵³ The character of the gain—ordinary including recapture, section 1231, or capital including “unrecaptured section 1250 gain”—is determined asset-by-asset.

Thereafter, all of the income and all of the deductions of the QSub will be reported directly on the S corporation's return and passed through to the S corporation's shareholders under section 1366.

2. QSub Election for a Pre-Existing C Corporation Subsidiary

If a QSub election is made for a pre-existing C Corporation, regardless of whether it previously had been owned by the S corporation parent or is newly acquired, the subsidiary is deemed to have liquidated under sections 332 and 337 immediately before the day the election is effective.²⁵⁴ If a C corporation makes an S election and makes a QSub election for a subsidiary effective on the same date as the S election, the deemed subsidiary liquidation occurs immediately before the S election becomes effective, while the electing parent is still a C corporation.²⁵⁵ Under section 332 no gain or loss is recognized to

²⁵² Reg. § 1.1361-4(a)(2)(i).

²⁵³ See I.R.C. § 1060.

²⁵⁴ Reg. § 1.1361-4(a)(2), -4(b).

²⁵⁵ Reg. § 1.1361-4(a)(2), -4(b)(1).

the parent.²⁵⁶

When section 332 applies to the parent of a liquidating corporation, section 337 provides a general exception to the basic rule of section 336 that a liquidating corporation recognizes gain or loss on liquidating distributions. If the subsidiary previously was a C corporation, the section 1374 built-in gains tax will apply to the subsidiary's assets as if the subsidiary had made a Subchapter S election.²⁵⁷ Furthermore, if the corporation maintained last-in-first-out (LIFO) inventories, the QSub election will trigger LIFO recapture under section 1363(d).²⁵⁸ This provision requires a corporation that makes a Subchapter S election and that has used the LIFO method of inventory accounting to include in gross income for its last year as a C corporation the amount by which its "inventory amount"—that is, the basis in its inventory—calculated under the first-in-first-out (FIFO) method of inventory accounting exceeds its inventory amount under the LIFO inventory accounting method.²⁵⁹ Because the FIFO inventory amount often significantly exceeds the LIFO inventory amount, section 1363(d) can impose a significant transition cost.

Under section 334(b), the basis of the QSub's assets remains the same as it was before the election. Cost recovery periods and depreciation and amortization methods remain unchanged.²⁶⁰ Likewise, accounting methods and inventory methods remain unchanged.²⁶¹

Section 381(a) provides that the tax attributes that the QSub possessed as a C corporation carry over to the parent. The most notable of these attributes are net operating loss carryovers, capital loss carryovers, and the earnings and profits accumulations or deficits.²⁶² If either the parent or the subsidiary has a deficit in its earnings and profits accounts after a section 332 liquidation, the parent must maintain separate earnings and profits accounts—the deficit of one corporation cannot be used to offset the surplus in the earnings and profits account of the other.²⁶³ Earnings and profits accumulated by the parent after the liquidation are used to exhaust the deficit account before the accumulated earnings and profits account of the parent is increased.²⁶⁴ Of course, the earnings and profits of an S corporation are relevant to the treatment of distributions under section 1368 only to the extent that the S

²⁵⁶Section 332 applies when any parent corporation completely liquidates a subsidiary corporation that it controls. Because a QSub must be 100% owned by its parent S corporation, the control requirement is *ipso facto* met. For the section 332 definition of "control," see *supra* note 100.

²⁵⁷I.R.C. § 1374(d)(8).

²⁵⁸See H.R. REP. No. 104-586, at 89 (1996).

²⁵⁹See I.R.C. § 1363(d).

²⁶⁰I.R.C. § 381(c)(6); Reg. § 1.381(c)(6)-1.

²⁶¹I.R.C. § 381(c)(4), (5).

²⁶²I.R.C. § 381(c).

²⁶³I.R.C. § 381(c)(2); see *Luckman v. Commissioner*, 56 T.C. 1216 (1971).

²⁶⁴Reg. § 1.312-11(b)(2), -11(c).

corporation does not have an adequate accumulated adjustments account to support treatment of distributions as a return of basis.²⁶⁵

3. QSub Elections in Connection with the Acquisition of a Subsidiary by an S Corporation

a. *Generally.* An S corporation that acquires another corporation may make a QSub election with respect to its newly acquired subsidiary. Regardless of the classification of the newly acquired subsidiary prior to the acquisition—whether it was a C corporation, another S corporation, or a QSub of another S corporation—the newly acquired subsidiary thereafter is a C corporation unless a valid QSub election is made.²⁶⁶

The subsidiary cannot be an S corporation itself because the acquired corporation now has an illegible shareholder, its parent S corporation. Section 1361(b) proscribes S corporation treatment for any corporation that has a shareholder that is itself a corporation, even if the shareholder corporation is itself an S corporation.²⁶⁷ If an S corporation does not own 100% of the subsidiary's stock on the day before the QSub election is effective, the deemed liquidation occurs immediately after the time at which the S corporation first owns 100% of the stock.²⁶⁸

b. *Acquisition of an S Corporation without a Section 338(g) Election.* If an S corporation (P) acquires another S corporation (T), T's S election terminates and T becomes a C corporation because T now has an illegible shareholder, P, unless P makes a QSub election for T effective on the acquisition date.²⁶⁹ If a QSub election is made effective on the day P acquires T, T is deemed to liquidate into P at the beginning of the day the termination of T's S election is effective. Thus, there is no period between the termination of T's S election and the deemed liquidation of T during which T is a C corporation. T's taxable year ends at the close of the preceding day.

Similar rules apply if a C corporation (P) acquires an S corporation (T) and P makes an S election for itself and a QSub election for T effective on the day of acquisition. T is deemed to liquidate into P at the beginning of the day when P's S election is effective, and there is no period between the termination of T's S election and the deemed liquidation of T into P during which T is a C corporation.²⁷⁰

c. *Acquisition of a C Corporation or an S Corporation with a Section 338(g) Election.* If an S corporation (P) acquires a C corporation (T), T remains a C corporation, unless a QSub election is made. If P acquires T in a

²⁶⁵ See I.R.C. § 1368(c). For the accumulated adjustments account, see I.R.C. § 1368(d) and Reg. § 1.1368-2.

²⁶⁶ See I.R.C. § 1361(a).

²⁶⁷ See I.R.C. § 1361(b)(1)(B).

²⁶⁸ Reg. § 1.1361-4(b)(3)(i).

²⁶⁹ Reg. § 1.1361-4(b)(3)(ii).

²⁷⁰ *Id.*

qualified stock purchase²⁷¹ of a target and, as a result of the acquisition owns all of T's stock, P may make both a section 338 election with respect to the acquisition and a QSub election for T.²⁷² If P makes both of these elections, the QSub election cannot be effective until the day after the acquisition date (within the meaning of section 338(h)(2)). If the QSub election is effective on the day after the acquisition date, the deemed liquidation of T occurs immediately after the deemed asset purchase by the new target corporation under section 338. The result is that T recognizes the gain and loss on the deemed sale of its assets while it is still a C corporation, and T must file a final return as a C corporation reflecting the deemed sale.²⁷³ The basis of T's assets, which is transferred to P pursuant to section 334(b) in the deemed section 332 liquidation, is determined under section 338(b) and the Regulations thereunder with reference to the purchase price of T's stock and T's liabilities.²⁷⁴

If an acquiring S corporation makes a section 338 election other than a section 338(h)(10) election with respect to a target (T) that was an S corporation on the day before the acquisition date, T must file a final return as a C corporation reflecting the activities of T for the acquisition date, including the deemed sale.²⁷⁵ As is the case in the acquisition of a C corporation for which both a section 338 election and a QSub election are made, the QSub election is effective on the day after the acquisition date, the deemed liquidation of the newly acquired subsidiary occurs immediately after the deemed asset purchase, and the basis of the assets is determined under section 338(b).²⁷⁶

d. *Acquisition of an S Corporation with a Section 338(h)(10) Election.*

A section 338(h)(10) election is available with respect to the purchase and sale of the stock of an S corporation, regardless of whether the purchaser is itself an S corporation.²⁷⁷ All of the shareholders of the S corporation, including any of them who have not sold their stock, must consent to the election.²⁷⁸ Under the election, no gain or loss is recognized on the stock sale.²⁷⁹ For the selling shareholders, the transaction is instead treated as an asset sale and liquidation of the S corporation. The target S corporation recognizes gain and loss on the deemed sale of its assets based on the aggregate deemed sales price as determined under section 338.²⁸⁰ The gains and losses are passed through to the target S corporation's shareholders under section 1366.²⁸¹

The deemed-passed-through gain and loss are taken into account by the

²⁷¹ See *supra* note 111 for the definition of a qualified stock purchase.

²⁷² Reg. § 1.1361-4(b)(4).

²⁷³ Reg. § 1.338-10(a).

²⁷⁴ I.R.C. § 338(b); Reg. § 1.338-5.

²⁷⁵ Reg. § 1.338-10(a).

²⁷⁶ I.R.C. § 338(b); see Reg. §§ 1.1361-5, -6.

²⁷⁷ Reg. § 1.338(h)(10)-1(c)(1).

²⁷⁸ Reg. § 1.338(h)(10)-1(c)(3); see also Reg. § 1.338(h)(10)-1(b)(5).

²⁷⁹ See Reg. § 1.338(h)(10)-1(d)(5)(iii).

²⁸⁰ Reg. § 1.338-4.

²⁸¹ See I.R.C. § 1366.

shareholders as an adjustment to the basis of their stock under section 1367, following which the S corporation is deemed to have been liquidated in a transaction in which the S corporation shareholders recognize gain or loss under section 331.²⁸² Because the S corporation's shareholders pay the resulting taxes on the deemed sale under section 338, neither the aggregate deemed sales price nor the adjusted grossed up basis of the assets in the deemed purchase reflects the tax liability resulting from the deemed sale of the target S corporation's assets.²⁸³

Even if the purchaser (P) in a sale and purchase of S corporation stock for which a section 338(h)(10) election has been made is itself an S corporation, the newly acquired subsidiary (T) becomes a C corporation unless P makes a QSub election for T effective on the acquisition date. If a QSub election is made effective on the day T was acquired, the same rules as described in Part III.C.3.b apply. T is deemed to liquidate into P at the beginning of the day the termination of T's S election is effective. Thus, there is no period between the termination of T's S election and the deemed liquidation of T during which T is a C corporation.

4. Acquisition of a QSub

a. *Former QSub Becomes a C Corporation.* If a QSub is acquired, the original QSub election is terminated, regardless of the identity of the acquirer.²⁸⁴ The transaction is treated as follows. Assume that X Corporation owns 100% of the stock of QSub Y Corporation, and Z Corporation, which is an unrelated C corporation, acquires all of the stock of Y Corporation. The transaction is treated as the sale by X Corporation to Z Corporation of all of Y Corporation's assets followed by the transfer of those assets by Z Corporation to a newly formed Y Corporation in exchange for Y Corporation stock in a section 351 transaction.²⁸⁵ The basis of Y Corporation's assets is determined by applying section 1060 to the Z Corporation's hypothetical purchase of the Y Corporation assets, which take a section 1012 cost basis, and then applying the transferred basis rule of section 362(a) to Z Corporation's hypothetical contribution of those assets to Y Corporation. Speaking generally, the result is that Y Corporation's assets now have a fair market value basis. Z Corporation takes a section 358 exchanged basis in the Y Corporation stock.

The same results logically follow if the purchaser of the stock is an individual or a group of individuals.

b. *S Corporation Election Made for Former QSub.* If the new owners of the stock are all eligible to be shareholders of an S corporation—for example, if the purchasers in the above example were U.S. citizens—an immediately effective S election could be made. This election could be made

²⁸² See Reg. § 1.338(h)(10)-1(d)(5).

²⁸³ See Reg. § 1.338(h)(10)-1(e), Ex. 10.

²⁸⁴ See Reg. § 1.1361-5(a)(1)(iii).

²⁸⁵ Reg. § 1.1361-5(b)(3), Ex. 9.

notwithstanding the provisions of section 1361(b)(3)(D), as long as there was no intervening day on which the corporation was a C corporation.²⁸⁶ In that case, the tax consequences of the sale and purchase as well as the basis consequences for both the shareholder's stock and the target corporation's assets are the same as they would have been had there been no S election.

c. *Acquiring S Corporation Makes a New QSub Election.* If the purchaser (Z) of all of the QSub (Y) stock is an S corporation, the purchasing S corporation (Z) may make an immediately effective QSub election with respect to the newly acquired subsidiary (Y).²⁸⁷ In that case, unlike in the example immediately above there is no hypothetical transfer by Z Corporation to Y Corporation of the assets in exchange for Y Corporation stock. The basis of Y Corporation's assets would be determined simply by applying the rules of section 1060 to the hypothetical purchase by Z Corporation of the Y Corporation assets, which take a section 1012 cost basis. In this case, Z Corporation has no basis in the Y Corporation stock.

D. *Termination of QSub Status*

1. *Revocation of QSub Election*

A QSub that ceases to qualify under section 1361(b)(3)(B) or whose election has been revoked is treated as a new corporation that has acquired all of its assets and assumed all of its liabilities from its S corporation parent in exchange for the subsidiary's stock immediately before the cessation of QSub status.²⁸⁸ This hypothetical transaction is governed by general income tax principles, including section 351 and its associated sections. For purposes of determining control under section 351, equity instruments that are not treated as a second class of stock under section 1361(b)(2)(D) are disregarded. If the QSub's liabilities exceed the basis of its assets, gain must be recognized by the parent pursuant to section 357(c).²⁸⁹ The Treasury Regulations also provide that the step transaction doctrine is applicable.²⁹⁰ Thus, a disposition of the stock of the former QSub will affect application of section 351.²⁹¹

2. *Termination of Eligibility by Sale of Stock*

The transfer of any of the stock of a QSub to another person by the parent S corporation results in the termination of the QSub election on the date of the transfer.²⁹² Section 1361(b)(3)(C)(ii) provides that a sale of QSub stock that results in termination of the subsidiary's QSub election, which automatically occurs unless the purchaser is another S corporation that elects to continue

²⁸⁶ See Reg. § 1.1361-5(c)(2).

²⁸⁷ *Id.*

²⁸⁸ I.R.C. § 1361(b)(3)(C); Reg. § 1.1361-5(b)(1).

²⁸⁹ See Reg. § 1.357-1.

²⁹⁰ Reg. § 1.1361-5(b)(1).

²⁹¹ Reg. § 1.1361-5(b)(3), Ex. 1.

²⁹² Reg. § 1.1361-5(a)(1)(iii), (4), Ex. 2.

the QSub election, will be treated as a sale of the QSub's assets in proportion to the percentage of the QSub stock that has been sold. The transaction is then treated as a pro rata transfer of the QSub's assets, by the selling S corporation and the purchaser of the stock, to a newly formed C corporation in a transaction governed by section 351.²⁹³ The legislative history indicates that section 351 will apply to the deemed contribution regardless of the percentage of the subsidiary's stock held by the S corporation that is the former QSub owner.²⁹⁴ For example, if an S corporation sells 21% of the stock of a QSub, the S corporation will be treated as selling 21% of the subsidiary's assets and then contributing the assets to a new corporation in a transaction to which section 351 applies.²⁹⁵

3. Termination of the Parent's S Corporation Election

If the parent corporation's S election terminates, a QSub election terminates automatically at the close of the last day of the parent's last taxable year as an S corporation.²⁹⁶ For example, X Corporation—an S corporation—owns 100% of QSub Y Corporation. X Corporation revokes its S election effective on January 1, 2012. Because X Corporation is no longer an S corporation, Y Corporation no longer qualifies as a QSub at the close of December 31, 2011. As with any other termination of a QSub election, the event is treated as the formation of a new corporation that has acquired all of its assets and assumed all of its liabilities from the parent corporation in exchange for the subsidiary's stock immediately before the cessation of QSub status.²⁹⁷ This hypothetical transaction is governed by general income tax principles, including section 351 and its associated sections.

A somewhat different result occurs if an S corporation parent of a QSub merges into an S corporation or an LLC that is wholly-owned by an S corporation in a section 368 tax-free reorganization, and the original S corporation parent goes out of existence—rather than having its S election terminated. Assume that T Corporation—an S corporation—owns Q Corporation—a QSub—and T Corporation merges into P Corporation—another S corporation. In this instance, what would otherwise be the deemed formation of Q Corporation by T Corporation as a consequence of the termination of Q Corporation's QSub election is disregarded. In addition to there being a valid

²⁹³Reg. § 1.1361-5(b)(1); STAFF OF THE JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE "SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007" AND PENSION RELATED PROVISIONS CONTAINED IN H.R. 2206 AS CONSIDERED BY THE HOUSE OF REPRESENTATIVES ON MAY 24, 2007, 23 (JCX-29-07, 2007).

²⁹⁴STAFF OF THE JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE "SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007" AND PENSION RELATED PROVISIONS CONTAINED IN H.R. 2206 AS CONSIDERED BY THE HOUSE OF REPRESENTATIVES ON MAY 24, 2007, 23 (JCX-29-07, 2007).

²⁹⁵*Id.*

²⁹⁶Reg. § 1.1365-1(a)(1)(ii).

²⁹⁷I.R.C. § 1361(b)(3)(C); Reg. § 1.1361-5(b)(1).

section 368(a)(1)(A) merger of T Corporation into P Corporation, the transaction is treated as a transfer of Q Corporation's assets to P Corporation followed by P Corporation's transfer of those assets to Q Corporation in exchange for Q Corporation stock.²⁹⁸ A similar result follows if T Corporation merges into a disregarded entity—either a wholly-owned LLC or QSub, owned by P Corporation, although the details are a bit more complicated.²⁹⁹

IV. Conclusion

The preceding material has described in general terms the income tax consequences of the transition between being a disregarded entity and a regarded entity that occurs because of (1) LLC activities—the change in the number of LLC owners, a check-the-box election, or revocation of an election to be taxed as a corporation—and (2) the making of, or termination of, a QSub election. This Article has not attempted to discuss the planning opportunities and issues arising from the availability of the incredibly flexible disregarded entity.

Nor does this Article attempt to discuss the many unanswered questions regarding the treatment of debt owed by single-member LLCs that are disregarded.³⁰⁰ For example, if debt is recourse as to a disregarded-entity LLC but not guaranteed by the LLC's owner, is that debt recourse or nonrecourse debt for purposes of applying the rules of Regulation section 1.1001-2? Is cancellation of debt income realized by an insolvent LLC owned by a solvent member excluded from gross income under the insolvency exception to the recognition of cancellation of debt income in section 108(a)(1)(B)?³⁰¹

Furthermore, while this Article has dealt only with domestic disregarded entities, the most challenging issues arise in connection with foreign disregarded entities.³⁰² These are only a few examples of the many challenging issues presented by disregarded entities.³⁰³ However, before one can begin to take advantage of the planning opportunities presented by the use of disregarded

²⁹⁸ See Reg. §§ 1.368-2(b)(1)(iii), Ex. 3, 1.1361-5(b)(3), Ex. 9.

²⁹⁹ See Reg. § 1.368-2(b)(1)(iii).

³⁰⁰ See, e.g., Alice G. Abreu, *Much Ado About Tax Nothings: Issues in Domestic Tax Planning with Disregarded Entities*, 754 PLI/TAX 599 (2006); Alice G. Abreu, *Paradise Kept: A Rule Based Approach to the Analysis of Transactions Involving Disregarded Entities*, 59 SMU L. REV. 491, 536–50 (2006).

³⁰¹ See Abreu, *supra* note 300, at 536.

³⁰² For foreign entities with limited liability that are not per se corporations (listed in Reg. § 301.7701-2(b)(8)(i)), the default rule is that the entity is a corporation unless it elects to be a partnership or disregarded entity. Reg. § 301.7701-3(b). For U.S. tax purposes, a foreign entity lacking limited liability is treated as a partnership if it has two or more members or as disregarded if it has only one owner, unless the entity elects to be treated as a corporation. Reg. § 301.7701-3(b).

³⁰³ Another hot issue is the treatment of series LLCs. See Prop. Reg. § 301.7701-1(a)(5), 75 Fed. Reg. 55,699–701 (2010). See generally Carter G. Bishop, *The Series LLC: Tax Classification Appears in Rear View*, 130 TAX NOTES 315 (Jan. 17, 2011); Charles T. Terry and Derek D. Samz, *An Initial Inquiry Into the Federal Tax Classification of Series Limited Liability Companies*, 110 TAX NOTES 1093 (Mar. 6, 2006).

entities, one must thoroughly understand the income tax consequences of the transition between being a disregarded entity and being a regarded entity. When those issues—most of the answers to which are known or reasonably predicted—are mastered, one is then ready to tackle those issues the answers to which heretofore are unknown.

