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Jerald David August

INTEGRATION OF SUBCHAPTER C WITH SUBCHAPTER S AFTER THE SUBCHAPTER S REVISION ACT*

JERALD DAVID AUGUST**

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** Jerald David August is a partner in Rogers and August of West Palm Beach, Florida. Mr. August is co-chairman of the Corporations (Regular) Committee and previously served as chairman of the S Corporations Committee of the Tax Section of The Florida Bar. He has also chaired various subcommittees of S Corporation's Committee of the ABA Tax Section and currently is the columnist on S corporations and is on the Board of Editors for the Journal of Partnership Taxation.

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I. INTRODUCTION

A. *The Emergence of the Subchapter S Corporation*

For federal income tax purposes, a regular or C corporation is treated as a separate entity from its shareholders.[1] Income derived by the corporation for each annual accounting period is taxable under the rates provided in section 11. Allowable net operating losses and credits may be used in reducing corporate-level tax and excess losses and credits may be carried over to other years.[2] Generally, no items of income, deduction, loss, or credit, however, are passed through to the shareholders whose basis in their shares of stock generally reflects actual cost plus additional contributions.[3] When and as the net-after-tax earnings are distributed to the shareholders, a second round of income taxation is visited upon the distributees, to the extent of the distributing corporation's earnings and profits.[4] Such distributions are taxable as ordinary income. Moreover, most operating distributions of appreciated property, especially after recent legislative reforms to section 311, trigger gain realization to the transferor corporation.[5] Despite the general rule of dividend income, share-

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1. *See* I.R.C. § 7701(a)(3) (1982) (defining "corporation" as including associations, joint stock companies, and insurance companies); *id* § 7701(a)(8) (defining "shareholder"); Treas. Reg. § 301.7701-2, T.D. 7889, 1983-1 C.B. 362.

2. I.R.C. §§ 172(a)-(b), 38(a), 39(a) (1982).

3. *But see id.* § 551(b) (West 1985) (each U.S. shareholder of a foreign personal holding company must include in gross income his share of undistributed foreign personal holding company income). A similar rule is provided for shareholders in a controlled foreign corporation with respect to the corporation's Subpart F income, and increase in investment of earnings in U.S. property. *Id.* § 951(a)(1) (1982). Moreover, certain foreign tax credits of a controlled foreign corporation may be passed through to the shareholders. *Id.* §§ 960, 962 (1982); *see also id.* § 565 (1982) (permitting the constructive payment of dividends with respect to consent stock in avoiding a personal holding company or accumulated earnings tax); Treas. Reg. § 1.1502-19, T.D. 7246, 1973-1 C.B. 381 (recapture of excess loss account).

4. I.R.C. §§ 301(c)(1), 316(a) (1982).

5. *See* J. EUSTICE, THE TAX REFORM ACT OF 1984 ¶ 3.02[1] (1984); Bloom & Calvert, *Corporate Changes Wrought by the Tax Reform Act of 1984*, 11 J. CORP. TAX'N 299, 315-18 (1985).

holders receiving distributions in exchange for terminating or significantly reducing their stock interest in the corporation, are permitted to realize gain at preferred rates despite the presence of earnings and profits.[6]

Due to the contrast between the relatively flat corporate rates and the graduated individual income tax brackets, which prior to 1981 attained maximum levels of 70 percent, and the ability in certain instances for shareholders to bail out earnings and profits as capital gains, there was ample incentive to accumulate and reinvest earnings at the corporate level and defer shareholder-level tax. In order to prevent this perceived abuse of the double tax on corporate earnings, which is a fundamental tenet of our nonintegrated system of corporate taxation under Subchapter C, Congress vested the Internal Revenue Service with the power to impose an additional tax on the undistributed income of a corporation needlessly accumulating earnings or on corporations whose income is primarily derived from investments and not from the conduct of an active trade or business.[7]

In stark contrast to the corporate model, the rules governing partnerships under Subchapter K treat the entity as a clearinghouse for funneling items of income, deduction, loss, and credit directly to the partners who must include such items on their individual returns for their taxable year in or with which the partnership year ends.[8] Each partner is further required to annually adjust the basis in his partnership interest to reflect the allocable amounts of income and deduction passed through from partnership operations.[9] Moreover, distributions to partners generally do not result in gain at either the entity or investor level to the extent of contributed capital and previously passed-through net earnings.[10] As such, the essential feature of Subchapter K is the single level of tax imposed on the partners bypassing the entity level. This model, which may also be used while attaining a modified form of limited liability under state statute,[11] was most attractive for noncorporate investors unable to reduce the

6. *See* I.R.C. §§ 302(a), 303, 331(a) (1982).

7. I.R.C. § 531 imposes an accumulated earnings tax, in addition to other taxes, on subject corporations accumulating earnings and profits beyond the reasonable needs of the business and in excess of a minimum credit of $250,000 for all corporations other than certain service corporations whereby the minimum credit is reduced by $100,000. The undistributed accumulated taxable income, as defined in § 535(a), is taxed at rates of 27.5% on the first $100,000 of such income and 38.5% thereafter. Under § 541, a corporation is subject to an additional tax of 50% on its undistributed personal holding company income, as defined under § 545(a). A personal holding company is excepted from the accumulated earnings tax by virtue of § 532(b)(1). The same exception applies to a foreign personal holding company described in § 552.

8. I.R.C. §§ 701-703 (West 1985); *see* Larsen v. Commissioner, 66 T.C. 159 (1976), *acq.*, 1979-1 C.B. 1; Treas. Reg. § 301.7701-3 (1960); *see also* I.R.C. §§ 7701(a)(2), 761(a)-(b) (1982) (defining "partnership" and "partner"). *See generally* W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶¶ 3.06-.09 (1977).

9. I.R.C. § 705 (West 1985).

10. *Id.* §§ 731(a)-(b), 736, 751(b) (1982).

11. A limited partnership is a partnership formed by two or more persons under the Uniform Limited Partnership Act, having as members one or more general partners and one or more limited partners. *See* Feld, *The Control Test for Limited Partnerships*, 82 Harv. L. Rev. 1471 (1969); Note, *Tax Classification of Limited Partnerships*, 90 Harv. L. Rev. 745 (1977).

double tax impact on corporate earnings through the benefit of a dividends-received deduction or under similar rules provided in the consolidated return regulations.[12]

In an effort to minimize the effect of federal income taxes on the choice of the form of doing business, Congress enacted the Subchapter S legislation in 1958. Although the early versions of this reform borrowed a strict partnership model for shareholder-level reporting,[13] the resulting legislation respected the separate identity of the electing corporation while at the same time it attempted to achieve a single level of tax at the shareholder level on the distributed and undistributed taxable income of the corporation.[14] In effect, Congress crossbred the pass-through of entity-level earnings (and losses) and basis adjustment concepts under Subchapter K with the distributional rules under Subchapter C which included maintaining a corporate-level account for earnings and profits. The result was that a third form for engaging in business operations was created for small groups of investors who were required, in the interests of promoting the efficient administration of our tax laws, to receive identical equity interests in the corporation. Since corporate-level earnings were passed through annually to the shareholders, the special accumulated earnings and personal holding company provisions did not apply to Subchapter S corporations.[15]

B. *The Need For the Subchapter S Revision Act (SSRA)*

Despite the welcome arrival of this hybrid between Subchapters C and K, access to Subchapter S was limited based on its various eligibility and investor limitations. Moreover, the inability of shareholders to carry forward losses in excess of basis (stock and debt) and the complex and formalistic rules governing distributions often resulted in hardship at the shareholder level, producing results nearly identical with those obtained under Subchapter C. These problem areas were specifically addressed by Congress in the Subchapter S Revision Act (SSRA) with the express purpose of significantly making the tax treatment of shareholders in S corporations more analogous to that of partners in partnerships under Subchapter K.[16] For example, section 1366(a) provides, in a manner

12. *See* I.R.C. §§ 243-246 (West 1985); Treas. Reg. § 1.1502-14(a)(1), T.D. 7246, 1973-1 C.B. 381; *id.* § 1.1502-26, T.D. 7631, 1979-2 C.B. 241.

13. *See* J. EUSTICE & J. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 1.2[1] n.2 (1982).

14. *Id.* ¶ 1.2[2].

15. However, this result may be otherwise in a year the corporation terminates its election. Sieh v. Commissioner, 56 T.C. 1386 (1971), *aff'd,* (8th Cir. 1973); *see also* 520 Co. v. United States, 230 F. Supp. 803 (N.D. Tex. 1964), *aff'd,* 342 F.2d 759 (5th Cir. 1965).

16. The general effective date of SSRA is for taxable years beginning after 1982. Under the new legislation, Subchapter S corporations have been renamed "S corporations". *See* I.R.C. § 1361(a)(1) (1982). In contrast, a "C corporation" is defined as a corporation that is not an S corporation for such year. *Id.* § 1361(a)(2) (1982).

For articles describing generally the impact of SSRA, see Bravenec, *The Subchapter S Revision Act of 1982* (pts. 1 & 2); 14 TAX ADVISOR 194, 280 (1983); Coven & Hess, *The Subchapter S Revision Act: An Analysis and Appraisal,* 50 TENN. L. REV. 569 (1983); Newmark & Lang, *The Subchapter S Revision Act of 1982,* 37 TAX LAW. 93 (1983); Shaw, *Subchapter S: A Fresh Start Under the Subchapter* similar to section 702, that each item of income, deduction, loss, and credit of the corporation is allocable to the shareholders on a daily basis based on each shareholder's proportionate interest in the corporation.[17] Prior to SSRA, the daily allocation rule only applied to the allocation of Subchapter S losses, while undistributed income and investment credits were allocable only to those shareholders owning stock on the last day of the corporation's taxable year.[18] Moreover, section 1366(d)(2) provides that losses in excess of basis may be carried forward indefinitely, which is the same rule as that contained in section 704(d).[19] A further benefit is provided in section 1366(d)(3) permitting the absorption of excess losses to the extent of stock basis as of the end of the corporation's post-termination transition period, as defined in section 1377(b).

Since no earnings and profits will arise from operations conducted by newly organized S corporations,[20] distributions, whether in the form of cash or property, may be received by a shareholder-distributee as a tax-free return of capital to the extent of such person's initial stock basis, as adjusted for previously passed-through items of income, deduction, and credit. This simple, two-tier rule contained in section 1368(b) provides relief for shareholders previously required to successfully penetrate the complex maze of distributional priorities under prior law and will produce results similar to those obtained by partners through operation of sections 733, 731, and 705.[21] However, complexity remains for distributions by S corporations having earnings and profits from years prior to the effective dates of SSRA and/or as may later be acquired in an acquisition described in section 381.[22] This results from the operation of section 1368(c),

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S Revision Act of 1982, 35 U. So. Cal. Tax Inst. 10-1 (1983) [hereinafter cited as Shaw, *Fresh Start*]; Shaw & August, *An Analysis of the Subchapter S Revision Act: Eligibility, Election, Termination*, 58 J. Tax'n 2 (1983) [hereinafter cited as Shaw & August, *Analysis*]; Shaw & August, *Subchapter S Revision Act: Distributions, Taxable Years and Other Changes*, 58 J. Tax'n 300 (1983) [hereinafter cited as Shaw & August, *Distributions*]; Shaw & August, *Subchapter S Revision Act Makes Significant Changes in Taxing C Corporation Operations*, 58 J. Tax'n 84 (1983) [hereinafter cited as Shaw & August, *Significant Changes*]; Yelen, *Choosing the S Corporation as the Preferred Entity*, N.Y.U. 42nd Inst. on Fed. Tax'n 13-1 (1984).

17. This is essentially the same rule used to allocate losses prior to SSRA. *See* I.R.C. § 1374(c)(1) (1976) (current version at I.R.C. § 1374(c)(1) (1982)). Generally, all tax items will be characterized at the corporate level. *Id.* § 1366(b) (1982).

18. I.R.C. §§ 1373, 1375 (repealed 1982). Although, a limited pass-through of net capital gains was permitted net capital losses were trapped at the corporate level as a five-year carryforward. *See* J. Eustice & J. Kuntz, *supra* note 13, ¶¶ 7.3-.5.

19. For taxable years beginning prior to 1983, S corporations and their shareholders were subject to the at-risk rules for losses in § 465, and for investment tax credits under § 46(c)(8) for property acquired and placed in service after February 19, 1981. Under SSRA, for taxable years beginning after 1982, the at-risk rules are applied solely at the shareholder level. *See* August, *Navigating the At-Risk Waters After the Tax Reform Act of 1984*, 63 Taxes 83 (1985); Bravenec, *Subchapter S Corporations and Shareholders Under the At-Risk Rules of Section 465*, 36 Tax Law. 93 (1982).

20. I.R.C. § 1371(c)(1) (West 1985).

21. *See* I.R.C. § 735(a) (1982) (providing that unrealized receivables and items of inventory distributed by a partnership retain their character at the partner level). No similar provision applies to distributions by a C or S corporation.

22. *See* Bravenec & Lassila, *Increased Planning Needed to Prevent S Corporation Distributions from Being Taxed*, 61 J. Tax'n 2 (1984); Shaw & August, *Distributions*, *supra* note 16.

which sets forth a three-tier distributional framework for characterizing shareholder distributions. The application of section 1368(c) is also important for S corporations attempting to avoid a termination or special corporate-level tax due to the combined presence of excess passive investment income and Subchapter C earnings and profits.[23]

C. *The Required Integration of Subchapter S with Subchapter C*

Despite SSRA's attempt at establishing parity between shareholders in S corporations and partners in partnerships, important distinctions may still be made on matters of certainty of tax status, eligibility, taxation of operations, basis computations, distributions, and sales or exchanges of equity interests.[24] Although many of these differences are directly contained in Subchapter S, the continuing hybrid nature of S corporations is dramatically demonstrated by the required reference to Subchapter C for determining the tax consequences of various corporate- and shareholder-level events impacting S corporations.

This interaction of Subchapter C with Subchapter S predominates in three areas: (1) transactions by an S corporation with respect to its own stock; (2) transactions where an S corporation is acting in a shareholder capacity; and (3) transactions where application of the general conduit rules used in the partnership provisions are to be superseded by the special corporate-level taxes under section 1374,[25] which imposes a capital gains tax on appreciated property sold under a "one shot" election, or section 1375, which taxes excess passive investment income of corporations having earnings and profits from Subchapter C years at the end of a taxable year.

This article will explore the important interrelationships between Subchapter S and Subchapter C and identify problem areas for which there are currently no clear solutions.

II. Integration of Subchapter S with Subchapter C under SSRA

The general rules referencing Subchapter C for S corporations are set forth in section 1371(a).

> (a) Application of Subchapter C Rules.-
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> (1) In general.—Except as otherwise provided in this title, and except

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23. I.R.C. §§ 1362(d), 1375 (West 1985); *see* Shaw & August, *Significant Changes, supra* note 16, at 86-87.

24. For articles comparing post-SSRA Subchapter S with partnerships, see generally August & Silow, *S Corporations vs. Partnership for Real Estate Ventures*, 1 J. Tax'n Investments 91 (1983); Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass-Through Paradigm*, 39 Tax L. Rev. 345 (1984); Gautreau & White, *Similarities and Differences Between S Corporations and Partnerships After the Sub S Revision Act of 1982*, 35 Tax Executive 336 (1983); Starr, *Recent Legislative Changes Affect the Selection of the Proper Entity for Tax Purposes*, 59 J. Tax'n 340 (1983).

25. It is also possible that the net capital gain subject to tax under § 1374 will result in a corporate-level preference tax under § 56. *See* I.R.C. § 58(d) (1982).

to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.

(2) S corporation as shareholder treated like individual.—For purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual.

The first integration rule, section 1371(a)(1), provides that Subchapter C will continue to apply to S corporations except as specifically provided in Subchapter S or otherwise inconsistent with the treatment of an S corporation as a conduit for tax purposes. A similar provision was previously contained in the regulations to Subchapter S which directed the reference to Subchapter C in addressing the tax consequences of redemptions, distributions, liquidations, reorganizations, and other events.[26] Transactions by an S corporation with respect to its own stock will be treated as if the S corporation were a regular corporation under Subchapter C.[27] Thus, section 1032 will continue to apply to S corporations issuing stock in exchange for property and section 351 will apply to certain transfers of property by shareholders in control of an S corporation.[28]

There are provisions under the new Subchapter S rules which will specifically override the application of Subchapter C. For example, section 1363(d), which requires that distributions to shareholders of appreciated property trigger gain recognition at the corporate level, denies an S corporation access to section 311(a) which, prior to the Tax Reform Act of 1984, generally provided that similar transfers by a C corporation did not result in gain. Exceptions are provided in section 1363(e), however, for distributions in complete liquidation and distributions of stock (nonboot) in corporate reorganizations or divisions.[29]

A second specific preemption of Subchapter C in Subchapter S is the distribution provision in section 1368, which overrides section 301 and certain related provisions, and perhaps, section 356. Finally, section 1371(c) provides rules concerning adjustments to earnings and profits for operations, distributions described in section 1368(c)(2), and certain other corporate events in partial preemption of section 312. Although prior accumulated earnings and profits may be adjusted, an S corporation will not produce current earnings and profits from its business operations for any post-SSRA taxable year.

The second rule, section 1371(a)(2), provides that an S corporation in a shareholder capacity will be treated as an "individual."[30] Thus, dividends re-

26. Treas. Reg. § 1.1372-1(c), T.D. 7564, 1978-2 C.B. 19.

27. S. Rep. No. 640, 97th Cong., 2d Sess. 15, *reprinted in* 1982 U.S. Code Cong. & Ad. News 3253, 3266-67.

28. *See* Ltr. Rul. 8417042 (Jan. 24, 1984) (as to I.R.C. § 1032); G.C.M. 38969 (Mar. 9, 1983), *reprinted in* 18 Tax Notes (Tax Analysts) 1124 (Mar. 28, 1983) (as to I.R.C. § 351).

29. Prior to SSRA, I.R.C. § 311 applied to Subchapter S corporations. *See* Treas. Reg. § 1.372-1(c)(5), T.D. 7564, 1978-2 C.B. 19; Oberst, *Reform of the Subchapter S Distribution Rules: Repudiation of Section 311(a)*, 38 Tax L. Rev. 79 (1982).

30. By definition, an S corporation may not own stock in another S corporation or own 80% or more of the stock of a C corporation unless it is an "inactive subsidiary" under § 1361(c)(6) (West 1985). *See* I.R.C. §§ 1361(b)(1)(B), 1361(b)(2)(A) (1982).

ceived by an S corporation-shareholder will be included in gross income at fair market value and passed through to the S corporation's shareholders, without the benefit of a dividends-received deduction under section 243.[31] This approach is consistent with treating an S corporation as a pass-through entity. Unfortunately, in commenting on section 1371(a)(2), the Committee Reports only refer to section 301.[32] However, section 301 is only one of many provisions in Subchapter C in which individual and corporate shareholders are dissimilarly treated. The distinction between a corporate and noncorporate shareholder is critical for qualifying a distribution as a redemption in partial liquidation described in section 302(b)(4), which will have a concomitant impact on the corporation-distributor under section 311(d)(2)(A), liquidations under sections 332 and 333, and purchases of target corporations under section 338. However, it appears that an S corporation should not be treated as an "individual" in instances where it seeks to qualify for a Type D reorganization or for purposes of section 304 when it purchases stock in a related corporation.

While several of the technical corrections made to SSRA in the Tax Reform Act of 1984 (TRA 84) addressed important problem areas concerning the integration of Subchapters C and S, other critical questions remain. This "integration gap" will continue to beset tax advisers in weighing alternative strategies in structuring corporate transactions. The reasons for this are twofold. First, prior to SSRA, there were still many unsettled areas concerning transactions involving Subchapter S corporations under Subchapter C. In addition, there are currently no guidelines as to when the application of the Subchapter C provisions to an S corporation will be deemed to be "inconsistent" with the conduit principles adopted by SSRA. Presumably the inconsistency clause in section 1371(a)(1) was intended to remedy situations where the constantly evolving overlay of Subchapter C to S corporations and their shareholders would result in an abusive situation not specifically foreseen at the time SSRA was enacted into law. However, the statutory language in section 1371(a)(1) is of uncertain scope and application, and, without careful definition and limitation by regulation, the chilling effect of this provision may unfairly inhibit tax advisers from recommending otherwise legitimate tax planning strategies. Hopefully the regulations, when issued, will limit the scope of this rule in the manner previously provided in Regulations section 1.1371-1(c), which specifically listed (some but not all) provisions in Subchapter C which directly applied to S corporations.

III. Distributions Not in Complete Liquidation

A. *Distributions to Shareholders Under Section 301*

1. Distributions From S Corporations

Prior to SSRA, the general rule governing distributions to shareholders in

31. As an "individual," it is unclear whether the S corporation may qualify for the nominal partial dividend exclusion under § 116.

32. S. Rep. No. 640, *supra* note 27.

regular corporations, section 301, also aplied to Subchapter S.[33] However, additional layers of distributional priorities were provided under former sections 1375(d) and 1375(f) which were principally designed to facilitate the tax-free recovery of income previously taxed, either as previously taxed income (PTI) or undistributed taxable income (UTI), to the particular shareholder-distributee.[34] This limited privilege to distribute PTI and UTI ahead of earnings and profits often proved to be a troublesome matter especially for corporations in need of working capital.[35]

Integration of PTI and UTI, which could only accompany distributions of money, with the general requirement under section 301 that a distribution, whether in cash or property, made with respect to a corporation's stock is taxable as dividend income to the extent of current or accumulated earnings and profits, resulted in a seven-tier system for reporting cash distributions. The first tier was comprised of distributions made within two and a half months after the close of the taxable year out of the preceding year's UTI (but only to the extent of the shareholder-distributee's share of such UTI) which constituted a recovery of stock basis.[36] Distributions of UTI in excess of basis result in gain from the sale or exchange of stock. The second tier constituted dividend income to the extent of current earnings and profits,[37] which account was reduced for any adjustments required under section 312(k), e.g., accelerated depreciation and cost recovery deductions in excess of straight line, and tax-exempt income.[38] Third-tier distributions qualified as a recovery of stock basis to the extent of the distributee's share of PTI.[39] PTI distributions in excess of stock basis generally resulted in capital gain.[40] After PTI was exhausted, the fourth tier required dividend treatment to the extent of current earnings and profits created by the adjustments required in section 312(k). The fifth tier was treated as dividend income to the extent of the corporaton's accumulated earnings and

33. Treas. Reg. § 1.1372-1(c)(2), T.D. 7564, 1978-2 C.B. 19.

34. The overlay of UTI and PTI to § 301 was technically acknowledged in the regulations as an exception to § 316. Treas. Reg. § 1.1372-1(c)(7), T.D. 7564, 1978-2 C.B. 19.

35. This was due to the fact that only distributions of "money" and not "property" could carry out PTI or UTI. Often the Service argued that the distribution of cash and an immediate loan back to the corporation constituted a distribution of a note or "property." *See* DeTreveille v. United States, 445 F.2d 1306 (4th Cir. 1971); McKelvey v. United States, 478 F.2d 1217 (Ct. Cl. 1973); Roesel v. Commissioner, 56 T.C. 14 (1971).

36. I.R.C. § 1375(f) (repealed 1982).

37. I.R.C. §§ 301(c)(1), 316(a)(2) (1982). These dividends could have resulted in ordinary income or capital gains under former § 1375(a)(1) to the extent net capital gain did not exceed taxable income determined under former § 1373(d). *See* I.R.C. §§ 1373(d), 1375(a)(1) (repealed 1982).

38. Former § 1377(d) specified that current earnings and profits were adjusted without regard to § 312(k) but only for purposes of former § 1375(d). I.R.C. § 1377(d) (repealed 1982). Again, these dividends could have resulted in ordinary income or capital gains to the extent provided under former § 1375(a)(1). *Id.* § 1375(a)(1).

39. *Id.* § 1375(d).

40. *Id.* §§ 301(c)(1), 316(a)(1). *But see* Treas. Reg. § 1.1375-4(c) (1959) (providing that all shareholders could annually elect to waive third-tier distributions of PTI so that additional distributions would come from earnings and profits).

profits. The sixth and seventh tiers constituted a tax-free return of capital[41] and gain from the sale or exchange of stock respectively.[42]

Distributions of property by Subchapter S corporations with respect to their stock were subject to only four distributional tiers. This reduction in the number of tiers was attributable to the fact that UTI and PTI could only accompany distributions of money.[43] Thus, the value of property distributed to a shareholder was first taxable as dividend income to the extent of current earnings and profits (after reduction for second-tier distributions of cash) allocated ratably with the current year's UTI.[44] The second tier constituted dividend income to the extent of accumulated earnings and profits.[45] The third and fourth tiers were treated as a tax-free return of capital[46] and gain from the sale or exchange of stock, respectively.[47]

Although the purpose of the complex rules governing distributions from Subchapter S corporations prior to SSRA was to facilitate the tax-free receipt of previously taxed earnings, too often shareholders failed to artfully navigate the distribution tiers and were treated as having received distributions of earnings and profits instead of the desired reduction in UTI and/or PTI.[48] Moreover, the termination of the corporation's election resulted in the total destruction of all shareholders' PTI accounts and the UTI accounts could only survive for an additional seventy-five days.[49] Where the termination was involuntary, and as such, retroactive to the first day of the taxable year, distributions designed to qualify as made from PTI or UTI were magically converted into ordinary income. Where the shareholders were unaware of a disqualification for an extended period of several taxable years, the cost of the lost election was magnified by the additional taxes owed on distributions of cash made during this interim period.[50]

As a result of the reforms introduced by SSRA, the taxation of distributions to shareholders will more closely resemble the partnership model than the double tax system under Subchapter C. This is primarily due to the fact that earnings

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41. I.R.C. § 301(c)(2) (West 1984).
42. *Id.* § 301(c)(3).
43. I.R.C. §§ 1373(c), 1375(d), 1375(f) (repealed 1982).
44. Treas. Reg. § 1.1375-4(b) (1959).
45. I.R.C. §§ 301(c)(1), 316(a)(1) (1982).
46. *Id.* § 301(c)(2).
47. *Id.* § 301(c)(3).
48. For an in-depth analysis of the distribution rules prior to SSRA, see J. EUSTICE & J. KUNTZ, *supra* note 13, chs. 9 & 10; *see also* Freeman, *The Subchapter S Corporation Distribution System After the Subchapter S Revision Act*, 62 TAXES 773 (1984).
49. Former § 1375(d) only applied to distributions by an "electing small business corporation." I.R.C. § 1375(d) (repealed 1982). Although the language used in former § 1375(f) was not limited in this manner, the two-and-a-half-month window for making distributions of UTI after the end of the preceding (last) Subchapter S year was often of little comfort after the discovery of a terminating event.
50. During this limbo period, the corporation could be accruing a substantial tax liability since it would be subject to all taxes imposed on regular corporations, or, if losses were sustained, the shareholders would have deficiencies in tax for any deductions claimed on mistaken reliance of the pass-through of such amounts.

and profits will not be generated by S corporations for taxable years beginning after 1982, and, to that extent, will no longer serve as a distributional tier. Moreover, the distinctions previously made between money and property distributions have generally been eliminated and with them the difficult concepts of PTI and UTI, subject only to a special grandfather rule in section 1379(c).

The primary set of distributional rules under Subchapter S is contained in sections 1368, 1367, 1371(a), 1371(e), and 1379(c). These rules presumably preempt application of section 301. In applying the new distribution rules, the basis adjustments set forth under section 1367 are required to be made prior to testing the tax treatment of distributions made during the same taxable year.[51] Under the same principle, presumably the determination of an S corporation's accumulated adjustments account, described in section 1368(e)(1)(A), is also made at the end of the year but prior to applying the distribution rules.[52] Although not entirely clear, the requirement that basis be adjusted prior to applying the distribution rules, which normally will not occur until the end of the S corporation's taxable year, will not suspend the time for including such distribution in the distributee's gross income.[53] Thus, for example, where a shareholder uses a calendar year and the corporation's taxable year ends on June 31, a distribution received in November 1985 will be includable in gross income for the shareholder's year ending December 31, 1985, even though final characterization of the distribution may not be determinable until July 1, 1986 when the required basis adjustments are known.

The key provision governing distributions is section 1368, which, per section 1368(a), applies to all distributions of property made by an S corporation "with respect to its stock to which (but for this subsection) section 301(c) would apply." Section 1368(b) provides that distributions of money or property (net fair market value) described in section 1368(a) by an S corporation without accumulated earnings and profits is first treated as the nontaxable return of the shareholder-distributee's stock basis, and any excess results in gain from the sale or exchange of stock in similar fashion to sections 301(c)(2) and 301(c)(3), respectively. Gain will be reported as long- or short-term capital gain depending on the shareholder's holding period in the stock and provided the stock is held as a capital asset and the corporation is not collapsible.[54]

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51. S. Rep. No. 640, *supra* note 27, at 18; H.R. Rep. No. 826, 97th Cong., 2d Sess. 17 (1982). For partnerships, however, distributions reduce basis first before losses are applied against basis. *See* Rev. Rul. 66-94, 1966-1 C.B. 166.

52. J. Eustice & J. Kuntz, *supra* note 13, ¶ 9.12[3][c] (Supp. II 1984).

53. *See* Treas. Reg. § 1.1373-1(f), T.D. 7564, 1978-2 C.B. 19 (appearing to override the constructive dividend rule under Treas. Reg. § 1.451-2(b), T.D. 7663, 1980-1 C.B. 101, for distributions of UTI and PTI for timing purposes). For entity comparison purposes, see Treas. Reg. § 1.731-1(a)(1) (1956), which suspends the timing of "draws" received by a partner for distribution purposes until the last day of the partnership's taxable year in which made.

54. It should be noted that although § 341(a)(3), which specifically applies to gain under § 301(c)(3), does not refer to distributions that result in gain under § 1368(b)(2) or § 1368(c)(3). This was apparently a technical oversight. Shareholder gain will probably be taxed as ordinary income if the S corporation making the distribution is collapsible. *See infra* notes 226-29 and accompanying text (discussion of I.R.C. § 341).

Section 1368(c) provides the second set of distribution rules for S corporations having accumulated earnings and profits. While no S corporation after SSRA will have current earnings and profits from operations, accumulated earnings and profits may be present from preelection years or for years beginning prior to 1983 while the S corporation was an electing small business corporation.[55] Where an S corporation acquires a C corporation in a reorganization, the transferor corporation's earnings and profits may be inherited under section 381(c)(2).

Where an S corporation with accumulated earnings and profits makes a distribution to a shareholder, the same results will be obtained as if the simple two-tier system in section 1368(b) applied to the extent the value of the distribution does not exceed the corporation's accumulated adjustments account (AAA), as defined in section 1368(e)(1)(A).[56] Annual distributions in excess of AAA are taxed as dividend income to the extent of accumulated earnings and profits as if sections 301(c)(1) and 316(a)(1) had applied.[57] After the AAA and accumulated earnings and profits tiers are eliminated, any further distributions are treated as a return of stock basis and gain from the sale of stock.[58]

The AAA, unlike the PTI account which was separately maintained (nontransferable) by each shareholder, is a corporate-level account which is adjusted in a manner similar to the basis adjustments required to be made by the shareholders under section 1367.[59] Although section 1367(b)(2) provides that a shareholder's basis in stock may not be reduced by the pass-through of deductions to an amount less than zero, section 1368(e)(1)(A), as recently revised by TRA 84, provides that AAA may be a negative number.[60] Unfortunately, this will prevent an S corporation with positive adjustments to AAA during its current taxable year from distributing its current profits without shareholder-level tax, if the ending AAA is still less than zero.[61] This may create a double-tax trap to the shareholders receiving distributions during such a taxable year, first on the pass-through of taxable income from operations and then on the distribution to the extent of accumulated earnings and profits.

Generally, AAA will consist of post-SSRA accumulated gross income less deductible expenses and prior distributions (net fair market value) allocable to the account. The account will not be increased for tax-exempt income, and, correlatively, will not be decreased for nondeductible expenditures allocable to

55. I.R.C. §§ 312(k), 1377(d) (West 1985).

56. *Id.* § 1368(c)(1).

57. *Id.* § 1368(c)(2).

58. *Id.* § 1368(c)(3).

59. Thus, the benefit of an S corporation's AAA may be bestowed upon a donee or transferee of stock provided the corporation continuously maintains its S election. In contrast, Treas. Reg. § 1.1375-4(e) provided that a shareholder's PTI account was not transferable in any manner. Treas. Reg. § 1.1375-4(e), T.D. 6960, 1968-2 C.B. 342. This limitation will continue to be important for those shareholders maintaining PTI accounts under the grandfather rule in I.R.C. § 1379(c) (1982).

60. Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(r)(1), 98 Stat. 494, 970. This revision has been given retroactive effect to taxable years beginning after 1982.

61. *See* Bravenec & Lassila, *supra* note 22; Shaw & August, *Distributions, supra* note 16.

the production of such income. Since tax-exempt income is an adjustment to a shareholder's stock basis under section 1367 but does not increase AAA, an item of tax-exempt income may not be distributed tax-free to the shareholders until the accumulated earnings and profits account is exhausted.

In allocating distributions of cash and the value of property distributed during the taxable year, TRA 84 provides that distributions in excess of AAA, as determined as of the close of the taxable year, will be allocated pro rata among all distributions made during the same period.[62] This rule will not discriminate against shareholders receiving distributions during the latter part of the taxable year which would have occurred had a FIFO rule for carrying out AAA been adopted. For example, if the balance in the AAA at the end of the year, prior to distributions, is $200x and the corporation distributes property having a value of $400x to shareholder A and cash in an equal amount to shareholder B, each will receive a distribution from AAA of $100x.[63] The balance of the distributions, $600x, will presumably carry out accumulated earnings and profits to the shareholders in chronological order of their distributions under the regulations to section 316.[64] Thus, if the distributions are made on the same date, A and B would each receive the same amount of dividend income. On the other hand, if the cash distribution to B was made after the distribution to A but during the same taxable year, each would be allocated the same amount of AAA but A would absorb the balance of his distribution from accumulated earnings and profits before B determines the nature of the balance of his distribution.

Under section 1368(e)(3), S corporations with accumulated earnings and profits making distributions during a taxable year may, with the consent of all shareholders receiving distributions during the same period, elect to bypass first-tier distributions of AAA under section 1368(c)(1).[65] The effect of the election will be to allocate the most recently accumulated earnings and profits, to the extent thereof, to those shareholders receiving distributions in chronological or-

62. Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(r)(2), 98 Stat. 494, 970. This revision has an effective date retroactive to the general effective date of SSRA. Tax Reform Act of 1984, Pub. L. No. 98-369, § 6, 98 Stat. 967 (1984). The pro rata allocation rule can work to the detriment of a shareholder, who, in the same taxable year, receives a distribution from the corporation prior to selling shares of his stock to a third person. Later distributions to the remaining shareholders, to the extent the sum of all distributions exceeds AAA, will convert what may have been the tax-free return of capital to the selling shareholder into dividend income. The Conference Report to the 1984 legislation states that a different rule may apply by regulation where substantial amounts of stock in the corporation are sold or exchanged during the taxable year. H.R. REP. No. 861, 98th Cong., 2d Sess. 1226, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 890-91.

63. A distribution from AAA parallels the rules in § 1368(b)(1) (same as § 301(c)(2)) and § 1368(b)(2) (same as § 301(c)(3)). *See supra* note 54 (application of § 341(a)(3) to §§ 1368(b)(2) & (c)(3)); *see also* Cox v. Commissioner, 78 T.C. 1021 (1982) (gain under § 301(c)(3) not a "sale" under § 453 prior to 1980 legislative changes to installment sales).

64. Treas. Reg. §§ 1.316-2(b) & (c) (1955).

65. Note that under Treas. Reg. § 1.1375-4(c), T.D. 6960, 1968-2 C.B. 342, all shareholders had to consent to waive distributions from PTI.

der, before recovering stock basis. In effect, the bypass election will achieve results similar to the three-tier rule in section 301(c).[66]

The AAA bypass election may allow an S corporation with excess passive investment income to avoid a termination under section 1362(d)(3) or a "sting" tax under section 1375, by distributing all of its Subchapter C accumulated earnings and profits prior to the close of its taxable year.[67] This procedure may also prove beneficial in avoiding a personal holding company or accumulated earnings tax for the year preceding the first taxable year under Subchapter S under section 563, since distributions of AAA will not be treated as dividends described in section 562(a).[68] Moreover, shareholders may desire dividend treatment in order to use expiring net operating losses or increase investment income for purposes of the section 163(d) limitation on investment interest.

Under section 1379(c), if an S corporation was taxed under Subchapter S for its last taxable year beginning before January 1, 1983, qualifying distributions of undistributed taxable income from pre-SSRA years may still be made to shareholders with PTI accounts under former sections 1375(d) and 1375(f).[69] Since the former rules permitted cash distributions of PTI to be made ahead of accumulated earnings and profits, presumably distributions qualifying under section 1379(c)(2), the accumulated earnings and profits tier.[70] Moreover, the AAA bypass election under section 1368(e)(3), should not prevent shareholders from reporting PTI distributions in advance of dividend income under section 1368(c)(2) although the former will not reduce earnings and profits.

One critical aspect of the distribution rules under SSRA is whether a separate basis must be maintained in each block of stock owned by an S shareholder. Both sections 1367, pertaining to adjustments to basis of stock, and 1368, for distributions, create the impression that the basis for all shares of stock is computed as an aggregate account. An argument supporting an aggregate basis

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66. An exception will apply to distributions of PTI under I.R.C. § 1379(c), which presumably may be received ahead of accumulated earnings and profits. *See infra* note 70 and accompanying text.

67. However, § 1368(e)(3) did not distinguish between Subchapter C accumulated earnings and profits and pre-SSRA Subchapter S accumulated earnings and profits, although only the former is of consequence for purposes of the passive investment income tax and termination rules. *See* I.R.C. § 1368(c)(3) (West 1985). Since the regulations under § 316(a) require that distributions from accumulated earnings and profits are considered to be made on a LIFO basis, an S corporation may not be able to earmark distributions under § 1368(c)(2), even under the bypass election, as first absorbing Subchapter C accumulated earnings and profits where Subchapter S earnings and profits were the last ones added to the account. *See id.* § 316(a) (1982); I.R.C. § 1368(c)(2) (West 1985).

68. A similar relief provision was recently enacted in TRA 84 by allowing shareholders to elect to bypass the special rule for cash distributions in a post-termination transition period under § 1371(e)(1), in order to obtain a dividends-paid deduction under § 561. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(o), 98 Stat. 494, 970.

69. It has been suggested, however, that distributions of property may also qualify. Eustice, *supra* note 24, at 428.

70. J. EUSTICE & J. KUNTZ, *supra* note 13, at S-19 n.277. *But see* Ellett & Tull, *Previously Taxed Income and the New S Corporation*, 61 TAXES 569 (1983) (suggesting that distributions of PTI under § 1379(c) have priority over AAA).

approach may be made since Congress's intent in structuring the distribution rules appartently was to promote the tax-free receipt of taxable income (for S corporations with accumulated earnings and profits) or economic income (for all other S corporations) generated after the effective dates of the new legislation.[71] This approach would achieve the same results as those obtained under Subchapter K for partners in partnerships. Moreover, since distributions under section 301(c)(2) may not create a taxable loss, a shareholder in an S corporation should arguably be permitted to fully recover basis in all of his shares of stock before gain recognition applies.

On the other hand, it appears that the authority supporting the separate share theory is stronger. First, the regulations under former section 1376, for adjusting stock basis for undistributed taxable income and net operating losses, applied a separate share rule.[72] Moreover, although still a source of debate and confusion, the case law under Subchapter C has generally applied a block-by-block method in computing gain or loss on the sale or exchange of stock or in computing gain under sections 301(c)(3).[73] Finally, a separate share rule was contained in the regulations to section 331.[74]

Assuming a separate block rule will apply to section 1368, consider, for example, the result where an S corporation makes a substantial cash distribution to a shareholder who has acquired shares of stock at various times. In this situation, it is quite possible that the distribution, as allocated among the various blocks based on the total number of shares in each block, may exceed basis, as adjusted under section 1367, for some shares but not for others. Moreover, it appears that an effort to earmark the distribution (e.g., high basis shares) would not succeed unless the distribution can be structured as a redemption taxable under section 302(d). In this event, specific shares with an identifiable cost basis redeemed by the corporation would be taxed to the shareholder as if sold to an unrelated third party provided that the transaction was not rife with abuse.[75] Selecting separate blocks of shares for redemptions under section 302(a) or sales of stock to third parties will most likely be respected. However, for partial distributions in complete liquidation the Service has ruled, as will be discussed later, that when a shareholder owns more than one block of stock, a separate computation of gain or loss must be made for each block and each distribution must be allocated in proportion to the number of shares in each block.[76] Although in-depth treatment of the rationale and problem areas gen-

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71. S. Rep. No. 640, *supra* note 27, at 20; H.R. Rep. No. 826, *supra* note 51, at 19; *see also* Zuckerman, *Aggregation of Basis under Sections 301(c)(2) and 301(c)(3)*, 33 Tax Law. 937, 946-48 (1980).

72. I.R.C. § 1376 (repealed 1982); Treas. Reg. § 1.1376-2(a) (1959).

73. *See* Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971) (dividend); Skinner v. Eaton, 45 F.2d 568 (2d Cir.) (sale of stock), *cert. denied*, 283 U.S. 837 (1930); Zuckerman, *supra* note 71. *See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶¶ 7.02, 9.01, 9.61 (1979).

74. Treas. Reg. § 1.331-1(e), T.D. 6949, 1968-1 C.B. 107; Rev. Rul. 79-10, 1979-1 C.B. 140.

75. *See* Treas. Reg. § 1.302-2(a) (1955); *see also supra* note 73.

76. Rev. Rul. 68-348, 1968-2 C.B. 141.

erated by applying a separate block rule are beyond the scope of this article, the tax adviser must be aware of the presence of this rule when planning distributions to shareholders in S (and C) corporations.

Where an S corporation distributes appreciated property (other than its own obligations) to its shareholders as a dividend, section 1363(d) overrides application of section 311(a), and requires that the corporation must recognize gain. This provision was designed to prevent shareholders from receiving a distribution of appreciated property without tax, claiming a step-up in basis to fair market value, and selling the asset for the same amount. Prior to SSRA, distributions of appreciated property by Subchapter S corporations were subject to section 311 (and sections 312 and 1377 for adjustments to earnings and profits).[77] Moreover, distribution of an appreciated capital asset may, in certain instances, have resulted in a capital gains tax under former section 1378 (now section 1374).

Although section 1363(d) in its original form did not have an exception, the Committee Reports to SSRA provided that gain recognition would not result for distributions in complete liquidation not resulting in the recapture of prior tax benefits (in matching the Subchapter C rule under section 336).[78] Fortunately, the Tax Reform Act of 1984, in new section 1363(e), expressly adopts the position taken in the Committee Reports for complete liquidations and further exempts distributions of stock which may be received without gain recognition in corporate reorganizations and divisions.[79] The effective date of these exemptions is retroactive to taxable years beginning after 1982.[80]

Since section 1363(d) treats the S corporation-transferor as if it sold the property to the shareholder-distributee at fair market value, gain will generally be characterized by reference to the nature of the asset in the hands of the corporation.[81] Thus, the distribution may trigger depreciation and investment credit recapture. Furthermore, if the shareholder-distributee of depreciable property is considered to own 80 percent or more in value of the corporation's stock, gain which otherwise would be subject to tax at preferred rates will be transmuted into ordinary income under section 1239.

As a result of the pass-through rules, the nondistributee shareholders must include their proportionate share of the section 1363(d) gain in gross income.[82] Thus, a shareholder receiving a distribution of appreciated property will obtain a step-up in basis for the property while the gain and recapture income generated at the corporate level is spread among all of the shareholders. Of course, the shareholder-distributee must separately determine whether the distribution is taxable under section 1368 after his stock basis is first adjusted for his allocable

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77. Treas. Reg. § 1.1372-1(c)(5), T.D. 7564, 1978-2 C.B. 19; *see* J. EUSTICE & J. KUNTZ, *supra* note 13, ¶ 10.2[2].

78. S. REP. No. 640, *supra* note 27, at 20; H.R. REP. No. 826, *supra* note 51, at 3.

79. Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(a)(1), 98 Stat. 494, 966.

80. *Id.* § 721(y)(1), 98 Stat. 494, 972.

81. *See* I.R.C. § 1366(b) (1982); *cf.* Treas. Reg. § 1.1375-1(d), T.D. 7728, 1980-2 C.B. 236. *But see infra* note 226 and accompanying text (discussion of I.R.C. § 341).

82. I.R.C. § 1366(a)(1)(A) (1982).

share of the corporation's income, including section 1363(d) gain, and deductions during the entire taxable year.[83]

For the S corporation whose shareholders are well advised as to the rules governing the pass-through of income and corresponding basis adjustments, distributions of appreciated assets may create some interesting tax planning opportunities. On the other hand, for the S corporation shareholders who are unaware of these rules, distributions creating gain under section 1363(d) may produce nightmarish results. One situation where the latter may occur is where the distributed asset is appreciated stock in another corporation and the transferor-S corporation has Subchapter C accumulated earnings and profits. Depending on the extent of the gain and the amount of passive investment income from other sources, section 1363(d) gain may be taxed under section 1375 and the net amount taxed to the shareholders. Even if section 1375 were inapplicable, the gain might cause the corporation to be subject to a capital gains tax under section 1374 and a corresponding preference tax under section 56. A second trap lurks for distributions of depreciable property subject to section 1239 as previously discussed.

It is important to note that section 1363(d) only applies to gains. For distributions of depreciated property, presumably section 311(a)(2) will apply which rarely triggers loss recognition at the corporate level. One statutory exception is section 453B(a) for distribution of an installment obligation having a value less than its basis.[84] However, the distribution of depreciated property to a shareholder will result in disappearing basis since the shareholder-distributee will have a fair market value basis in the asset.

After an S corporation terminates its election, the general rules under section 301 will apply for subsequent distributions.[85] For S corporations without accumulated earnings and profits, distributions made after a termination will result in shareholder-level tax to the extent of future earnings. Earnings from prior S years reflected in stock basis may then be recovered tax-free. Although post-termination distributions for corporations with prior accumulated earnings and profits must, in addition to prospective earnings, be taxed as dividend income to the shareholders before basis may be recovered under section 301(c)(2), SSRA granted a partial amnesty from first reporting dividends from earnings and profits for distributions of money made during a "post-termination transition period," e.g., the one-year period beginning the first day after the termination of the S election.[86] This override of Subchapter C, which is contained in section

83. *See id.* § 48(q)(6) (stock basis adjustments for the pass-through of entity-level qualified investment in § 38 property).

84. Treas. Reg. § 1.1372-1(c)(5), T.D. 7564, 1978-2 C.B. 19. However, any realized loss may go unrecognized under I.R.C. § 267(a)(1). *See* B. Bittker & J. Eustice, *supra* note 73, ¶ 7.21; J. Eustice & J. Kuntz, *supra* note 13, at ¶ 10.2[1].

85. I.R.C. § 1362(d) (West 1985).

86. The "post-termination transition period" begins on the day after the last day of the corporation's last taxable year as an S corporation and ends on the later of (1) one year after the effective date of termination or (2) the due date for filing the return for the last S corporation year, including extensions; or the end of the 120-day period beginning on the day of the "determination" that the S corporation's election had terminated for a prior taxable year. *See id.* §

1371(e)(1), effectively permits shareholders to bypass section 301(c)(1) to the extent qualifying distributions do not exceed the corporation's AAA from S years.[87] As previously discussed, if the amount of all distributions made during the taxable year exceeds AAA, the account is allocated to each shareholder-distributee in proportion to his respective share of the total distributions made. However, since distributions of "property" do not qualify for this special relief, presumably the allocation of AAA for post-termination transition period distributions should only be made with respect to distributions of money.

2. Distributions to S Corporations

An S corporation may own stock in another corporation as long as the corporations are not members of an affiliated group under section 1504, now determined without regard to section 1504(b).[88] Thus, an S corporation may not own 80 percent of the voting stock and 80 percent in value of all outstanding shares of stock in another corporation. However, ownership of an inactive subsidiary is permitted.[89] Although S corporations may frequently own stock in a C corporation, an S corporation may not have a corporate shareholder.[90]

Under section 1371(a)(2), an S corporation is treated as an individual in its capacity as a shareholder. Accordingly S corporations receiving distributions of property under section 301(a) will apply the rule applicable to noncorporate distributees in section 301(b)(1)(A) and include in gross income the fair market value of the distribution. In contrast, a regular corporation includes in gross income the lesser of fair market value or the transferor corporation's adjusted basis, plus gain recognized on the distribution, under section 301(b)(1)(B). As an individual, an S corporation is not eligible for a dividends-received deduction under section 243 and must pass through the dividend (presumably net of the exclusion under section 116) to its shareholders as a separately computed tax item under section 1366(a)(1) for reporting on their individual returns. Since fair market value is included in gross income, the basis rule in section 301(d)(1) for noncorporate distributees will also apply and the corporation will start a fresh holding period for the asset.[91] These results are clearly consistent with treating an S corporation as a conduit for federal income tax purposes. However, dividends constitute passive investment income under section 1363(d)(3)(D)(i)

1377(d). An added benefit during a post-termination transition period is that a shareholder may deduct prior years' excess losses to the extent of additional contributions to stock. *Id.* § 1366(d)(3).

87. However, § 1371(e)(2) provides shareholders with an election not to apply § 1371(e)(1). *Id.* § 1371(e)(2). This elect-out provision may be helpful in avoiding a personal holding company or accumulated earnings tax in a post-termination transition period. *See supra* notes 7 & 68. Moreover, S corporations without accumulated earnings and profits must still determine their AAA for purposes of making post-termination distributions under § 1371(e)(1).

88. I.R.C. § 1361(b)(2)(A) (1982). Certain affiliated members permitted under prior law are also grandfathered in under SSRA.

89. *Id.* § 1361(c)(6).

90. *Id.* § 1361(b)(1)(B).

91. As an "individual," § 301(e)-(f) will not apply to S corporations owning stock in a regular corporation.

and the fair market value of any property received as a distribution from another corporation may be taxed at the corporate level at the current maximum rate of 46 percent if section 1375 applies for such year. If the shareholders are taxed at maximum rates, the double tax effect of the corporate-level sting tax and the pass-through of the net dividend may currently reach 73 percent of value (without regard to state income tax considerations).[92]

B. *Stock Redemptions Under Section 302*

Prior to SSRA, redemptions of stock of Subchapter S corporations were subject to section 302 in testing for dividend equivalence.[93] Although testing the redemption itself under section 302(b) did not produce results different from those applicable to shareholders in regular corporations, the overall impact of the redemption was not limited to the shareholder redeeming his shares, but was also felt by the nondistributee shareholders. This was due to the fact that UTI, which was taxable to those shareholders owning stock on the last day of the taxable year, was not reduced for redemptions that were treated as exchanges under section 302(b).[94] Moreover, dividend equivalent redemptions described in section 302(d) would only reduce UTI to the extent the distribution was in cash and not property. Accordingly, redemptions treated as exchanges did not reduce the tax liability of the shareholders owning stock in the corporation at the end of the year.[95] However, as noted by leading authorities on Subchapter S, this did not necessarily leave the continuing shareholders without some tax planning opportunities.[96]

As for the redeemed shareholder, gain from an exchange of stock under section 302(2) was generally the same as that which would otherwise have resulted from a distribution of UTI or PTI which was already reflected in stock basis.[97] However, if the redeemed shareholder continued to own shares of stock in the corporation, he might have preferred "exchange" treatment to avoid any reduction to his PTI account.

As to the corporation, the pre-SSRA rules required application of section 311 (and sections 312 and 1377 for adjustments to earnings and profits) for distributions in redemption of stock. Thus, if a Subchapter S corporation distributed appreciated property in a redemption which did not meet any of the

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92. For an excellent discussion of state taxation of S corporations, see Maule, *Effect of State Law on the Use of S Corporations*, 37 TAX LAW. 535 (1984).

93. Treas. Reg. § 1.1372-1(c)(3), T.D. 7564, 1978-2 C.B. 19; *see* J. EUSTICE & J. KUNTZ, *supra* note 13, ¶ 15.5.

94. I.R.C. § 1373(c) (repealed 1982); Treas. Reg. § 1.1373-1(g) ex. 5, T.D. 7564, 1978-2 C.B. 19; *see* Rev. Rul. 75-433, 1975-2 C.B. 118.

95. As to the redeemed shareholder, he would still receive his allocable share of any net operating loss for the taxable year even though UTI was allocable only to those shareholders owning stock at the end of the year. I.R.C. §§ 1373(b), 1374(b) (repealed 1982); *see* Estate of Bette v. Commissioner, 36 T.C.M. (CCH) 1636 (1977).

96. J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 15.5[2].

97. Thus, there was generally no need to make a distribution of PTI prior to redeeming shares of a stockholder that qualified for exchange treatment.

exceptions in section 311(d), gain recognition at the corporate level increased undistributed taxable income.[98]

The treatment of redemptions of stock of an S corporation after SSRA will presumably continue to be governed by section 302. If a redemption constitutes an exchange under section 302(a), it is outside the scope of the general distribution rules under section 1368.[99] However, for S corporations with no accumulated earnings and profits, characterization of a distribution as a redemption under section 302(a) or a distribution under section 1368(a) may make little or no difference to the redeeming shareholder. This may occur where a shareholder terminating his direct stock investment in an S corporation is denied exchange treatment by application of section 318. However, for shareholders redeeming part but not all of their direct investment in the corporation, exchange or dividend treatment may produce different results. This is due to the fact that only the basis in the shares of stock being redeemed will cushion return of capital amounts for a redemption treated as an exchange, whereas presumably the redeemed shareholder's entire stock basis in both the redeemed and remaining shares may be absorbed as a tax-free return of capital where nonexchange status results. If the regulations under Subchapter S treat stock basis as an aggregate account, which, as previously discussed, is still uncertain, it may, in this and in certain other instances (i.e., potential application of section 341(a)(3)) be more advantageous to purposely sidestep section 302(a).[100]

For S corporations with accumulated earnings and profits, shareholders will generally seek to qualify redemptions for exchange treatment in order to avoid dividend income. Even if the redemption is not treated as an exchange, however, the same result will apply (e.g., return of capital, gain from the sale of stock) if the amount received by the shareholder does not exceed the corporation's AAA as of the close of the taxable year and as allocated among all dividend distributions made during the same period. Obviously, to the extent the distribution exceeds AAA, ordinary income will follow to the extent of accumulated earnings and profits, which, as previously discussed, will presumably be allocated to shareholders receiving distributions in chronological order.[101] In either event, under sections 1366 and 1377(a)(1), the redeemed shareholder will be taxed on his allocable daily portion of the S corporation's income or loss in the year of the redemption. For redemptions in complete termination of a shareholder's direct stock interest, consideration should also be given to electing under section 1377(a)(2) to hypothetically close the taxable year so that postredemption income or loss during the taxable year will not result in further adjustment of the gain or loss on the redemption.[102]

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98. However, net capital gains generated from distributions taxable under § 311 could be passed through intact to the shareholders under former § 1375(a)(1). *See* I.R.C. § 1375(a)(1) (repealed 1982).

99. Presumably, stock basis will first be adjusted by the pass-through of separately and nonseparately computed tax items in the year of the redemption in determining gain or loss under § 302(a) as of the date of the exchange. *See supra* note 52.

100. *See supra* notes 71-74 and accompanying text (discussion of the separate block rule).

101. *See supra* text accompanying notes 51-53.

102. This election is made with the consent of all shareholders. However, the allocation of

Although section 1368, by definition, will not apply to redemptions described under section 302(a), the scope of the post-termination distribution rule under section 1371(e)(1) appears to include redemptions.[103] Despite section 1368's preemption of direct application of section 302, the tax consequences of a cash distribution from (prior years') AAA under section 1371(e) will generally be the same as those obtained under section 302. Differences may arise, however, where payments in exchange for stock qualify for installment sale reporting under section 453. In such an instance a redeemed shareholder may contend that section 1371(e)(1) allows the full recovery of basis in the redeemed shares to the extent cash received during the post-termination transition period does not exceed allocable AAA, instead of requiring that gain be reported under the ratable basis rule in section 453(a)(1).[104]

While the Tax Equity and Fiscal Responsibility Act (TEFRA) and TRA 84 severely contracted and modified the exceptions to nonrecognition of gain provided under section 311(d)(2) for distributions in redemption of stock by regular corporations, section 1363(d) results in gain recognition for *all* distributions of appreciated property in redemption of stock.[105] Thus, an electing corporation contemplating distributions of substantially appreciated assets in redemption of stock eligible to be redeemed under section 302(b)(4) (or qualifying dividends described in section 311(e)(3)) should consider a prior revocation of S status to avoid gain recognition at the expense of living under Subchapter C for the succeeding four-year period required under section 1362(g).

For S corporations with accumulated earnings and profits redeeming shares of its stock under section 302(a), sections 1368(e)(1)(B) and 1371(c)(2) require adjustments to AAA and accumulated earnings and profits respectively. The redemption will reduce AAA, determined as of the end of the taxable year in which the redemption occurs, in direct proportion to the ratio which the number of shares redeemed bears to all issued and outstanding shares of stock prior to the redemption. Presumably, the balance of AAA will then be allocated among those shareholders receiving distributions under section 1368. Thus, it may generally be more advantageous to effectuate stock redemptions treated as ex-

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AAA (aggregate) generated after the hypothetical closing date and ending as of the end of the taxable year, presumably may still be allocated to the redeeming shareholder where the redemption is treated as a dividend under § 302(d). Presumably, the election under § 1377(a)(2) does not accelerate the time for when the shareholder is required to report his pass-through of tax items on his individual return. *See* I.R.C. § 1377(a)(2) (1982).

103. However, § 1371(e)(1) only applies to the lesser of the shareholder's stock basis or AAA, and a distribution in excess of either amount may result in dividend income as opposed to capital gain under § 302(a). *See id.* § 1371(e)(1); *see also supra* note 54 (concerning potential application of § 341(a)(3)).

104. *See* Cox v. Commissioner, 78 T.C. 1021 (1982).

105. For regular corporations, under § 311(d)(2) distributions of appreciated property in redemption of stock will not result in gain in six instances: (1) distributions to certain noncorporate shareholders in partial liquidation; (2) distributions constituting qualified dividends; (3) distribution of stocks or obligations of certain 50% controlled subsidiaries; (4) § 303 redemptions; (5) certain distributions to private foundations in redemption of stock; and (6) distributions for certain redemptions by regulated investment companies.

changes under section 302 in taxable years subsequent to the distribution of AAA to the nonredeeming shareholders. As for accumulated earnings and profits, section 1371(c)(2), which provides that "proper adjustment" be made to account for any transaction involving Subchapter C, presumably will result in the same adjustment required under sections 312(n) (redemptions), 312(h) (divisions), and 381 (reorganization).[106] Thus, for a redemption treated as an exchange, the proportionate share rule used in reducing AAA is also used under section 312(n)(8) in reducing accumulated earnings and profits.[107]

For S corporations having their shares of stock redeemed in a regular corporation, section 1371(a)(2), as previously discussed, requires that the redemption be tested for dividend equivalence under the rules applicable to individuals. Thus, as an "individual," an S corporation should qualify for exchange treatment for redemptions in partial liquidation under section 302(b)(4).[108] In addition, an S corporation-shareholder should qualify the distributing corporation to avoid gain recognition on the distribution of appreciated property made with respect to "qualified stock," as defined in section 311(e), for "qualified dividends" under section 311(d)(2)(A)(ii), and for distributions in partial liquidation under section 311(d)(2)(A)(i).

TRA 84 clarified the rules for determining whether a distribution of appreciated property is made with respect to qualified stock where the shareholder is a pass-through entity.[109] As applied to S corporation shareholders, this rule, which is contained in new section 311(e)(1)(C), requires that the determination of whether the redeemed shares constitute qualified stock be made at the shareholder level with each shareholder considered as owning an amount of stock in the distributing corporation in proportion with his "interest" in the S corporation.

In testing for dividend equivalence for post-SSRA redemptions under section 302, until the passage of TRA 84 it was uncertain whether an S corporation-shareholder was to be treated as a corporation or a partnership in applying the attribution rules under section 318. Under the Tax Reform Act of 1984, new section 318(a)(5)(E) specifically provides, retroactive to the general effective dates under SSRA, that an S corporation will be treated as a partnership under section 318.[110] This will result in attribution to and from shareholders owning less than 50 percent of an S corporation's stock which is in contrast to the 50 percent or more stock ownership requirement for attributing shares of stock

106. Substantial revisions to § 312 were made in TRA 84. For discussion of these changes, see J. EUSTICE, *supra* note 5, at ¶ 3.02[2]; Bloom, *The Stark Reality of the New Liquidations and Redemption Rules*, 10 J. CORP. TAX'N 3 (1983); Bloom & Calvert, *supra* note 5; Ginsburg, *Taxing Corporation Acquisitions*, 38 TAX L. REV. 171 (1983). *See generally* B. BITTKER & J. EUSTICE, *supra* note 73, ch. 7.

107. This reverses the decision in Jarvis v. Commissioner, 43 B.T.A. 439, *aff'd*, 123 F.2d 742 (4th Cir. 1941).

108. The shareholders of an S corporation may also qualify under I.R.C. § 302(b)(4), although § 1363(d) will override § 311(d)(2)(A) to the S corporation-tranferor.

109. Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(y)(1), 98 Stat. 494, 972.

110. *Id.*

between a regular corporation and its shareholders under sections 318(a)(2)(C) and 318(a)(3)(C).

C. *Redemption of Stock from a Decedent's Estate Under Section 303*

Section 303 permits stock in a corporation included in a shareholder's gross estate to be redeemed without resulting in dividend income provided the amount distributed does not exceed death taxes and allowable deductions for funeral and administration expenses.[111] Prior to SSRA, stock in a Subchapter S corporation could be redeemed under section 303.[112]

Since there is no inconsistency between the use of section 303 and the conduit rules introduced by SSRA, estates of deceased shareholders of S corporations should continue to qualify for redemption treatment under section 303. Qualification will be important for non-section 302(a) redemptions from S corporations with accumulated earnings and profits in avoiding dividend treatment. The impact of qualifying section 303 redemptions will generally be the same as that previously described under section 302(a). However, consideration should be given to whether it is equitable that section 1363(d) will apply to distributions of appreciated property in redemption of S corporation stock under section 303 while C corporations benefit under section 311(d)(2)(C). Until an exception is provided in this area, an S corporation anticipating making redemptions under section 303 should ensure that it will have an ample supply of cash.

D. *Sales of Stock Between Related Corporations Under Section 304*

Section 304 prevents the "bailout" of corporate earnings and profits as long-term capital gains on sales of stock in one corporation to a related corporation. This is accomplished by recasting such sales as redemptions, thus bringing into play sections 302 and 303, and testing for dividend equivalence by the selling shareholder's reduction in ownership in the issuing corporation.[113]

Prior to SSRA, the parent-subsidiary rule in section 304(a)(2) did not apply to a Subchapter S corporation due to the fact that a corporation (subsidiary) was an ineligible shareholder. Thus, even though an S corporation could be in "control" of a subsidiary acquiring its stock under section 304(c)(1), the purchase itself would terminate the election retroactive to the first day of the issuing corporation's taxable year. This would require the transaction to be analyzed as involving two regular corporations.[114]

As far as the brother-sister fact pattern described in section 304(a)(1), it was possible for a Subchapter S corporation to purchase stock in another corporation and cause the sales proceeds to be taxed as dividend income to the seller to the extent of its earnings and profits as computed under section

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111. *See generally* B. Bittker & J. Eustice, *supra* note 73, at ¶ 9.40.

112. Treas. Reg. § 1.1372-1(c)(3), T.D. 7564, 1978-2 C.B. 19; *see* J. Eustice & J. Kuntz, *supra* note 13, at ¶ 15.5.

113. *See generally* B. Bittker & J. Eustice, *supra* note 73, at ¶ 9.30.

114. *See* I.R.C. § 1372(e) (repealed 1982).

304(b)(2)(A). Presumably, the full set of distribution rules under Subchapter S, which included the ability to make distributions of PTI and UTI, applied in characterizing any dividend equivalent payments received by the seller.[115]

The current application of section 304 to S corporations raises important questions which need to be answered in the forthcoming regulations.[116] This confusion emanates from giving a literal interpretation to section 1371(a)(2) which requires that an S corporation be treated as an "individual," an S corporation is not a "corporation" for section 304 purposes. If this interpretation is correct, the use of an S election would be an effective technique to bail out earnings and profits of a related corporation at at preferred rates. For example, a majority shareholder in a regular corporation with earnings and profits could organize an S corporation to purchase shares of stock in the related corporation. The purchase would be financed over a prescribed period by the profitable entity's payment of dividends to the S corporation-purchaser. The tax on dividends could be substantially reduced by operation of section 243, if the purchasing corporation terminated its election after the redemption was completed.[117]

In order to prevent the avoidance of section 304 by an S corporation acquiring stock in a regular corporation the "individual" rule under section 1371(a)(2) should not be used in testing for section 304 relationships, which result should be endorsed in the forthcoming regulations. Apparently this language problem may be confined to section 304(a)(1) since a nonaffiliated subsidiary's purchase of an S corporation-parent's stock under section 304(a)(2) will terminate the parent's S election and start a short C year on the date of purchase.[118] This will remove any impediment to application of section 304(a)(2).

Even if an S corporation is treated as a corporation for purposes of section 304(b)(1) another problem must be considered. Under section 304(b)(2), as revised by TEFRA, the hypothetical distribution which increases current earnings and profits to the acquiring corporation in a brother-sister redemption is not compatible with section 1371(c), which precludes an S corporation from generating or acquiring current earnings and profits during its post-SSRA years.[119] Unless the "hypothetical" dividend rule could be analogized to an S corporation's acquiring another corporation's earnings and profits under section 381(c)(2), which certainly is a strained analysis, a shareholder selling stock in a controlled corporation with significant earnings and profits could still avoid dividend treatment despite the lack of any meaningful reduction in his interest in the issuing corporation. Fortunately, this potentially abusive use of an S corporation under section 304(a)(1) will be limited to stock acquired between

115. J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 15.4[2] n.158. There is no authority specifically holding that redemption payments in cash taxed as dividends under I.R.C. § 304 may reduce or carry out UTI and PTI under former I.R.C. §§ 1373(c), 1375(d) or (f).

116. *See* Shaw, *Fresh Start, supra* note 16 at ¶ 1005.3.D.

117. Prior to TEFRA, this gambit could also be used with a new C corporation (without earnings or profits).

118. I.R.C. §§ 1362(d)(2)(B), 1363(e)(1)(B) (West 1985).

119. Tax Equity and Fiscal Responsibility Act of 1982, § 226(a)(3), I.R.C. § 304 (West 1985).

the effective date of revised section 304(b)(2). By revision in TRA 84, for purchases of stock on or after June 19, 1984, the hypothetical distribution concept has been replaced.[120] Now the earnings and profits of both the acquiring and issuing corporations will be analyzed directly in computing dividend income. Thus, where an S corporation without earnings and profits acquires stock from a C corporation with earnings and profits under section 304(a)(1), a dividend equivalent redemption will result in ordinary income to the seller.[121]

In testing whether a distribution qualifies under section 302(a), section 304(a)(1) focuses on the selling shareholder's change in stock ownership, after application of the constructive ownership rules in section 304(c)(3), the issuing corporation and not the acquiring corporation. Assuming an S corporation will be treated as a "corporation" in purchasing stock in another corporation under section 304(a)(1), if the selling shareholder qualifies for exchange treatment under section 302(a) or 303 the distribution will fall outside of section 1368. Thus, any resulting gain to the seller, net after the stock basis adjustments required under the regulations to section 304,[122] which do not appear to be inconsistent with the adjustments required under section 1367, will be taxed at preferred rates provided the stock is a capital asset in the hands of the seller.

Where dividend treatment follows in a section 304(a)(1) transaction, the direction contained in section 304(b)(2)(A) that the distribution be treated as a dividend to the extent of the acquiring corporation's earnings and profits is in conflict with section 1368(c)(1) for S corporations with AAA. It appears that the inconsistency clause in section 1371(a)(1) requires that section 1368(c)(1) will control and dividend equivalent payments may first be made tax-free from AAA. However, where section 304(b)(4)(A) is inapplicable (by preemption of section 1363(c)(1)) section 304(b)(2)(B) then directs that the distribution be treated as directly received by the issuing corporation to the extent of its earnings and profits. Even in this instance it is still unclear whether AAA and accumulated earnings and profits of the acquiring S corporation must first be exhausted before section 304(b)(2)(B) applies since section 1371(a)(1) is still in direct conflict with section 304(b)(2).

In the event a purchase described under section 304(a)(1) is taxed as a dividend, any reduction in the acquiring S corporation's accumulated earnings and profits and/or AAA will result in the required adjustments to such accounts

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120. Tax Reform Act of 1984, Pub. L. No. 98-369, § 712(l)(1), 98 Stat. 953 (1984); *id.* § 712(l)(7), 98 Stat. 494, 954-55.

121. For a discussion of these changes, see Bloom & Calvert, *supra* note 5.

122. *See* Treas. Reg. § 1.304-2(a), (c) (1955). These basis rules apply for both dividend equivalent and exchange redemptions under I.R.C. § 304. However, because of the inconsistency clause in I.R.C. § 1371(a)(1), query whether the basis adjustments in § 1367 constitute the exclusive method for adjusting basis. Apparently the basis rules in Subchapter S will be applied throughout. For example, the debt restoration rule in § 1367(b)(2)(B) may apply to a shareholder-creditor in the year in which shares of his stock are purchased by an S corporation under § 304(a)(1). *See* I.R.C. § 1367(b)(2)(B) (West 1984). This will increase gain to the extent the redemption is treated as an exchange, or will reduce the basis in stock to be allocated under the § 304 regulations if dividend equivalent results.

under sections 1368(e)(1)(B) and 1371(d)(2) respectively. Furthermore, if appreciated property is used in acquiring the stock, gain recognition will result under section 1363(d) regardless of whether dividend or exchange treatment applies to the seller. However, the gain under section 1363(d) will not increase the earnings and profits of the acquiring S corporation in applying section 304(b)(2)(A).

E. *Distributions of a Corporation's Stock to its Shareholders Under Sections 305 and 306*

When a corporation distributes shares of its stock (or rights to acquire its stock) to its shareholders, the value thereof is generally not included in the distributees' gross income by virtue of section 305(a). Five specific statutory exceptions and a sixth exception, which is provided under the regulations in sections 305(b) and 305(c), respectively, trigger dividend treatment under section 301.

Section 306 generally provides that stock in a corporation which is distributed tax-free to its shareholders under section 305(a) (except a distribution of common on common) will generally give rise to ordinary income upon its subsequent sale or redemption to the extent gain on the disposition reflects the earnings and profits of the issuing corporation.

Although sections 305 and 306 presumably were and should continue to be applicable to small business corporations under Subchapter S, the one-class-of-stock limitation under section 1361(b)(1)(D) will generally limit application of both provisions to S corporations.[123] More specifically, since the distribution of common stock on common stock is outside the scope of section 306, the application of this section to S corporations will generally be limited to shareholders holding section 306 stock in a regular corporation which is exchanged in a carryover basis transaction (i.e., section 351) for stock in an S corporation. The shares received for the section 306 stock will be tainted by virtue of section 306(c)(1)(C). As to section 305(b), which provides for dividend treatment on certain distributions of stock, shareholders in S corporations who can elect to receive additional shares of stock or property (including money) will be taxed under section 305(b)(1). Similarily, distributions in a planned series of redemptions which result in the receipt of property by some shareholders and an increase in the proportionate share of other shareholders in the stock ownership of the corporation will trigger dividend treatment under section 305(b)(2).

One unresolved question in this area is whether the repayment of straight debt or other debt, recharacterized as equity, will constitute "preferred stock" for sections 305 and 306.[124] Thus, for example, section 305(b)(3) could apply where some shareholders receive straight debt instruments which, although not jeopardizing the corporation's S election, constitute a preferred equity under

123. Treas. Reg. § 1.1372-1(c)(4), T.D. 7564, 1978-2 C.B. 19. The one-class-of-stock limitation under former law was contained in I.R.C. § 1371(a)(4). *See* I.R.C. § 1371(a)(4) (repealed 1982).

124. *See* I.R.C. § 1361(c)(5)(B) (West 1985) (defining straight debt); *id.* § 1361(c)(5)(C) (authorizing the Treasury to issue regulations for the proper treatment of straight debt under Subchapter S and for purposes of integration with all other provisions of the Internal Revenue Code).

section 385 principles, while other shareholders receive additional shares of common stock. This will result in all shareholders being viewed as having received a distribution made with respect to their stock in the corporation. Moreover, a straight debt instrument later exchanged for common stock could be analyzed as the exchange of preferred for common under section 368(a)(1)(E). These are just two of many potential problem areas to be encountered by S corporations which issue straight debt whose equity features may predominate (e.g., 100:1 debt-equity ratio) in assessing the results of the issuance, timing, and deductibility of interest payments, repayments of principal, and exchange into other debt or equity interests as part of a reorganization described under section 368(a).[125]

Under prior law, a distribution of stock taxed to a shareholder in a Subchapter S corporation as a dividend under section 305 presumably was treated as "property" for purposes of applying the special rules for undistributed taxable income under former sections 1373(c), 1375(d), and 1375(f). However, the distributing corporation did not recognize gain on the distribution of stock regardless of whether the distributions was taxable to the shareholder.[126] In the event a distribution resulted in tax under section 301, a corresponding reduction to earnings and profits was required.[127]

After SSRA, stock or stock rights distributed to shareholders described under section 305(b) should also be outside the scope of the gain recognition rule in section 1363(d), although there is no language in the statute (including section 1363(e)) or the legislative history which ensures this result. Support for non-application of section 1363(d) in this context may be found in section 317(a), which provides that the term "property" under the distribution rules of Subchapter C does not include stock or rights to acquire such stock in the corporation making the distribution.

For the S shareholder receiving a tax-free distribution of common stock under section 305(a), the distribution rules under section 1368 are inapplicable. The basis in the stock will presumably be determined in accordance with section 307 which generally requires that basis be allocated between the "old" and "new" shares according to relative values on the date of distribution. Where the distribution is described under section 305(b) or 305(c), section 1368(a) will apply. For S corporations without accumulated earnings and profits, the value of the stock will either constitute a return of capital, to the extent of basis in the "old" shares, or gain from the sale of stock. Where the S corporation distributing shares of its stock has accumulated earnings and profits, the dis-

125. The Senate Report to SSRA provided that where a C corporation, with accumulated earnings and profits, has preexisting straight debt instruments at the time it files its S election, which instruments are properly treated as equity for tax purposes, the election will not result in a deemed exchange of the debt for stock but may later constitute a redemption at the time of repayment. S. REP. No. 640, *supra* note 27, at 8.

126. Under I.R.C. § 317(a) (1982), "property" did not include stock in the corporation making the distribution (or rights to acquire such stock). Accordingly, it would not be subject to § 311(a) for distributions to shareholders.

127. I.R.C. § 305(d)(1)(B) (1982); Treas. Reg. § 1.312-1(d) (1955).

tributee should be able to avoid potential dividend treatment to the extent of the corporation's AAA under section 1368(c)(1) in overriding section 301(c)(1). The excess of the value of the stock distributed less AAA will then constitute dividend income from accumulated earnings and profits. Section 1379(c), allowing post-SSRA distributions of PTI, should not apply, however, since the stock will be treated as "property" (and not "money") for this purpose but hopefully not for purposes of section 1363(d). Where the distribution is subject to section 1368, the fair market value of the stock should constitute basis in the "new" block which will subsequently be adjusted under section 1367 for the pass-through of separately and nonseparately computed tax items. Appropriate adjustments are also required under sections 1371(c)(2) (AAA) and 1371(c)(3) (accumulated earnings and profits) for stock distributions tested under section 1368(c).

As to section 306, it generally will not apply to distributions of stock by an S corporation due to the one-class-of-stock-limitation. Even the presence of nonvoting common should not change the analysis, except that the Service may contend that section 306 could apply to an S corporation's distribution of nonvoting common redeemable at a formula price (e.g., percentage of book value) which does not apply to all other shares of common stock and provided that at the time of distribution the corporation has accumulated earnings and profits.[128] Where section 306 stock is later redeemed by an S corporation, unless the corporation has accumulated earnings and profits at such time, the distribution is not subject to ordinary income treatment provided the stock is held as a capital asset.[129] Moreover, since section 1368(c) apparently overrides section 301(a)(2) to the extent of any inconsistency, if there are accumulated earnings and profits at such time, the redemption proceeds will first constitute a distribution from AAA with the excess from accumulated earnings and profits. If the proceeds exceed both AAA and accumulated earnings and profits, the balance will be treated as a return of capital and any excess as gain from the sale of stock.

In the sale situation, section 306(a)(1) bifurcates the gain into two parts: (1) that amount which would have been a dividend if cash were received instead of the stock, and (2) any balance as an amount realized from the sale. No loss is permitted on the sale or other disposition of section 306 stock. Again, in the very narrow situation where an S corporation could be construed as having issued preferred stock (i.e., straight debt in an S corporation with a 100:1 debt-equity ratio), presumably the first-tier rule in section 1368(c)(1) (AAA) will override application of section 306(a)(1)(A)(ii) to prevent the "tainting" of the straight debt.

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128. *See* Rev. Rul. 57-132, 1957-1 C.B. 115; Rev. Rul. 79-163, 1979-1 C.B. 131. It is currently uncertain whether a formula buyout price for certain shares, i.e., restricted stock under I.R.C. § 83, creates a second class of stock if the shares are otherwise identical to all other shares. *See* Rev. Rul. 73-611, 1973-2 C.B. 312; Ltr. Rul. 8247017 (Aug. 13, 1982); Ltr. Rul. 8411057 (Dec. 13, 1983); Ltr. Rul. 8407082 (Nov. 17, 1983). *See generally* Note, *S Corp. May Have Numerous Restrictions*, 60 J. TAX'N 372 (1984).

129. I.R.C. § 306(a)(2) (1982); *see also* I.R.C. § 306(b) (West 1985) (providing exceptions).

Where an S corporation owns stock in a regular corporation, a distribution of stock will be subject to section 305 or 306[130] If dividend treatment follows, the fair market value of the stock (or other property) received will be passed through to the shareholders and will also constitute passive investment income under section 1362(d)(3)(D)(i).

F. *Distributions of Property Under Section 311*

As previously highlighted throughout this section pertaining to distributions, section 1363(d) overrides application of section 311(d) to S corporations. As a result, distributions of appreciated property by an S corporation, other than its own obligations, will trigger gain recognition. Exceptions are provided in section 1363(e) for distributions in complete liquidation (except recapture items) and of qualifying stock (nonboot) in a transaction described in section 354, 355, or 356. Another exception should apply to distributions by an S corporation of its own stock or stock rights since this is not a recognition event to a C corporation under section 317(a)(1). Thus, all other distributions of appreciated property in redemption of stock, but not in complete liquidation of the S corporation, will trigger gain recognition which will be allocated among all shareholders. This is in contrast to the narrow relief provided under section 311(d)(2) for regular corporations. Furthermore, gain may be recharacterized for recapture amounts and application of the related party rule in section 1239. It is also possible that a distribution of property by an S corporation will trigger a capital gains tax under section 1374 (and piggyback preference tax under section 56) or, if it involves stock in another corporation, a passive investment income tax under section 1375.[131]

Although operation of section 1363(d) will subsume the liability-in-excess-of-basis rule under section 311(c),[132] such will not always be the case with respect to distributions of LIFO inventory described in section 311(b). Accordingly, any LIFO recapture amount may be taxed to an S corporation under section 311(b) even though the value of the inventory does not exceed cost for purposes of triggering application of section 1363(d). For distributions of depreciated property, the general rule under section 311(a)(2) will apply to S corporations so that any loss will not be recognized.[133] However, an exception to section 311(a) for the disposition of an installment obligation under section 453B should permit loss recognition except if section 267(a)(1) applies. All distributions of property will be reported at fair market value for purposes of applying section 1368 at the shareholder level.[134]

130. I.R.C. § 137(a)(2) (West 1985).

131. *See also id.* § 1363(b)(4) (potential application of § 291 to S corporations during any of the three immediately preceeding years).

132. *See* Commissioner v. Tufts, 461 U.S. 300 (1983).

133. Treas. Reg. § 1.1372-1(c)(5), T.D. 7564, 1978-2 C.B. 19.

134. It is also possible that depreciated property transferred to a shareholder will trigger loss recognition if used to satisfy a previously declared and unpaid dividend.

G. *Adjustments to Earnings and Profits Under Section 312*

Under section 1371(c)(1), an S corporation, for taxable years beginning after 1982, will not adjust (produce current) earnings and profits. However, it will retain accumulated earnings and profits from prior Subchapter S taxable years or from years in which it was a regular corporation. Accumulated earnings and profits may also be acquired in a reorganization pursuant to section 381(c)(2).

Where an S corporation has earnings and profits, the three-tier distribution rule under section 1368(c) applies. Section 1371(c)(3) directs that distributions from accumulated earnings and profits are not subject to the nonadjustment rule under section 1371(c)(1). Thus, the accumulated earnings and profits account must be reduced to reflect the distribution. Furthermore, section 1371(c)(2) provides that in the case of any transaction under Subchapter C (e.g., redemption, liquidation, reorganization), "proper adjustment" must be made to the accumulated earnings and profits, if any, of an S corporation. Under both provisions, Congress presumably intended that the rules under section 312 were to provide the proper adjustments.[135]

One common example where an adjustment to accumulated earnings and profits must be made is an S corporation's distribution of appreciated property. Although section 1363(d) triggers gain recognition, section 1371(c)(1) prevents any increase to current earnings and profits for the gain. However, the adjusted basis of the property and recognized gain will reduce earnings and profits by virtue of sections 312(a)(3) and 312(c)(3), if and to the extent the distribution is taxed as a dividend under section 1368(c)(2).[136] Where depreciated property is distributed, accumulated earnings and profits apparently will be reduced under sections 1371(c)(3) and 312 by the asset's adjusted basis even though the value of the distribution sets the ceiling for the taxable portion of the distribution to the shareholder. This may make it advisable to make an AAA bypass election for a taxable year in which depreciated property is distributed to the shareholders even though there will be income at the shareholder level.

Where a C corporation files an S election, the earnings and profits adjustments required under section 312 for its last taxable year or years as a regular corporation may have an adverse impact at both the corporate and shareholder levels after the election is effective. Problems in this area will primarily arise due to timing differences in determining economic and taxable income or loss since economic concepts, especially after TRA 84, are required to be used in making adjustments to earnings and profits under section 312(n).[137] Such adjustments may either accelerate an increase to the account where deferral (i.e., section 453 sales or exchanges) or nonrecognition treatment (i.e., distributions under section 311(d)(2)) is permitted in computing taxable income or defer reduction in the account for certain allowable deductions (i.e., intangible

135. *See supra* note 106. *See generally* B. BITTKER & J. EUSTICE, *supra* note 73, ch. 7.

136. Treas. Reg. § 1.312-3, T.D. 7209, 1972-2 C.B. 204.

137. I.R.C. § 312(n) (West 1985); *see also id.* § 312(k) (requiring use of longer recovery periods for ACRS property). For a review of recent revisions to the adjustments to earnings and profits under § 312 in reflecting economic income and eliminating certain perceived abuse situations, see J. EUSTICE, *supra* note 5, at ¶ 3.20(2)(b).

drilling costs, construction period charges) that must be capitalized. Increases to an S corporation's Subchapter C earnings and profits reflected by economic gain not only will increase the likelihood of dividend treatment for subsequent distributions to shareholders but may also trigger a "sting tax" under section 1375 or an eventual termination under section 1362(d)(3) if such corporation also receives excess passive investment income. Similarly, since an S corporation will not adjust earnings and profits by virtue of section 1371(c)(1), which overrides section 312, consideration should also be given to the application of both provisions in determining the proper time for revoking the S election or engaging in a transaction which will cause the election to be terminated.[138] Moreover, it may be advisable in certain instances for a C corporation to make a "one-shot" election in order to avoid application of section 312. This may occur where a corporation desires to sell substantially appreciated property (i.e., a section 1231 asset) on the installment method under section 453. Although the recognized (nonrecapture) gain in the year of sale will be subject to a capital gains tax under section 1374 and preference tax under section 56, the corporation, based on a literal interpretation of sections 1371(a)(1) and 1371(c)(1), will not increase its earnings and profits under section 312(n)(6) for the realized gain. The election could then be terminated as early as the following year and the cash proceeds distributed to shareholders as payments are received on the installment obligation. The recognized gain in succeeding years will be taxed at the corporate level under sections 1201 and 56 which will result in roughly the same incidence of tax as that generated under sections 1374 and 56. Arguably, earnings and profits should not be increased to reflect additional payments made on the installment obligation after the corporation terminates its S election.[139] Thus, the shareholders may receive distributions from the installment obligation without receiving dividend income.[140] This untested strategy could be particularly attractive for shareholders having marginal tax brackets greater than the corporation, (i.e., use of surtax exemption and loss of credit carryovers from C years) not only in reducing the impact of tax on the gain, but on interest income reported on the obligation.

IV. Complete Liquidations of S Corporations

A. *Liquidations Pursuant to Sections 331, 336, and 346(a)*

Prior to the Subchapter S Revision Act (SSRA), a Subchapter S corporation engaged in making one or a series of distributions in complete liquidation,

138. *See* Bravenec & Dill, *Many 1984 Act Changes to S Corporation Rules Likely to Have Widespread Application*, 61 J. Tax'n 342 (1984).

139. In other words, § 312(n)(6) is currently the exclusive method for increasing earnings and profits for realized gain from an installment sale.

140. In the Senate Report to TRA 84, comment was made that regulations should be issued under § 312(n) to prevent amounts from being duplicated or omitted. However, it does not appear from the legislative history to TRA 84 that consideration was given to the various timing problems that will be encountered in adjusting earnings and profits for economic gain or loss where a corporation goes from C to S or vice versa.

under section 331 and former section 346(a)(1), was accorded the same tax treatment as that of a Subchapter C corporation.[141] Accordingly, under section 336, liquidating distributions of property by a small business corporation to its shareholders (in their shareholder capacity) did not result in recognition of gain or loss to the corporation except for recapture amounts attributable to depreciable property, LIFO inventory, certain installment obligations, and other items.[142] Undistributed taxable income (UTI) earned during the course of liquidation was allocated only to those shareholders owning stock on the last day of a taxable year including the corporation's final taxable year. Losses, however, were allocated under the daily allocation rule required by former section 1374(c)(1). Since liquidating distributions were treated as made in exchange for stock, they did not reduce UTI under former section 1373(c) and also could not qualify (if made in cash) as distributions of previously taxed income (PTI) or UTI under section 1375(d) or 1375(f) respectively. However, cash distributions made prior to the adoption of a plan of liquidation were eligible to carry out UTI or PTI.

Since UTI earned during the last taxable year was allocated only to shareholders owning stock as of the date the corporation made its final liquidating distribution, a shareholder completely terminating his stock interest after the adoption of the plan, but prior to the last day of the corporation's final taxable year, could avoid an allocation of UTI for that year.[143] Where the corporation used a different fiscal year than its shareholders, and generated operating profits for its final and preceding taxable years, shareholders who waited to receive their final liquidating distributions until the last day of the final year would have two years' UTI bunched on their individual returns.

As with shareholders in regular corporations, a Subchapter S shareholder's gain or loss on liquidation was measured by the net fair market value of all property received from the corporation less the shareholder's adjusted stock basis in the stock, including adjustments for the final year's UTI or net operating

141. Treas. Reg. § 1.1372-1(c)(3), T.D. 7564, 1978-2 C.B. 19; *see also* Kind v. Commissioner, 54 T.C. 600 (1970), *acq.* 1970-2 C.B. XX. *See generally* J. EUSTICE & J. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 13.02 (rev. ed. 1985). It is also important to consider whether the liquidation-reincorporation doctrine could be raised by the Service in denying a basis step-up in assets distributed in the liquidation and imposing dividend treatment on retained property (boot), especially in light of the new definition of control for Type D reorganizations. I.R.C. § 368(c)(2) (West 1985).

142. *See* Fairman v. Commissioner, 32 T.C.M. (CCH) 1084, 1087 n.6 (1973). However, Treas. Reg. § 1.1372-1(c) does not specifically list I.R.C. § 336. *See* Treas. Reg. § 1.1372-(c), T.D. 7564, 1978-2 C.B. 19. The LIFO recapture rule in I.R.C. § 337(f) was effective for distributions and dispositions pursuant to plans of liquidation after December 31, 1981. However, for plans of liquidation adopted in 1982 and completed by the end of the following calendar year, an exception was provided in former § 337 (f)(4)(A) that limited the LIFO trigger to amounts in excess of $1 million. *See* Miscellaneous Revenue Act of 1982, Pub. L. No. 97-362, § 101, 96 Stat. 1726.

143. Early departure of a shareholder primarily motivated to avoid UTI may have caused the Service concern. *See* I.R.C. §§ 446(b), 482 (1982); I.R.C. § 1375(c) (1976) (current version at I.R.C. § 1375(c) (1982)); *see also* Dayton Hydraulic Co. v. United States, 592 F.2d 937 (6th Cir. 1979); Jones v. United States, 531 F.2d 1343 (6th Cir. 1976); Kinsey v. Commissioner, 447 F.2d 1058 (2d Cir. 1973).

loss.[144] The character of the gain or loss depended on whether the stock was held as a capital asset and the shareholder's holding period.[145]

Where all liquidating distributions were made on the last day of the corporation's final year, the process of making the necessary basis adjustments and computing shareholder gain or loss under section 331(a) was relatively simple. However, if a series of distributions in complete liquidation was made pursuant to former section 346(a)(1), the proper time for making the basis adjustments for losses under former section 1376(b) was uncertain.[146]

First, it was clear that UTI did not increase stock basis under former section 1376(a) until it was allocated on the last day of the taxable year. As for losses, former section 1374(c)(2)(A) provided that this adjustment was made on the same date unless a shareholder sold or otherwise disposed of all or a portion of his stock prior to such time, in which case the daily portion of the loss would reduce basis as of the day preceding the date of disposition.[147] Where pro rata interim period distributions were made, or if no shares of stock were actually surrendered in a pro rata distribution, the decrease to basis for net operating losses was presumably still made at the last day of the corporation's last taxable year. Thus, the amount realized for the interim period distribution would be reduced by stock basis determined as of the end of the preceding year in computing gain.[148] This could limit the shareholder's remaining basis for deducting his final year's losses under former section 1374(c) since the preceding year's distribution reduced stock basis. Although uncertain, where shares of stock were actually surrendered as part of a non-pro rata interim distribution, it was arguable that the disposition rule in Regulations section 1.1376-2(a)(3)(i) was controlling and that the redeemed shares' portion of the final year's loss reduced basis as of the day prior to the exchange even though the losses could not be claimed by the shareholder until the year in which the corporation's last taxable year ended.[149] Presumably, the disposition rule applied to shareholders who completely terminated their stock interest prior to the last day of the corporation's last taxable year.

Where a shareholder owned only a single block of stock, the shareholder

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144. *See* I.R.C. § 1373(b) (repealed 1982); Rev. Rul. 68-477, 1968-2 C.B. 317.

145. I.R.C. §§ 1221-1223 (West 1985). An S shareholder's loss under § 331(a) may qualify for ordinary loss treatment under § 1244. *See* Harwell v. Commissioner, 33 T.C.M. (CCH) 669 (1974). Moreover, the liquidation may trigger recapture of investment tax credits at the shareholder level. *See* Treas. Reg. § 1.47-4 (1967).

146. *See* J. Eustice & J. Kuntz, *supra* note 141, at ¶ 13.02[1][b].

147. The same rule was applicable to adjustments to debt basis under I.R.C. § 1374(c)(2)(B) (repealed 1982).

148. *See* J. Eustice & J. Kuntz, *supra* note 141, at ¶ 13.02[1][b].

149. I.R.C. § 1374 (c)(2)(A) (1976) (current version at I.R.C. § 1374(c) (1982)); Treas. Reg. § 1.1374-1(b)(4)(ii)(a), (b)(4)(iii), T.D. 6667, 1963-2 C.B. 343. This would have preserved the distributee's right to claim a greater amount of his share of the net operating loss for the final taxable year. *But see* Abdalla v. Commissioner, 647 F.2d 487 (5th Cir. 1981) (dictum). The Fifth Circuit's views expressed in its opinion in *Abdalla* were rejected by SSRA for purposes of applying § 165(g), and by TRA '84 (retroactive to SSRA) for applying § 166(d) to shareholders owning worthless stock or debt in an S corporation where the end of the taxable year of the shareholders in which worthlessness was established preceded the last day of ther corporation's last taxable year.

was generally entitled to fully recover stock basis upon receipt of an interim period distribution where no accompanying surrender of stock was made.[150] Losses on the stock could not be recognized until all liquidating distributions were received.[151]

Where stock was acquired in different blocks, the regulations under section 331 require that the recovery of basis be made with respect to each block instead of among all shares.[152] However, where specific shares are surrendered in exchange for interim period distributions, it is arguable that each distribution constituted a separate sale or exchange in which event the shares surrendered could be selected by the shareholder so as to choose the desired amount of gain or loss.[153] On the other hand, the Service has ruled that partial liquidation distributions in complete liquidation for shareholders with different blocks of stock still result in basis recovery for each block before gain is recognized, and, losses are not allowable until the final liquidating distributions have been completed.[154] The amount of each distribution is allocated between the blocks in the proportion that the number of shares in each block bears to the total number of shares outstanding. Whether shares are actually surrendered at the time a distribution is made is ignored.

Under either approach, it was uncertain whether the exchange treatment of section 331(a)(2) would still require that net operating losses be allocated to basis under former section 1374(c)(2)(A) in measuring the recovery and gain portions to interim period distributions.[155] As discussed above, if the basis adjustments for losses were accelerated as of the day prior to disposition, it was more likely that gain recognition would also be accelerated where a shareholder-distributee received the distribution in his taxable year which ended prior to the end of the corporation's last taxable year.[156]

After SSRA, the complete liquidation of an S corporation will still be subject to sections 331 and 346(a) which rules are not inconsistent with the conduit principles enacted in SSRA.[157] However, partnerships holding appreciated assets

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150. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 7.02, 9.01, 9.51, 9.61 (4th ed. 1979).

151. *See* Palmer v. United States, 58-1 U.S.T.C. ¶ 9288 (D. Conn. 1958); Schmidt v. Commissioner, 55 T.C. 335 (1970); Estate of Maguire v. Commissioner, 50 T.C. 130 (1968).

152. Treas. Reg. § 1.331-1(e), T.D. 6949, 1968-1 C.B. 107; *see id.* § 1.333-4(a); *see also supra* notes 71-76 and accompanying text.

153. This approach is based on analogizing the distribution to a sale of specifically identified stock or securities to a third person. *See* B. BITTKER & J. EUSTICE, *supra* note 150, at ¶ 9.61; *see also* Lakeside Irrigation Co. v. Commissioner, 128 F.2d 418 (5th Cir.), *cert. denied*, 317 U.S. 666 (1942).

154. Rev. Rul. 68-348, 1968-2 C.B. 141; *see* Rev. Rul. 85-48, 1985-16 I.R.B. 5; *accord* Quinn v. Commissioner, 35 B.T.A. 412 (1937); Letts, Jr. v. Commissioner, 30 B.T.A. 800 (1934), *aff'd on other grounds*, 84 F.2d 760 (9th Cir. 1936).

155. J. EUSTICE & J. KUNTZ, *supra* note 141, at ¶ 10.03[1][a].

156. However, the shareholder may have had no cause to argue with this result since it facilitated the passthrough and deduction of final-year losses, though deferred until his following year's return.

157. TEFRA revised I.R.C. § 346 by moving former § 346(a)(2) to new § 302(b)(4) & § 302(e), which apply to partial liquidations for noncorporate shareholders. *See* I.R.C. § 302(b)(4),

are able to liquidate without triggering gain recognition at either the entity or the partner level at the expense of maintaining carryover basis in the distributed assets.[158]

In similar fashion to the general rule in section 336, section 1363(e)(1) provides that distributions of appreciated property in complete liquidation will not result in gain recognition under section 1363(d). However, the statutory and judicially recognized exceptions to section 336 (e.g., depreciation, investment tax credit and LIFO inventory recapture, and the tax benefit rule) presumably will still apply. Distributions of depreciated assets will be subject to nonrecognition treatment by direct application of section 336.[159]

At the shareholder level, the net fair market value of property received by each shareholder will be set off against his final adjusted stock basis in computing gain or loss under section 331(a). Section 1368 is not applicable since the liquidating distributions are not described under section 301(c).[160] Again, stock basis should be adjusted for the pass-through of separately and nonseparately stated income and loss for the final tax year of the S corporation before assessing the tax impact of the distributions. Moreover, unlike prior law where UTI was allocated on the last day of the taxable year, under SSRA, items of income (deductions and credits) in the year of liquidation will be allocated daily based on stock ownership.

Although the required integration of section 331 with S corporations is not conceptually complex, uncertainty remains on several important aspects of determining shareholder gain or loss. As previously discussed, section 301 is unclear whether a block-by-block rule is required for measuring basis recovery and gain for distributions described under section 1368(a). Assuming a block rule will apply to S shareholders receiving liquidating distributions under section 331(a), it is still unclear how a shareholder surrendering a specific block of shares in exchange for an interim distribution in complete liquidation will report gain or loss. In this regard, the Service should not be expected to deviate from its prior ruling position that basis in stock is first recovered for interim distributions.[161] However, in reporting basis recovery or gain, the uncertainty that previously existed regarding whether net operating losses for the corporation's final year were to be accelerated for basis (but not for claiming loss) purposes in this context remains after SSRA. Moreover, the problem is no longer limited to losses since the adjustments for all tax items under section 1367 are based on a daily allocation rule which was the rule for net operating losses prior to

(e) (1982). The serial distribution in liquidation provision, former § 346(a)(1), was retained as new § 346(a), and prior references to the term "partial liquidations" set forth in former § 331(a) and § 336(a) were removed. *See id.* § 346(a). For discussion of this reform, see D. Ward, The TEFRA Amendments to Subchapter C: Corporate Distributions and Acquisitions (1983); Ginsburg, *Taxing Corporate Acquisitions*, 38 Tax. L. Rev. 171 (1983); Steines, *Taxation of Corporate Distributions-Before and After TEFRA*, 68 Iowa L. Rev. 937 (1983).

158. I.R.C. §§ 731-733, 751(b) (1982); I.R.C. §§ 734-735 (West 1985).

159. *See* I.R.C. §§ 1363(b)(4), 291(a)(1) (West 1985).

160. This also prevents any distribution in complete liquidation from qualifying as PTI under § 1379(c).

161. *See* Rev. Rul. 68-348, 1968-2 C.B. 141; *supra* text accompanying note 155.

SSRA. In the case of complete liquidations by calendar-year S corporations and shareholders within a single year, many if not all of the problems in this area will be avoided. However, where the corporation's permitted year is different than its shareholders', or the liquidation process covers more than one taxable year and interim distributions in liquidating are made, complexity abounds.[162]

As a starting point, a shareholder is required to report on his individual return his proportionate share of the tax items of the corporation for his taxable year in which the S corporation's taxable year ends.[163] Exception is only provided for the death of a shareholder.[164] Therefore, despite the complete termination of an S shareholder's stock interest in a taxable year that ends prior to the end of the corporation's final year, such person's share of the corporation's items of income or loss is not reported until the following year in which the corporation's year ends.[165] However, this will not defer the proper year for the shareholder's reporting gain or loss on the liquidating distribution. Clearly, if a shareholder completely terminates his stock interest prior to the end of the corporation's final year, the proper amount of gain or loss on liquidation must incorporate the final year's adjustments to stock basis as of the date of termination. At the other end of the spectrum, where shareholders receive pro rata interim distributions over more than one taxable year, the Service may contend that basis adjustments are not made until the final liquidating distributions are received. This again creates the possibility that basis reduced by interim distributions will prevent shareholders from fully deducting final year's losses.

Finally, it is similarly uncertain what rule will apply where a shareholder actually surrenders some, but not all, of his stock after the plan of liquidation is adopted but prior to the last day of the corporation's final taxable year, in return for an interim distribution. Presumably, such person's allocable share of corporate-level tax items under section 1366 will be proportionately reduced but the question remains whether the basis adjustments should be accelerated

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162. Evaluation must also be made to repayments of shareholder debt, particularly in situations where debt basis has been previously reduced for the pass-through of losses. For example, appreciated property distributed to retire outstanding shareholder indebtedness will trigger a *Davis-Keenan* gain outside of §§ 1363(d), 1363(e)(1), and 336. *See also* I.R.C. § 108(d)(7)(C) (West 1985) (concerning contributions to capital by S shareholders of cancelled debt previously reduced by § 1367(b)(2)(A)).

163. *Id.* § 1366(a)(1). However, taxable distributions received by a shareholder are includable in gross income for the taxable year of the shareholder in which there was actual or constructive receipt. *See* S. Rep. No. 640, *supra* note 27 (basis adjustments required before applying distribution rules under § 1368).

164. SSRA did not adopt a rule similar to I.R.C. § 706(c)(2)(A), which provides that where a partner completely terminates his interest in the partnership, by sale or transfer to a third party or in liquidation, his distributive share of income or loss for the short period ending with the date of termination is determined and included on his return for his taxable year which includes that date. *See* Treas. Reg. § 1.705-1(a) (1956); *id.* 1.706-1(c)(2)(ii), T.D. 7286, 1973-2 C.B. 149; *id.* § 1.736-1(a)(6), T.D. 6832, 1965-2 C.B. 292.

165. *See* I.R.C. § 1377(a)(2) (1982) (permitting tax items to be allocated based on a hypothetical closing of the books and records as of the date of termination). The items are not reported on the terminated shareholder's return until the year in which the S corporation's year also ends. *Id.*

to the date prior to the date the stock is surrendered in measuring recovery of basis and gain on the interim distribution. The strongest case for accelerating the basis adjustments will be where the exchange and distribution is non-pro-rata and the value of the shares surrendered approximates the value of property received.

Assuming that a partial (non-pro-rata distribution) or complete termination of a shareholder's interest during the liquidation process requires that a corresponding basis adjustment be made as of the date or dates prior to the actual surrender of shares, determination of the shareholder-distributee's gain or loss may not be determinable until after the due date for filing his return. This could arise where the termination occurs for a shareholder's year that ends prior to the last day of the corporation's final taxable year. However, for shareholders completely terminating their stock interest prior to the final liquidating distribution, the regulations should permit the filing of one or more elections to hypothetically close the corporation's taxable year under section 1377(a)(2). This will avoid distortions in the allocation of corporate income or loss between shareholders during liquidation and will facilitate the timely reporting of gain or loss to the withdrawing shareholder.[166]

Even a simple fact pattern reveals the wide spectrum of potential issues in liquidating an S corporation. For example, an S corporation (without earnings and profits) has two equal shareholders, *A* and *B*, who adopt a plan of complete liquidation on January 1, 1986. The net assets of the corporation have a value of $200x which are to be distributed equally to *A* and *B*, who have both held their stock as capital assets for the period required under section 1223(3). The corporation, *A*, and *B* are all calendar-year taxpayers. The plan further contemplates that *A*, because she is moving out of the area, will receive her distribution of $100x on June 30, 1986 in exchange for her entire stock interest. Each shareholder's stock basis as of the end of the preceding year was $50x and an election was not made under section 1377(a)(2) to hypothetically close the corporate books as of June 30.[167]

Assuming the corporation diligently carries out the plan and makes a final liquidating distribution of $100x to *B* on December 31, 1986, consider the result to both shareholders if the corporation for its final taxable year realizes (1) $100x of ordinary income or (2) $100x of ordinary loss. As to situation (1), *A* will include only $25x in ordinary income on her 1986 return, and, after making the necessary basis adjustment of $25x, report the liquidating distribution as long-term capital gain (LTCG) of $25x. *B*, on the other hand, by waiting until December 31, must include $75x in ordinary income and $25x as LTCL unless, and only to the extent, the loss qualifies for special treatment under section 1244. In situation (2), *A* will be allocated only $25x of ordinary loss and will realize LTCG of $75x. However, *B*'s allocable share of the loss

166. *Id.* Potential assignment of income problems during the liquidation process may generate suspicion of an abuse by the Service. *See* B. Bittker & J. Eustice, *supra* note 150, at ¶ 1.02[2].

167. For purposes of this illustration it was assumed that the income or loss for the corporation's final year was anticipated in advance of determining the amounts A and B would receive in liquidation. Obviously, even during a wind-up period, this may not always be the case.

($75x) exceeds his basis in his stock ($50x) by $25x, which will never be of tax benefit to *B* as a result of the liquidation. Accordingly, *B* will report $50x of ordinary loss and $100x of LTCG. Again, the potential for economic and income tax distortions may be eliminated if an election were made under section 1377(a)(2) to close the corporation's books on the date *A*'s stock interest was terminated.

In addition to the general corporate- and shareholder-level rules for complete liquidations, an S corporation may also be saddled with a passive investment income tax under section 1375 while winding up its affairs. Where all shareholders are in 50 percent tax brackets, there is currently an additional tax cost of 23 percent to the shareholders, in reporting corporate- and shareholder-level taxes in liquidation, on each dollar of corporate income taxed under section 1375.

The potential for this "sting" tax to a liquidating S corporation is greatest where the adoption and completion of the plan of liquidation encompasses more than one taxable year of the corporation. For example, a calendar-year S corporation with Subchapter C earnings and profits and excess passive investment income adopts a plan of complete liquidation on July 15, 1985 and completes the process by June 30 of the following year. The corporation will be subject to the sting tax for the year ending December 31, 1985 as long as it has not previously distributed all of its C earnings and profits. Since it is arguable that earnings and profits are ratably reduced for liquidating distributions, which rule would be consistent with the operation of new section 312(n)(8), the corporation cannot bail out its tainted earnings by the close of the taxable year ending December 31, 1985 in an attempt to avoid the "sting" tax once the plan of liquidation has been adopted.[168] For the final short year ending June 1986, the regulations should provide that at the "close" of its final taxable year (i.e., on the date final liquidating distributions are made), there will be no Subchapter C earnings and profits outstanding and thus will not be subject to section 1375.

Assuming the Treasury, by regulation, endorses the position that section 1375 cannot apply to an S corporation for its final taxable year, once a corporation adopts a plan of liquidation it will have little opportunity to avoid a sting tax for the year(s) preceding its final taxable year.[169] This is because an accumulated adjustments account (AAA) bypass election under section 1368(e)(3) cannot be made with respect to distributions in liquidation described in section 331(a). The bypass election requires that transfers be described in section 1368(a) which requires a section 301(c)(3) nexus. Furthermore, even if the AAA bypass election is made for qualifying distributions prior to the adoption of the plan of liquidation, efforts to purge the Subchapter C earnings and profits account may require distributing untainted Subchapter S earnings and profits as well. This situation will be present where the Subchapter S earnings and profits (pre-

168. *See* I.R.C. § 1375(a)(1) (1982); *supra* notes 67 & 157.

169. Another option would be for the corporation to terminate its election, but such manuevering would only be effective for the ensuing C short year and following years for which the election was no longer in effect. *See* I.R.C. § 1362(d) (West 1985).

SSRA) are layered in front of older Subchapter C earnings and profits.[170]

Although SSRA retained essentially the same definition of passive investment income as prior law, one important change is that only the net gain from the disposition of capital assets (other than stock and securities) and not the amount realized, is included in gross receipts.[171] As discussed below, this revision may cause S corporations liquidating under section 337 to inadvertently fall under section 1375 because of the cessation of active business operations and the continued receipt of passive investment income.

Because of the potential traps in this area, the regulations should specifically address the application of section 1375 to an S corporation in the process of liquidation,[172] although statutory relief may be necessary.

Generally, where an S corporation receives distributions in complete liquidation with respect to stock held in another corporation, gain or loss will be determined under section 331. In most cases, the character of the gain or loss will be based on the purpose and holding period of the S corporation-distributee.[173] Gain will constitute passive investment income unless the corporation owns more than 50 percent of each class of stock of the liquidating corporation.[174] It is also possible that gain could be subject to tax under section 1374 and the piggyback preference tax under section 56.[175]

B. *Liquidation of a Controlled Subsidiary Under Section 332*

As an exception to section 331, section 332 provides for nonrecognition treatment to a corporate shareholder in complete liquidation of a controlled subsidiary.[176] Control for this purpose requires ownership of at least 80 percent in voting power and value of all classes of stock.[177] In exchange for nonrecognition treatment, the parent receives a carryover basis in the subsidiary's assets under section 334(b)(1). Since a Subchapter S corporation under prior law was

170. Treas. Reg. § 1.316-2(a) (1955) (LIFO rule for reducing accumulated earnings and profits for distributions); *see* Meyers' Estate v. Commissioner, 200 F.2d 592 (5th Cir. 1952); I.R.C. § 1375(d) (West 1985); *see also* Lyon, *Tax Blunders: Treasury Should Reduce Their Cost*, 45 TAXES 575 (1967).

171. Prior to SSRA, gross receipts included the entire amount realized from the sale or exchange of property (other than stocks or securities) including sales under § 337. However, for installment sales, only amounts actually received were included as gross receipts. Treas. Reg. 1.1372-4(b)(5)(iv)(b) ex. 3, T.D. 7414, 1976-1 C.B. 266.

172. One possible relief measure would be to adopt a rule similar to that provided in I.R.C. § 316(b)(2)(A) for designated distributions to noncorporate shareholders made by personal holding companies, by allowing the shareholders to report, as ordinary income, their allocable share of Subchapter C earnings and profits.

173. *But see infra* note 232 (discussion of Treas. Reg. § 1.1375-1(d) and I.R.C. § 341).

174. I.R.C. § 1362(d)(3)(D)(iv) (1982). Presumably, the direct ownership and control date requirements contained in Treas. Reg. § 1.1372-4(b)(5)(B)(xi) will continue to apply until new regulations are issued.

175. I.R.C. § 58(d) (1982).

176. *See* B. BITTKER & J. EUSTICE, *supra* note 150, ch 11, pt. C.

177. I.R.C. § 332(b)(1) (1982) (providing an exception for nonvoting preferred stock that is limited as to dividends).

precluded from being a member of an affiliated group, reference to section 332 in liquidating a subsidiary was generally not called for. One such reference was needed for the complete liquidation of an inactive subsidiary described in former section 1371(d) (now section 1361(c)(6)). A second was recognized by the Service for certain "momentary affiliations."[178] Thus, where a Subchapter S corporation purchased all of the stock of another corporation and liquidated the acquired corporation within thirty days in a *Kimbell-Diamond* acquisition, permission to use section 332 was granted without terminating the acquiring corporation's election.

With the passage of SSRA, an S corporation will not be able to use section 332 in liquidating a subsidiary. This is because section 1371(a)(2) treats an S corporation as an "individual" when acting in a shareholder capacity. In other words, a post-SSRA liquidation of a momentary or inactive subsidiary may only be accomplished under section 331. Gain or loss will be recognized by the S corporation-distributee, the assets received will have a fair market value basis, and tacking of holding periods will be unavailable. The cost of acquiring control of an active (non-section 1361(c)(6)) subsidiary and seeking section 332 treatment will be the loss of the corporation's S status.

Since an S corporation may not have a corporate shareholder, it cannot be liquidated (under both prior and present law) under section 332 without first losing its election. Even where a regular corporation acquires the requisite control in a single transaction, the acquired corporation's S election will terminate as of the day prior to the acquisition.[179]

C. *Shareholder Elections Under Section 333*

As a second statutory exception to section 331, section 333 allows shareholders to avoid gain recognition on liquidating distributions provided a sufficient number of shareholder consents are filed with the Service.[180] Gain is recognized, however, to a qualified electing noncorporate shareholder as ordinary income to the extent of his ratable share of the liquidating corporation's earnings and profits, and generally as capital gain, to the extent that cash and post-1954 stocks and securities exceed his ratable share of earnings and profits.[181] For a qualified electing corporate shareholder, gain is recognized to the extent of the greater of its share of earnings and profits or the amount by which cash and post-1954 stocks and securities exceed such ratable share of earnings and profits.[182] No portion of a corporate shareholder's recognized gain is taxed as dividend income, thereby denying it access to a dividends-received deduction

178. Rev. Rul. 73-496, 1973-2 C.B. 312; *see* Rev. Rul. 72-320, 1972-1 C.B. 270 (transfer to new subsidiary in carrying out a Type D reorganization).

179. A "momentary ineligible shareholder" rule has not been recognized in this area.

180. However, loss may be recognized under I.R.C. § 333 even though the shareholders file elections to defer a gain. Treas. Reg. § 1.333-4(a) (1955); *see* I.R.C. § 333(c) (1982).

181. I.R.C. § 333(e) (1982). The separate share rule for computing gain and loss is also used in § 333 so that there may be loss on some shares and gain on other shares. Only the latter qualifies for the special rules under § 333.

182. *Id.* § 333(f).

under section 243. A shareholder's basis for assets received in a section 333 liquidation is the same as its stock basis plus any gain recognized.[183]

The classic use of a section 333 election is where a corporation has highly appreciated, illiquid assets and low earnings and profits.[184] This may have described many Subchapter S (pre-SSRA) corporations since earnings and profits were reduced by UTI.[185] An added characteristic of the integration of section 333 under Subchapter S was that the shareholders' stock basis was increased for the pass-through of UTI for the corporation's final year. While this adjustment did not increase gain on liquidation, it did result in each shareholder's receiving a higher basis in the distributed assets.[186] It was also advisable to consider making preplan cash distributions of PTI in order to reduce the overall tax impact under section 333.

In the year a section 333 liquidation occurred, current earnings and profits allocated to UTI or actual dividend distributions apparently did not increase accumulated earnings and profits taxable as ordinary income under section 333(e)(1).[187] However, UTI was still taxed to those shareholders owning stock on the last day of the year without reduction for distributions in liquidation,[188] while net operating losses were allocated on a daily basis to the shareholders.

Distributions by the liquidating corporation similarly did not result in gain or loss recognition to the corporation except to the extent of the statutory and judicial exceptions to section 336. If gain was recognized, it was reflected in the final year's UTI and passed through to the shareholders as ordinary income or net long-term capital gain.

After SSRA, shareholders in an S corporation should still be able to elect section 333 since the operation of this provision does not appear to be inconsistent with revised Subchapter S. Indeed, the Supplemental House Report to the Tax Reform Act specifically acknowledged use of section 333 by S shareholders.[189] Assuming continued applicability, section 333 represents a pure deferral technique for shareholders completely liquidating S corporations. This will prove to be particularly beneficial for corporations organized after 1983 which have always maintained S status since the absence of any accumulated earnings and profits (unless acquired under section 381) will limit gain recognition at

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183. *Id.* § 333(c).

184. *See* B. BITTKER & J. EUSTICE, *supra* note 150, at ¶ 11.20.

185. *See* I.R.C. § 1377(a) (repealed 1982); J. EUSTICE & J. KUNTZ, *supra* note 141, at ¶ 13.02[3][a]. Since an S corporation may not have a corporate shareholder, consideration of the rules under I.R.C. § 333 in liquidating an S corporation may be limited to those affecting noncorporation shareholders.

186. Obviously, the passthrough of UTI was directly responsible for limiting the corporation's accumulated earnings and profits to only that amount generated under former § 1377. *See* I.R.C. § 1377(a) (repealed 1982).

187. Rev. Rul. 76-347, 1976-2 C.B. 253; *see* Rev. Rul. 79-149, 1979-1 C.B. 132. *But see* I.R.C. § 1371(c)(1) (West 1985).

188. Rev. Rul. 76-347, 1976-2 C.B. 253; *see* Treas. Reg. § 1.1373-1(d), (g) exs. 5, 6, T.D. 7564, 1978-2 C.B. 19.

189. H.R. REP. No. 432, pt. 2, 98th Cong., 2d Sess. 1640, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 1263-64.

the shareholder level to cash and post-1954 stocks and securities, receipt of which will generally be taxed at capital gains rates.

Where an S corporation has accumulated earnings and profits, it may be advisable to make a distribution of cash out of the accumulated adjustment account (AAA), or even accumulated earnings and profits, prior to adopting a plan of liquidation under section 333, in order to limit the amount of cash and the value of post-1954 stocks and securities subsequently distributed in the one-calendar-month liquidation to an amount not in excess of each shareholder's ratable share of accumulated earnings and profits.

At the corporate level, section 1363(e)(1) replaces the general gain recognition rule of section 1363(d) for distributions of appreciated property. Thus, only the normal exceptions to section 336 will create additional corporate-level income on distributions. However, section 336 recapture income will not increase accumulated earnings and profits but instead must be passed through as separately stated items of income to the shareholders.[190] All final year's tax items, including recapture amounts, will be reflected in the basis adjustments under section 1367 prior to determining gain (or loss) on liquidation and in determining basis for the assets received.[191]

Where an S corporation holds stock in a regular corporation, it will presumably be treated as a noncorporate shareholder under section 333.[192] This will result in the pass-through of dividend income to the extent of the S corporation-shareholder's ratable share of the liquidating corporation's accumulated earnings and profits and is consistent with treating an S corporation as a conduit.[193] Furthermore, as an "individual," an S corporation-shareholder owning 50 percent or more of a nonaffiliated C corporation should not be treated as an "excluded corporation" under section 333(b). However, the Service may take the position that if an S corporation owned 50 percent or more of the total voting power of another corporation at any time between January 1, 1954 and the last day of its taxable year beginning during 1982 (last year prior to SSRA), it will still be treated as an "excluded corporation" under section 333(b) and must report gain or loss on liquidation under section 331.

D. *Liquidations Completed Within One Year Under Section 337*

Section 337 allows a corporation and its shareholders to adopt a plan of complete liquidation and sell assets on or after the date the plan is adopted without recognizing gain or loss, provided the corporation completes its liquidation within one year.[194] Exceptions to nonrecognition treatment apply to

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190. Since distributions in complete liquidation under § 333 are still in exchange for stock, it appears that the general distribution rule under § 1368(a) is inapplicable. Thus, distributions under § 333 cannot consist of AAA under § 1368(c)(1).

191. *See supra* text accompanying note 146.

192. I.R.C. § 1371(a)(2) (1982).

193. *Id.* § 1371(a)(1).

194. *See generally* B. BITTKER & J. EUSTICE, *supra* note 150, at ch. 11, pt. D. Section 337 may not be combined with a one-calendar-month liquidation under § 333 and does not apply to any

sales or dispositions of depreciable property, non-bulk sales of inventory, LIFO inventory, and installment obligations in existence prior to the adoption of the plan. Section 337 has an added shareholder-level benefit to the extent postplan qualifying asset sales are eligible for installment sale reporting.[195] Installment obligations may be distributed by the corporation without triggering gain at the corporate level under section 453B(d)(2), while the value of the obligation, to the extent in excess of the distributee's stock basis, is not taxed until and as payments are received on the indebtedness.[196]

Before SSRA, a Subchapter S corporation was permitted to sell qualifying assets under section 337.[197] The nonrecognized gain did not increase UTI, and UTI or a net operating loss for the corporation's final taxable year was still passed through to the shareholders.[198] Section 337 also was beneficial to the corporation by overriding the special capital gains tax in former section 1378.[199]

A potential problem for Subchapter S corporations in the process of selling assets and liquidating prior to the SSRA was avoiding an involuntary termination for passive investment income. Former section 1372(e)(5) provided that a termination would occur, retroactive to the first day of the taxable year, where more than 20 percent of the corporation's gross receipts consisted of passive investment income. A termination would result in a double tax on operating income and, in certain cases, a personal holding company tax under Section 541.[200] The latter situation could have arisen where appreciated section 1231 assets were sold under section 337 for an installment obligation. Usually, the gross sales price would be included in gross receipts.[201] However, for in-

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sale or exchange of a collapsible corporation defined in § 341(b). *See* Rev. Rul. 58-241, 1958-1 C.B. 179 (collapsible corporation which realizes all taxable income from sale of assets does not result in double application of ordinary income under § 341 at shareholder level).

195. *See* I.R.C. § 453(h) (1982).

196. *See id.* § 453(h)(2). The corporate and shareholder-level benefits from engaging in installment sales qualifying assets under § 337 were provided in the Installment Sales Revision Act of 1980. Proposed regulations to § 453(h) were issued last year. *See* Prop. Reg. § 1.453-2, II [1985] FED. TAXES (P-H) ¶ 70,415; *see also* Bogdanski, *The 453(h) Regulations: Hard Choices*, 11 J. CORP. TAX'N 177 (1984).

197. Treas. Reg. § 1.1372-4(b)(5)(iv), T.D. 7414, 1976-1 C.B. 266; Rev. Rul. 78-89, 1978-1 C.B. 272.

198. *But see* B. BITTKER & J. EUSTICE, *supra* note 150, at ¶ 6.40.

199. Rev. Rul. 78-89, 1978-1 C.B. 272.

200. *See* I.R.C. § 316(b)(2)(B) (1982) (providing that liquidating distributions to noncorporate shareholders may qualify for a dividends-paid deduction under § 562(b)(1) if designated for dividend income treatment to the recipient and made within 24 months of the adoption of the plan of complete liquidation); *see also id.* § 543(b)(1)(A)-(B) (that gains from the sale of capital or § 1231 assets are not included in the computation of ordinary gross income).

201. Prior to SSRA, only gains from sales of stocks or securities, without deduction for losses, were included in gross receipts. Treas. Reg. § 1.1372-4(b)(5)(iv), T.D. 7414, 1976-1 C.B. 266. However, the fact that the gross sales price was used from sales of other assets often led corporations to "churn" assets to avoid a termination. *See* Rev. Rul. 79-294, 1979-2 C.B. 305. Under SSRA, however, only the net capital gain from sales or exchanges of property (other than stocks or securities) increases gross receipts. I.R.C. § 1362(d)(3)(C) (West 1985). As for sales or exchanges of stocks and securities, the rule prior to SSRA will generally apply. *See id.* §§ 1362(d)(3)(D)(i) (general rule), 1362(d)(3)(D)(iv) (certain liquidations of more-than-50-percent-owned corporations).

stallment sales, only the installments received were included in gross receipts.[202] Moreover, interest on a deferred payment obligation was passive investment income.[203] By converting operating assets into installment notes, which would limit the amount of the corporation's gross receipts, the combination of reducing operating income while proportionately increasing passive investment income may have triggered a termination. Thus, in a particular situation it may have been more advantageous for the corporation to elect out of installment sale reporting under section 453(d) in a closed transaction in order to avoid a termination, which would have had the effect of taxing income from nonqualifying asset sales (as well as recapture income and general operating profits) for the final taxable year, first to the corporation under the general corporate tax rates, and a second time on distribution of the net proceeds to the shareholders.[204] However, it appears that despite the election-out, the shareholders may still have qualified for installment reporting under section 453(h) after the note was distributed by liquidation.

There is nothing in the statute or the Committee Reports to SSRA specifically indicating whether access to section 337 is still available to S corporations. Since section 1363(b) provides that the taxable income of an S corporation will generally be computed in the same manner as an "individual," it has been suggested that since an individual may not benefit from section 337, an S corporation is similarly restricted.[205] However, use of section 337 by an S corporation is not inconsistent with the pass-through rules enacted by the SSRA, provided shareholders are not permitted to adjust their basis in stock (or debt) under section 1367 to the extent of nonrecognized gain or loss from qualifying asset sales. Indeed, the Supplemental House Report to TRA 84 acknowledges

202. Treas. Reg. § 1.1372-4(d)(5)(iv)(b) ex. 3; T.D. 7414, 1976-1 C.B. 266. Presumably, the validity of this regulation was not affected by SSRA.

203. *But see* I.R.C. § 1362(d)(3)(D)(ii) (1982) (interest on notes received by an S corporation on sales of inventory made in the normal course of its trade or business does not constitute passive investment income). Presumably interest on a deferred payment obligation received pursuant to a bulk sale of inventory under § 337(b)(2) will not qualify under this new exception provided in SSRA. Similar relief was provided in SSRA for interest received by lending or finance companies meeting the quantitative requirements under § 542(c)(6). Another consideration in this area after TRA 84 will be the generation of passive investment income from imputed interest on deferred payment obligations under §§ 1274 and 483. It is further noteworthy that a corporation that derives more than 50% of its aggregate gross receipts from passive sources (over the preceding five-year period) will not meet the requirement under § 1244(c)(1)(C). *But see id.* § 1244(c)(2)(C).

204. Consideration of avoiding a termination for passive investment income was also required in determining whether a Subchapter S corporation should completely liquidate under I.R.C. § 337 or merely sell its assets on a deferred payment basis. Use of the latter strategy was and continues to be desirable where the corporation's inside basis in its assets exceeds the shareholders outside basis in their stock, and the assets to be sold would generate capital or § 1231 gain. Obviously, this plan would result in disaster if the corporation involuntarily lost its election and had not elected under § 337. It may be possible for a corporation to hedge its position in this area. *See* Milwaukee Sanitarium v. United States, 193 F. Supp. 299 (E.D. Wis. 1961); City Bank of Washington v. Commissioner, 38 T.C. 713 (1962), *nonacq. in part*, 1964-2 C.B. 8, *acq. in part*, 1964-2 C.B. 4; Rev. Rul. 77-150, 1977-1 C.B. 88; *see also* B. BITTKER & J. EUSTICE, *supra* note 150, at ¶ 11.64; J. EUSTICE & J. KUNTZ, *supra* note 141, at ¶ 13.02[2][c].

205. *See, Does New Sub S Law Void Section 337*, 59 J. TAX'N 382 (1983).

that section 337 will continue to apply to an S corporation in the process of liquidation.[206] The regulations should confirm this result.

Assuming section 337 will apply to S corporations, only recognized gain (including recapture income) or loss from nonqualifying asset sales and operating income or loss of the S corporation after the plan of liquidation has been adopted will pass through to the shareholders and result in corresponding basis adjustments under section 1367. Thus, it is still important to consider the sale of loss assets prior to the adoption of the plan of liquidation.

For liquidating S corporations with accumulated earnings and profits from Subchapter C years, the previous concern associated with passive investment income has changed from a retroactive termination to the imposition of a sting tax.[207] Where this situation is present, consideration should be given to several nonexclusive strategies: (1) an AAA bypass election under section 1368(e)(3) and distributions from accumulated earnings and profits prior to the adoption of the plan of complete liquidation; (2) electing out of installment sale treatment on qualifying asset sales under section 337 in order to increase the amount of net gain used in computing gross receipts; and/or (3) assessing the potential impact of stated and unstated interest on deferred payment obligations.[208] Moreover, as was the case under prior law, qualifying asset sales under section 337 should insulate an S corporation from a capital gains tax under section 1374 (and 56). However, it is unclear whether the same analysis can be extended to gain from the sale of stocks or securities after the plan has been adopted, which would otherwise constitute passive investment income under section 1362(d)(3)(D)(i). Although it is conceivable that such gain is still subject to tax under section 1375 despite the presence of section 337, it is hoped that the regulations will not require such amount to increase taxable income for the purpose of computing the limitation in section 1375(b)(1)(B).[209]

An S corporation generally may sell its assets in liquidation and obtain a single level of tax without using section 337. However, using section 337 will be more desirable where the inside basis spread (value of qualifying assets less adjusted basis) is greater than the outside or shareholder basis spread. Section 337 also is beneficial where an S corporation has appreciated inventory which can be sold in bulk to one purchaser. In this instance, section 337 may convert ordinary income into capital gain at the shareholder level.[210] Furthermore, qual-

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206. H.R. Rep. No. 432, *supra* note 189.

207. *See supra* text accompanying notes 27-34 (discussion of I.R.C. § 1375). Under SSRA, a termination will not arise until the corporation has a continuous three-year period of excess passive income and Subchapter S earnings and profits. Moreover, if the final taxable year is any of the first three consecutive years, the termination will not become an issue.

208. *See* I.R.C. § 483 (West 1985); I.R.C. § 1274 (1982).

209. A similar dilemma confronts S corporations for receipts of tax-exempt interest. *See* Shaw & August, *Subchapter S Revision Act Makes Significant Changes in Taxing Corporation Operations*, 58 J. Tax'n 84, 86-87 (1983).

210. *But see* I.R.C. § 337(b)(2) (1982) (LIFO inventory). Electing § 337 may also be beneficial for S corporations for state income tax purposes, especially in states where Subchapter S is not recognized. *See* Maule, *Effect of State Law on Use of S Corporations*, 37 Tax Law. 535 (1984).

ifying installment sales under section 337 will not result in the acceleration of gain to the corporation in distributing the note to its shareholders. Shareholder-level gain for the value of the installment obligation (in excess of stock basis) may also be deferred until payments are received.

Another benefit from using section 337 is where a corporation, C or S, plans to sell its assets and liquidate but is potentially collapsible under section 341(b). In such circumstances, it may be prudent to elect (or maintain) S status and adopt a plan of liquidation under section 337 to minimize the imposition of federal income taxes on the sale of assets in liquidation.[211] If the corporation is collapsible, the Subchapter S election will allow the gain recognized on all asset sales and recapture amounts to be taxed to the shareholders in their individual capacities.[212] In contrast, if the corporation is collapsible and thereby denied use of section 337, the failure to make an S election could result in a combined federal income tax liability to shareholders as high as 65 percent, in comparison with a 50 percent ceiling if S status had been perfected.[213] Of course, where collapsible status forecloses eligibility under section 337, the corporation and its shareholders may not use the special relief provisions for certain installment sales obligations.[214]

Distributions by an S corporation in complete liquidation, as previously discussed, are subject to the special exception in section 1363(e)(1) which provides that gain will not be recognized under section 1363(d). Distributions of depreciated assets will not result in loss recognition under section 336. However, the special exceptions to section 336 for recapture items will create taxable income to the S corporation for allocation to the shareholders for its final taxable year.

E. *Stock Purchases Treated as Asset Acquisitions Under Section 338*

TEFRA made important changes in the rules governing corporate acquisitions involving stock purchases.[215] One important revision was the repeal of section 334(b)(2) which, under certain conditions, treated the purchase and liquidation of a corporation as an asset acquisition, and its replacement with new section 338. Section 338 allows a corporation that acquires at least 80 percent of a target corporation's voting power and total number of shares by purchase within a twelve-month period, to timely elect to treat the target as

211. *See* Hauptman v. Director of Internal Revenue, 309 F.2d 62 (2d Cir. 1962), *cert. denied,* 372 U.S. 909 (1963).

212. *But see* I.R.C. §§ 1374-1375 (West 1985).

213. *See* Rev. Rul. 58-241, 1958-1 C.B. 179.

214. *See* I.R.C. § 337(b)(1)(B) (1982); I.R.C. § 453(h) (West 1985).

215. *See generally* J. EUSTICE, BITTKER AND EUSTICE'S FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 SPECIAL SUPPLEMENT S-25 to 28 (1982); Bloom, *The Stark Reality of the New Liquidation and Redemption Rules,* 10 J. CORP. TAX'N 3 (1983); Bonavitz, *Taxable Dispositions of a Corporate Business Before and After TEFRA,* 60 TAXES 812 (1982); Ginsburg, *Taxing Corporate Acquisitions,* 38 TAX L. REV. 170 (1982); Ward, *The TEFRA Amendments to Subchapter C; Corporate Distributions and Acquisitions,* 9 J. CORP. TAX'N 277 (1983).

having sold its assets in a single transaction under section 337.[216] On the date following the acquisition date, the target corporation is deemed to be a new corporation which purchased the assets at a stepped-up basis equal to the purchasing corporation's grossed-up basis in the target's stock. Thus, section 338 permits a corporation to acquire the stock of a target corporation and obtain a basis step-up in the target's assets without requiring the liquidation of the target.[217]

Where 80 percent or more of an S corporation's stock is acquired in a single purchase as described in section 338(d)(3), the target will cease to be an S corporation on the day prior to the acquisition date.[218] The target S corporation's final taxable year will accordingly be split into three periods: (1) a short year ending on the day before the qualifying acquisition of its stock;[219] (2) a one-day "C short year" which begins and ends on the date of the qualifying stock acquisition;[220] and (3) a short C year which begins on the day after the acquisition date.[221]

Prior to TRA 84, the recapture income from the hypothetical section 337 sale was allocated pro rata among the S shareholders based on the number of days in the S short year, unless the shareholders of the target S corporation and the purchasing corporation agreed to hypothetically close the books and records of the S corporation as of the acquisition date.[222] Fortunately, TRA 84 removed this trap for the unwary by adding section 1362(e)(6)(C), which has a retroactive effective date to taxable years beginning after December 31, 1982. Section 1362(e)(6)(C) provides that all recapture income resulting from the deemed section 337 sale must be reported on the target S corporation's one-day C short year. Presumably recapture income must be annualized under section 443.[223]

As previously discussed, prior to SSRA, the Service permitted a Subchapter S corporation to acquire 80 percent or more of the stock of a subsidiary and immediately liquidate under sections 332 and 334(b)(2) without triggering a loss of the acquiring corporation's Subchapter S election. Assuming the Service continues to permit such "momentary affiliation," an S corporation is now foreclosed from electing section 338 as a purchasing corporation described in section 338(d)(1) since section 1371(a)(2) treats an S corporation as an "individual" when acting in a shareholder capacity. It would appear reasonable

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216. *See* I.R.C. § 338(b)(3), (e)-(g) (West 1985). Various technical amendments to I.R.C. § 338 were made in § 712(k) of TRA 84. *See* J. Eustice, The Tax Reform Act of 1984 ¶ 3.03(1) (1984); Bloom & Calvert, *Corporate Changes Wrought by the Tax Reform Act of 1984*, 11 J. Corp. Tax'n 299 (1985). *See generally* B. Bittker & J. Eustice, *supra* note 150, at ¶ 11.47 Supp. III (1984). Exhaustive temporary regulations to I.R.C. § 338 have been filed.

217. Once the S corporation target has a corporate shareholder, a termination of its election will occur by virtue of §§ 1362(d)(2) and 1361(b)(1)(B).

218. I.R.C. § 1362(d)(2)(B) (West 1985).

219. *Id.* § 1362(e)(1)(A).

220. *Id.* § 1361(e)(1)(B)

221. *Id.* § 338(a)(2).

222. *Id.* § 1362(e)(3). The acquisition date is defined in § 338(h)(2).

223. *Id.* § 1362(e)(5).

that an S corporation will be allowed to deliberately sacrifice its S election by establishing more than a "momentary" relationship with the target in order to engage in a section 338 stock acquisition.[224] On the other hand, where retention of S status is critical, an S corporation will either have to make a direct purchase of the target's assets or acquire and immediately liquidate the target under section 331, assuming momentary affiliation is still permissible, in order to achieve the desired step-up in asset basis. A third alternative would be for the shareholders of the S corporation to form a regular corporation which would purchase the stock of the target corporation and elect under section 338. The purchasing corporation would subsequently be merged with the S corporation in a Type A reorganization whereby the S corporation would retain its S election and indirectly obtain a stepped-up basis for the assets of the target.[225]

V. The Collapsible S Corporation

The collapsible corporation rules contained in section 341 are designed to prevent shareholders from realizing long-term capital gain as the result of receiving cash or other property from a sale of stock, a distribution in excess of stock basis, certain redemptions in partial liquidation, or distributions in complete liquidation where the corporation was formed or availed of by those in control of the corporation to engage in a prescribed "collapse" prior to the corporation's realization of a substantial portion of the taxable income to be derived from its business activities.[226] Assuming none of the relevant defenses to collapsibility at either the shareholder or the corporate levels are available,[227] gain realized by a shareholder on a sale or exchange of stock is taxable as

224. It should be noted that the corporation must be a "corporation" for purposes of meeting the qualified stock purchase requirements under I.R.C. § 338(d)(3). I.R.C. § 338(d)(3) (1982). However, in a "creeping" control acquisition, the S election of the purchasing corporation will not be terminated until the date prior to the date on which it acquires 80 percent of the target. *See id.* § 338(h)(1). Does it mean that the preceding purchases cannot be counted for purposes of qualifying under § 338 since the purchasing corporation was still an "individual" at the time such stock was acquired?

225. Since an S corporation will be denied access to I.R.C. § 332 in liquidating a subsidiary, the tax history (and carryover basis of assets) of an acquired corporation may only be inherited without loss of the acquiring corporation's S election by engaging in a tax-free reorganization under § 368.

226. *See* B. Bittker & J. Eustice, *supra* note 150, ch. 12; Ginsburg, *Collapsible Corporations-Revisiting an Old Misfortune*, 331 Tax L. Rev. 307 (1978). Section 341(a) does not specifically apply to stock redemptions described in § 302(a) (resulting in long-term capital gains which are not described under § 302(b)(4)). Although uncertain, § 302(b)(1)-(3) redemptions could be described under § 341(a)(1). On the other hand, Treas. Reg. § 1.341-1 requires an "actual sale or exchange" for purposes of I.R.C. § 341(a)(1). Treas. Reg. § 1.341-1, T.D. 7655, 1980-1 C.B. 72. In certain instances, however, final resolution of this issue proved unnecessary. Where the corporation's sale of assets used generated cash to fund the redemption, or where property was distributed in kind, the triggering of corporate-level gain under I.R.C. § 311(d) resulted in satisfying the substantial realization requirement. However, with the new two-thirds realization requirement under § 341(b)(1)(A), the uncertain application of § 341 to § 302(b)(1)-(3) redemptions is not merely an academic exercise.

227. *See, e.g.*, I.R.C. § 341(d) (West 1985); I.R.C. § 341(e)(2) (1982) (shareholder-level defenses

ordinary income instead of long-term capital gain,[228] and collapsibility status denies access to section 333 or section 337.[229]

Prior to the Subchapter S Revision Act (SSRA), the regulations provided that section 341 was also applicable to Subchapter S corporations.[230] In addition, the regulations under Subchapter S warned that if an electing corporation was availed of by any substantial shareholder or group of shareholders for the sale of property that would not generate capital gain if sold by the shareholders individually, corporate-level gain would be taxed as ordinary income.[231] Thus, even if the corporation was not collapsible under section 341(b) or did not engage in transaction described in section 341(a), a sale of assets by the corporation left the Service with a weapon to transmute long-term capital gain to the corporation otherwise available to be passed through to the shareholders under former section 1375(a)(1) into ordinary income.[232] Although several decisions involved the potential application of this regulation, which several commentators challenged as an unreasonable interpretation of the statute, no court directly ruled on its validity.[233]

Where a shareholder in a collapsible Subchapter S corporation received a distribution under section 301(c)(3) (or in redemption under section 302(a), if applicable), payments of cash recharacterized as ordinary income were still ineligible to carry out previously taxed income (PTI) or undistributed taxable income (UTI) under former section 1375(d) or section 1375(f).[234] Moreover,

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for liquidations under § 333 or § 337); *see also id.* § 341(f) (certain sales of stock of consenting corporations).

228. I.R.C. § 341(a) is applicable to gain that otherwise would be taxable as long-term capital gain and, as such, does not of its own force trigger gain recognition. Thus, tax-free exchanges of stock in a collapsible corporation may be effectuated. *See* Rev. Rul. 73-378, 1973-2 C.B. 113.

229. I.R.C. §§ 337(c)(1)(A), 333(a) (1982); *see also* Leisure Time Enterprises, Inc. v. Commissioner, 56 T.C. 1180 (1971) (§ 341(d) not applicable to collapsible corporation's sale of assets pursuant to plan of complete liquidation); Rev. Rul. 58-241, 1958-1 C.B. 179, *distinguished in*, Rev. Rul. 63-125, 1963-2 C.B. 146 (nonavailability of § 337 on sale of corporate assets may satisfy substantial realization requirement to avoid ordinary income treatment to shareholders under § 331(a)). The application of § 341 to a § 333 liquidation may be different from the application to § 337. In particular, § 337(c)(1)(A) provides that § 337 is unavailable for any collapsible corporation (as defined in § 341(b)). I.R.C. § 337(c)(1)(A) (1982). However, § 333(a) only makes reference to § 341(a) and not to § 341(b). *See id.* § 333(a). Accordingly, it may be possible that a one-month liquidation can be effectuated under § 333 by satisfying the limitations set forth in § 341(d) (as well as the safe harbor contained in § 341(e)(3)).

230. Treas. Reg. § 1.1372-1(c)(8), T.D. 7564, 1978-2 C.B. 19; *see also* Estate of Diecks v. Commissioner, 65 T.C. 117 (1975), *acq*, 1978-1 C.B. 1.

231. Treas. Reg. § 1.1375-1(d), T.D. 7728, 1980-2 C.B. 236 ("shareholder reference" test).

232. Unlike the shareholder reference provision contained in § 341(e) which limits its inspection to the preceding three-year period, Treas. Reg. § 1.1375-1(d) takes into account subsequent sales of similar assets by corporations in which the shareholders own stock. *See id.*

233. *See* Buono v. Commissioner, 74 T.C. 187, 207 (1980); Howell v. Commissioner, 57 T.C. 546 (1972), *acq.*, 1974-2 C.B. 3. As to the criticism directed at this regulation, see B. Bittker & J. Eustice, *supra* note 150, at ¶ 6.26 n.58; Ginsburg, *Collapsible Corporations — Revisiting an Old Misfortune*, 33 Tax L. Rev. 307, 402 (1978).

234. Treas. Reg. § 1.1375-4(b), T.D. 6960, 1968-2 C.B. 342; *id* § 1.1375-6(a)(2)(ii), T.D. 6960, 1968-2 C.B. 342.

since the payments were made in exchange for stock, no reduction would be made to the current year's UTI.[235]

The new rules under SSRA did not specifically address the continued application of section 341 to S corporations. Unfortunately, the legislative history also was silent on this point despite its broad directive that the conduit principles applicable to partnerships will generally apply to S corporations.[236] Despite this attempt at parity, section 751, which blocks capital gain on sales of partnership interests, unlike section 341 only applies to the extent gain is attributable to unrealized receivables or substantially appreciated inventory.[237] Despite the lack of an aggregate theory concept to fragment gain realized on the sale of stock, the all ordinary income or long term capital gain approach under section 341 (via section 1371(a)(1)) should continue to apply to S corporations.

For the particular corporate venture prone to section 341 concerns (e.g., real estate development and sales conducted by a closely held group of shareholders) filing an S election may be particularly attractive in reducing the impact of federal income taxes. This is because the two-thirds of taxable income realization requirement at the corporate level needed to avoid collapsible status can be satisfied while only a single level of tax imparts corporate profits.[238] Assuming precision can be achieved in measuring when the corporation has realized at least two-thirds of its taxable income from the project, the balance of the project may be distributed under section 331 or reflected in the price paid for the shareholders' stock by a third party and result in long-term capital gain to the shareholders. If all shareholders are in 50 percent tax brackets, the maximum net-after-tax profit the shareholders may derive from the venture, after sidestepping section 341, may be as high as 60 percent. In contrast, if an S election were not made, the resulting shareholder profits (net-after-liquidation or stock sale) could reach 45.3 percent. The difference in net-after-tax yields is attributable to the increase in the shareholders stock basis on the previous income realized by the S corporation in meeting which will reduce gain on the bailout transaction.[239]

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235. Treas. Reg. § 1.1373-1(d), (g), ex. 5, T.D. 7564, 1978-2 C.B. 19.

236. S. REP. No. 640, *supra* note 27, at 6, 15.

237. *See* I.R.C. § 751(d)(2)(D) (1982) ("partner reference" provision).

238. TRA 84 § 65(a) set forth the "two-thirds" requirement under I.R.C. § 341(b)(1)(A) for sales, exchanges, and distributions made after July 18, 1984. Prior to TRA 84 all that was required was that the corporation realize a "substantial part" of the taxable income. In interpreting this latter phrase, the court in Commissioner v. Kelley, 293 F.2d 904 (5th Cir. 1961), *aff'g* 32 T.C. 135 (1959), *nonacq.*, 1962-1 C.B. 5 (withdrawn), *acq.* 1972-2 C.B. 2, held that realization of approximately one third of the total income constituted a "substantial part." The recent statutory amendment reflects the prior views that only an insubstantial amount of income was left for the corporation to realize at the time of the collapse. Abbot v. Commissioner, 258 F.2d 537 (1958); *see also* Rev. Rul. 72-48, 1978-1 C.B. 102.

239. This assumes a 46% corporate tax rate without regard to the surtax exemption. Before the *Kelley* case was effectively repealed by the 1984 legislation, the comparable net-after-tax rates for a bailout after the one-third test was met, for Subchapter S shareholders, was approximately 70%, whereas for shareholders of regular corporations, the net-after-tax profit was approximately 66.5%, again assuming that all shareholders were in 50% tax brackets.

As discussed under section 301,[240] section 1368(b) provides that distributions by an S corporation without accumulated earnings and profits first reduce stock basis and any excess is treated as gain from the sale or exchange of stock. Although the rules of section 1368(b) and sections 1368(c)(1) (AAA distributions in excess of stock basis) and 1368(c)(3) parallel sections 301(c)(2) and 301(c)(3), reference in section 341(2)(3) is limited to section 301(c)(3). Apparently, SSRA's failure to make a conforming amendment to section 341(a) to distributions in excess of stock basis as in section 1368 was simply an oversight. Moreover, ordinary income from a distribution in excess of basis under section 341(a)(3) (or for redemptions in partial liquidation in section 341(a)(2)(B)) presumably will still result in adjustments to the accumulated adjustment accounts (AAA) and earnings and profits under sections 1368(e)(2) and 1371(c)(2) respectively.

Finally, it appears that the Service will persist in its efforts to apply the "shareholder reference" test contained in the old regulations despite the fact that section 341(e) uses a shareholder dealer test for 20 percent-or-greater shareholders in tainting corporate assets for section 341 purposes.[241] Curiously, no provision in the statute or comment in the legislative history to SSRA was made with respect to the substance of this regulation.[242] Until withdrawn by the Treasury or tested in court, tax advisers should seriously weigh the potential application of Regulations section 1.1375-1(d) to corporate asset sales. In this regard, selling qualified assets under section 337 may effectively foreclose the government from invoking this regulation. However, if section 337(c)(1)(A) (vis-a-vis section 341(b)) prevents the corporation from qualifying under section 337, what otherwise may have been capital gain to the corporation will be converted into ordinary income if the regulation is successfully invoked.

VI. The Impact of SSRA on Corporate Formations and Reorganizations

A. *Transfers of Property to a Controlled S Corporation Under Section 351*

Section 351 permits a person or persons to transfer property to a corporation solely in exchange for stock or securities of the transferee corporation without recognizing gain or loss, provided that immediately after the exchange, the transferor group is in "control" of the transferee. For this purpose, control is defined in section 368(c) as the ownership of 80 percent or more of the total number of voting and nonvoting shares of stock.[243]

In satisfying the control group requirement, persons receiving stock in ex-

240. *See supra* note 122 and accompanying text.

241. *See* G.C.M. 38969 (Mar. 9, 1983), *reprinted in* 18 Tax Notes (Tax Analysts), 1124 (Mar. 28, 1983).

242. Furthermore, in attempting to move S corporations closer to partnerships it should be noted that I.R.C. § 751(d)(2)(B) only taints the gain of the dealer partner or partners and not that of the nondealer partners. *See* I.R.C. § 751(d)(2)(B) (1982). The shareholder reference test, if applicable, converts the entire corporate gain into ordinary income. *But see id.* § 724 (visiting the opposite result upon nondealer partners in the contribution setting.

243. *See generally* B. Bittner & J. Eustice, *supra* note 150, ch. 3.

change for services are treated as not having transferred "property" in exchange for stock or securities, but are still counted in determining whether the other transferors satisfy the 80 percent control group requirement.[244] Thus, issuance of more than 20 percent of a corporation's stock to a service provider will result in gain or loss recognition to the remaining transferors.[245]

Under section 1032, no gain or loss results to the corporation-transferee on the issuance of its stock or options to acquire its stock in making the exchange, and, where section 351 is satisfied at the transferor level, the assets are received by the transferee with a carryover basis (plus gain recognized) under section 362(a). The contributing shareholder determines basis in his stock under section 358, which generally will result in a carryover basis from the property contributed to the corporation.[246] However, liabilities assumed or taken subject to by the corporation in the exchange reduce stock basis under section 358(d).

Prior to SSRA, it was generally acknowledged that section 351 applied to electing small business corporations.[247] Furthermore, there was nothing in SSRA to suggest that tax-free incorporations or midstream transfers of property by shareholders in control of an S corporation in exchange for stock or securities were inconsistent with the partnership-like treatment prescribed in revised Subchapter S.[248] Indeed; the Service has endorsed continued application of section

244. In certain instances, the issuance of stock for services may raise a second class of stock issue. *See* Paige v. United States, 580 F.2d 960 (9th Cir. 1978); Rev. Rul. 71-522, 1971-2 C.B. 316. *See also* Shaw, *Fresh Start, supra* note 16, at 10-11; Shaw & August, *Analysis, supra* note 16 at 3. If stock issued for services is not substantially vested and thus is not includible in the recipient's gross income it is uncertain whether such person is still treated as a shareholder for other purposes, for example, receiving allocation of the S corporation's tax items under I.R.C. § 1366. *See* Treas. Reg. §§ 1.83-1(a)(1), 1.83-2(a); 1.83-3(b) (West 1985). *See also* Orbach, *Impact of Section 83 on Subchapter S Corporation,* 55 TAXES 754 (1977). Consideration of whether the issuance of stock qualifies under § 1244 is also essential. Compare the passive income prohibition under § 1244(c)(1)(C) with § 1362(d)(3).

245. *See* Treas. Reg. § 1.351-1(a)(1)-(2), T.D. 6942, 1968-1 C.B. 136. For a glimpse of the analysis required in order to recognize service-flavored property, see United States v. Stafford, 727 F.2d 1043 (11th Cir. 1984); Stafford v. United States, 611 F.2d 990 (5th Cir. 1980); United States v. Frazell, 335 F.2d 487 (5th Cir. 1964). It should also be noted that debt of a transferee which is not evidenced by a security, and accrued interest on a transferee debt, is not considered "property" for transfers made after 1980. *See* I.R.C. § 351(d)(2)-(3) (1982). Moreover, § 351 is inapplicable to the transfer of a diversified investment portfolio. *Id.* § 351(e)(1); *see also id.* § 721(b).

246. The basis of nonqualifying property received in the exchange (other than cash) will be its fair market value. I.R.C. § 358(a)(2) (1982). The Conferee's Report to the TRA '84 explaining revisions to the at-risk rules under § 46(c)(8) provides that transfers of § 38 property which relate to mere changes in form of doing business will not result in recapture of investment credit if the transferor remains liable on any debt with respect to the transferred property and does not reduce his direct or indirect at-risk investment in the property. *See* Treas. Reg. § 1.47-3(f), T.D. 7203, 1972-2 C.B. 12; 1.47-4 (1967). For a discussion of the recent revisions to the at-risk rules for investment tax credits concerning S corporations, see August, *Navigating the At-Risk Waters After the Tax Reform Act of 1984*, 63 TAXES 83 (1985).

247. *See* J. EUSTICE & J. KUNTZ supra note 13, at ¶ 6.02[2].

248. I.R.C. § 1371(a)(1) (1982). Clearly, the tax-free transfer of property by partners in a

351 in a Subchapter S context, but unfortunately appears to have added an additional requirement which arguably goes beyond the statutory language (i.e., that the transfer does not involve the contribution of dealer property by a substantial shareholder or group of shareholders under Regulation section 1.1375-1(d)).[249] The application of this regulation as a road block to section 351 for shareholders in S corporations should be rejected.[250]

Where one or more transferors of property to an S corporation desire receipt of a security (nontaxable) in a section 351 exchange, use of straight debt, under section 1361(c)(5), will avoid a second class of stock issue.[251] Moreover, whenever a security or nonsecurity debt instrument is issued in the exchange, consideration of the new time value of money provisions is required.[252]

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partnership is permitted under § 721. One important distinction between contributions of property to S corporations and partnerships is that there is no control group requirement under § 721. I.R.C. § 721 (1982). *See* August & Silow, *S Corporation vs. Partnership for Real Estate Ventures*, 1 J. TAX'N INVESTMENTS 91, 102-05 (1984). Moreover, § 118 should continue to apply to contributions to capital not made in exchange for stock. *See* B. BITTKER & J. EUSTICE, *supra* note 150, ¶ 3.14; *cf.* I.R.C. § 108(e)(6) (1982). In certain instances, it may be more desirable to purposely avoid § 351 by transferring appreciated property for a note. *See* Murphy Logging Corp. v. United States, 378 F.2d 222 (9th Cir. 1967); Nye v. Commissioner, 50 T.C. 203 (1968), *acq.* 1979-2 C.B. XXV; J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 6.03[3]; *see also* I.R.C. § 267(a)(1) (West 1985) (possibly preventing loss recognition for non-§ 351 "sales" of depreciated property by a shareholder to a corporation).

249. G.C.M. 38969 (Mar. 9, 1983), *reprinted in* 18 TAX NOTES (TAX ANALYSTS) 1124 (Mar. 28, 1983).

250. Obviously, the Service has also been concerned about contributions of dealer property in the partnership setting although the prescribed remedy is not the denial of nonrecognition treatment under § 721 but in tainting the assets at the partnership level. I.R.C. § 724 (West 1985). For a discussion of this new rule, see Hyman, *A Transaction Encounter with the Partnership Rules of Subchapter K: The Effects of the Tax Reform Act of 1984*, 62 TAXES 830, 836-38 (1985); McKee, Nelson & Whitmire, *The Tax Reform Act of 1984: Provisions Affecting the Taxation of Partnerships and Partners*, 62 TAXES 927, 939 (1985).

251. *See* Shaw & August, *Analysis*, *supra* note 16, at 3-4. The leading cases on the definition of a "security" in this context are Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); Smith v. Commissioner, 116 F.2d 642 (2d Cir. 1941); Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737, 750-51 (1954), *aff'd*, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956). It should also be noted that a straight debt instrument may be classified as equity for other tax purposes (e.g., straight-debt-to-equity ratio of 100:1). *See* Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984); Gilbert v. Commissioner, 248 F.2d 399, 407 (2d Cir. 1957).

252. For example, market discount under § 1276 will arise where an appreciated asset is transferred to a corporation under § 351(a) in exchange for a security, which obligation will be carried by the transferor at the adjusted basis of the asset and not its face amount. I.R.C. § 1278(a)(2)(A) (1982). Furthermore, if the security does not provide for the payment of interest in conformity with 100% applicable federal rate under § 1274(d), original issue discount may also be charged with respect to the same indebtedness. *Id.* § 1267(a)(2)(B).

On the other hand, where boot in a § 351 transaction is received in the form of a debt (nonsecurity) instrument, original issue discount may arise under § 1274 to the extent of the unstated interest element. *Id.* § 1274(c). Thus, the particular attributes given to debt issued in a § 351 transaction

Where nonqualifying property (boot) is received by a transferor-S shareholder, gain is recognized.[253] This will arise, for example, where appreciated property is exchanged for stock and a straight debt instrument which is not a "security."[254] However, since taxable boot is still received as part of a sale or exchange, the distribution rules under sections 1368 and 1379(c) (PTI) are not applicable in characterizing the transferor's gain.[255]

Where appreciated property subject to a liability is transferred by a shareholder, the assumption of the liability is not treated as boot, except to the extent the unpaid balance of the debt exceeds the basis of the property contributed.[256] However, the entire liability may be treated as boot if the principal purpose for the creation or assumption of the indebtedness was the avoidance of tax and such transfer was devoid of any business purpose.[257] Even if the liability boot provisions are inapplicable, liability assumptions (property taken subject to a liability) will still reduce the transferor's basis in his S stock under section 358(d), which may limit such shareholder's ability to currently deduct expenses and recovery allowances passed through by the corporation.[258]

For the transferee S corporation, section 1032 should continue to override section 1363(d) with respect to the issuance of its stock (or options to acquire

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should also be evaluated with respect to the time-value-of-money provisions. *See id.* §§ 483, 1271-1288, 7872; J. EUSTICE, THE TAX REFORM ACT OF 1984, ch. 2 (1984). Where loans are issued to shareholders with adequate or below-market interest, potential application of § 267(a)(2) to the debtor corporation lurks as a trap for the unwary. *See* I.R.C. § 267(a) (West 1985).

See STAFF OF THE JOINT COMM. ON TAX'N, 98TH CONG., 2ND SESS. GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, at 96 (1984) (providing that Congress did not intend that market discount would arise on a § 351 transfer of appreciated property). Presumably, a technical correction in this area should be anticipated in the near future.

253. As to the applicability of § 453 to gain recognized under § 351, see Prop. Reg. § 1.453-1(f)(3)(ii), II [1985] FED. TAXES (P-H) ¶ 70,431; Friedman, *An Analysis of Nonrecognition Exchanges and Installment Rules Under the Recent Proposed Regulations*, 61 J. TAX'N 158 (1984). *See also* STAFF OF SENATE FINANCE COMM., 99TH CONG., 1ST SESS., FINAL REPORT ON SUBCHAPTER C. THE SUBCHAPTER C REVISION ACT OF 1985 (which would codify another of the proposed regulations under § 453 or § 362 with respect to certain organization transfers). The Final Report also recommends that §§ 1367 and 1368 be revised to deny shareholders in an S corporation any basis increase with respect to 80% of long term capital gain (LTCG) and 50% of all other gain recognized by one corporation on the sale or disposition of its assets for a five-year period after it converted from a C to an S corporation but only to the extent of the benefit in gain in such assets as of the conversion. *Id.*

254. *See* Prop. Reg. § 1.453-1(f)(3)(iii), ex. (1), 49 Fed. Reg. 87 (1984).

255. I.R.C. § 1368(a) (1982) only applies if the distribution, had the corporation not elected S status, would have been subject to the rules under § 301(c). Under prior law, a distribution of previously taxed income (PTI) (money only) under similar circumstances could not have been made if the payment was received as part of a sale or exchange. Treas. Reg. § 1.1373-1(g), ex. 5, T.D. 7564, 1978-2 C.B. 19; *see* Renard v. Commissioner, 31 T.C.M. (CCH) 1210 (1972).

256. I.R.C. § 357(c)(1) (1982). The regulations allow for aggregating liabilities in applying § 357(c) to multiple-asset transfers. Treas. Reg. § 1.357-2, T.D. 7728, 1980-2 C.B. 236. For exceptions to the general rules under § 357, see I.R.C. § 357(c)(2)-(3) (West 1985).

257. I.R.C. § 357(b) (1982); *see also* Thompson v. Campbell, 353 F.2d 787 (5th Cir. 1965).

258. I.R.C. § 1366(d)(1) (1982); *see* Weibusch v. Commissioner, 59 T.C. 777, *aff'd* 487 F.2d 515 (8th Cir. 1973).

stock) in the exchange.[259] Moreover, section 1363(d) will not apply to distributions by an S corporation of its own debt instruments. However, where distributed boot includes other appreciated property, section 1363(d) will apply and the resulting gain will be allocated among all shareholders in proportion to their daily stock ownership during the taxable year in which the transfer is made.[260]

Although beyond the scope of this article, it is important to consider the potential overlap between section 351 and other provisions in Subchapter C. For example, the same transaction may meet the technical requirements under section 351(a) and the reorganization provisions under section 368(a).[261] In other instances, sections 304 and 351 may overlap, in which case section 304 is generally dominant.[262]

B. *Corporate Reorganizations Involving S Corporations*

A central purpose for the enactment of SSRA was to establish parity between Subchapters S and K. Although this goal was substantially attained in the areas of operations and distributions, important and often critical differences remain between S corporations and partnerships, which, in large measure, are attributable to the required integration of Subchapters C and S under section 1371(a)(1). Perhaps the most striking example of the lack of parallel treatment is found in the area of corporate reorganizations.[263] Retention of the Subchapter C model for S shareholders exchanging equity interests with another (C or S) corporation represents a distinct advantage for S corporations over partnerships.[264] Due to the one class of stock limitation, however, the ability for an

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259. *See* S. Rep. No. 640, *supra* note 27, at 15; H.R. Rep. No. 826, *supra* note 51; *see also* Ltr. Rul. 8417042 (Jan. 24, 1984).

260. I.R.C. § 1366(a) (1982).

261. *See* Rev. Rul. 84-71, 1984-1 C.B. 106 (revoking Rev. Rul. 80-284, 1980-2 C.B. 117 and Rev. Rul. 80-285, 1980-2 C.B. 119). It may matter whether a particular transaction is governed by § 368(a) or § 351(a) particularly where boot is received by a shareholder. If § 351(a) applies, the character of gain is determined by reference to the character of the assets transferred. I.R.C. § 351(a) (1982). On the other hand, if § 356 applies, a dividend equivalent payment will be taxed as ordinary income if the transferee corporation has accumulated earnings and profits. I.R.C. § 356 (1982).

262. *See* I.R.C. § 304(b)(3)(A) (West 1984). *See generally* B. Bittker & J. Eustice, *supra* note 150, at ¶ 9.30-.32.

263. Although (pre-SSRA) Treas. Reg. § 1.1371-1(c) did not specifically refer to § 368 (and related provisions), it was firmly established that Subchapter S corporations were subject to Part III of Subchapter C. Treas. Reg. § 1.1371-1(c), T.D. 7920, 1983-2 C.B. 69; *see* J. Eustice & J. Kuntz, *supra* note 13, at ¶ 12.01.

264. This is especially true after TRA '84 which, by amending I.R.C. § 1031(a)(2)(D), provides that interests in a partnership are not "like kind" property under § 103(a) for exchanges of partnership interests made after July 18, 1984. *See* I.R.C. § 1031(a)(2)(D) (West 1985). The Senate Report to TRA '84 provided that this revision was not intended to apply to exchanges of interests within a single partnership or to alter the status of preexisting law. *See generally* Pappas v. Commissioner, 78 T.C. 1078 (1982); Gulfstream Land & Dev. Co. v. Commissioner, 71 T.C. 587 (1979); Estate of Meyer, Sr. v. Commissioner, 58 T.C. 311 (1972), *aff'd*, 503 F.2d 566 (9th Cir.

S corporation to issue various equity interests to shareholders in an acquired corporation or among its own shareholders in a recapitalization is limited when viewed in comparison with the flexibility offered to nonelecting corporations.[265]

After SSRA, where an S corporation is a party to a reorganization described in section 368(a), the corporation and its shareholders should still be governed by the rules under Part III of Subchapter C.[266] This is based on the first integration rule in section 1371(a)(1) (the "inconsistency clause").[267] However, it appears that the Service could challenge a purported reorganization involving an S corporation where the results obtained under Subchapter C are inconsistent with treating an S corporation as a pass-through entity. Not only is it extremely difficult to predict when such circumstances will arise, but it appears inappropriate for the Service to reserve the right to challenge an otherwise qualifying reorganization involving an S corporation for an "inconsistency" under section 1371(a)(1), especially in light of the fact that the rules under Part III of Subchapter C were designed for regular corporations subject to a double tax regime in distributing profits to its shareholders and not for pure pass-through entities.[268]

In addition to the possible use of the inconsistency clause under the first integration rule to upset a reorganization, there may be technical problems in qualifying an S corporation under a particular reorganization provision if the second integration rule under section 1371(a)(2) is literally applied. As previously discussed, section 1371(a)(2) provides that an S corporation as a shareholder is treated as an "individual." Will this preclude an S corporation from qualifying

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1974); W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnership and Partners ¶ 15.04 (1977). Based on the analysis underlying the Tax Court's recent decision in Magneson v. Commissioner, 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985), it has been suggested that a three-step "distribution-swap-recontribution" dance may be a potential, albeit risky, end around § 1032(a)(2)(D). *See* Pennell, *An Analysis of the Deficit Reduction Act Provisions Affecting Partnerships: Part II*, 61 J. Tax'n 378, 380-81 (1984).

265. Although there are no limitations on the economic size of S corporations, the various shareholder eligibility rules and definition of a small business corporation in § 1361(b) limit the application of the acquisitive reorganization provision to S corporations. As to the recapitalization of an S corporation, the use of nonvoting stock may be helpful in structuring management control between various business factions or in shifting the incidence of income tax between shareholders of different generations or tax brackets without sacrificing voting control. However, the prohibition on dividend (and liquidation) preferences makes S corporation status undesirable for restructuring equity interests in a Type E recapitalization. Moreover, the 1984 amendments to § 1031 do not preclude partners from recapitalizing (tax-free) their interests within a single partnership, thus preserving a method by which distribution and liquidation preferences may be rearranged among the investors.

266. *See infra* note 282. These provisions govern the taxation of certain qualifying and nonqualifying consideration received in a reorganization, the basis of the assets or other property transferred and exchanged by the corporate parties and their shareholders, and further provide for the transfer of the acquired corporation's tax history to the acquiring corporation. *See generally* B. Bittker & J. Eustice, *supra* note 150, chs. 12, 14 & 16; J. Eustice & J. Kuntz, *supra* note 13, ch. 12.

267. *See supra* notes 26-32 and accompanying text (discussing integration at subchapter S and Subchapter C).

268. *See supra* note 264.

as a "corporation" under section 368(b)(1) where it exchanges its stock for stock of an acquired corporation in a Type B reorganization?[269] The same question will surface where an S corporation distributes the stock of a controlled subsidiary in a Type D reorganization.[270] Furthermore, it is similarly uncertain whether momentary stock ownership of an S corporation by another corporation in a Type A or Type C reorganization will cause the S corporation to lose its election by virtue of having an ineligible shareholder.[271] Until specific rulings or regulations are issued involving the various reorganization patterns, awareness of potential technical traps in reorganizations involving S corporations is essential.[272]

Inasmuch as a review of the basic statutory and judicial concepts applicable to corporate reorganizations and divisions is beyond the scope of this article, discussion will be limited to isolating certain aspects of reorganizations involving S corporations which deserve special attention. These areas include the termination and reelection of S status as a result of a combination or division, taxation of operations in the year of the reorganization, carryover of special tax attributes of an S corporation (e.g., AAA) and of its shareholders (e.g., PTI), excess losses, and integration of the rules governing distributions of nonqualifying property (boot) under sections 356 and 361 with the distribution rules generally applicable under Subchapter S.

C. *The Resultant Status of the S Corporation in the Wake of Reorganization*

In a Type A statutory merger where an S corporation is designated as the surviving entity, its election will not be terminated provided all persons in the acquired corporation receiving stock in the merger are eligible shareholders and the total number of shareholders (post-merger) does not exceed thirty-five.[273]

269. The same argument could be made where an S corporation acquires stock of a target corporation in a "creeping" acquisition prior to terminating its S status (i.e., when 80% of the target's stock is acquired) and elects to step up the basis of the subsidiary's assets under § 338. *See supra* notes 74-84 and accompanying text.

270. I.R.C. § 1361(b)(1)(B) (1982). In this regard, the Service has never acknowledged a momentary (ineligible) shareholder rule. It has been suggested that the potential risk in this area may be minimized if the S stock is transferred directly to the shareholders of the acquired corporation. *See* J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 12.04[2].

271. *See* Rev. Rul. 71-266, 1971-1 C.B. 262; Rev. Rul. 69-566, 1969-2 C.B. 565.

272. See I.R.C. § 1363(e)(2) (West 1985) (implicitly accepting the notion that an S corporation can distribute stocks or securities of another corporation in a reorganization).

273. Rev. Rul. 79-52, 1979-1 C.B. 283; Rev. Rul. 69-566, 1969-2 C.B. 65 (merger); Ltr. Rul. 8351110 (Sept. 22, 1983). Although stock of a surviving S corporation that is transferred momentarily to an acquired corporation could be viewed as resulting in an ineligible shareholder, apparently this potential foot fault has previously been ignored by the Service in a Type A reorganization. Obviously, if the ultimate distributee of the S stock is an ineligible shareholder, the election of the acquiring S corporation will terminate. A termination may also arise by virtue of the assets an S corporation receives in a merger or other acquisitive transaction (i.e., an 80% or more stock interest in another corporation). I.R.C. § 1361(b)(2)(A) (1982). Even if a termination is avoided because, for example, an S corporation issues more than 50% of its stock to the shareholders of the acquired corporation, it may result in the loss of a previously grandfathered

However, it is also possible for a majority of the postmerger shareholders to revoke the corporation's election under section 1362(d)(1).[274]

Where an S corporation is merged into or consolidates with another corporation, its election will immediately terminate since it is no longer in existence. In these situations, the Service formerly considered the election as not having terminated "during" the S corporation's final taxable year and avoided a retroactive termination.[275] This favorable conclusion prevented the corporation from being subject to corporate tax on its final year's income or resulting in the denial of the pass-through of final year's losses to its shareholders. After SSRA, concern over a retroactive termination is eliminated since section 1362(d)(2) specifically provides that a termination will be effective as of the date of the terminating event, which, in the context of a merger or consolidation, will be prescribed by state law.[276]

Where the election of an acquiring S corporation is terminated as a result of a Type A merger (i.e., the presence of an ineligible shareholder), it presumably will be unable to reelect S status for the succeeding four years unless consent is obtained from the Service.[277] On the other hand, where a regular corporation acquired an S corporation in a merger, or, electing or nonelecting corporations are fused in a consolidation, the survivor or new entity, as the case may be, should be able to immediately file an S election,[278] although in certain instances there may be a delayed effective date.[279]

In a Type B reorganization, one corporation acquires 80 percent or more of the stock of another solely in exchange for its voting stock (or the voting

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fiscal year or delayed application of the partner-type fringe benefit provisions to more than 2% shareholders. *See id.* § 1378(c); Subchapter S Revision Act of 1982, § 6 (I.R.C. § 1361 (West 1985)). Moreover, a more than 50% change in stock ownership will also result in a termination if the S corporation had a pre-SSRA permitted subsidiary. *Id.* § 6(c).

274. Of course, this ability to revoke the election may be circumscribed by the plan of merger. Prior to SSRA, a revocation could be made by any new shareholder who affirmatively refused to consent to the election by so informing the Service within 60 days after the day on which the stock was acquired. I.R.C. § 1372(e)(1) (repealed 1982).

275. *Id.* § 1372(e)(3); Rev. Rul. 69-94, 1964-1 (pt. 1) C.B. 317 (merger); Rev. Rul. 70-232, 1970-1 C.B. 177 (consolidation).

276. *But see* I.R.C. § 381(b)(2) (1982).

277. I.R.C. § 1372(f) (1976) (current version at I.R.C. § 1362(g) (1982)). Service consent for an early reelection does not seem likely even where the shareholders of the acquired corporation end up with a majority of the stock in the surviving corporation. *See* Treas. Reg. § 1.1372-5(a) (1959); *see also* Subchapter S Revision Act of 1982 § 6(e), I.R.C. § 1361 (1982) (providing that elections terminated prior to 1983 are not subject to the five-year waiting period under § 1362(g)); S. Rep. No. 640, *supra* note 27, at 11.

278. An exception may apply where the acquired corporation had terminated its election prior to the reorganization and, as such, the acquiring corporation is treated as its "successor". *See* I.R.C. § 1362(g) (1982).

279. Rev. Rul. 70-232, 1970-1 C.B. 177. A delayed effective date will arise where a C corporation merges (and survives) with an S corporation after the third month and 15th day of its taxable year. Even if the election was filed immediately after the merger, it would not become effective until the first day of the succeeding year. On the other hand, had the corporations consolidated, the taxable year for each corporation presumably would have ended, and an S election could be filed with an immediate effective date, which elevates matters of form over substance.

stock of its parent).[280] Where an S corporation acquires another corporation in a Type B reorganization, its election will terminate as a result of a prohibited affiliation because of an ineligible shareholder.[281] Where control of an S corporation is acquired in a Type B reorganization, its election will be terminated.[282] In either case, under prior law, termination of the S election was retroactive to the first day of the corporation's taxable year which may have had a dramatic impact on both the corporation and its shareholders.[283] In contrast, the present rules provide that the election will be terminated on the date of the terminating event.[284] Where the acquiring corporation loses its election as a result of acquiring the subsidiary, a new election generally will not be allowed until expiration of the following four-year period under section 1362(g).[285]

In a Type C reorganization, the acquiring corporation must receive substantially all the assets of the acquired corporation in exchange for its voting stock (or voting stock of its parent). A limited amount of other consideration is also permitted to be transferred in acquiring the target's assets.[286] Present law provides that in Type C reorganizations for plans of reorganization adopted after July 18, 1984, the acquired corporation must distribute the stock, securities, and other property it receives in the reorganization, as well as any other assets not transferred to the acquiring corporation, to its shareholders.[287] However, a waiver of the actual distribution requirement is permitted upon appli-

280. *See* B. Bittker & J. Eustice, *supra* note 150, at ¶ 14.13.

281. I.R.C. § 1361(b)(2)(A) (1982). As noted above, it is possible that the Service may deny an S corporation access to § 368 where it acquires another corporation in a Type B reorganization under the second integration rule of § 1371(a)(2). If a literal application of an S corporation as an "individual" where it acquires stock in another corporation for purposes of § 368(b)(2) is rejected, the service presumably will allow an acquiring S corporation to maintain its election if the acquired corporation is immediately liquidated. *See* Rev. Rul. 73-496, 1973-2 C.B. 312. However, an immediate liquidation may convert the transaction into a Type C reorganization. *See* South Bay Corp. v. Commissioner, 345 F.2d 698 (2d Cir. 1965); Commissioner v. Dana, 103 F.2d 359 (3d Cir. 1939).

282. Versitron, Inc. v. United States, 76-2 U.S.T.C. (CCH) ¶ 9780 (Ct. Cl. 1976); Rev. Rule. 69-168, 1969-1 C.B. 24.

283. I.R.C. § 1372(d) (1976) (current version at I.R.C. § 1362(c) (1982)). However, Rev. Rul. 80-169, 1980-1 C.B. 188 provided an exception that the election of an acquired Subchapter S corporation in a Type B reorganization would occur on the date of the acquisition if the acquired corporation was immediately included in a consolidated return with the acquiring corporation. Treas. Reg. § 1.1502-76(b)(3), (d), T.D. 7246, 1973-1 C.B. 381; *see* J. Eustice & J. Kuntz, *supra* note 13, at ¶ 12.03[2] n.92.

284. I.R.C. §§ 1362(d)(2)(B), 381(b)(2)(B) (1982).

285. Versitron, Inc. v. United States, 76-2 U.S.T.C. (CCH) ¶ 9780 (Ct. Cl. 1976); Rev. Rul. 78-364, 1978-2 C.B. 225.

286. I.R.C. §§ 1368(a)(1)(C), (a)(2)(B) (1982); *see also* Everett v. United States, 448 F.2d 357 (10th Cir. 1971). *See generally* B. Bittker & J. Eustice, *supra* note 150, at ¶ 14.14.

287. I.R.C. § 1368(a)(2)(G) (1982) (effectively repealing Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935)). It does not appear that the transferor must completely liquidate and dissolve in fulfilling the distribution requirement in § 1368(a)(2)(G)(i). *See* Rev. Rul. 84-2, 1984-1 C.B. 6. The new legislation also authorizes the Treasury to issue regulations under § 312(h)(2) (for Types C and D reorganizations), allocating earnings and profits of the transferor corporation between or among any corporation in control of the transferor corporation immediately before the reorganization and the acquiring corporation. *See* Bloom & Calvert, *supra* note 5, at 323-25; Silverman & Johnson,

cation to the Service, where substantial hardship would otherwise occur by an actual liquidation (e.g., distribution of a valuable franchise or other asset), and provided the transferor corporation and its shareholders are treated as if their retained assets were distributed and recontributed to a new corporation. In either case, the actual or constructive distribution of boot may result in dividend income to the shareholders under section 356(a)(2).[288]

Where substantially all of an S corporation's assets are acquired in a Type C reorganization, its election will be terminated when the liquidation process is actually completed unless an earlier terminating event occurs.[289] On the transfer of the S corporation's assets in exchange for the acquiring corporation's stock or securities and other property, the general rules under section 361 should apply. As to liquidating distributions, section 1363(e)(2) will apply with respect to the distribution of the acquiring corporation's stock and securities and section 1363(e)(1) will apply for avoiding gain recognition on other boot under section 1363(d).[290] Moreover, since AAA may not be described in section 381(c), a distribution of boot by an S corporation with accumulated earnings and profits which is acquired in a Type C reorganization, may constitute a distribution of AAA under section 1368(c)(1) in preemption of section 356(a)(2).[291]

Where an S corporation acquires the assets of another corporation in a Type C reorganization, it is uncertain whether a termination will occur where the S stock transferred in the exchange is immediately distributed to the transferor corporation's shareholders.[292] It has been suggested that a termination may be avoided by transferring the stock directly to the shareholders of the acquired corporation.[293] Where a termination does occur (e.g., stock held by the transferor corporation), section 1372(g) will deny a reelection by the acquiring S corporation for the succeeding four-year period.

In a nondivisive Type D reorganization, a corporation transfers substantially all its assets to another corporation controlled by the transferor and/or its shareholders and immediately thereafter distributes all of its assets to its shareholders as part of the plan of reorganization.[294] Where this transfer is accomplished by

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New Tax Laws Focus in Corporate Area Has Been Basically as a Closer of Loopholes, 61 J. TAX'N 386, 388-89 (1984).

288. In granting a waiver under § 368(1)(2)(6)(ii), it is hoped that the Service will not deny the "new corporation" from immediately reelecting under Subchapter S.

289. Rev. Rul. 71-266, 1971-2 C.B. 262; *see* J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 12.04[2].

290. I.R.C. § 137(a)(1) (1982). The exception provided in § 1363(e)(2) only applies to property which can be received under §§ 354-356 without gain recognition.

291. This analysis should also apply to the constructive distribution provision in I.R.C. § 368(1)(2)(G)(ii). *See* I.R.C. § 312(h) (1982); *supra* note 287.

292. *See* I.R.C. § 1361(b)(1)(B) (1982) (preventing an S corporation from having a corporate shareholder). As previously discussed, it is uncertain whether the Service will ignore a momentary corporate shareholder.

293. J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 12.04[2]. As previously discussed, terminations under prior law were retroactive to the first day of the taxable year. Under SSRA, the termination is effective on the date of the terminating event. I.R.C. § 1362(d)(2)(B) (1982).

294. I.R.C. §§ 368(a)(1)(D), 354(b)(1)(A)-(B) (1982); *see id.* § 368(c)(2) (enacted under TRA '84 § 64(a), which replaced the control requirement in § 368(c)(1) (80%) to that used in § 304 (50%) for Type D reorganizations).

statutory merger or consolidation, the transaction may overlap with the Type A reorganization pattern.[295] Where an S corporation is a party to such a merger, the termination-of-election aspects of a nondivisive Type D reorganization should be the same as those examined above under Type A.[296] Where the transfer is not made pursuant to a state merger statute, there may be an overlap between a Type C and a Type D reorganization, however, the tie-breaker rule in section 368(a)(2)(A) will require Type D treatment. In this event, if the newly created corporation is not permitted to have a momentary corporate shareholder, it will be ineligible to file an election in the year in which the reorganization occurs.[297] Since the newly organized entity will never have elected S status, an election will be permitted for the following year.[298]

In a divisive Type D reorganization, only a part of a corporation's assets are transferred to another corporation which is controlled immediately thereafter by the transferor corporation and/or its shareholders. The shares of stock (or securities) of the controlled corporation are then distributed to the shareholders of the transferor corporation per section 355 or section 356, as required under section 368(a)(1)(D). Although prior to SSRA, a Subchapter S corporation was generally prohibited from owning 80 percent or more of the stock of a subsidiary, momentary affiliation was permitted by the Service in carrying out a Type D reorganization.[299] Even if momentary affiliation is not reendorsed by the Service, or if the electing corporation holds the stock of the subsidiary for more than a "moment," it is theoretically possible for an S corporation to satisfy the 80 percent control test for a Type D reorganization or division under section 355 without becoming affiliated under section 1504(a)(2).[300]

In curbing perceived abuses in the liquidation-reincorporation area, the Tax Reform Act of 1984 changed the control requirement for Type D reorganizations (but not divisions under section 355) from that commonly used in section 368(c), to the standard of section 304(c).[301] This requirement will be met where an S corporation owns, directly or through section 318 attribution (modified under

295. Rev. Rul. 57-465, 1957-2 C.B. 250. In certain instances it will be critical to determine which provision is controlling. Rev. Rul. 75-161, 1975-1 C.B. 114 (I.R.C. § 357(c) applicable to trigger gain recognition in liability assumption to Type D reorganization that was also a Type A reorganization); *id.* 76-188, 1976-1 C.B. 99; *see* B. BITTKER & J. EUSTICE, *supra* note 150, at ¶¶ 14.14, .32. .55.

296. See J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 12.07[3].

297. *But see supra* note 273.

298. I.R.C. §§ 1361(b)(1)(B), 1362(b)(2)(B)(i) (1982).

299. Rev. Rul. 72-230, 1972-1 C.B. 270 (immediate distribution under § 368(a)(1)(D)); *id.* 73-496, 1973-2 C.B. 312 (30-day amnesty for *Kimbell-Diamond* acquisitions). Prior to SSRA, affiliation between a Subchapter S corporations and corporations described in § 1504(b) was permissible. Thus, it was possible to spin-off or split-off a permitted subsidiary under § 355(a)(2)(C) independently of a Type D reorganization. However, SSRA now prohibits affiliations other than an "inactive subsidiary" defined in § 1361(c)(6). *See* Subchapter S Revision Act of 1982 § 6(c), I.R.C. § 1361 (1982) (prescribing a special grandfather rule for existing, permitted affiliations).

300. I.R.C. § 368(c)(1) (West 1985); *see id.* § 1504(a)(2) (80% voting and value); *see also* I.R.C. § 1504(a)(4) (West 1985) (excluding certain preferred stock from § 1504(a)(2)). Rev. Rul. 71-593, 1971-2 C.B. 181.

301. I.R.C. § 368(c)(2) (West 1985).

section 304(c)(3)), 50 percent of the voting power or 50 percent of the value of shares of all classes of stock.[302] Thus, effective for plans of reorganization (or transfers) made after July 18, 1984, S corporations may engage in a non-divisive Type D reorganization without necessarily forfeiting their Subchapter S election.[303]

In a Type E reorganization, a single corporation reshuffles its equity interests among its shareholders by exchanging debt, securities, and/or stock.[304] Prior to SSRA, a recapitalization of a Subchapter S corporation which resulted in the issuance of nonvoting stock or another form of preferred stock terminated the corporation's election retroactive to the first day of its taxable year. After SSRA, an exchange of voting for nonvoting common is permissable although it will be of limited benefit for freezing the value of certain equity interests for estate-planning purposes.[305] Where a security is issued in the exchange, it should be tailored to meet the definition of a straight debt instrument under section 1361(c)(5) in preventing a termination.[306]

A Type F reorganization occurs where a single corporation undergoes a mere change in its "identity, form, or place of organization."[307] Where an S corporation engages in an F reorganization, its election should not be terminated.[308]

As to a Type G insolvency reorganization, generally an S corporation will not be acquired in such a reorganization because of the one-class-of-stock restriction, but it may be an acquiring corporation, subject to the prohibited affiliation rule.[309]

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302. For a discussion of the recent revisions to §§ 368(a)(1)(D) and 304, see J. ELSTICE, *supra* note 5, at ¶ 3.04[3]-[4].

303. In certain instances, a Type D reorganization may not be the preferred outcome. *See* Smothers v. United States, 642 F.2d 894 (5th Cir. 1981); Telephone Answering Serv. Co. v. Commissioner, 62 T.C. 423 (1974), *aff'd*, 545 F.2d 423 (4th Cir. 1976); Rev. Rul. 61-156, 1961-2 C.B. 62; *see also* I.R.C. § 312(h)(2) (West 1985) (authorizing the Treasury to issue regulations allocating earnings and profits among or between corporations which are parties (or corporations in control of such parties) in a Type D reorganization). *See generally* B. BITTKER & J. EUSTICE, *supra* note 150, at ¶ 14.54.

304. I.R.C. § 369(a)(1)(E) (1982); *see* B. BITTKER & J. EUSTICE, *supra* note 150, at ¶ 14.17; J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 12.08.

305. *See* Kopple, *Corporate Recapitalization and Partnership Freezes*, 17 MIAMI INST. EST. PLANNING, ch. 11 (1983). Again, where a termination does arise, it will be effective as of the date of the exchange and not retroactive to the first day of the taxable year. I.R.C. § 1362(d)(2)(B) (1982).

306. For a discussion of the use of straight debt and I.R.C. § 351, see *supra* text accompanying notes 243-262.

307. The one corporation requirement was passed in TEFRA § 225(b), and applies to transactions after August 31, 1982.

308. I.R.C. § 381(b)(1) (1982) (taxable year does not end in F reorganization); Rev. Rul. 64-250, 1964-2 C.B. 333; Ltr. Rul. 7928056 (April 12, 1979).

309. I.R.C. § 368(a)(1)(G) was added by the Bankruptcy Tax Act of 1980. *See* B. BITTKER & J. EUSTICE, *supra* note 150, at ¶ 14.02 (1982 Supp. No. 1); J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 12.11; *see also* Eustice, *Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 — Corporate Aspects*, 36 TAX L. REV. 1 (1980). For a discussion of the triangular reorganization provisions in § 368(a)(2)(D) & (E) involving Subchapter S corporations, see J. EUSTICE & J. KLUNTZ, *supra* note 13, at ¶ 12.05-.06.

D. *Taxation of Operations in Year of Reorganization*

Prior to SSRA, where the election of an acquired Subchapter S corporation was terminated as a result of a reorganization, the effective date of termination generally was retroactive to the first day of its taxable year. As a result, the income or loss of the corporation during the year of acquisition could not be passed through to the shareholders and corporate income would be subject to tax under section 11 (and possibly sections 1201, 56, 531, or 541). Furthermore, premerger distributions were subject to dividend treatment under section 301(c) without regard to each shareholder distributee's PTI account.[310] The Service, however, had previously issued several rulings which held, in certain prescribed instances, that the effective date of termination occurred on the actual date of transfer.[311] In situations falling within the scope of these rulings, the acquired Subchapter S corporation's final year's income or loss was still passed through to its shareholders. This further facilitated the premerger distribution of PTI.

Where a Subchapter S corporation acquired another corporation in a reorganization and retained its status as a tax option corporation, UTI was still allocable to those shareholders owning stock on the last day of its taxable year.[312] Thus, an acquiring Subchapter S corporation could shift a portion of its premerger UTI to the shareholders of the target based on their percentage of stock ownership on the last day of the taxable year. The daily allocation rule significantly limited any similar opportunity to shift losses to the new shareholders. However, losses realized during the acquiring corporation's entire taxable year were still partially allocable to the new shareholders. Where the acquiring corporation forfeited its election as a result of the reorganization, it would be taxed as a regular corporation retroactive to the first day of its taxable year. Again, in such instances, gain or loss of the corporation would not be passed through to the shareholders.

The statutory reforms introduced by SSRA significantly revise the operational rules where an S corporation is involved in a reorganization. First, section 1362(d)(2)(B) provides that a termination is effective on the date of the terminating event, thus avoiding corporate and/or shareholder level hardships which may be suffered from a retroactive termination. Second, section 1366(a) requires that all tax items of an S corporation be allocated to its shareholders on a daily basis. Thus, there can be no dumping of UTI on shareholders of the acquired corporation for mid-year reorganizations. The allocation of tax items is based on daily stock ownership during the acquiring S corporation's entire taxable year. Even where its election terminates as a result of the acquisition, its S termination year is comprised of an S short year up through the day prior to the effective date of the reorganization (pass-through rules apply) and a C short

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310. Distributions of the preceding year's UTI made within the first two and one-half months of the tax year could still qualify under I.R.C. § 1375(f) (repealed 1982).

311. *See, e.g.,* Rev. Rul. 80-169, 1980-1 C.B. 188 (B reorganization-consolidated return); *id.* 64-94, 1964-1 C.B. 137 (merger); *see also* I.R.C. § 381(b)(1) (1982) (taxable year of acquired or transferor corporation closes on date of transfer).

312. *See* I.R.C. § 381(b)(1) (1982) (only operated to close the taxable year of the transferor corporation).

year beginning on the succeeding day and ending on the last day of its taxable year.[313] Under this rule, premerger income, loss, or credits can still be allocated to shareholders of the acquired corporation. There are certain instances, however, in which the allocation of tax items is made as of the date of the reorganization so that only postmerger events are allocable to shareholders of the acquired corporation. This will occur where the shareholders of the acquired corporation receive 50 percent or more of the stock of the acquiring S corporation.[314] Even if there is no 50 percent or more change in stock ownership, the shareholders (and the corporation) may elect a hypothetical closing if the acquiring corporation has its election terminated.[315] A third situation in which a hypothetical closing may occur is where a shareholder terminates his interest in the acquiring corporation as a result of the reorganization.[316]

Where both a termination and hypothetical closing of the acquiring S corporation's tax items occur in a reorganization, it is unclear whether its shareholders must report the results of the S short year for their taxable year in which the S short year ends or in which the S termination year ends. Congress's use of a delayed reporting date for the S short year (same date as the C short year) suggests that no acceleration of the reporting of the corporation's tax items for its S short year is required.[317] However, where an S corporation is acquired in a reorganization and its taxable year closed by operation of section 381(b)(1) (other than a Type F), it appears its shareholders will be required to accelerate the reporting of the acquired corporation's tax items for its final taxable year.

E. *Recapture of Investment Tax Credits (ITC) After a Reorganization*

The investment tax credits (ITC) previously claimed by shareholders of an S corporation may be recaptured as a result of a reorganization by application of the regulations under section 47 governing sales or exchanges of stock by shareholders in an S corporation which have the effect of reducing stockholder's interest by more than one-third from his percentage of stock ownership in the year the corporation purchased section 38 property.[318] Thus, recapture of prior

313. *Id.* § 1362(e)(1) (1982); I.R.C. § 1362(c)(2) (West 1985). It is possible, however, to avoid an S termination year if a revocation is made within two and one-half months of the beginning of the taxable year. *Id.* 1362(d)(1)(C).

314. *Id.* § 1362(e)(6)(D) (West 1985). The same rule also applies to § 338 acquisitions. *Id.* § 1362(e)(6)(C) (West 1985). Furthermore, a greater than 50 percent change in ownership may have other important consequences. *See* I.R.C. § 1378(c) (West 1985); Subchapter S Revision Act of 1982, § 6(c)(1), (d)(2)(C); I.R.C. 1361 (1982).

315. I.R.C. § 1362(e)(3) (1982). Consents must be given by all shareholders owning stock at any time during the S short year and all shareholders owning stock on the first day of the C short year.

316. *See id.* § 1377(a)(2). It should be noted that the hypothetical closing for a termination will occur on the date prior to the termination event whereas the hypothetical closing for a termination of a shareholder's interest is made on the date of transfer.

317. *Id.* § 1362(e)(6)(B) (1982); *see* J. Eustice & J. Kuntz, *supra* note 13, at ¶ 5.08[1].

318. Treas. Reg. § 1.47-4(a) (1967); 1.48-5(a)(3), T.D. 7203, 1972-2 C.B. 12. There are two tiers of a reduction in stock ownership which trigger recapture; first when stock ownership (before

S year's ITC may be imposed with respect to shareholders in an S corporation that is acquired or acquires another corporation in a reorganization.[319]

There is no shareholder level recapture rule where investment credits were claimed for years in which the corporation was not an electing corporation under Subchapter S. In such a case, liability for recapture remains at the corporate level. Generally, a transfer of section 38 property by a corporation in a reorganization will not trigger ITC recapture to the corporation. Prior to SSRA, an election by a regular corporation was treated as a disposition under section 47 unless the corporation and its shareholders agreed to be personally liable for future recapture.[320] For taxable years beginning after 1982, however, new section 1371(d)(2) dispenses with the special election provision and imposes continued liability for the corporation for an early disposition of ITC property purchased and placed in service during a nonelecting year.

F. *Transfer of Tax History and Carryovers of Loss, Credits, etc.*

For reorganizations described in section 381(a)(2), the acquiring corporation will inherit the tax history of the acquired corporation, including its earnings and profits, net operating losses, and ITC carryovers.[321] A pickup of the acquired corporation's earnings and profits will be of concern to an acquiring S corporation that has passive investment income (i.e., a potential postmerger sting tax under section 1375) or any acquiring S corporation when evaluating the characterization of postmerger distributions made with respect to its stock.[322] Where an S corporation acquires a C corporation with net operating loss or investment credit carryovers, these tax attributes may not be used by the acquiring corporation until its election terminates, provided the applicable carryover period has not previously expired.[323] In this regard, section 1371(c)(3)

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and after) is reduced by one third or more, and second, when a two-thirds reduction occurs. The amount of recapture is based on the actual percentage decrease in stock ownership.

319. For specific application of the recapture rules to shareholders and S corporations involved in a reorganizing, see J. Eustice & J. Kuntz, *supra* note 13, at ¶ 12.02[5] (Type A), *id.* ¶ 12.03[5] (Type B); *id.* ¶ 12.04[5] (Type C); *id.* ¶ 12.10[6] (Type D); *see also* I.R.C. § 47(d) (West 1985) (ITC recapture triggered by an increase in nonqualified nonrecourse financing).

320. Treas. Reg. § 1.47-2(b)(1), T.D. 7203, 1972-2 C.B. 12; *see* Tri-City Dr. Pepper Bottling Co. v. Commissioner, 61 T.C. 508 (1974).

321. I.R.C. § 381(c) (1982); *see id.* § 137(c)(2) (adjustments to earnings and profits for reorganizations and divisions); *id.* § 312(h)(2); *see also id.* § 382(b) (reductions in NOL carryovers due to changes in stock ownership as a result of reorganizations and divisions); Tax Reform Act of 1984 § 62(a), I.R.C. § 382-83 (West 1984) (extending the effective dates of the revised § 382 provisions until 1986). Where consolidated reporting follows the acquisition, see Treas. Reg. §§ 1.1502-21(c), (e), 1.1502-3(c), 1.1502-22(c), 1.1502-1(f),(g). *See generally* B. Bittker & J. Eustice, *supra* note 150, chs. 15, 16; J. Eustice & J. Kuntz, *supra* note 13, at ¶ 12.02[6] (Type A); *id.* ¶ 12.03[6] (Type B); *id.* ¶ 12.04 (Type C); *id.* ¶ 12.10[5] (Type D). I.R.C. § 47(b)(2) provides that no recapture will result to the transferor in a transfer described in § 381(a). I.R.C. § 47(b)(2) (1982).

322. *See supra* note 122 and accompanying text.

323. *See* I.R.C. §§ 1362(d), 1371(b)(1) (1982); IRS §§ 1375, 1368(c)(2) (West 1985); Treas. Reg. § 1.381(c)(23)-1(h), T.D. 7982, 1984-2 C.B. 9.

requires that each S year must still be counted for carryover purposes. Where the acquiring corporation's S election terminates as a result of the acquisition, it may immediately benefit from the acquired corporation's carryovers. In addition to inheriting section 381(c) items, it should be noted that the transfer of assets from the acquired corporation to an S corporation (e.g., Type A merger) may possibly result in corporate-level capital gains and/or preference taxes if such assets are sold shortly after the merger.[324]

Where an S corporation is acquired in a reorganization, it generally will not have any net operating losses or tax credits that may be carried over to the acquiring corporation. Such items generally will have already passed through to the shareholders for reporting on their individual returns.[325] However, an S corporation may have carryovers from years in which it was not an electing corporation or which were previously acquired from another corporation in a reorganization. In similar fashion, an S corporation may not have earnings and profits, especially if it has always been an (post-SSRA) electing corporation.[326]

One important question which was not specifically addressed in SSRA was whether an S corporation's AAA can be acquired by another S (or even C) corporation under section 381. Indeed, there seems to be no policy reason why an AAA should not be classified as a tax item in section 381(c), especially where the reorganization involves two (or more) S corporations. Until an AAA is specifically listed in section 381(c) it appears that the account may not be inherited by the acquiring corporation.

Assuming the non-portability of AAAs, it will be important to consider making preacquisition distributions by an acquired S corporation.[327] On the other hand, it appears as if shareholders receiving stock from an S corporation in an acquisition may receive postmerger distributions from the acquiring corporation's AAA even where the election is terminated as a result of the transaction.[328] Where a corporation has a significant AAA, it may be desirable for it to serve as the acquiring corporation in a reorganization.

Where an S shareholder with excess losses from the pass through of prior years' operations exchanges his stock for shares in another S corporation pursuant to a reorganization, it is unclear whether such shareholder may continue to maintain his suspended loss with respect to the acquired stock. Where the acquiring corporation is a C corporation, or the acquiring corporation's prior

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324. *See* I.R.C. §§ 1374(c)(3), 58(d) (1982); *id.* §§ 56, 291, 1363(b)(4) (West 1985). The same result could apply to a C corporation that files an S election after acquiring another corporation in a reorganization. *See* J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶¶ 7.04[23], 7.05[3][c].

325. I.R.C. § 1371(b)(1) (1982). Prior to SSRA, former § 1373(d) foreclosed a Subchapter S corporation from claiming a net operating loss deduction. *See* I.R.C. § 1373(d) (repealed 1982).

326. I.R.C. § 1371(c)(1) (West 1985). *But see* S. REP. No. 1622, 83d Cong., 2d Sess. 227, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621-784.

327. Such early countdown manuevering could be upset if the acquiring corporation funds the distribution of an AAA.

328. I.R.C. § 1368(a) refers to distributions made by the corporation with respect to its stock. *See* I.R.C. § 1368(e)(1) (1982) (permitting the distribution of money from the corporation's AAA during a posttermination transition period).

S election is terminated as a result of the acquisition, such shareholder of the acquired S corporation) should still be allowed to deduct the suspended loss in the succeeding (posttermination transition period) year under section 1366(d)(3)(A).[329]

G. *Distributions of Property Pursuant to the Reorganization*

Generally, no gain or loss is recognized by shareholders in a reorganization who exchange stock or securities in one corporation solely for stock or securities in another corporation.[330] If boot, including the fair market value of excess securities described in section 356(d)(2)(B), is also received, gain is recognized but only to the extent of such boot.[331] If the boot received in the exchange has the effect of a dividend, gain will be characterized as ordinary income under section 356(a)(2) to the extent attributable to the recipient's share of accumulated earnings and profits of the transferor corporation.[332] The balance, if any, will generally constitute (capital) gain from the sale or exchange of stock or securities. These rules apply to boot distributions in reorganizations and transfers decided in section 355 (i.e., spin-offs and split-ups). However, if boot is received in a straight section 355 distribution (spin-off), it is automatically treated as a dividend under section 301.

In integrating Subchapter C with Subchapter S corporations prior to SSRA, there were unanswered questions regarding the interrelationship between the

329. A technical interpretation of I.R.C. § 1366(d)(3)(A) could block this result since the loss was not incurred by the acquiring corporation nor is the stock held by the shareholder at the time the *loss* is allowed the stock of the acquired corporation. Prior to SSRA, a shareholder's allocable portion of each year's net operating losses in excess of stock and debt basis was permanently lost. Treas. Reg. § 1.1375-1(b)(4)(i), T.D. 7728, 1980-2 C.B. 236. However, SSRA provided that excess loses may be indefinitely carried over in adopting the partnership model under § 704(d).

330. I.R.C. § 354(a)(1) (1982). *But see id.* § 354(a)(2) (a well-recognized exception providing that the excess amount of principal for securities received over securities surrendered (or the entire amount if no securities are surrendered) may result in gain recognition). The issuance of securities by a corporation in a reorganization may create market discount where the recipient's basis in the obligation is less than the face amount of the instrument. Moreover, where market discount bonds are exchanged in a reorganization, a realization of the market discount income may be avoided. *See id.* § 1276(c)(2), (d)(1)(B). As to the rules under I.R.C. §§ 354-356 in general, see B. BITTKER & J. EUSTICE, *supra* note 150, ¶¶ 14.34, 13.10, 13.12.

331. I.R.C. § 356(a) & (b) (1982). Losses are not recognized. *Id.* § 356(c); *see also id.* § 356(e).

332. However, several battles have been fought on the relevance of the transferee corporation's earnings and profits. *See, e.g.*, Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966) (earnings of both the acquired and acquiring corporations); American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970) (acquired only). Furthermore, the Service has since retreated from its prior stance that the automatic dividend standard in I.R.C. § 356(b) also applied to § 356(a)(2). Rev. Rul. 74-515, 1974-2 C.B. 118; *id.* 74-516, 1974-2 C.B. 121; *see* Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978) (stock of acquired corporation); Wright v. United States, 482 F.2d 600 (8th Cir. 1973) (dividend equivalence tested by reference to stock of the acquiring corporation); Rev. Rul. 75-83, 1975-1 C.B. 112. For possible legislative changes in this area, see STAFF OF SENATE FINANCE COMM., 99TH CONG., 1ST SESS., FINAL REPORT ON SUBCHAPTER C — THE SUBCHAPTER C REVISION ACT OF 1985; Milner, *Boot Under the Senate Finance Committee's Reorganization Proposal: A Step in the Wright Direction*, 62 TAXES 507 (1984).

distribution rules in section 356 and the special rules for distributing PTI and UTI under sections 1375(d) and 1375(f). For example, it was presumed that section 356(a)(2) overrode direct application of section 1375 for distributions of cash. Moreover, because of the presence of an "exchange," it was likely that neither PTI nor UTI could be recovered even in a dividend equivalent distribution.[333] Furthermore, it was unclear whether the presence of undistributed earnings previously taxed to the shareholders could be used as a factor in support of nondividend equivalence.[334]

As for section 356(b) distributions, it appeared that the lack of an "exchange" in a spin-off transaction made it possible to reduce UTI or distribute PTI by a distribution of cash in override of section 301(c)(1). Distributions of boot by the corporation-transferor were generally afforded nonrecognition treatment under section 361(b)(1)(A) in a reorganization, and by section 311(a) or 336 for section 355 transactions.[335]

After SSRA, the proper integration of the boot distribution rules under section 356(a)(2) to S corporations is still unresolved, including application of section 1379(c), which permits the post-SSRA recovery of PTI. In addressing this problem area, it initially appears that the new distribution rules in section 1368 will not totally preempt section 356(a)(2).[336] However, SSRA added the corporate-level account of AAA in order for an S corporation to distribute its aggregate taxable income for its post-SSRA history without triggering dividend status at the shareholder level. Thus, in balancing the policy considerations behind the nondividend distribution of AAA under section 1368(c)(1) with the dividend equivalence rule in section 356(a)(2) arguably an S corporation which distributes boot in a reorganization to its shareholders should be permitted to distribute its AAAs in advance of earnings and profits. However, by the same analysis used in examining PTI and UTI under section 356(a)(2) prior to SSRA, since the "exchange" in section 356 is not described in section 301(c), a literal interpretation leads to the conclusion that section 1368 is still inapplicable to section 356(a)(2). Again, as speculated under prior law, it is uncertain what weight should be given to the presence of AAA (and PTI) in applying the dividend equivalence test in section 356(a)(2).[337]

For automatic dividend distributions under section 356(b), section 1368(c)(1) appears to partially preempt section 301(c)(1) as section 355(a)(1)(A)(i) uses similar language to that used in section 1368(a).[338]

For distributions of boot by an S corporation-transferor, section 1363(d) appears to override section 361(b) with respect to distributions of property other

333. *See* Treas. Reg. § 1.1373-1(d), (g), ex. 5, T.D. 7564, 1978-2 C.B. 19; *id.* § 1.1375-4(b), T.D. 6960, 1968-2 C.B. 342; Rev. Rul. 71-266, 1971-1 C.B. 252.

334. *See* J. EUSTICE & J. KUNTZ, *supra* note 13, at ¶ 12.

335. *See* I.R.C. § 311(d)(2)(B) (West 1985); I.R.C. § 311(e)(2) (1982).

336. *See* I.R.C. § 1371(a)(1), (c)(2) (1982).

337. *See id.* § 1371(a)(1); *supra* note 122 and accompanying text.

338. It still may be necessary to consider the acquiring corporation's earnings and profits.

than stock or securities of a party to the reorganization.[339] However, where the acquired S corporation completely liquidates as part of the reorganization (e.g., Type C) section 1363(e)(1) should prevent gain recognition.

Where an S corporation acquires a C corporation in a transaction described in section 381(a)(2) it will inherit the acquired corporation's earnings and profits account.[340] This will not only impact on the characterization of postacquisition distributions at the shareholder level, but may also result in a sting tax under section 1375 or possible termination under section 1362(d)(3) where passive income is also present. As previously discussed, it is uncertain whether an acquired S corporation will transfer its AAA to an acquiring corporation (i.e., merger of two S corporations) since the AAA is not specifically listed in section 381(c). Finally, it is important to recognize that posttermination transition period distributions under section 1371(e) may only be made by a corporation that was an S corporation.[341] In the context of a reorganization, a posttermination transition period will arise where the acquiring corporation loses its election as a result of the transaction. Thus, in situations where it is possible to make section 1371(e) distributions it will be critical that the S corporation be the acquiring corporation. Presumably, section 1371(e) distributions may be made to shareholders of the acquired corporation. Where an S corporation with AAA is acquired in a reorganization, premerger distributions from its account may be advisable provided such distributions are not funded by the acquiring corporation.

VII. Section 385: The Importance of Distinguishing Debt from Equity Interests in an S Corporation

Whether a purported debt instrument constitutes an equity interest (i.e., capital contribution, preferred stock, or common stock) in a corporation has frequently been litigated in the courts with varying and, at times, irreconcilable results. There are a variety of contexts in which this problem may arise. For example, a corporation's payment of interest is deductible from gross income while a dividend is nondeductible.[342] Moreover, an interest holder's receipt of the principal of an indebtedness generally results in a tax-free return of capital, whereas distributions made with respect to an equity interest result in ordinary income to the extent of the distributing corporation's earnings and profits. In

339. *See* I.R.C. § 1368(e)(2) (1982) (distribution of qualifying stocks and securities not subject to § 1363(d)).

340. *Id.* § 381(c)(2); *see also id.* § 1371(c)(2). *But see id.* § 312(h) (requiring proper allocation of earnings and profits for Type C and Type D reorganizations and distributions or exchanges described in § 355). *See also id.* § 1371(c)(2).

341. This rule similarly applied to distributions of UTI under former § 1375(f). However, for PTI, the distribution corporation had to be an electing corporation under Subchapter S. *See.* I.R.C. § 1375(d) (repealed 1984); I.R.C. § 1379(c) (1982).

342. In certain instances dividend status may be more desirable. *See, e.g.,* I.R.C. §§ 163(d)(3)(B)(i), 243 (West 1985).

many instances the stakes become quite high since judicial resolution of this issue has historically been an all-or-nothing proposition.[343]

In response to the lack of workable tests or guidelines emanating from case law for distinguishing corporate debt from equity, in 1969 Congress enacted section 385 and delegated to the Treasury the authority to write regulations determining whether an interest in a corporation constitutes debt or equity for federal income tax purposes. A partial list of factors taken from case law which Congress desired to be used in the regulations is set forth in section 385(b).[344] After eleven years, proposed regulations and final regulations were ultimately issued and subsequently withdrawn.[345] Thus, in the absence of regulations, evaluation of the debt-equity question continues to depend on a review of all the facts and circumstances, including the intent of the parties.

One aspect of the debt-versus-equity question that has been particularly important under Subchapter S is whether debt recharacterized as equity constitutes a prohibited second class of stock. Prior to SSRA, the regulations under Subchapter S pursuant to which recharacterized debt could be treated as a second class of stock were invalidated by the courts.[346]

Since the Treasury's regulation project under section 385 was in full swing when Congress considered the SSRA legislation, the Treasury insisted that section 385 principles should govern in determining whether a purported debt instrument constituted a second class of stock. The Treasury wanted to prevent the issuance of a hybrid debt instrument to an otherwise ineligible shareholder (e.g., a nonresident alien or a corporation), and the issuance of debt where the allocation of taxable income or loss (only to shareholders) was inconsistent with the actual allocation of economic income or loss among all investors (both lenders and stockholders).[347]

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343. *See generally* B. BITTKER & J. EUSTICE, *supra* note 150, ch. 4.

344. This list includes:

> (a) [W]hether the promise to pay was unconditional and payable on a specific date or on demand with provision for a fixed rate of interest; (b) whether the interest was subordinated or preferred over other indebtedness of the corporation; (c) the corporation's debt-equity ratio; (d) whether the interest was convertible into stock of the issuing corporation; and (e) the proportionality between the parties holding the particular interest in question and the holders of the stock in the corporation.

345. *See* T.D. 7920 (Nov. 2, 1983); *see also* Bloom & Bush, *New Reproposed Regs. on Section 385 Compared to the Prior Regs*, 56 J. TAX'N 153 (1982); Manning, *Hyper Lexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9 (1982).

346. First, Treas. Reg. § 1.1371-1(g) initially provided that recharacterized debt constituted a second class of stock. *See* Treas. Reg. § 1.1371-1(g) (1960) (now Treas. Reg. § 1.1371-1(g), T.D. 7920, 1983-2 C.B. 69). This regulation was invalidated by the Tax Court in Gamman v. Commissioner, 46 T.C. 1 (1966), where two shareholders made pro rata advances to their tax-option corporation. After this defeat, the regulation was amended so that only disproportionate debt, especially in situations where the corporation was thinly capitalized, would result in a termination. *See* T.D. 6904, 1967-1 C.B. 219. After judicial review, the revised regulation was again invalidated. *See* Portage Plastics Co. v. United States, 468 F.2d 632 (7th Cir. 1973); Amory Cotton Oil v. United States, 468 F.2d 1046 (5th Cir. 1972); Stinnett v. Commissioner, 54 T.C. 221 (1970).

347. *But see* I.R.C. § 1366(e) (1982) (permitting the Service to reallocate income between members of the family group to accurately reflect the value of services or capital provided to the corporation), *see also id.* § 482.

As a compromise between the Treasury's position and the private sector's view — which strenuously objected to the use of section 385 to terminate or foreclose an S election — Congress carved out a statutory safe harbor for S corporations issuing "straight debt instruments" defined under section 1361(c)(5).[348] Although straight debt will not result in a second class of stock, it presumably may constitute an equity interest for other purposes.[349] However, the legislative history provides that no corporate income or loss will be allocated among holders of straight debt and that payments on such instruments will be includable in the income of the holder and deductible by the corporation.[350]

As to nonstraight debt (or straight debt which subsequently falls outside of section 1361(c)(5)), the Committee Reports endorsed the current status of case law in determining whether recharacterized debt will trigger a termination.[351] Although the case law in this area has been liberal in upholding eligibility of S status, there may be instances where a purported debt instrument will go too far.[352]

Beyond the eligibility area, where purported debt, including straight debt, constitutes equity will greatly impact on S corporations and their shareholders. For example, the Service may treat the repayment of straight debt as a distribution made with respect to stock where the instrument constitutes an equity interest,[353] in which case the distribution may be eligible to carry out AAA.[354] Another example concerns whether recharacterized debt distributed to shareholders in exchange for common stock constitutes a Type E reorganization.

348. A straight debt instrument may be defined as a written unconditional promise to pay on demand or on a specific date, a specific sum of money provided that the interest rate and interest payment dates are not contingent on profits, the borrower's discretion or similar factors, the debt is not convertible into stock and the creditor would otherwise be an eligible shareholder. *See* J. Eustice & J. Kuntz, *supra* note 13, at ¶ 3.07[3][b].

349. I.R.C. § 1361(c)(5)(C) (1982). In acknowledging that straight debt may constitute equity under general tax principles, the Committee Reports to SSRA requested that the Treasury issue regulations with suspect to the treatment of straight debt for noneligibility purposes under Subchapter S and other provisions of the Code. In particular, Congress was concerned that opportunities for tax avoidance in this area be minimized while avoiding any unfair or harsh results to the holder of the debt instrument. S. Rep. No. 640, *supra* note 27, at 8.

350. S. Rep. No. 640, *supra* note 27, at 8. The Committee Reports provided that interest payments on straight debt may require examination where treatment as interest would give a taxpayer an "unwarranted" tax advantage. As to preexisting straight debt obligations that actually constitute equity of a C corporation with earnings and profits, the legislative history provides that the corporation's election will not be treated as an exchange of debt for stock but a subsequent repayment of principal may constitute a redemption under § 302.

351. After withdrawing its 1966 regulation in 1980 while the regulations to § 385 were being considered, the Service reissued Treas. Reg. § 1.1371-1(g) in 1983.

352. This may arise where the payment of interest is contingent upon or participates in earnings, the instrument is convertible into stock, or the holder of the debt instrument has limited voting rights.

353. However, the Committee Reports seem to provide that any payment of "interest" made with respect to a straight debt instrument will be treated as ordinary income to the recipient and deductible to the corporation regardless of whether it would otherwise be considered an equity interest.

354. I.R.C. § 1368(a) (1982); I.R.C. § 1368(c)(1) (West 1985); *see* Shaw & August, *Distributions*, *supra* note 16, at 302.

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Furthermore, it will still be important to not only distinguish debt from equity but also debt from a security (e.g., sections 351 and 354).

VIII. Transfers of Partnership Interests by an S Corporation Under Section 386

Section 386, which was added to the Internal Revenue Code by the Tax Reform Act of 1984, provides that where a corporation distributes a partnership (or trust) interest in an operating or liquidating distribution or sells or exchanges a partnership (or trust) interest under section 337, it will recognize gain to the extent of its proportionate share of the partnership's (or trust's) "recognition property."[355] Recognition property includes assets of the partnership (or trust) which, if directly distributed or sold by the corporation, would result in gain recognition.

Although it would appear that there is no inconsistency with respect to treating an S corporation as a pass-through entity and applying section 386 to an S corporation, certain important questions have surfaced. First, presumably section 1363(d) will be the operative provision for testing for gain from recognition property under section 386(a) where an operating distribution of a partnership interest is made by an S corporation. Thus, any potential relief afforded to regular corporations under section 311(d) will be unavailable to S corporations.[356] A second problem under section 386 is its potential impact on the passive investment income rules under sections 1362(d) and 1375.[357] In this regard, the Service has ruled that gain realized from the distribution of a limited partnership interest constituted passive investment income without regard to the recharacterization-of-gain provision in section 751(a).[358] Assuming that gain from the sale of a partnership interest (general or limited) constitutes passive investment income,[359] section 386 gain recognized by an S corporation may also be subject to a 46 percent corporate-level sting tax which, net after shareholder level tax on the balance of the gain, could result in an aggregate tax of 73 percent.[360] Thus, for an S corporation potentially subject to section 1375, a

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355. Although the Committee Reports stated that new § 386 was not intended to influence prior transactions, the Claims Court in Holiday Village Shopping Center v. United States, 5 Ct. Cl. 566 (1984), *aff'd*, 773 F.2d 276 (Fed. Cir. 1985), held that application of the recapture provisions under § 1250 was required in testing for recapture of depreciation for a corporation's distribution of its 99% limited partner interest in a complete liquidation. The court rejected the taxpayer's argument that recapture did not apply to a nonsale or exchange under § 741 based on an entity approach was held to be controlling. *See also* Tennyson, Jr. v. United States, 76-1 U.S. Tax Cas. (CCH) ¶ 9264 (D. Ark. 1976) (aggregate theory applied to gift of partnership interest aggregate theory upheld under § 267).

356. *See supra* note 122 and accompanying text.

357. Ltr. Rul. 7922083 (March 1, 1979) (general and limited partnership interest constitutes an interest or participation in a profit-sharing agreement for purposes of Treas. Reg. § 1.1372-4(b)(5)(x)), T.D. 7414, 1976-1 C.B. 266.

358. *See* I.R.C. § 1372(e)(5)(C) (1976) (current version at I.R.C. § 1362(d)(3)(D) (West 1985).

359. An operating distribution of a partnership interest by an S corporation may also trigger a capital gains tax under § 1374. In this instance, application of § 751(a) should be required.

360. One question that arises under § 386(b), for sales of partnership interest under § 337,

termination of its election prior to making the liquidating sale or distribution may reduce its (and its shareholders) maximum exposure under section 386 (and section 331) to 56.8 percent. On the other hand, where a corporate level tax under section 1375 (or section 1374) is not relevant, the maximum shareholder tax for gain recognized under section 386 for an operating or liquidating distribution from an S corporation is currently 50 percent, whereas the maximum aggregate corporate and shareholder level taxes for a regular corporation will be 73 percent for a operating distribution and 56.8 percent for a liquidating distribution.

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is whether the inventory of the partnership will be treated as a separate pool of inventory for purposes of § 337, and, furthermore, whether the corporate seller is entitled to use § 337(b)(2) in avoiding characterization of its underlying interest in the partnership's inventory as recognition property under § 386(c)(2).