# Chapter 9: Entity



Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

This chapter is designed to further a reader's understanding of certain tax aspects of closely-held corporations. It is not intended to be a complete exposition on any subject. The following four topics related to corporations and shareholders are covered:

1. Converting a C corporation to an S corporation
2. Using debt and equity instruments in a corporation's capital structure
3. Stock sales, asset sales and the IRC §338 election
4. Distributing land (and other valuable property) out of a corporation and into the hands of the shareholders

The text and examples in this section are for instructional purposes only and are not intended to substitute for the analysis and research of actual tax situations.

**Note.** Some of the material in this chapter is adapted from the *Corporation Taxation Guide*, 2006 Edition, published by CCH, Inc., and authored by Robert W. Jamison. It is used with the permission of the publisher and the author.

## CONVERTING A C CORPORATION TO AN S CORPORATION

A business that wants to avoid the federal tax complications of a C corporation has two tax entity options: an S corporation or a partnership. Two primary motives for electing S corporation status are:

1. To eliminate double taxation on corporate distributions to shareholders, and
2. To allow shareholders to deduct corporate losses on their personal tax returns.

The first motive benefits highly profitable corporations, since a C corporation may face excessive compensation problems or accumulated earnings difficulties. The second motive benefits start-up corporations or businesses in transition.

A **partnership** may be a superior choice over an S corporation in terms of flexibility of allocations and the ability to transfer property between an entity and its owners. However, according to IRS Statistics of Income, the S corporation is the single most popular business entity and the number of S corporation filings continues to grow. A limited liability company (LLC) may be treated as a partnership and file Form 1065, *U.S. Return of Partnership Income*.

Transitioning from one business form to another may create serious tax problems. While going from a partnership to a corporation is often quite easy and inexpensive, the tax consequences of converting a corporation to a noncorporate entity may be expensive when there are appreciated properties in the entity.

The conversion of a corporation to an LLC with partnership or disregarded-entity status is treated as a liquidation, producing generally undesirable tax results. However, a change in business form from C corporation to an S corporation, while keeping corporate tax classification, is usually tax free. Converting a **C corporation to S corporation** status is a preferable option, although there are some eligibility hurdles.

## ELIGIBILITY FOR S CORPORATION STATUS

To become an S corporation, a corporation must not be an **ineligible corporation**, which the law defines as an insurance company (not an agency), a bank using the reserve method for bad debts, a corporation using the Puerto Rico tax credit of IRC §936, a domestic international sales corporation (DISC), or a former DISC. A bank may change to the direct charge-off method of accounting and obtain S status if it meets the other qualifications, but the others may not be S corporations under any circumstances.

**Eligible corporations** must meet the following qualifications:

- The corporation must be a **domestic** corporation.
- The **shareholders** must meet the eligibility requirements, both in number and classification.
- The corporation must have only **one class of stock** outstanding at all times while the S election is in effect.

Most closely-held corporations will have little trouble in complying with the eligibility rules for S corporation status, but others may find the rules problematic or even prohibitive. Each of these requirements is briefly discussed below.

### Domestic Corporation

An S corporation must be organized under the laws of the United States, a state, or a territory.[1] The corporation may have U.S. or international business operations, or both. It may even own foreign subsidiaries. However, the corporation must be chartered in a U.S. jurisdiction.

The term **corporation** must comply with the definition used under federal income tax law. Thus, an unincorporated entity, such as an LLC or a partnership that elects to be taxed as a corporation under IRC §7701(a)(3), may be eligible to make an S election.[2] The election to be a corporation for tax purposes may apply to any unincorporated entity, and is not restricted to LLCs. Accordingly, the IRS approved an S election for a general partnership that elected association status under Treas. Reg. §301.7701.[3]

### Shareholder Eligibility

Shareholder eligibility is one of the most complicated sets of rules in all of Subchapter S. Although there is a seemingly straightforward numerical limit to the number of shareholders, this limit is deceptive. The shareholder eligibility requirements become extremely complex, especially once a corporation has one or more trusts as shareholders.

1. Treas. Reg. §1.1361-1(c)
2. See Ltr. Rul. 7918056, allowing an Arizona Close Corporation to make an S election, and Ltr. Rul. 8342088, which permitted an S election for a Massachusetts Business Trust. See also Ltr. Ruls. 9016011 and 9701008.
3. Ltr. Rul. 200221035, February 21, 2002

**Maximum Number of Shareholders.** From January 1, 1997 through December 31, 2004, an S corporation could have no more than 75 shareholders. After 2004, an S corporation may have **up to 100 shareholders**.[4] All members of a "family" are considered as a single shareholder for purposes of this limit.[5] A family includes six generations of descendants from a common ancestor, plus those added by adoption or marriage.[6]

The American Jobs Creation Act of 2004 (AJCA) added this rule, and required an election for this attribution to be in effect. However, the Gulf Opportunity Zone Act of 2005 amended the rule so that an election is not necessary. This amendment also provided that the estate of a family member is subject to inclusion in the family group.[7]

**Shareholder Classifications.** The limit on the number of shareholders is rarely a problem, since most S corporations are closely-held. However, the limitation on the type of shareholders can be more troublesome. To be eligible for S corporation status, shareholders must fall into one of the following taxpayer classifications:

- Individual (U.S. citizen or resident only)
- Estate
- Trust (subject to complicated restrictions)
- Charitable organization
- Pension trust
- Employee stock option plan (ESOP)

**Individuals.** Any U.S. citizen or resident may qualify as a shareholder, regardless of his place of residence. However, the prohibition against foreign ownership extends to the spouse of a U.S. citizen or resident, where the laws of either the U.S. or foreign jurisdiction confer ownership rights upon the nonresident alien spouse.[8]

> **Note.** The law continues to prohibit persons who are neither U.S. citizens nor U.S. residents from holding stock in S corporations. When foreign investment is important, the parties should consider using a C corporation or an LLC with partnership tax status.



**Estates.** No special elections or restrictions apply to decedents' estates, if the decedent was a permitted shareholder. An estate can have multiple beneficiaries, and the executor or administrator may have flexibility with respect to distributions of S corporation income, and other property. However, a decedent's estate that is unduly prolonged may be treated as a trust,[9] which may cause complications. A bankruptcy estate is also permitted as a shareholder.[10]

**Trusts.** Only certain specified trusts may qualify to be S corporation shareholders. Generally, these are revocable trusts, or those trusts specifically designed to satisfy unique rules in Subchapter S. Some trusts are required to make a separate election to qualify.

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4. American Jobs Creation Act of 2004, §232, amending IRC §1361(b)(1)(A)
5. IRC §1361(c)(1)
6. IRC §1361(c)(1)(B)
7. Gulf Opportunity Zone Act of 2005 (PL 109-135), §403(b)
8. Treas. Reg. § 1.1361-1(g)(1)
9. *Old Virginia Brick Co. v. Commr.*, 44 TC 724 (1965), aff'd 66-2 USTC 9708 (4th. Cir.), August 24, 1965
10. IRC §1361(b)(3)

The following trusts **are qualified:**

- Grantor trusts
- Beneficiary controlled trusts
- Grantor trusts, after the death of the grantor
- Qualified Subchapter S trusts
- Electing small business trusts
- Testamentary trusts
- Voting trusts

There are many pitfalls in the rules governing trusts. If an S election is revoked because a trust fails to qualify as a shareholder, the IRS may grant inadvertent termination relief through a letter ruling.

**Tax-Exempt Organizations, Pension Trusts, and ESOPs.** These entities were added as eligible shareholders in 1998. There are several tricky rules associated with these types of shareholders. These entities, except for ESOPs, must treat any income passing through from the S corporation as unrelated business income.

ESOP rules require that participation must be widely dispersed, so that persons owning 10% or more of the stock, directly and indirectly, must be a participant in the ESOP. Pension trusts do not include individual retirement arrangements.

**Caution.** Tax professionals should seek the advice of an S corporation specialist if they discover that an S corporation has a trust as a shareholder, is planning to transfer stock to a trust, or has tax-exempt organization, pension trust, or ESOP shareholders.

**Note.** The international CPA firm KPMG presently is embroiled in substantial litigation resulting from the promotion of abusive tax shelters. One of the issues involves the transfer of S corporation stock to a charity while the historic owner retained rights to reacquire substantially all of the economic interests. As this edition goes to press, several of the former partners of that firm are facing criminal prosecution, and the firm itself is burdened with pending malpractice suits.

## Class of Stock

An S corporation may have only one class of stock, at least as far as rights to current and liquidating distributions are concerned. This rule applies only to issued and outstanding stock.[11] Thus, treasury stock or authorized but unissued stock may be of any class or classes.

In spite of this seemingly hard and fast rule, an S corporation may issue shares with different voting rights and not be in violation of the single class of stock requirement.[12] This leeway has important implications for family financial planning, and for maintenance of control.

11. Treas. Reg. §1.1361-1(l)(1)

12. IRC §1361(c)(4)

What cannot be waived or sidestepped are the rights of each share to all current and liquidating distributions.[13] Unequal rights will create a second class of stock if they are required by state law, contained in corporate charter or bylaws, or part of any binding shareholder agreement, but only if the agreement has a principal purpose to circumvent the single class of stock requirement.[14] An innocent mistake will not necessarily cause a corporation to lose its S status.

If all shares receive equal distributions on identical dates, a corporation would appear to have a single class of stock. Under the regulations, differences in timing of distributions do not create a second class of stock, although the IRS may apply IRC §7872 to impute interest, or other recharacterization provisions.[15]

**Example 1.** KT Corporation is an S corporation with two equal shareholders, Kelly and Tracy. KT is chartered in a state that requires income tax withholding by an S corporation on nonresident shareholders, but does not require withholding for resident shareholders. The withholding rate is 3% of the income allocated to each. Kelly is a resident of the same state, but Tracy is not.

KT withheld $3,000 on behalf of Tracy in 2006. Since this withholding is a payment of Tracy's potential liability, it is treated as a distribution to Tracy under general tax principles. Since KT does not withhold any of Kelly's share of profits, it should make a compensatory distribution of $3,000 to Kelly, so that the distributions are proportionate to the stock held by each shareholder.

If there is an appreciable lapse of time between the payment on behalf of Tracy and the distribution to Kelly, KT should pay Kelly some interest to reflect the time value of money.

A corporation has a second class of stock only if distributions are pursuant to a binding plan to alter the interests of each share's rights to current and liquidating distributions. One example is a plan to equalize after-tax income of shares.[16] However, a corporation may compute distributions based on varying interests of the shareholder-employees during the current or preceding year.[17]

**Caution.** Although the regulations are tolerant of many situations in which distributions are not distributed at identical times or in identical amounts, a corporation must be aware of state securities' laws that define classes of stock and shareholder rights. Failure to adhere to these laws could result in shareholder litigation.

Some precautions are appropriate if a corporation carries heavy debt to shareholders or has options or warrants outstanding. There has not been any litigation of this rule in many years.

## S CORPORATION ELECTION PROCEDURES

To become an S corporation, a special election must be filed on Form 2553, *Election by a Small Business Corporation (Under Section 1362 of the Internal Revenue Code)*. A corporation must meet all of the eligibility requirements before it can file for election. Corporations should follow election procedures meticulously, although the Code provides some relief for imperfectly filed elections.

A corporation should retain evidence of filing Form 2553, such as a registered mail receipt stapled to a signed copy of the form. The corporation should receive an IRS letter acknowledging and accepting the S election, which also should be retained. An S election remains in effect until it is terminated. It is not required to be renewed.

13. Treas. Reg. §1.1361-1(l)(1)
14. Treas. Reg. §1.1361-1(l)(2)
15. Treas. Reg. §1.1361-1(l)(2)(i)
16. Treas. Reg. §1.1361-1(l)(2)(v), Example 6
17. Treas. Reg. §1.1361-1(l)(2)(iv)

All persons who are shareholders at the time of the election must provide their consent. Before providing consent, shareholders should be aware that the **burden of taxation shifts** from the corporation to the shareholders after the election is approved. This burden and other detrimental tax consequences that might arise must be weighed against any benefits that S corporation status provides.

### Time and Place

Elections must be timely filed. There are two options for determining the proper time for filing an election.[18] A corporation may file during the taxable year immediately prior to the year in which the election takes effect, or the corporation may file within 2 months and 15 days of the beginning of the taxable year for which S status is to take effect.

An election takes effect at the beginning of a corporation's taxable year. The beginning of the taxable year requires some special definitions for a new corporation. The IRS states that the taxable year begins on the earliest date that the corporation issues shares, acquires property or commences business.[19]

There may be a slight problem for an existing corporation converting to S status, if the corporation has been using a fiscal year. S corporations are required to use a calendar year or another permitted year. Therefore, a corporation may need to change its year to comply with subchapter S. Fortunately, the IRS has held that filing Form 2553 with a proper year stated thereon constitutes a change in year end, for which permission is automatic.[20] There are several other considerations for a corporation that wants to use a fiscal year.

Form 2553 must be mechanically correct and signed, under penalties of perjury, by a corporate officer. A paid preparer may not sign the form. The IRS will not accept any statement in lieu of Form 2553. The requirement for filing Form 2553 has been sustained in court.[21] The corporation must file Form 2553 with the IRS service center where it will file Form 1120S, *U.S. Income Tax Return for an S Corporation.*[22]

### Late Elections

The IRS is directed to grant relief for **inadvertently defective or late** S elections. Congress has directed the IRS to apply the same standards to late or defective elections that it applies in granting inadvertent termination relief.[23]

**Defective elections must be inadvertent** in order for the IRS to grant relief. The sole judge of inadvertence is the national office of the IRS. The only way to apply for such relief is to request a private letter ruling. A letter ruling request must be accompanied by a user fee. While it is better to do it right the first time, this provision limits any damage resulting from a failure to make a timely election.

In contrast to the defective election relief rules, **the IRS may accept late elections if there is reasonable cause.** Reasonable cause is a less stringent standard than inadvertence. The IRS has the power to delegate dispositions of late elections to its service centers, or to rule on such requests in the national office. The major distinction between these different avenues is that a request to a regional office does not need to be a ruling request and does not require the payment of any user fee.

**Rev. Proc. 2003-43** extends the time for filing a relief request with the service center (Ogden or Cincinnati) where the corporation files its returns. A corporation that qualifies under this revenue procedure does not need to file a formal ruling request, and is not subject to user fees.

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18. IRC §1362(b)
19. Form 2553 and Treas. Reg. §1.1362-6(a)(2)(ii)(C)
20. Treas. Reg. §1.1378-1
21. *Rockwell Inn, LTD v. Commr.*, 65 TCM 2374, TC Memo 1993-158, April 13, 1993
22. Instructions to Form 2553, page 2 (Rev. March 2005)
23. H.R. Conf. Rep. 104-737, p. 204

The rules in this procedure apply only under the following circumstances:

- If the corporation has not yet filed a return for the first affected year, the election and relief request must be filed by the extended due date for the return.
- If the corporation has filed a return for the year in question, the election and relief request must be filed within two years of the original deadline for filing the return. This rule is likely to be applicable with delinquent trust elections.

Rev. Proc. 2003-43 also applies to certain late trust elections and elections to treat a 100% subsidiary corporation as a disregarded entity under the qualified subchapter S subsidiary rules. An unincorporated organization seeking S corporation federal tax status may file for late election relief under the provisions of Rev. Proc 2004-48.

**Rev. Proc. 97-48** allows an IRS service center to accept elections more than 12 months late if all intended S years are still open at the corporation and shareholder levels. This revenue procedure provides special procedures to obtain relief for certain late S corporation elections in two situations.[24] One is no longer available since it applied to open years before 1997. The other is quite useful, although it only applies in rare circumstances.

If a corporation did not file Form 2553, but filed a timely Form 1120S, its shareholders reported their income consistent with S corporation status for the taxable year, and the corporation did not receive notification from the IRS regarding any problem with the S corporation status within six months of filing the Form 1120S, the corporation files Form 2553 stating it is claiming relief under Rev. Proc. 97-48. The IRS must grant the election.

A late election that does not qualify for relief at the service center level under one of these two revenue procedures requires a ruling from the IRS National Office. Although there is a user fee and the request procedure is detailed, the IRS usually grants the request.

**Caution.** The IRS grants most requests for late S elections. To date, reasonable cause has been almost any cause for failure to file a timely Form 2553. It is always helpful to have some evidence that the client believed that the corporation was an S corporation. Minutes of meetings, correspondence with counsel, etc. are good sources of documentation. One fatal error would be for a client to sign Form 1120 for a year in which the corporation is seeking late election relief. That would be evidence that the client knew the corporation was not an S corporation.



### Consents

As of the date of the S election, all shareholders must consent to the election. They may sign on the face of Form 2553, or attach a separate consent statement.[25] Any other person who is treated as a part-owner or co-owner must also consent. These persons include spouses, if the shares are held in joint tenancy, tenancy in common or community property.[26]

In general, any person who acquires shares after a corporation files an election is not required, or even permitted, to consent to the S election. The courts have ruled that a shareholder must include income from the S corporation on his return, even if the shareholder is unaware that the corporation has S status.[27]

If a corporation files for late election relief, additional consents may be necessary. Whether the corporation requests relief from a service center or the national office, the request must be signed by all persons who hold any stock from the desired effective date of the S election to the date of the request. If any shareholder hostility arises during this period, relief may be difficult, if not impossible, to obtain.

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24. Rev. Proc. 97-48, 1997-43 IRB
25. Treas. Reg. §1.1362-6(b)(3)(i)
26. Treas. Reg. §1.1362-6(b)(2)(i), *Clemens v. Commr.*, TC Memo 1969-235, November 4, 1969
27. *Knott v. Commr.*, TC Memo 1991-352, July 31, 1991

## DISADVANTAGES OF CONVERTING TO AN S CORPORATION

There are few disadvantages to converting a C corporation to S status. When comparing the conversion to a liquidation, which is required to convert a corporation to noncorporate status, the transition from C corporation to S corporation is relatively painless. Some repercussions may result from the transformation, but these consequences usually do not favor continuation of C corporation status.

### Fringe Benefits

One area where a C corporation has a tax advantage over other entities is the exclusion of fringe benefits paid to owners. A shareholder-employee of a C corporation, even one who owns all of the stock, is treated as an employee for fringe benefit purposes. Thus, an owner can exclude the economic benefit of certain fringe benefits paid by the corporation and a C corporation can claim an immediate deduction for the cost of benefits provided.

This double tax advantage does not extend to S corporation shareholders. Although an S corporation may deduct the cost of fringe benefits, the shareholder-employee cannot exclude the value of these benefits from his gross income.[28] Before electing to receive S corporation status, this cost should be evaluated.

A common concern is accident and health insurance, which falls under this inclusion rule. However, a more than 2% shareholder-employee, even though technically not self-employed, is allowed to deduct the cost of this insurance in the same manner as a self-employed proprietor or partner.[29]

Fringe benefits that a more than 2% shareholder **cannot** exclude are:

- Group term life insurance
- Medical reimbursement plan
- Meals and lodging for the convenience of the employer
- Parking and transit subsidies
- Cafeteria plans that include any of the above benefits as an option

A more than 2% shareholder may be able to exclude other fringe benefits provided by the S corporation, such as employer-provided day care.

### Tax-Free Conversion

There is no tax imposed on the conversion of a corporation from C to S status, per se. However, there may be some corporate level taxes imposed on built-in gains and passive investment income. There also may be an immediate tax liability if a corporation uses the LIFO inventory method. A corporation might find the conversion to S status a good time to evaluate its accumulated earnings and profits. Each of these items is briefly discussed below.

**Built-in Gains Tax.** The built-in gains tax is a corporate level tax imposed on certain S corporations. As such, this tax deviates from the general rule that S corporations pay no federal income tax. However, only certain S corporations are subject to the built-in gains tax: S corporations that were formerly C corporations and S corporations that acquire assets from C corporations in tax-free liquidations, mergers or other reorganizations.

28. IRC §1372

29. IRC §162(l)

This tax applies to built-in gains and losses on **dispositions** of certain property within a 10-year period following conversion. The tax is imposed on the corporation's **net recognized built-in gain**, which may require three separate computations. The recognized built-in gain tax rate is the highest corporate rate.[30] The three computations of net recognized built-in gain are:

1. The **pre-limitation amount (PLA),** for which a corporation computes taxable income as if it were a C corporation, and the only income and deductions of the current year were its recognized built-in gains and recognized built-in losses. These are gains and losses which were already in existence while the corporation was a C corporation, but had not yet been recognized until the current year.

2. The **taxable income limitation (TIL),** which requires a corporation to compute its taxable income as if it were a C corporation. For this calculation the corporation includes all of its income and deductions for the current year, just as if it had never elected S status.

3. The **net unrealized built-in gain limitation (NUL).** This limit is the difference between the fair market value and the adjusted basis of a corporation's assets on the first day of the first S corporation year, and is adjusted every year. It sets an overall limit for the taxable built-in gains for the entire 10-year period that the corporation is subject to this tax.

A corporation may reduce or eliminate the built-in gains tax with certain offsets, such as salaries to shareholder-employees. To offset the tax, an S corporation may need to act like a C corporation for 10 years following conversion.

**Observation.** There was considerable discussion of the built-in gains tax in the 1999 *University of Illinois Federal Tax Workbook*, Chapter 9, "S Corporations." Although the material is now several years old, it is still valid for 2006.

**Example 2.** Winco was a C corporation through December 31, 2005. It became an S corporation on January 1, 2006. Winco used the cash method of accounting. Its January 1, 2006 balance sheet reflected the following:

| Description | Adjusted Basis | Fair Market Value |
|---|---|---|
| Assets | | |
| Cash | $ 45,000 | $ 45,000 |
| Accounts receivable | 0 | 500,000 |
| Equipment | 250,000 | 200,000 |
| Investment securities | 360,000 | 400,000 |
| Real estate | 1,500,000 | 1,750,000 |
| Intangible assets | 0 | 105,000 |
| Total assets | $2,155,000 | $3,000,000 |
| Liabilities and shareholders' equity | | |
| Trade accounts payable | 0 | 140,000 |
| Mortgage on real estate | 1,250,000 | 1,250,000 |
| Retained earnings | 405,000 | 1,110,000 |
| Capital stock | 500,000 | 500,000 |
| Total liabilities and equity | $2,155,000 | $3,000,000 |

30. IRC §1374(b)(1)

In 2006, Winco collects all $500,000 of its beginning accounts receivable and pays all $140,000 of its beginning accounts payable. Winco sells its investment securities for $420,000. Winco's prelimitation amount is computed as follows:

| Description | Amount | Recognized Built-In Gain | Tax Character |
|---|---|---|---|
| Accounts receivable | $500,000 | | |
| Accounts payable | (140,000) | | |
| Net accounts | $360,000 | $360,000 | Ordinary |
| Securities sale price | $420,000 | | |
| Less basis | (360,000) | | |
| Less post-conversion appreciation ($400,000 FMV at S election − $420,000 sale value) | (20,000) | | |
| | $ 40,000 | 40,000 | Capital |
| Pre-limitation amount | | $400,000 | |

Winco collects $5,500,000 of fees in 2006. Winco pays $2,000,000 of accounts payable and $3,200,000 of officers' compensation during the year. It has no unusual transactions other than the securities sale described above. Winco's **taxable income limitation** is computed as follows:

| Description | Amount | Net | Tax Character |
|---|---|---|---|
| Fees collected | $5,500,000 | | |
| Trade payables | (2,000,000) | | |
| Officer compensation | (3,200,000) | | |
| | $ 300,000 | $300,000 | Ordinary |
| Sale of Securities | $ 420,000 | | |
| Basis | (360,000) | | |
| | $ 60,000 | 60,000 | Capital |
| Taxable income limitation | | $360,000 | |

Winco also needs to compute its net unrealized built-in gain limitation. For 2006, the first year that Winco is an S corporation, the **net unrealized built-in gain limitation** can be derived from the opening balance sheet.

| | |
|---|---|
| Fair market value of all assets | $3,000,000 |
| Less adjusted basis of all assets | (2,155,000) |
| Subtotal | $ 845,000 |
| Less liabilities that will create deductions when paid | (140,000) |
| Net unrealized built-in gain | $ 705,000 |

Winco uses the least of these three measures, which in this case is the taxable income limitation (TIL) amount, to determine its net recognized built-in gain for the year.

| | | |
|---|---|---|
| Pre-limitation amount (PLA) | $400,000 | |
| Taxable income limitation (TIL) | $360,000 | Net recognized built-in gain |
| Net unrealized built-in gain limitation (NUL) | $705,000 | |

Winco must compute its tax at the highest statutory corporate rate (currently 35%).

| | |
|---|---|
| Net recognized built-in gain | $360,000 |
| Tax rate | × 35% |
| Tax | $126,000 |

At this point, the corporation has determined its built-in gains tax. However, it must now allocate its taxable income to the shareholders. In doing so, the built-in gains tax is treated as a loss, allocable to each type of income that created the tax. In this case, the corporation has ordinary income and capital gain. Accordingly, it **allocates the tax in proportion to the net built-in gain produced by each:**

| Description | Amount | Allocation Percentage | Tax Allocated |
|---|---|---|---|
| Ordinary income | $360,000 | 90% ($360,000 ÷ $400,000) | $113,400 ($126,000 × 90%) |
| Long-term capital gain | 40,000 | 10% ($40,000 ÷ $400,000) | 12,600 ($126,000 × 10%) |
| Total | $400,000 | 100% | $126,000 |

Winco uses this allocation to calculate the amount that flows through to the shareholders.

| Description | Pretax Total | Less Allocated Tax | Flow Through |
|---|---|---|---|
| Ordinary income | $300,000 | ($113,400) | $186,600 |
| Long-term capital gain | 60,000 | (12,600) | 47,400 |
| Net | $360,000 | ($126,000) | $234,000 |

The final flow-through amount of $234,000 is also the year's addition to the corporation's Accumulated Adjustments Account (AAA). The last step in the calculations is to adjust the net unrealized built-in gain limitation for next year. Each year, the corporation reduces this limitation to reflect its net recognized built-in gain. Accordingly, this calculation is:

| | |
|---|---|
| Net unrealized built-in gain beginning of 2006 | $705,000 |
| Net recognized built-in gain 2006 | (360,000) |
| Net unrealized built-in gain limitation for 2007 | $345,000 |

Winco must also determine whether its TIL was the final built-in gain. If this is the case, the corporation must calculate a recognized built-in gain carryforward. This is the difference between the second lowest calculation (PLA or NUL) and the TIL. In this case, the TIL was $40,000 less than the PLA (i.e., the second lowest computation). Winco must carry $40,000 forward. It is treated as part of the PLA for 2007.

**LIFO Recapture.** A LIFO recapture tax is imposed in a corporation's last year as a C corporation, as if the corporation had liquidated its LIFO reserve on the last day of the year.[31] Since this tax is determined by reference to a C corporation's taxable income, it has an entirely different operation from the tax on built-in gains or excess net passive income (discussed below).

The LIFO recapture amount is calculated by determining the difference between the FIFO inventory and the LIFO inventory.[32] A corporation adds the recapture amount to its income for its last C year. The tax is based on the income tax for the final C corporation year, but can be paid in four equal installments. The first payment is due on the due date for the final C corporation return. The other payments are due by the filing deadline for the next three S corporation returns. No interest is applied and estimated tax payments are not required.

31. IRC §1363(d)(1)

32. Ibid

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**Earnings and Profits.** A C corporation may accumulate "earnings and profits," a term that has no clear definition in the code or regulations, although each of these authorities describes pieces of the puzzle. The calculations can become quite complex, and the rules are rather lengthy and detailed. Most corporations never compute earnings and profits.

**Current earnings and profits** approximate net income after tax. The IRS provides Form 5452, *Corporate Report of Nondividend Distributions*, to assist with the calculation. This form includes some of the adjustments, but not all that may be necessary for the calculations.

The principal differences between taxable income and current earnings and profits relate to the measurement of taxable income and the need for a measure of distributable income. Exempt items, such as tax-exempt interest and life insurance proceeds, as well as artificial deductions like the dividends-received deduction, are included in earnings and profits but not in taxable income.

Conversely, nondeductible items, such as the income tax itself, as well as disallowed expenses, like the nondeductible portion of meals and entertainment, reduce earnings and profits. Timing differences, such as carryovers, depreciation, and installment gains, may affect earnings and profits in a year other than that in which they are included in gross income.

An S corporation does not acquire any earnings and profits in the normal course of its business, but a C corporation retains earnings and profits at the time of conversion, posing two possible problems. One deals with distributions from the corporation to the shareholders and the other concerns certain types of passive investment income.

**Distributions.** If a C corporation distributed earnings and profits before converting to an S corporation, the distributions would have been taxable as dividends. These amounts are still taxable as dividends if they are distributed after conversion.

This should not be an obstacle to making an S election, since the conversion does not increase the potential of the corporation to distribute double-taxed earnings. However, it does add complexity to making distributions. Shareholders may be surprised to learn they have taxable dividends when they thought distributions from an S corporation would be tax free.

**Passive Investment Income.** If an S corporation has any retained earnings and profits, it is limited in its ability to generate certain types of passive investment income without facing unpleasant consequences. If an S corporation has earnings and profits at the end of the year and its passive investment income exceeds 25% of its gross receipts, it is subject to income tax. The S corporation is taxed on its excess net passive income at the corporate rate of 35%.[33]

If an S corporation has retained earnings and profits at the end of three consecutive taxable years in which passive investment income exceeds 25% of gross receipts, it loses its S election and reverts to C corporation status at the start of the next (fourth) year. This problem may be eliminated with a careful investment strategy or by distributing earnings and profits to shareholders.

> **Note.** Taxpayers faced with the prospect of paying taxes at the maximum rate for the next several years should consider electing to distribute earnings and profits under IRC §1368(e)(3)(A). Practitioners should be mindful the passive income rule will still eliminate the S corporation election in the fourth year.

With all of the problems a corporation may face when it converts to S status, conventional wisdom implies a new corporation should opt to be an S corporation from inception. However, it is not possible to recast history when planning the most effective tax strategy for an existing corporation. The facts and circumstances of each corporation dictate whether an S election is worth the expense.

33. IRC §1375

**Example 3.** Larry, Sue and Steve want to form a new corporation to manufacture and sell specialized computer equipment. Each plans to transfer appreciated property in exchange for stock.

If their corporation begins its existence as a C corporation, it may face lower taxes, since a C corporation may have up to $100,000 of taxable income taxed at rates lower than the top individual bracket. Moreover, under 2006 law, qualified dividends from a C corporation are taxable to the individual shareholders at a maximum rate of 15%. Thus, C corporation status may be a valid consideration.

However, if their corporation ever disposes of any of the appreciated property, it will be subject to corporate level tax on the resulting gains. If their corporation starts life as a C corporation but converts to S corporation status before selling any valuable property, it will be subject to the built-in gains tax. However, if it is an S corporation from its inception there will be no corporate level tax on the disposition of property.

## DEBT AND EQUITY PROBLEMS OF C AND S CORPORATIONS

The IRS has challenged debt and equity arrangements since the early days of tax law. Most cases are decided on the interpretation of unique facts. However, case law has developed some universal factors to serve as guidelines.

In 1969, Congress enacted IRC §385, a statutory classification rule, to provide support for the IRS. However, this rule has had little impact and case law continues now in much the same manner as it did before 1969.

In addition to being a shareholder, a taxpayer may be involved with a closely-held corporation as an employee, vendor, contractor, landlord, tenant, borrower or lender. Considerable tax savings may result from careful structuring of these relationships. This section focuses on debt and equity considerations for owners of a closely-held corporation.

There may be both tax and nontax reasons underlying shareholder-corporate relationships. However, it is best from both a tax and legal point of view if these arrangements reflect economic reality. This avoids any challenges from fellow shareholders, independent lenders and other interested parties.



Most case law to date has dealt with shareholders who were attempting to structure advances to a corporation as loans rather than capital contributions. There are three principal reasons why a corporation and shareholder may want advances to be treated as loans:

1. Interest paid by a corporation is deductible, whereas dividends are not. Repayment of a loan results in recovery of basis, and perhaps capital gain or loss.
2. A redemption of stock may result in a dividend to the shareholder with no offset for basis. There are several tests for the treatment of stock redemptions, but the basic rule is that if a person is in control of the corporation after the redemption, then all proceeds are treated as dividend income.
3. A shareholder-employee may be advancing funds to a troubled corporation. If the advance is a loan, the shareholder may be able to claim a bad debt deduction in the event the corporation is unable to repay. However, most individuals must treat these losses as short-term capital losses, under the nonbusiness bad debt rule of IRC §165(g).

   A capital contribution will nearly always result in a capital loss, and may be recognized only when the stock becomes worthless. This rule is especially important when a corporation advances money to a related corporation, since corporations, other than S corporations, are allowed unlimited bad debt deductions.

On the other hand, there are some reasons why it might be better to structure advances as equity contributions, rather than as loans. Under current law, dividend income from domestic corporations is taxable at the capital gain rate, whereas interest income is taxable at the full ordinary income tax rate.

A second consideration may be for mere convenience. A debt advance will need to bear interest at the applicable federal rate, or there may be imputation. An equity contribution is not subject to this rule. However, most case law has dealt with situations in which taxpayers were trying to structure a transaction as debt, and the IRS reclassified the transaction as an equity contribution.

### IRC §385

IRC §385 has no operative provisions, per se, but authorizes the IRS to write legislative regulations to define debt and equity. The law suggests that the IRS use the following questions to make the distinction:[34]

- Is there a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest?
- Is there subordination to or preference over any indebtedness of the corporation?
- What is the ratio of debt to equity of the corporation?
- Is the advance convertible to stock in the corporation?
- What is the relationship between holdings of stock in the corporation and holdings of the interest in question?

IRC §385 does not attempt to define debt and equity in the absence of regulations. In the early 1980s, the IRS made several attempts to issue regulations under §385. Each draft of the regulations was met with substantial criticism. On August 5, 1983, the IRS withdrew the §385 regulations. As of 2006, there has been no attempt to introduce any subsequent regulations on the topic.

### Case Law Factors

Although §385 is still occasionally cited, extensive case law provides a better means of distinguishing debt from equity. Several relevant factors have emerged; however, the Supreme Court acknowledges there is no one factor which distinguishes the two.[35] The most important factors emerging from case law follow:[36]

- The names given to the certificates evidencing indebtedness
- The presence or absence of a maturity date
- The source of payments
- The right to enforce the payment of principal and interest
- Participation in management
- A status equal to or inferior to that of regular corporate creditors
- The intent of the parties
- "Thin" or inadequate capitalization
- Identity of interest between creditor and stockholder
- Source of interest payments
- The ability of the corporation to obtain loans from outside lending institutions
- The extent to which the advance was used to acquire capital assets
- The failure of the debtor to repay on the due date or to seek a postponement

34. IRC § 385(b)

35. *John Kelley Co. v. U.S.*, 46-1 USTC 9133 (S Ct.), November 20, 1945

36. *Texas Farm Bureau, v. U.S.*, 84-1 USTC 9247 (5th Cir.), February 21, 1984 provides a clear description and useful list.

The following discussion describes how the court has weighed several of these factors in deciding whether an advance is a loan or an equity investment in a corporation.

**Thin Capitalization.** The absence of any risk capital may lend credence to the reclassification of debt as equity. In some cases, the lack of other equity capital appeared to influence a court's decision that purported debt was in fact equity.[37] In other instances, courts have respected the form of debt, even though the corporation was thinly capitalized.[38]

**Loans in Proportion to Stock.** Loans in proportion to share holdings are more likely to be subject to equity classification than loans which are held in part by shareholders and in part by others. If any portion of a debt is held by persons who are not shareholders, a corporation may be able to use this fact in its defense.[39] In other cases, however, loans in proportion to share holdings have successfully resisted reclassification as equity.[40]

A court may consider a loan by a related party to a shareholder as a loan made by the shareholder for the proportionality test. Courts, however, do not always agree to this treatment. Especially when the parties are independent adults, the courts tend not to force attribution of ownership.[41]

**Lender's Business Purpose.** If the loan is related to the lender's business, rather than a mere investment in the borrowing corporation, the courts tend to respect the form of the debt. This argument was useful in several cases.[42]

**Consistent Treatment by Parties.** There is a general policy that a taxpayer is bound by the tax consequences of the form chosen for the transaction.[43] If the parties want treatment of a financing instrument as debt, both the borrower and lender should treat the instrument as debt, rather than equity on their financial statements and tax returns.[44]

The position taken on a tax return is more important than that taken on a financial statement, and may prove to be decisive.[45] When a taxpayer takes a position on a tax return which is inconsistent with the desired tax treatment, the courts are likely to force the taxpayer to abide by the tax consequences of the tax return.[46]

**Enforcement of Terms.** Enforcement of the terms of a debt, such as timely payments of principal and interest, may have an important effect on an instrument's classification. Failure of the debtor to make payments has caused courts to uphold the reclassification of debt as equity.[47]



**Repayment Subject to Sale of Property.** Repayment of a loan may be dependent upon the sale of property, especially if the loan was a purchase money financing arrangement. If the property is not readily salable, the entire transaction might appear to be an equity investment in the borrowing corporation by the lender.[48]

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37. *Henderson v. U.S.*, 65-2 USTC 9598 (Mid. D. Ala), July 19, 1965; *W. C. Gamman v. Commr.*, 46 TC 1, April 4, 1966

38. *Byerlite Corp. v. Williams*, 61-1 USTC 9138 (6th Cir.), December 15, 1960; *Austin Village v. U.S.*, 70-2 USTC 9620 (6th Cir.), September 29, 1970; *Piedmont Corp. v. Commr.*, 68-1 USTC 9189 (4th Cir.), January 4, 1968; *Mills v. IRS*, 88-1 USTC 9220 (4th Cir.), March 4, 1988

39. *Mills v. IRS*, 88-1 USTC 9220 (4th Cir.) March 4, 1988; *Baker Commodities v. Commr.*, 69-2 USTC 9589 (9th Cir.) August 8, 1969; *Jaeger Auto Finance Co. v. Nelson*, 61-1 USTC 9465 (DC Wis.) March 14, 1961

40. *Raynor v. Commr.*, 50 TC 762 (1968), August 28, 1968

41. *Proctor Shop, Inc. v. Commr.*, 36-1 USTC 9203 (9th Cir.) March 20, 1936; *McDermott v. Commr.*, 13 TC 468 (1949) September 30, 1949; *Curry v. Commr.*, 43 TC 667 (1965) February 18, 1965; *Hofert Co. v. U.S.*, 69-1 USTC 9220 (CD Cal.), January, 15, 1969

42. *Lots, Inc. v. Commr.*, 49 TC 541 (1968) February 28, 1968; *Piedmont Corp. v. Commr.*, 68-1 USTC 9189 (4th Cir.) January 4, 1968; *Baker Commodities v. Commr.*, 69-2 USTC 9589 (9th Cir.), August 8, 1969

43. *Danielson v. Commr.*, 50 TC 782 (1968), August 29, 1968

44. *Bauer v. IRS*, 84-2 USTC 9996 (9th Cir.), December 7, 1984

45. *Comdisco, Inc., v. U.S.*, 85-1 USTC 9245 (7th Cir.) March 6, 1985; *Weinert's Estate v. Commr.*, 61-2 USTC 9644 (5th Cir.) August 31, 1969

46. *Illinois Power v. Commr.*, 87 TC 1417 (1986) December 13, 1986

47. *Henderson v. U.S.*, 65-2 USTC 9598 (Mid. D. Ala), July 19, 1965

48. *Aqualane Shores, Inc. v IRS*, (59-2 USTC 9632 (5th Cir.), August 13, 1959

If, on the other hand, the connection between the sale of property and the repayment of the loan is a reasonable business arrangement, the courts have held that the purchase money loan is valid debt.[49] In these circumstances, the taxpayer's case is strengthened if the property is readily salable.[50]

## RECENT DEVELOPMENTS

Transactions between closely-held businesses and their owners are often targeted for close scrutiny by the IRS. Many small businesses pay the price for dealing informally in a controlled environment. This portion of the chapter describes some of the issues that have developed in the 10 years preceding this publication.

### Loans from Shareholder to Corporation

A C corporation made advances to a subsidiary, and then attempted to claim a bad debt deduction. The court found no concrete evidence that the lender expected any repayment, since it continued to advance funds after the subsidiary corporation was insolvent and clearly in financial trouble.[51] In a slightly different case, but with the same results, the court denied a deduction for bad debts of an individual who had advanced a corporation funds to cover losses.[52]

In another recent case, shareholders had advanced funds to a family corporation, which deducted interest on the repayment. The IRS argued that the loan repayment did not come from normal operations, but from additional borrowing by the corporation. The Tax Court sided with the IRS and ruled the interest could not be deducted.[53] However, the taxpayers prevailed on appeal when the 6th Circuit, impressed that the funds were borrowed from independent lenders on similar terms, ultimately allowed a deduction for interest.[54]

### Loans from Corporation to Shareholder

Tax implications also arise when a corporation loans money to a shareholder, although the issues are different. A corporation's main concern usually is whether it may deduct any interest on a loan made to, or on behalf of, one or more shareholders.

The court upheld the IRS's disallowance of an interest deduction in one case where there was a lack of a written repayment agreement.[55] Similarly, the court declared a loan invalid in a case in which a corporation loaned funds to an LLC that was under the control of the lending corporation's shareholders.[56]

Most cases, however, involve controversy at the shareholder level, in which an advance may be considered a valid loan, compensation, or a dividend. In one case in which some of the advances were valid loans that were later forgiven, the shareholders had to recognize cancellation of debt income.[57] In the same case, however, other loans were treated as constructive dividends at inception. Another case held that purported loans were constructive dividends, due to the lack of any interest or formal repayment terms.[58]

When the lender is an **S corporation** and the borrower is a shareholder, the treatment may be somewhat different. In several cases, the IRS has persuaded the court that a purported loan was compensation, subject to all of the payroll and withholding tax requirements, as well as penalties for failure to make timely payments.[59]

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49. *Bauer v. IRS*, 84-2 USTC 9996 (9th Cir.), December 7, 1984; *Hardman v. IRS*, 87-2 USTC 9523 (9th Cir.), September 18, 1987

50. *Sun Properties v. Commr.*, 55-1 USTC 9261, (5th Cir.), March 2, 1955; *Piedmont Corp. v. Commr.*, 68-1 USTC 9189 (4th Cir.), January 4, 1968

51. *CMA Consolidated, Inc. v. Commr.*, TC Memo 2005-16, January 31, 2005

52. *Tigrett v. U.S.*, 96 AFTR 2d 2005-5649(WD TN)

53. *Indmar Products Co., Inc. v. Commr.*, TC Memo 2005-32 February 23, 2005

54. *Indmar Products Co., Inc. v. Commr.*, 97 AFTR 2d 2006-1956 (6th Cir.), April 14, 2006

55. *PK Venture, Inc. and Subsidiaries, et al. v. Commr.*, TC Memo 2006-36, March 7, 2006

56. *Hubert Enterprises, Inc. and Subsidiaries, et al. v. Commr.*, 125 TC No. 6 (2005), September 21, 2005

57. *Benson v. Commr.*, TC Memo 2004-272, November 29, 2004

58. *McCurley v. Commr.*, TC Memo 1997-371, August 14, 1997

59. *Joly v. Commr.*, TC Memo 1998-361, aff'd in *Joly v. Commr.*, 85 A.F.T.R.2d 2000-1234 (6th Cir.), October 5, 1998

# TREATING A STOCK PURCHASE AS AN ASSET PURCHASE (IRC §338)

## STOCK PURCHASE VERSUS ASSET PURCHASE

The sale of a corporation normally consists of either the sale of a corporation's stock or the sale of a corporation's assets followed by a liquidation. From a tax perspective, the form of sale that transpires can have important tax consequences.

### Asset Purchase

An asset sale offers some advantages to the purchaser, especially if the asset value is greater than the basis inside the corporation. However, a stock sale may hold an advantage to the seller, since a seller generally recognizes capital gain on the sale of stock. To tip the advantage, a sophisticated seller will usually discount a stock sale and a sophisticated buyer will usually put a premium on an asset purchase.

When a corporation sells all its operating assets, the shareholders retain stock in the corporation. However, a corporation then consists only of some investment assets and perhaps obligations from the purchaser.

S corporation gains and losses flow through to shareholders and are reported on their returns for the year of sale. An S corporation might have a built-in gains tax liability if it formerly was a C corporation, had been an S corporation for less than 10 years, and had owned some of the sold assets before it converted to S status.

C corporations recognize gains and losses in the year of sale. There is no effect on the shareholders' bases in their stock.

### Basis of Stock to Purchaser

There are three reasons why the purchaser usually prefers an asset purchase rather than a stock purchase.

1. After completing a stock purchase, a buyer is left with a historic corporate asset basis. If the buyer liquidates the corporation, it will face unfavorable tax consequences.
2. There may be contingent or hidden liabilities of the corporation.
3. The corporation may have assets that the purchaser does not want.

Someone, either the seller or the buyer, must pay taxes on the liquidation of a corporation or the buyer foregoes any opportunity to obtain a step-up in asset basis to reflect the purchase price. A sophisticated buyer will always discount the value of a stock purchase to reflect the tax cost of obtaining asset basis.

**Example 4.** Purco and Targco are two corporations. Purco is seeking to acquire all of the business of Targco. The parties have agreed that the FMV of Targco's assets is $1,463,636. However, the FMV of the stock is only $1,000,000 when the corporate level tax on disposition of assets is factored in, as shown by the following calculations:

| | | |
|---|---|---|
| FMV of assets | $1,463,636 | $1,463,636 |
| Adjusted basis of assets | (100,000) | |
| Gain if assets were sold | $1,363,636 | |
| | × 34% | |
| Tax if assets were sold | $ 463,636 | (463,636) |
| Net value of stock | | $1,000,000 |

Targco's shareholder has a $150,000 stock basis. For primarily nontax reasons, the parties have agreed to structure the deal as a purchase of Targco's stock for $1,000,000. Therefore Targco's shareholder recognizes a gain of $850,000 ($1,000,000 – $150,000).

If Targco's selling shareholder is subject to the individual tax rates, the tax on the gain is $127,500. The shareholder would have $872,500 ($1,000,000 – $127,500) of after-tax proceeds from the sale.

At the conclusion of the transaction, Targco's basis in its assets is still $100,000. Therefore, Purco can only get tax benefits of $100,000 through depreciation or basis recovery even though it paid $1,000,000 for the stock.

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### Effect of Corporate Liquidation

The liquidation of a subsidiary corporation into a parent corporation that holds 80% or more of the stock typically results in no gain or loss to the parent corporation or to the subsidiary in its liquidating distribution.[60] The subsidiary's basis in each asset becomes the basis of the parent.[61]

When a parent corporation liquidates a subsidiary, the stock basis becomes irrelevant. Thus, it simply disappears and has no future tax consequence.

**Example 5.** Continue with the same facts as in **Example 4**. Purco liquidates Targco. Since Purco is a corporation and owns at least 80% of the stock, the liquidation will be tax-free to both corporations. Accordingly, Purco's basis in the assets it receives from Targco will be $100,000.

When Purco liquidates Targco, the tax consequences are as if Targco still survives as a part of Purco. Thus, Targco's asset basis, earnings and profits, elections and other tax attributes go to Purco along with the basis of each asset. The price Purco paid for the stock is irrelevant.

## PURCHASE OF C CORPORATION STOCK

In the years preceding the 1954 rewrite of the Internal Revenue Code, corporations were structuring acquisitions to be stock purchases in form but asset purchases in substance. Since case law went both ways, Congress enacted IRC §334(b)(2) in 1954, which allowed acquiring corporations purchasing the stock of target corporations to liquidate the newly acquired target and assign the purchased stock basis to the assets received in liquidation.

### IRC §338 Requirements

In 1982, Congress replaced §334(b)(2) with IRC §338, which offers similar rules for certain stock purchases. The §338 rules include two elections:

1. An election by the purchaser under §338(g) treats a subsidiary corporation as if it sold all of its assets at FMV on the acquisition date.
2. A variation under §338(h)(10) applies only when a parent corporation sells a subsidiary corporation and the two corporations have been filing consolidated returns, or when shareholders sell stock of an S corporation.

IRC §338 elections are only available to corporations purchasing at least 80% of the stock of another corporation. This procedural rule is rigid, but can be circumvented.

**Note.** Since staggered acquisitions of stock can become complicated, this section focuses on a simple situation whereby the purchasing corporation acquires all of the stock of the target corporation in one transaction. All of the stock sells for the same price per share. There are no discounts for minority interests and premiums for controlling blocks, as may be found in actual negotiations.

Since an individual cannot make a §338 election, an individual taxpayer who wants to acquire a corporation can form another corporation to become the actual purchaser. The new corporation then can make the §338 election. However, it is always best to have a nontax business reason for setting up the new corporation, such as a state law consideration, liability protection, or a plan to acquire other subsidiaries.

A purchasing corporation may be a C corporation or an S corporation. A purchaser must acquire at least 80% of the stock of the target corporation within a 12-month period, and none of the acquisitions may be from persons or other entities considered related to the corporation.[62] The relationship restriction generally excludes a person who owns less than 50% of the corporation's stock.

60. IRC §§332 and 337

61. IRC §334(b)

62. IRC §338(h)(3)

An acquiring corporation must make a §338 election no later than the 15th day of the 9th month after the purchaser acquires the stock that puts it over the 80% threshold.[63]

**IRC §338(g) Election.** A §338(g) election treats a target corporation as if it had sold all its assets for FMV on the acquisition date, which is the date that the acquired stock reached the 80% level. At that time the "old" target ceases to exist for federal tax purposes. On the following day, "new" target comes into existence, and acquires all of old target's assets.

The price new target pays is the **"adjusted grossed-up basis**.[64] When a lump sum is paid for all of the stock, the basis equals the price paid by the purchaser for the stock plus any liabilities of old target, including any income tax liability resulting from the deemed sale of assets. The basis computation can become complicated when there are staggered acquisitions, different prices, or the acquiror does not purchase all of the stock.

Any gains or losses on this liquidation are recognized by the selling corporation and are reported on its tax return for the "year" of the sale. A year can be either a normal tax year or a short tax year. If the subsidiary corporation is filing a consolidated return with the selling parent corporation, the subsidiary has a 1-day tax year as a stand-alone corporation. Also, if the acquired corporation was an S corporation it has a 1-day tax year for the acquisition.

**Example 6.** Purco acquires all Targco's stock on May 21, 2006. Purco makes a §338 election. Targco is treated as if it sold all its assets for their FMV of $1,463,636. This creates an income tax liability for old Targco of $463,636, as calculated in **Example 4**.

At the close of the day on May 21, 2006, "old" Targco ceases to exist for tax purposes. On May 22, 2006, "new" Targco comes into existence. New Targco has none of the tax attributes of old Targco. The assets were purchased for the following amounts:

| | |
|---|---|
| Price paid by Purco | $1,000,000 |
| Old Targco tax liability | $463,636 |
| Adjusted grossed-up basis | $1,463,636 |

Although Targco now has a stepped-up basis, the cost is an immediate tax liability. Targco's selling shareholder still must recognize the gain on the sale of the Targco stock. This rule is completely unaffected by a §338(g) election.

**Observation.** The §338(g) election had several applications before 1987, when corporations did not recognize gain or loss on the distribution of property in complete liquidation. However, IRC §336, as amended by the Tax Reform Act of 1986, now requires that all gains must be immediately recognized. Under current law, §338(g) is only useful in very limited circumstances.

### IRC §338(h)(10) Election

A §338(h)(10) election is a variation of the §338 election which has retained considerable popularity. This election normally does not result in the double counting of gains, as does the regular §338(g) election. It requires a joint election, signed both by the buyer and the seller. However, there are only two types of sellers that qualify for this special election:

1. A parent company that is selling a subsidiary corporation with which it has filed consolidated returns.
2. Shareholders of an S corporation.

63. Treas. Reg. §1.338(h)(10)-1(d)(2)

64. IRC §338(b)

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The other requirements are quite similar to those discussed previously, except that a purchaser must acquire at least 80% of the target's stock on one day, and must not have acquired any stock before that date. The election dates, deemed sale and repurchase of assets, and discontinuity of the target's existence are identical.

When the seller is a parent corporation, a §338(h)(10) election results in the subsidiary being treated as if it were liquidated into the selling parent in a tax-free §337 liquidation. The parent is then treated as if it took a carryover basis from the subsidiary and then sold the assets at FMV to the purchasing corporation. The purchaser is treated as if it dropped the newly acquired assets into a newly formed subsidiary under IRC §351.

**Example 7.** Purco acquires all Targco stock on May 21, 2006. Targco's selling shareholder was a C corporation that filed consolidated returns with Targco. Purco is willing to pay $1,463,636 for the stock to step up the basis of Targco's assets to FMV. Purco and Targco's selling shareholder join in a §338(h)(10) election.

Targco is treated as if it distributed all its assets to the selling parent corporation. The parent took these assets at Targco's adjusted basis of $100,000. Targco's selling parent then sold all these assets for their FMV of $1,463,636. This creates an income tax liability for old Targco's parent of $463,636, as calculated in **Example 4**.

For a hypothetical moment, Purco is treated as the owner of assets which now have a cost basis of $1,463,636. It instantly contributes those assets to "new" Targco, which has just come into existence. In this example, Targco has no liabilities other than income tax imposed on the deemed sale. However, with the §338(h)(10) election, Targco's selling parent has the tax liability. Therefore its adjusted grossed-up basis is:

| | |
|---|---|
| Price paid by Purco | $1,463,636 |
| Old Targco tax liability | 0 |
| Adjusted grossed-up basis | $1,463,636 |

Although Targco now has a stepped-up basis, the cost is still an immediate tax liability. However, Targco's selling shareholder recognizes no gain on the sale of the Targco stock. The selling parent is treated as selling assets, and its basis in the Targco stock is irrelevant.

## PURCHASE OF S CORPORATION STOCK

An S corporation may be a purchaser, a target corporation, or both corporations may be S corporations. When an S corporation is a target, the purchaser still must be a corporation, but a corporation is ineligible to be an S corporation shareholder. Therefore, some extra steps are necessary if a purchasing corporation wants to preserve the benefits of an S election.

### Applicability of §338

In 1982, §338 and the current version of subchapter S were both signed into law in separate bills. Since neither bill was well articulated, it was unclear whether an S corporation could be a purchaser in a §338 transaction. In 1996, Congress cleared up this confusion by specifically permitting an S corporation to be a purchaser with §338 eligibility.

### IRC §338(g) Election

A purchaser may make a §338(g) election for an acquired S corporation. However, this option rarely makes sense since it results in a strange set of events. The "old" S corporation's S election terminates the day before acquisition date. The "new" corporation comes into existence the day after acquisition date.

On the acquisition date, the target corporation is a C corporation since it is owned by another corporation and cannot be an S corporation. The deemed sale of assets takes place on the "1-day year" of the C corporation of old target. The tax on this sale is a liability of target that arises after the acquisition date. Therefore, the new parent corporation ultimately bears the burden of this tax, although it should be factored into the purchase price.

### IRC §338(h)(10) Election

In contrast to the §338(g) election, a §338(h)(10) election can be quite useful. When a buyer and a target corporation's shareholders make a §338(h)(10) election, the target corporation is treated as if it had sold all its assets at FMV on the acquisition date and then liquidated.

The target corporation's shareholders must report all of the corporation's gains and losses on their returns, as if the sale of the corporation's assets took place on the day immediately before the sale.[65] The target corporation shareholders recognize no gain or loss on the sale of their stock, per se, although they may recognize gain or loss on the deemed liquidation.

**Example 8.** Purco acquires all Targco stock on May 21, 2006. Targco's selling shareholder is an individual and Targco was an S corporation. Purco is willing to pay $1,463,636 for the stock if it is able to step up the basis of Targco's assets to the FMV. Purco and Targco's selling shareholder join in a §338(h)(10) election. Under this scenario, Targco is treated as selling all its assets at FMV. The gain would be:

| | |
|---|---|
| FMV of assets | $1,463,636 |
| Adjusted basis of assets | (100,000) |
| Gain if assets were sold | $1,363,636 |

However, since Targco was an S corporation, any gain on the sale of assets flows through to the selling shareholder, who reports the gain as part of his taxable income for the year. The net gain also adds to the selling shareholder's basis.

If Targco's deemed sale is subject to capital gains tax rates, the gain will be taxed at the 15% rate. However, some assets, such as inventory or property with recapture, may be subject to ordinary income tax rates of up to 35%. Assuming the Targco sale is subject to capital gains tax rates, the shareholder reports the following:

| Description | Basis | Tax Consequences |
|---|---|---|
| Amount realized from the deemed liquidation of Targco (actually received directly from Purco) | | $1,463,636 |
| Basis of stock before deemed sale | $ 150,000 | |
| Add gain from deemed sale | 1,363,636 | |
| Basis for deemed liquidation | $1,513,636 | (1,513,636) |
| Loss on deemed liquidation | | ($ 50,000) |

The following information is reported on the **selling** shareholder's tax return to reflect both the deemed sale and the deemed liquidation.

| | |
|---|---|
| Gain from deemed sale | $1,363,636 |
| Loss from deemed liquidation | (50,000) |
| Net capital gain | $1,313,636 |
| | × 15% |
| Capital gains tax | $ 197,045 |

**Summary of Section 338(h)(10) Election.** The selling shareholder would have $1,266,591 ($1,463,636 – $197,045) in after-tax proceeds. Contrast that to $872,500 in after-tax proceeds from a straight stock sale, as shown in **Example 4.**

65. Treas. Reg. §1.338(h)(10)-1(e)(2)(ii)

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The purchasing corporation would be paying $1,000,000 for the stock without a §338(h)(10) election and would only have a $100,000 basis in the acquired assets. In exchange for a §338(h)(10) election, the buyer agreed to pay $1,463,636 for the stock, with the step up in tax basis of the assets. This then allows the purchaser to depreciate/amortize $1,463,636. In practice, the price would be negotiated to lie somewhere between these two extremes.

### Sale of a Qualified Subchapter S Subsidiary (QSub)

Using a **qualified subchapter S subsidiary (QSub)** to structure a stock sale may accomplish the same result as a §338(h)(10) election, in that it may treat a stock sale as an asset sale. The rationale is quite simple, since a QSub is a domestic corporation that is 100% owned by an S corporation. However, the S corporation must have made an election to treat the corporation as a QSub.

A QSub is treated as a disregarded entity (DE) for federal income tax purposes.[66] If the parent corporation sells the QSub, a new tax entity must be created for tax purposes. This can be accomplished in the following manner:

1. The parent corporation transfers the assets and liabilities that are inside the QSub to a new corporation in exchange for all of its stock.[67]
2. The parent then sells the stock to the new owners.

The key to the desired treatment is in transferring assets to a corporation in exchange for its stock. If the parent corporation or its current shareholders are in control of the subsidiary immediately after the exchange, the asset transfer is tax free under §351. The "new" subsidiary's basis in its assets is the same as it was to the parent that was treated as the owner of the assets while the subsidiary was a DE.

However, a binding commitment to sell stock to persons who are not shareholders will cause the parent S corporation to be treated as not in control after the deemed asset transfer. Thus, the parent corporation must recognize gain when it receives stock in exchange for the assets, and the assets deemed transferred will get a new basis equal to their FMVs. Moreover, the "new" corporation has no tax history, such as earnings and profits, tax elections, or any other tax attributes.

**Example 9.** Suppose that Purco was not eligible to make a §338 election with respect to Targco. Perhaps Purco is an individual or a partnership, or perhaps it is a company controlled by members of the Targco shareholder's family.

The parties can accomplish the same objectives by taking the following steps:

1. The Targco current shareholder forms a new corporation, Newco, and makes an immediate S election. Alternatively, if the Targco corporation already owns an S corporation, the existing corporation could serve as the intermediary.
2. The shareholder then transfers all his Targco stock to Newco. Newco immediately makes a QSub election for Targco. This is treated as a tax-free liquidation of Targco into Newco. Thus, Targco has gone out of existence for federal income tax purposes.
3. Newco enters into a binding contract to sell all Targco stock.
4. Newco sells the stock.

Targco is now treated as a newly formed corporation, created when Newco transferred assets and liabilities that were actually already in Targco. The exchange does not qualify as a tax-free §351 transfer because Newco was under a binding commitment to sell all of the Targco stock.

Therefore, Newco recognize gains on each asset deemed transferred as if they had been sold to Targco at FMV. Targco's basis in each asset is its FMV. The sale is then completed, with the identity of asset basis and FMV.

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66. IRC §1361(b)(3)

67. Treas. Reg. §1.1361-5(b)(1)

The purchase and sale of stock in a corporation is subject to traps and pitfalls. An S corporation offers more flexibility for negotiating the structure of sales than most other corporations, outside of the consolidated return area. As is the case with many tax problems in the corporate world, both substance and form may be equally important.

## DISTRIBUTING LAND OUT OF A CORPORATION

A corporation is not an ideal tax entity to hold land or other valuable property if the shareholders ever wish to have the corporation distribute the property. If property **appreciates** in value, the distribution typically results in taxable gains, both to the distributing corporation and to the receiving shareholders.

If property **depreciates** in value, the distribution may not result in a deduction to the corporation, but still may constitute income to the shareholders. When land depreciates in value, the transfer to the shareholder results in a basis reduction, even if there is no tax benefit to the corporation or the shareholder.

**Keeping land in a separate entity is a business strategy that provides both tax and nontax benefits.** One nontax advantage is the ability to diversify real estate ownership in a manner different from the core business. Medical practices often employ this strategy. A practice rents an office from a partnership, often an LLC under state law but a partnership for federal income tax purposes.

From a tax point of view, there are significant advantages to keeping land out of a corporation. Land may appreciate substantially over time, but in the short run its price may fluctuate. A partnership has a tax advantage whether the price rises or falls. If land rises in value, it may be possible to distribute it to one or more partners with no recognition of gain. If land falls in value, its high basis can be preserved by distributing it to a partner.

However, this strategy is not possible with a corporation. Although current conventional wisdom implies that land is best kept out of a corporation, this was not always the case. Consequently, tax professionals may face situations in which land is already inside a corporation.



Although partnerships have the most liberal rules of any entity for getting property out of a business and distributing it to owners, these rules are also the most complicated. As such, this section focuses on the tax problems that corporations and shareholders face in getting land out of a corporation.

### ILLUSTRATIVE EXAMPLES

The material in this portion of the chapter describes three different transaction types that may be used to distribute land to shareholders. These three transaction types are:

1. Dividend distributions
2. Stock redemptions
3. Complete liquidations

**Examples 10 through 21** illustrate the effect of each type of transaction on C corporations, S corporations recently converted from C corporations that have built-in gains, and other S corporations. Below are basic facts applicable to all the examples.

**Basic Fact Scenario.** Abby and Jake are equal shareholders in the AJ Corporation (AJ), with the following bases:

| Shareholder | Basis |
|---|---|
| Abby | $300,000 |
| Jake | 650,000 |

AJ Corporation owns the following two parcels of land:

| | FMV | Adjusted Basis |
|---|---|---|
| Goodland | $500,000 | $100,000 |
| Badland | 500,000 | 700,000 |

**Note.** These examples do not attempt to tie all of the facts together in a consistent manner, so the numbers may be inconsistent from example to example. No balance sheets are shown.

## DIVIDEND DISTRIBUTIONS

A dividend has different connotations for tax and nontax purposes. For nontax purposes, a dividend is considered a distribution of cash or property approved by a board of directors in compliance with state securities laws and the U.S. Securities and Exchange Commission, if publicly traded.

### Earnings and Profits (E&P)

For tax purposes, a dividend is considered a distribution that does not exceed a corporation's **earnings and profits (E&P)**. E&P is the term given to the amount that a corporation can distribute without impairing its capital account. It measures the extent to which a distribution is made out of the corporation's economic income as opposed to its taxable income or its paid-in capital.

E&P is not defined in the Code and it has no counterpart in corporate law or financial accounting. It is not the same as retained earnings or earned surplus. However, Rev. Proc. 75-17 provides a summary of the general information that must be maintained by a corporation, including sample computations and schedules that illustrate a detailed year-by-year analysis of E&P.[68]

The IRS has indicated that it will not issue private letter rulings or determination letters regarding the computation of E&P. As a practical matter, few corporations actually compute E&P regularly. The computation is not necessary in order to file a proper Form 1120. The balance sheet and other schedules on Form 1120 do not even provide a place to show the calculation.

Although **Form 5452, *Corporate Report of Nondividend Distributions***, provides a guide, there is no requirement to file this form unless a corporation claims that its tax year distributions exceed both its current and accumulated E&P. Current E&P is computed by starting with a corporation's current taxable income or loss and making certain adjustments, some of which are prescribed in IRC §312.

68. Rev. Proc 75-17, 1975-1 CB 677, January 1, 1975

**Computing E&P.** For purposes of computing E&P, taxable income is determined by the same cash or accrual accounting method normally used by the taxpayer.[69] However, several adjustments must be made to taxable income to arrive at current E&P.

Taxable income must be **increased** by items of income which are excluded or which may be deferred (e.g., tax-exempt income and installment sale income but not gain deferred under the like-kind exchange provisions of §1031 or involuntary conversion rules of §1033).[70] Taxable income is also increased by certain artificial deductions (e.g., the dividends received deduction).

Taxable income is **reduced** by expenses and losses which are not deductible in computing taxable income, but which reduce a corporation's ability to pay dividends (e.g., federal income taxes and capital losses). Taxable income is also reduced by losses not recognized under §267.[71]

For depreciable property acquired in tax years beginning after June 30, 1972, some adjustments are required which generally slow down depreciation for E&P purposes.[72] Consequently, **the gain or loss realized on disposition of property for E&P purposes normally differs from the gain or loss computed for income tax purposes.**[73]

For years beginning after September 30, 1984, corporations must make adjustments to taxable income to reflect "**economic income**" pursuant to IRC §312(n). These rules affect LIFO inventory, installment sales, and a few other items, most of which are industry specific.

**Current E&P** is computed without regard to distributions made during the year.[74] **Accumulated E&P** is the sum of current E&P for all taxable years reduced by distributions, including the allocable charge to E&P for any stock which is redeemed.

**Effect of E&P on Basis.** If a distribution exceeds a corporation's current and accumulated E&P it is treated as a reduction of the shareholder's basis to the extent thereof. Any amount in excess of E&P and basis is treated as a gain from the sale of stock. When a corporation distributes noncash property, it creates problems at both the corporation and shareholder levels. **Example 10** illustrates the recognition of gain and loss at the corporate level.



### C Corporation Dividend Distributions

A corporation cannot reduce its E&P below zero for a distribution. If the FMV of distributed property exceeds the current and accumulated E&P after including the gain from the distribution, a corporation reduces paid-in capital for the excess.

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69. Treas. Reg. §1.312-6(a)

70. IRC §§312(n)(5) and (f)(1), and Treas. Reg. §1.312-7(b)

71. Treas. Reg. §1.312-7(b)

72. IRC §312(k)(3)

73. Treas. Reg. §1.312-7(a)

74. IRC §316(a)

**Example 10. C Corporation — Dividend Distributions.** Using the basic fact scenario, AJ, a C corporation, distributes Goodland to Abby and Badland to Jake. AJ recognizes a gain of $400,000 on the distribution of Goodland, as if it had sold the property to Abby.[75] The corporation recognizes no loss on the distribution of Badland to Jake.[76]

The gain increases the corporation's E&P in the same manner as any other income item. The corporation reduces its E&P by the amount of the basis of the property distributed to the shareholders, after adjusting basis upward for recognition of gain.[77]

Assuming a 34% corporate tax rate, the effects of this distribution on AJ's E&P are:

| | |
|---|---|
| Gain recognized on distribution | $400,000 |
| Tax on gain ($400,000 × 34%) | (136,000) |
| Reduction for Goodland ($100,000 + $400,000) | (500,000) |
| Reduction for Badland | (700,000) |
| Net reduction of E&P | ($936,000) |

**Shareholders** must report the value of property received upon distribution. The amount is considered **dividend income** to the extent the value does not exceed the corporation's E&P.[78] A shareholder reduces his stock basis by the amount of any distribution in excess of E&P.[79] After the shareholder's basis is exhausted, any remaining distribution amount is treated as gain from the sale of stock.[80]

**Example 11. C Corporation — Dividend Distributions Continued.** Continuing with **Example 10**, shareholders Abby and Jake are each treated as receiving a distribution equal to the $500,000 FMV of the respective properties they received.[81] This distribution results in Badland losing $200,000 of basis ($700,000 – $500,000), with no corresponding tax benefit to either AJ or Jake.

The 2006 tax rate on the dividend (assuming all qualified dividend requirements are satisfied) is 15% for each shareholder. The **total tax cost** of getting the property out of the corporation is:

| | |
|---|---|
| Tax on corporation ($400,000 × 34%) | $136,000 |
| Tax on Abby ($500,000 × 15%) | 75,000 |
| Tax on Jake ($500,000 × 15%) | 75,000 |
| Total | $286,000 |

Considering that the combined value of the properties is $1,000,000 and the corporation's basis was $750,000, the total tax is more than the $250,000 appreciation. Without the current dividend rate advantage, the burden would be considerably higher.

## S Corporation Dividend Distributions

**S corporations** generally fare better than C corporations with dividend distributions. However, if an S corporation has only recently converted from a C corporation, the savings may not be as great. One reason is that distributions may still be considered dividends to the extent they exceed any earnings accumulated after conversion to S status. Another reason is the **built-in gains tax,** which may be imposed on a corporation. This applies to the pre-conversion appreciated value in assets for 10 years after the date of the conversion to an S corporation. (For more on these topics, see "Converting a C Corporation to an S Corporation" earlier in this chapter.)

75. IRC §311(b)
76. IRC §311(a)
77. IRC §§312(a)(3), 312(b)(2)
78. IRC §301(c)(1)
79. IRC §301(c)(2)
80. IRC §301(c)(3)(A)
81. IRC §301(b)(1)

**Example 12. S Corporation (Recently Converted) — Dividend Distributions.** Use the same basic facts scenario, except AJ Corporation recently converted from C corporation to S corporation status. The following facts also are assumed:

- AJ has an Accumulated Adjustments Account (AAA) of $100,000 since becoming an S corporation
- Each shareholder has received $50,000 in stock basis increases since the S election took effect
- The corporation has at least $1,000,000 of accumulated E&P as of the current year
- The value of each land parcel was $425,000 on the conversion date and each appreciated by $75,000 since the S election has been in effect

The distribution of Goodland results in gain recognition for the corporation.[82] To the extent of any built-in gain, the corporation is liable for a 35% tax. The after–tax gain flows through to the shareholders in proportion to their stock ownership. It also increases the AAA.[83] The distribution is treated as a return of capital, to the extent of the AAA.

Since AJ cannot recognize a loss on the distribution of Badland, it cannot offset the taxable gain from the distribution of Goodland. The recognized built-in gain from the distribution of Goodland is limited to the appreciation at conversion.

With a FMV of $425,000 at that date and a basis of $100,000, the **taxable built-in gain is $325,000.**[84]

The corporation's calculations of gain at the time of the dividend are:

| | | |
|---|---|---|
| Taxable built-in gain | $325,000 | $325,000 |
| Built-in gains tax rate | × 35% | |
| Tax on built-in gain | $113,750 | (113,750) |
| Gain on distribution of Goodland | $400,000 | |
| Amount subject to built-in gains tax | (325,000) | |
| Gain not subject to built-in gains tax | $ 75,000 | 75,000 |
| Net gain to shareholders: adjustment to shareholder basis and AAA | | **$286,250** |

Each shareholder must include half of the corporate gain on his tax return. Since each shareholder owns 50% of the stock, each basis increases by 50% of this total, or **$143,125** ($286,250 ÷ 2), and each has sufficient basis to absorb his share of the AAA. Assuming a capital gains tax rate of 15%, Abby and Jake's tax liability from this gain is each **$21,469** ($143,125 × 15%).

Each shareholder's basis is adjusted as follows:

| | Abby | Jake |
|---|---|---|
| Basis before gain on distribution of Goodland | $300,000 | $650,000 |
| Effect of gain on basis | 143,125 | 143,125 |
| Basis before distribution | $443,125 | $793,125 |

82. IRC §§311(b), 1371(a). Subchapter S does not modify the gain and loss rules for distribution of noncash property to shareholders.

83. IRC §§1366(a)(1) and 1368(e)(1)(A)

84. IRC §1374(c)(2)

Abby and Jake must adjust their bases as a result of these distributions, to the extent AAA is less than basis. Any difference between distributions received and the reduction to shareholder basis is considered a dividend from the corporation's E&P. In this case, AJ's E&P exceeds the value of the distributed property. Therefore, the distribution produces the following tax consequences:

| | | |
|---|---|---|
| Total distribution | | $1,000,000 |
| AAA before distribution | $100,000 | |
| Addition due to gain recognized (net) | 286,250 | |
| Balance available for distribution | $386,250 | (386,250) |
| Remainder of distribution, from E&P | | $ 613,750 |

Since each shareholder owns 50% of the stock, they each report:

| | |
|---|---|
| Total distribution | $500,000 |
| Distribution from AAA (reduce stock basis) | (143,125) |
| Distribution taxable as dividend | **$356,875** |

Assuming a 15% tax rate on the dividend distribution, each shareholder would incur **$53,531** ($356,875 × 15%) of income tax liability. The **total tax liability** incurred to get the properties out of the corporation in this scenario is shown below:

| | | |
|---|---|---|
| Tax on Abby | Cap gains $21,469 + dividend $53,531 | $ 75,000 |
| Tax on Jake | Cap gains $21,469 + dividend $53,531 | 75,000 |
| Built-in gains tax on AJ | | 113,750 |
| Total tax | | $263,750 |

Each **shareholder's basis** after distribution:

| | Abby | Jake |
|---|---|---|
| Basis before distribution | $443,125 | $793,125 |
| Distribution ($386,250 ÷ 2) | (193,125) | (193,125) |
| Basis after distribution | $250,000 | $600,000 |

**Example 13. S Corporation (Other) — Dividend Distributions.** Use the same facts as **Example 12**, except AJ is an S corporation that never was a C corporation. Accordingly, it has no E&P and the characterization of distributions is determined solely by shareholder basis. Moreover, there is no built-in gains tax, so all allowable gains and losses are subject only to tax at the shareholder level.

The corporation still must recognize gain on the distribution of Goodland and cannot recognize the loss on Badland. Thus, the corporation recognizes $400,000 of gain allocated evenly between Abby and Jake.

Since each shareholder has enough basis to absorb their $500,000 respective distributions, neither recognizes gain from the distribution, per se. Abby reduces her basis to zero and Jake reduces his to $350,000:

| | Abby | Jake |
|---|---|---|
| Basis before gain on distribution of Goodland | $300,000 | $650,000 |
| Increased basis from gain | 200,000 | 200,000 |
| Basis before distribution | $500,000 | $850,000 |
| Distribution | (500,000) | (500,000) |
| Basis after distribution | $ 0 | $350,000 |

The only tax imposed on the entire transaction is from the gain passed from AJ to the shareholders, due to the gain recognition by the corporation. With each shareholder being liable for capital gains tax of 15% on their respective $200,000 shares, **the entire tax is $60,000** ($200,000 × 2 × 15%).

## REDEMPTION DISTRIBUTIONS

A **stock redemption** is simply a purchase by a corporation of its own stock from its shareholders. From the shareholder's point of view, a redemption of stock is simply the sale of stock back to the corporation. When a shareholder desires to dispose of part or all of his interest in a business, redemption may be a useful financing technique.

IRC §317(b) indicates that a redemption occurs when a corporation acquires its stock from a shareholder in exchange for property. There is no need for the stock to be canceled or retired. **While a redemption appears to be a sale, it may be a disguised dividend.** Consequently, before the sale treatment is granted, the redemption portion of the transaction must pass certain tests. Failure of these tests normally subjects the transaction to dividend treatment.

These tests are:

1. Not essentially equivalent to a dividend[85]
2. Substantially disproportionate (non pro rata)[86]
3. Complete termination of the shareholder's interest in the corporation[87]
4. Redemption from noncorporate shareholder in distribution qualifying as a partial liquidation[88]
5. Redemption to pay death taxes[89]

85. IRC §302(b)(1)
86. IRC §302(b)(2)
87. IRC §302(b)(3)
88. IRC §302(b)(4)
89. IRC §303

If a distribution does not meet one of the above tests, it does not qualify as an exchange of stock by the shareholder. In such case, the distribution is subject to the normal distribution rules contained in IRC §301 and treated as a dividend to the extent it does not exceed E&P.[90]

### C Corporation Redemption Distributions

The same gain or loss rules discussed above apply to corporations. Regardless of how a shareholder treats a redemption, a corporation must recognize gains, but not losses, on distributions of property in redemption of stock.[91] If a redemption is treated as an exchange, a corporation reduces its accumulated E&P by the percentage of shares redeemed or by the value of the consideration given to a shareholder in exchange for his stock.[92]

**Example 14. C Corporation — Redemption Distributions.** AJ intends to distribute Goodland to Abby in redemption of her stock. The corporation recognizes a gain of $400,000 on the distribution of Goodland, as if it had sold the property to Abby.[93] The gain increases the corporation's E&P in the same manner as any other income item.

The corporation then reduces its E&P, but the amount of the reduction depends on whether the redemption is treated as a dividend or as an exchange. If the transaction is treated as a dividend, the corporation reduces its E&P by the property's basis after adjusting the basis upward for any gain recognized on the distribution. The effects of this distribution on the corporation's E&P, assuming a corporate tax rate of 34%, is:

| | |
|---|---|
| Gain recognized on distribution | $400,000 |
| Tax on gain (34%) | (136,000) |
| Reduction for Goodland ($100,000 adjusted basis + $400,000 gain) | (500,000) |
| Net reduction of E&P | ($236,000) |

A **shareholder** reports a distribution in redemption of stock at its FMV.

**Example 15. C Corporation — Redemption Distributions Continued.** Continuing with the previous example, Abby is treated as receiving a $500,000 distribution equal to the FMV of Goodland. If this distribution is considered a dividend, Abby reports $500,000 of dividend income and has no basis recovery.

If it is treated as an exchange, Abby recovers her basis and reports the difference as capital gain. Since Abby's basis is $300,000, she reports a gain of $200,000 ($500,000 – $300,000). Thus, it is in her interest to see that the transaction qualifies as an exchange.

If the redemption is considered a dividend, the total tax cost of getting the property out of the corporation is:

| | |
|---|---|
| Tax on corporation ($400,000 × 34%) | $136,000 |
| Tax on Abby ($500,000 × 15% dividend tax rate) | 75,000 |
| Total tax | $211,000 |

Since Abby's recognized gain was only $200,000, an aggregate tax of $211,000 is rather steep. If the transaction were treated as an exchange, the tax would be considerably less.

| | |
|---|---|
| Tax on corporation ($400,000 × 34%) | $136,000 |
| Tax on Abby ($200,000 × 15% capital gains tax rate) | 30,000 |
| Total tax | $166,000 |

90. IRC §302(d)

91. IRC §§311(a)and (b)

92. IRC §312(n)(7)

93. IRC §311(b)

The most likely tests to classify this redemption as an exchange are the substantially disproportionate redemption test or the complete termination of a shareholder's interest test.

To qualify as a **substantially disproportionate redemption,** a shareholder whose stock has been redeemed must own less than 50% of the outstanding shares in the corporation after the redemption. Furthermore, she must possess less than 80% of the relative voting power and less than 80% of the relative percentage of shares she owned before the redemption.

Since Abby owns no shares after the redemption, she appears to meet these tests. However, the term "ownership" includes constructive ownership under the rules of §318. These rules state that shares owned by a taxpayer's spouse or children are considered owned by the taxpayer.[94] If Abby and Jake are not related under §318, the redemption qualifies for preferential tax treatment.

However, if Abby and Jake are related under §318, she is treated as the owner of all of Jake's stock after the exchange. Therefore, Abby is treated as the owner of 100% of the stock after the redemption, and the transaction would be characterized as a dividend.

The only test remaining that might allow Abby exchange treatment is the **complete termination of a shareholder's interest.**[95] If certain requirements are satisfied, termination of a shareholder's interest can be determined without application of the family attribution rules. This enables some redemptions in closely-held corporations to qualify for exchange treatment.

The following three tests must be met to qualify for a **waiver of the family attribution rules.**[96]

1. Immediately after the redemption, a shareholder must not have any type of interest in the corporation, other than that of a creditor.
2. A redeemed shareholder cannot acquire any prohibited interest for **10 years after the redemption,** including an interest in a subsidiary, parent, or successor corporation. The "**prohibited interest**" rule expressly prohibits involvement as a shareholder, employee, director, or officer.
3. A shareholder must sign an agreement as contained in IRC §302(c)(2)(iii), agreeing to notify the IRS if the shareholder acquires a forbidden interest.

However, these tests are not violated if a shareholder acquires any interest by bequest or inheritance.

A shareholder claiming a complete termination must be careful not to acquire any type of interest either directly or indirectly through services, including management, rendered to a corporation. Generally, the IRS has taken the position that the performance of services for a corporation by a redeeming shareholder will be considered an acquisition of a prohibited interest.

This conclusion derives from the presumption that an ex-shareholder's continued service is evidence that he never intended to completely sever his interest from the corporation, and thus the redemption was merely a means to bail out E&P at capital gains rates. Several decisions in this area suggest that no services may be performed for a redeeming corporation.[97]

If Abby complies with all of these requirements, she can treat her redemption as an exchange. By doing so, she subtracts her adjusted basis in the shares from the redemption proceeds to determine her gain or loss realized. If there is a gain, it is most likely a capital gain.

94. IRC §318(a)(1)

95. IRC §302(b)(3)

96. IRC §302(c)(2)

97. See *Seda v. Commr.,* 82 TC 484 March 19, 1984, *Lewis v. Commr.,* 47 TC 129 November 18, 1966, *Estate of Lennard v. Commr.,* 61 TC 554 January 29, 1974, *Lynch v. Commr.,* 86-2 USTC 9731 (9th Cir.), October 8, 1986

If Abby realized a loss, she would not be able to claim a deduction, since she would have sold her stock to a related party, within the meaning of IRC §267(b). Her loss would be disallowed under §267(a)(1), which does not waive family attribution. These attribution rules are much broader than those that determine constructive ownership of stock, and include brothers, sisters, all ancestors, and descendants.[98] They are not waived for a complete termination of shareholder interest.

However, consider what would happen if the parties agree that AJ will buy all of Jake's shares for $500,000 and AJ will not redeem any of Abby's shares. He would realize a loss, since his basis before the redemption was $650,000. If he had no relationship to Abby, he would be allowed to recognize the loss, although it would be a capital loss. If he and Abby were related, however, he would be selling property to a related party, since he would be treated as the constructive owner of Abby's shares. Therefore, in this situation, he would not be allowed to recognize a loss.

## S Corporation Redemption Distributions

**Example 16. Corporation (Recently Converted) — Redemption Distributions.** Use the same facts as **Example 12.** AJ recently converted to S status. Its AAA is $100,000, and its accumulated E&P are $1,000,000. The value of each parcel of land was $425,000 on the conversion date.

If AJ redeems Abby's stock, the built-in gain results would be **$286,250** as computed in **Example 12.**

Since each shareholder owns 50% of the stock, they each increase their basis by 50% of this total, or **$143,125** ($286,250 ÷ 2). Each shareholder includes half of the total gain on his tax return, even though Abby is the only one who is receiving property in this instance. Assuming a 15% capital gain rate, each shareholder has a **$21,469** ($143,125 × 15%) tax liability resulting from this gain.

| | Abby | Jake |
|---|---|---|
| Basis before gain on distribution of Goodland | $300,000 | $650,000 |
| Effect of gain on basis | 143,125 | 143,125 |
| Basis before distribution | $443,125 | $793,125 |

**If the redemption meets one of the exchange tests** described above, Abby will receive all of the value as consideration for her stock. Thus she reports:

| | |
|---|---|
| Value of property received | $500,000 |
| Basis at time of distribution | (443,125) |
| Abby's gain on distribution | **$ 56,875** |

Thus, the **total tax cost** of getting Goodland out of AJ is:

| | |
|---|---|
| Tax to Jake on corporate gain | $ 21,469 |
| Tax to Abby on corporate gain | 21,469 |
| Tax to Abby on distribution ($56,875 × 15%) | 8,531 |
| Built-in gains tax on AJ ($325,000 × 35%) | 113,750 |
| Total tax | $165,219 |

**If the redemption is treated as a distribution,** the results are the same for the corporate built-in gains tax and the tax on each shareholder resulting from the recognized gain. However, the results to Abby will not be the same, since distributions must come from the AAA to the extent of its positive balance, and the excess from accumulated E&P is taxed as a dividend.

98. IRC §274(c)

Abby's distribution is prorated as follows:

| | | |
|---|---|---|
| Total distribution | | $500,000 |
| Beginning AAA | $100,000 | |
| Gain (net of tax) | 286,250 | |
| Adjusted AAA balance | $386,250 | (386,250) |
| Remainder of distribution (dividend) | | $113,750 |

The **total tax cost** of getting the property out of the corporation is:

| | |
|---|---|
| Tax to Jake on corporate gain | $ 21,469 |
| Tax to Abby on corporate gain | 21,469 |
| Tax to Abby on distribution ($113,750 × 15% dividend tax rate) | 17,063 |
| Built-in gains tax on corporation | 113,750 |
| Total tax | $173,751 |

Even with an S election in effect, Abby still benefits from ensuring her redemption qualifies as an exchange because the corporation has not built up a sufficient AAA balance to absorb the entire distribution and some of the distribution is taxable as a dividend.

**Example 17. S Corporation (Other) — Redemption Distributions.** Use the same facts as **Example 13.** The corporation has always been an S corporation and therefore is not subject to the built-in gains tax. The distribution of Goodland in this redemption has exactly the same effect on AJ. The corporation recognizes $400,000 of gain on the distribution of Goodland, which passes through to the shareholders pro rata. The effect on each shareholder's basis is:

| | Abby | Jake |
|---|---|---|
| Basis before gain on distribution of Goodland | $300,000 | $650,000 |
| Effect of gain on basis | 200,000 | 200,000 |
| Basis before distribution | $500,000 | $850,000 |

Since Abby's basis is the same as the FMV of the property she receives, she recognizes no gain on the distribution. The only tax is on the flow-through of the corporate gain to the shareholders. With each shareholder being liable for a 15% capital gains tax on $200,000, **the entire tax is $60,000** ($200,000 × 15% × 2).

The total tax in this example is the same to all parties whether the distribution is treated as a dividend (local law definition) or a redemption of stock treated as an exchange. Thus, to the shareholder whose stock is being redeemed, it does not matter how the redemption is classified.

The outcome could be different if the corporation redeemed part, but not all, of the shareholder's stock. But, without E&P and built-in gains tax to complicate the issue, there is little significance whether the redemption meets or fails to meet one of the exchange tests.

## LIQUIDATION DISTRIBUTIONS

For a transaction to constitute a complete liquidation, the corporation must cease to be a going concern. Any remaining activities must relate to paying debts and distributing property to shareholders.[99] The corporation need not be dissolved under state law. Its charter may be retained to protect its name for possible future reactivation. A formal plan is not necessary, but it is advisable to draft one. Without such a plan, there may be some confusion about the distribution of the corporation's property.

In general, the liquidation of a corporation is a completely taxable event at both the corporation and shareholder levels. It may be very inexpensive to get property into a corporation, but prohibitively expensive to get it back out. Often, an alternative is for the corporation to become an S corporation. These problems are discussed later in this chapter.

The same general rules apply to both C and S corporations, although the tax liabilities may be quite different, due to the double tax on C corporation distributions and single tax on S corporation distributions. An S corporation recognizes all gains and losses on the distribution of property in a complete liquidation. The gains and losses, however, pass through to shareholders, who adjust their stock basis upon liquidation.

### C Corporation Liquidation Distributions

A liquidating corporation recognizes all gains and losses on distribution of liquidated property.[100] In general, property distributed to shareholders is treated by the corporation as if it were sold to the shareholders at FMV on the date of liquidation. However, special rules must be observed.

In general, the related party loss disallowance rules of IRC §267 do not apply. Thus, a corporation may be able to distribute depreciated property to a person who owns more than 50% of the corporation's stock, and the corporation may still be allowed to deduct a loss. However, **losses are disallowed if property is distributed to a controlling shareholder or a related party, and either:**

- The property was received as a contribution to capital or received in an IRC §351 exchange within five years, **or**
- The "loss" property was not distributed pro rata.[101]

A **controlling shareholder** means a shareholder with more than 50% stock ownership, subject to the broad attribution rules of §267. For example, if Abby and Jake were brother and sister, the constructive ownership rules would not apply in a stock redemption situation, but they would apply in a complete liquidation.

Losses may be limited on recently acquired property, if the property is not related to a corporation's business.[102] This disallowance rule applies to any property contributed to a corporation within two years prior to the liquidation **if both:**

- The corporation's basis exceeds the FMV of the property at the time of contribution, **and**
- The property is unrelated to the corporation's trade or business activities.

> **Note.** This may be a partial, rather than a complete, disallowance of loss.

99. Treas. Reg. §1.332-2(c)
100. IRC §336
101. IRC §336(d)(1)
102. IRC §336(d)(2)

**Example 18. C Corporation — Liquidation Distributions.** AJ is a C corporation and the two land parcels are the only corporate assets. Since the distribution of both properties constitutes a complete liquidation, AJ's gains and losses are computed as follows:

| | |
|---|---|
| Gain on Goodland | $400,000 |
| Loss on Badland (assuming no disallowance rules apply) | (150,000) |
| Taxable income of corporation | $250,000 |
| Tax on corporation (at 2006 graduated rates) | $ 80,750 |

This represents a savings over either a dividend or a redemption, due to the ability of the corporation to deduct the loss on the distribution of Badland. However, if Badland was contributed within the past five years, a problem might arise if Abby and Jake were related. If Abby and Jake are not considered related parties, neither would be a majority shareholder. However, if they were considered related **and** the corporation had received Badland as a §351 or capital contribution within the five years preceding the liquidation distribution, the loss disallowance rule would apply.

**Shareholders** must report all gains and losses on the disposition of their shares in a complete liquidation.[103] A corporation's E&P is completely irrelevant in a complete liquidation. Unless a shareholder at the time of liquidation is a dealer in securities, or a loss qualifies under IRC §1244, any gain or loss will be characterized as capital in nature.[104]

Basis rules follow logically, since the entire transaction is treated as a fully taxable exchange. The basis of property received in the liquidation is its FMV on the date of distribution.[105]

**Example 19. C Corporation — Liquidation Distributions Continued.** Continuing with **Example 18**, AJ has enough cash to pay its final income tax liability resulting from the distribution. The shareholders report the following as a result of their liquidating distributions.

| | Abby | Jake |
|---|---|---|
| Amount realized on distribution | $500,000 | $500,000 |
| Basis before distribution | (300,000) | (650,000) |
| Gain or loss | $200,000 | ($150,000) |

Assuming Abby pays tax at 15% on her capital gain, but that Jake gets no significant tax benefit from his $150,000 capital loss, the total tax costs of the liquidation are:

| | |
|---|---|
| Tax on corporation | $ 80,750 |
| Tax on Abby's distribution ($200,000 × 15%) | 30,000 |
| Tax on Jake's distribution | 0 |
| Total tax | $110,750 |

103. IRC §331. Different rules govern the treatment of a parent corporation and a subsidiary corporation. See IRC §§332, 337.

104. IRC §1244 may characterize some or all of a loss, up to $100,000, as ordinary.

105. IRC §334(a)

## S Corporation Liquidation Distributions

**Example 20. S Corporation (Recently Converted) — Liquidation Distributions.** Use the same facts in **Example 18,** except AJ recently converted from a C corporation to an S corporation. The value of each land parcel was $425,000 on the conversion date and each property appreciated in value by $75,000 since the S election.

Since the distributions are now considered a complete liquidation, the corporation may recognize a loss on the distribution of Badland as well as the gain on Goodland when it computes its built-in gains tax.

| | |
|---|---|
| Built-in gain on Goodland | $325,000 |
| Loss on Badland | (150,000) |
| Taxable built-in gain of corporation | $175,000 |
| Built-in gains tax ($175,000 × 35%) | **$ 61,250** |

The following net gain flows through to the shareholders:

| | |
|---|---|
| Gain on Goodland (not limited to built-in gain) | $400,000 |
| Loss on Badland | (150,000) |
| Built-in gains tax on corporation (35%) | (61,250) |
| Net gain flowing through to shareholders | $188,750 |

Abby and Jake would each take into account **$94,375** ($188,750 ÷ 2) of gain as an increase to basis at the moment before liquidation. They determine their income tax liabilities by first computing their adjusted bases at the time of the liquidating distribution.

| | Abby | Jake |
|---|---|---|
| Basis before gain on distribution of Goodland | $300,000 | $650,000 |
| Effect of gain on basis | 94,375 | 94,375 |
| Basis before distribution | $394,375 | $744,375 |

The shareholders would report the following as a result of their liquidating distributions.

| | Abby | Jake |
|---|---|---|
| Amount realized on distribution | $500,000 | $500,000 |
| Basis before distribution | (394,375) | (744,375) |
| Gain or loss | $105,625 | ($244,375) |

The net gain or loss for each shareholder is:

| | Abby | Jake |
|---|---|---|
| Pass-through gain | $ 94,375 | $ 94,375 |
| Gain or loss on distribution | 105,625 | (244,375) |
| Net gain or loss | $200,000 | ($150,000) |

Note that the flow-through gain to Jake is eliminated by his substantial capital loss. Assuming that Jake gets no immediate tax benefit from the large capital loss, the **total tax liability** is:

| | |
|---|---|
| Built-in gains tax on corporation ($175,000 × 35%) | $61,250 |
| Tax on Abby's distribution ($200,000 × 15%) | 30,000 |
| Tax on Jake's distribution | 0 |
| Total tax | $91,250 |

**Example 21. S Corporation (Other) — Liquidation Distributions.** Use the same facts as in **Example 18,** except AJ is an S corporation that never was a C corporation. The corporation is still subject to the same gain and loss rules, but is not subject to any corporate level tax.

| | |
|---|---|
| Gain | $400,000 |
| Loss | (150,000) |
| Net gain to flow through to shareholders | $250,000 |

Abby and Jake each report half of the gain, or **$125,000,** on their personal returns. They determine their income tax liabilities by first computing their adjusted bases at the time of the liquidating distribution.

| | Abby | Jake |
|---|---|---|
| Basis before gain on distribution of Goodland | $300,000 | $650,000 |
| Effect of gain on basis ($250,000 ÷ 2) | 125,000 | 125,000 |
| Basis before distribution | $425,000 | $775,000 |

The shareholders determine their gains and losses as a result of the following liquidating distributions:

| | Abby | Jake |
|---|---|---|
| Amount realized on distribution | $500,000 | $500,000 |
| Basis before distribution | (425,000) | (775,000) |
| Gain or loss | $ 75,000 | ($275,000) |

The total amount each shareholder must include in gross income is:

| | Abby | Jake |
|---|---|---|
| Pass through gain | $125,000 | $125,000 |
| Gain or loss on distribution | 75,000 | (275,000) |
| Net gain or loss | $200,000 | ($150,000) |

Note that the flow-through gain to Jake is eliminated by his substantial capital loss. Assuming that Jake gets no immediate tax benefit from his large capital loss, the **total tax liability** is computed as follows:

| | |
|---|---|
| Tax on corporation | $ 0 |
| Tax on Abby's distribution ($200,000 × 15%) | 30,000 |
| Tax on Jake's distribution | 0 |
| Total tax | $30,000 |

## CONCLUSION

There are three types of distributions: dividend, liquidation and redemption. A dividend distribution is the most expensive and a liquidation is the least expensive method for distributing property out of a corporation. A redemption falls somewhere in the middle. Infinite combinations of factors (e.g., other shareholders, other assets, built-in gains exposure, asset basis, and stock basis) affect tax liability, making each situation unique.

In nearly all cases, a partnership or an LLC treated as a partnership for tax purposes, reduces the tax burden. In some scenarios, partnership rules are simple and may result in no immediate tax liability on distribution. In other situations, partnership rules are extremely complicated. Despite their complexity, they usually result in more tax savings than the relatively simpler corporate rules.

As these examples demonstrate, there really is no escape from taxation on appreciated real estate. But, an S corporation has an advantage over a C corporation, especially if any built-in gains tax exposure has expired. Perhaps the two most important lessons to take from these examples are:

1. When acquiring real estate, do not put it into a corporation. Instead use a partnership or an LLC taxed as a partnership.
2. If real estate is already in a corporation, tax liability can be reduced by making an S election, then waiting as long as possible, preferably 10 years, before selling or distributing the property.