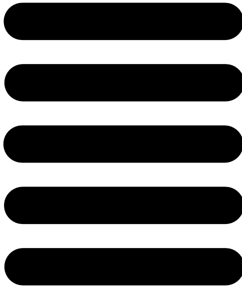


THE M&A Tax Report

VOLUME 13, NUMBER 9
APRIL 2005

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES

**EDITOR-IN-CHIEF**
Robert W. Wood
Robert W. Wood, P.C.
San Francisco

**ASSOCIATE EDITOR**
Joanna Schaller
Tax Institute
San Francisco

**ADVISORY BOARD**

Dominic L. Daher
University of San Francisco
San Francisco

Paul L. Davies III
The Cambria Group
Menlo Park

Jonathan R. Flora
Lindquist & Vennum
Minneapolis

Lawrence B. Gibbs
Miller & Chevalier
Washington

Steven K. Matthias
Deloitte & Touche
San Francisco

Mark A. Muntean
Robert W. Wood, P.C.
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate,
Meagher & Flom
New York

Joseph L. Schiffhouer
Federal Express Corp.
Memphis

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

# S Corporation Didn't Terminate After Stock Purchase

**By Richard C. Morris • Robert W. Wood, P.C. • San Francisco**

We all know that once an S corporation terminates its S election, it generally cannot elect S again for five years. But, when is five years equal to five years? According to the IRS, in certain situations, five years just isn't what it used to be. The IRS has recently ruled that a former S corporation could re-elect S status prior to the expiration of the five-year window.

In LTR 200506007 [Oct. 29, 2004], the IRS ruled that an S corporation's election didn't terminate when an ineligible shareholder (*i.e.*, a foreign corporation) bought 100 percent of the S corporation's stock and, together with the seller, made a Code Sec. 338(h)(10) election. Since the S election didn't terminate, the corporation wasn't shackled by the five-year rule, and its shareholders were able to make another S election when, during the five-year window, they bought the stock back from the foreign corporation.

## Buyer's Remorse

Acquirer, a foreign corporation, decided to purchase all of the stock of Target, an S corporation. As part of the purchase, Acquirer and Target's shareholders jointly made a 338(h)(10) election to treat the stock purchase as an asset purchase.

Later, due to unforeseen circumstances, Acquirer decided to sell Target back to some of its former shareholders and a few new shareholders (collectively, "the New Target Shareholders"). The New Target Shareholders formed a holding company to purchase Target. After the purchase, the holding company distributed Target to the New Target Shareholders. Target then filed a new S election, as well as Qualified Subchapter S Subsidiary (QSUB) elections for its subsidiaries.

The IRS Service Center did not accept the S election, citing Code Sec. 1362(g), which provides that if an S election has been terminated,

*(continued on page 2)*

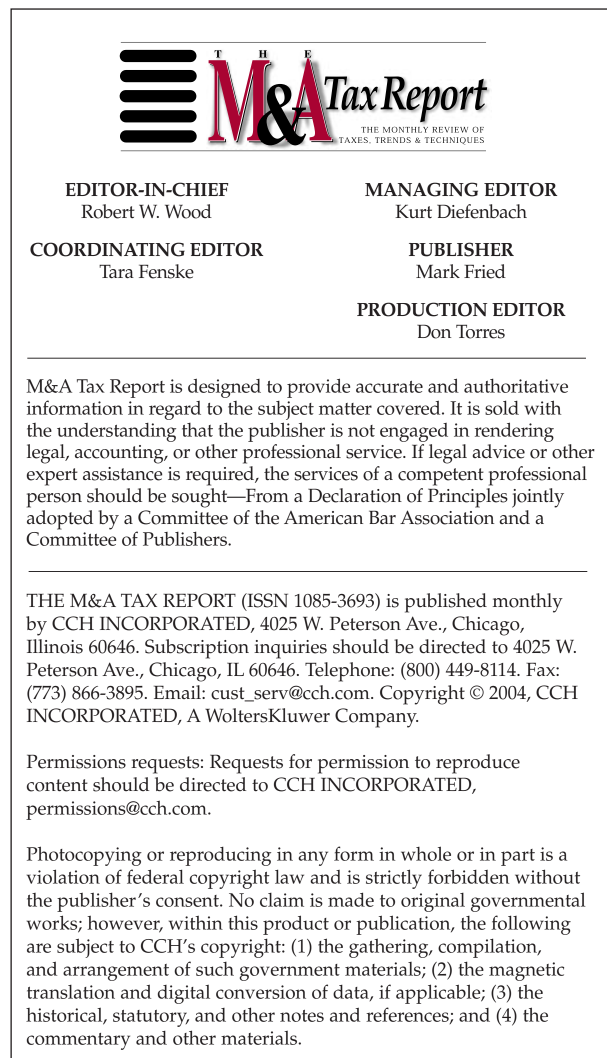
**ALSO IN THIS ISSUE**

The Great Escape Or, Life Is a Beach ....................3
Book Review: Taxation of Damage Awards and Settlement Payments ....................5
The Built-in Gains Tax and the New Carryover Basis Regulations ....................6

the corporation is not eligible to make another S election before its fifth tax year after the year of termination. Plus, the Service Center did not accept the QSUB elections either, since Target did not have a valid S election.

## S Eligibility

The S corporation eligibility rules aren't complicated, though they do keep changing, usually for the better, further expanding the scope of this important pass-through entity. For example, the American Jobs Creation Act of 2004, P.L. 108-357, increased the shareholder maximum to 100. Yet, an S corporation cannot have a foreign corporation as a shareholder. [Code Sec. 1361(b)(1).] Thus, the Service Center apparently thought that when Acquirer purchased Target, Target's S corporation election terminated so that it could not elect S again for five years. That seems logical.




EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Fenske

PUBLISHER
Mark Fried

PRODUCTION EDITOR
Don Torres

M&A Tax Report is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH INCORPORATED, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com. Copyright © 2004, CCH INCORPORATED, A WoltersKluwer Company.

Permissions requests: Requests for permission to reproduce content should be directed to CCH INCORPORATED, permissions@cch.com.

Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly forbidden without the publisher's consent. No claim is made to original governmental works; however, within this product or publication, the following are subject to CCH's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory, and other notes and references; and (4) the commentary and other materials.

After all, an S election is generally effective for all tax years once made, until the election is terminated. The termination of an S election occurs when the S corporation ceases to be a small business corporation, as when the S corporation gets a foreign corporation as a shareholder. Thus, the S election presumably terminated on the date the Acquirer purchased Target.

## Simple Facts, Simple Law

Once terminated, the former S corporation cannot re-elect S status before its fifth tax year, which begins after the first tax year for which the termination is effective, unless the IRS *consents* to the election. That didn't happen here—the IRS wasn't even asked to consent to a re-election. Given that, it would appear that this would be an open-and-shut case. So, what gives?

Target's S election was terminated; re-election of S status requires a five-year wait unless the IRS consents. No consent means no relief.

Fortunately, however, the IRS did not follow this logical road map. Instead, it looked to the rules under Code Sec. 338 to chart a completely different map, one worthy of a skilled cartographer. To understand why the IRS used another map, we need to review the mechanics of Code Sec. 338.

## Code Sec. 338 Machinations

Code Sec. 338 is one of those complicated Code sections that spawned voluminous and complicated regulations. Curiously, its concept was never complex. For many decades, acquisition planners knew that if they bought the stock of a target and then, within two years of closing, liquidated it, they would get a stepped-up basis in the assets they acquired in the liquidation.

In effect, if they finished the second piece (the liquidation) within two years, their stock acquisition would be treated as an asset acquisition, with the price they paid for the stock allocated across the assets they got up to two years later.

Code Sec. 338 was enacted to make the *actual* liquidation of the target unnecessary. Seems simple, right?

Generally speaking, a Code Sec. 338 election is available when a purchasing corporation acquires the stock of another corporation (the target) in a qualified stock purchase. The election is made jointly by the purchasing

corporation and the shareholders of the target. The Regulations clarify that although the target is a single corporation under corporate law, if a Code Sec. 338 election is made, then two separate corporations, Old Target and New Target, are generally considered to exist for tax purposes. Old Target is treated as transferring all of its assets to an unrelated person (which is really New Target) in exchange for consideration that includes the discharge of its liabilities, and New Target is treated as acquiring all of its assets from an unrelated person (which is really Old Target) in exchange for consideration that includes the assumption of those liabilities. After the fictional transfer, Old Target is deemed to liquidate. This transaction is referred to as a deemed asset sale.

The regulations clarify the timing of these mechanics. It provides that Old Target is treated as transferring all of its assets to New Target in a single transaction at the close of the acquisition date (but before the deemed liquidation). Old Target realizes the tax consequences of the deemed sale before the close of the acquisition date while Old Target is owned by the S corporation shareholders, and Target's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation).

Old Target is treated as if it liquidated. The deemed liquidation occurs after the deemed asset sale, but before the close of the acquisition date, and while Old Target is still owned by the S corporation shareholders. As part of the deemed liquidation, Old Target is treated as if it transferred all of its assets to the S corporation shareholders and ceased to exist. In most cases, the transfer will be treated as a distribution in complete liquidation to which Code Sec. 336 or Code Sec. 337 applies.

The S corporation shareholders (whether or not they sell their stock to Acquirer) take their *pro rata* share of the deemed sale tax consequences into account under Code Sec. 1366, and increase or decrease their basis in Target stock under Code Sec. 1367. Furthermore, they are treated as if they received Old Target's assets in the liquidation (which occurs after the deemed asset sale and before the close of the acquisition date). In most cases, the transfer will be treated as a distribution in complete liquidation to which Code Sec. 331 or Code Sec. 332 applies.

## Happy Ending

After a careful review, the IRS concluded that Target's S corporation election did not terminate when Acquirer purchased all of Target's stock because the parties made a Code Sec. 338(h)(10) election. The Code Sec. 338(h)(10) election treated Target's S corporation election as continuing through Acquirer's deemed purchase of Target's assets and Target's deemed liquidation. Further, it treated Target as a new corporation (*i.e.*, New Target) after the liquidation. Since the Code Sec. 338 election causes Target to be treated as a new corporation, Target wasn't "re-electing" S status.

Perhaps this all just sounds like semantics, but it has important consequences. Indeed, the Target here was electing S status for the first time, so the five year rule for re-electing S status by definition could not apply. Thus, Target's shareholders did not need permission to make a new S corporation election for Target.