S Corporation Mergers and Distributions: Which Rules Govern?

by Robert W. Wood • San Francisco

Despite the seemingly unending parade of S corporation reform legislation that keeps bubbling to the surface in Congress every year or two, there are a variety of tensions between the S corporation and C corporation rules. No matter what happens with S corporation reform legislation (including the currently pending version), closely-held businesses and their advisors will probably still have to grapple with some of these issues when effecting acquisitions and dispositions.

It should come as no surprise that a large number of target corporations today are S corporations. With a public company buyer and an S corporation seller (a scenario I often see), the people on the seller's side of the transaction (if not on *both* sides) will have to be concerned about the S corporation rules.

Easy Road?

The IRS has been surprisingly helpful on a number of issues, notwithstanding the difficulty Congress has had in passing some pretty straightforward S corporation reform provisions. It seems amazing that many of the S corporation reform provisions keep getting introduced and reintroduced virtually every year. Hopefully, this time!

Even without legislation, the IRS has been quite helpful from an administrative standpoint. An S corporation's momentary ownership of a subsidiary, for example, will not destroy an S election. This commonly occurs with a drop down of assets under Section 351, followed by a spinoff under Section 355. And it occurs in other situations, too.

However, there are other issues that can be real headscratchers when they arise. For example, what

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about boot distributions that may be made in connection with a merger?

Look to §1368 or §356?

A recent article highlights this problem and is certainly worth a perusal if not a complete read. See Indenbaum and Stead, "Characterization of Distributions in Connection With S Corporation Mergers," Vol. 7, No. 3, *J. of S Corp. Tax'n* (Winter 1996), p. 233. In this article, the authors pose the following fact pattern:

> TS is an S corporation with C corporation earnings and profits (E&P). TS' shareholders are Mr. A (80 percent) and Ms. B (20 percent). TS is worth $4 million and has an accumulated adjustments account of $100,000. TS agrees to be merged into XY, an S corporation with no C corporation history and with a value of $10 million. The merger consideration to Mr. A consists of $3 million of XY stock and $200,000 of cash. The merger consideration to Ms. B consists of $600,000 of XY stock and $200,000 in cash. After the transaction, Mr. A and Ms. B own 22 percent and 1 percent, respectively, of the issued and outstanding stock of XY.

With this hypothetical transaction, the authors ask:

- Do the rules of Subchapter C or Subchapter S govern a merger of S corporations?
- Will the distribution of boot to the S corporation's shareholders be received tax-free to the extent of the S corporation's AAA?
- What is the effect on the shareholders of the receipt of boot in a merger?
- Does Section 356 or Section 1368 govern the treatment of boot distributions?

Tough Analysis

Readers may want to review the entire article to follow the authors' analysis. While they do not answer each question they raise *seriatim*, the answers, mixed in with considerable discussion, seem to come out like this:

Both the rules of Subchapter C and Subchapter S govern a merger. This seems to be a pretty obvious point, since it has long been clear that the reorganization rules can apply to S corporations. There are, after all, no reorganization provisions (no counterpart to Section 368 of the Code) in Subchapter S. On the other hand, it is also rather clear that an S corporation engaging in a reorganization is an S corporation, governed by all of Subchapter S.

Whether a distribution of boot to an S corporation's shareholders is tax-free up to the amount of the accumulated adjustments account is more thorny. If, as part of a reorganization, an S corporation makes distributions, they would seem to have to be characterized in one of two ways. A boot distribution could simply be treated as any other S corporation distribution, and therefore taxed under the familiar rules of Section 1368.

The other option would be to view the distribution as taxable under the boot rules of Sections 354 and 356, in the C corporation regime. Under Section 356, if a shareholder receives boot in addition to stock in the acquiring entity, the shareholder may have gain. The gain would be recognized up to the amount (but not in excess) of the boot received.

Of course, Section 356 has a characterization rule, too. Section 356(a)(2) states that if the exchange has the effect of the distribution of a dividend, then the taxpayer's recognized gain must be treated as a dividend to the extent of his ratable share of post-1913 accumulated earnings and profits. Any additional gain over and above this share of earnings and profits will be treated as a gain from the sale or exchange of property (in other words, as a capital gain).

Effect of a Dividend

How does one determine whether the payment of boot has the effect of a dividend? Under *Commissioner v. Clark*, 489 U.S. 726 (1989), one uses a post-merger test, applying the principles of Section 302 to determine whether the distribution should be treated as a dividend or as a redemption. Thus, it is the shareholder's ownership in the acquiring rather than the acquired corporation that is pertinent.

The character of boot received by a shareholder in a reorganization under Section 356 will consequently

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usually be capital gain, unless the shareholder has a substantial continuing equity ownership in the acquiring corporation.

In the S context, an alternative is to treat the receipt of boot as a distribution under the rules of Section 1368. This provision contains different characterization rules depending on whether the distributing S corporation has C corporation earnings and profits. If it does, the amount of the distribution that does not exceed the accumulated adjustments account will be taxed under Section 1368(b). Thus, distributions will be tax-free up to the extent of a shareholder's basis in his stock. Then, they will be treated as capital gain from the sale or exchange of the stock. I.R.C. §1368(c)(1).

Distributions in excess of the accumulated adjustments account will be treated as a dividend to the extent that the distribution does not exceed the accumulated C corporation earnings and profits of the distributing S corporation. I.R.C. §1368(c)(2).

The remaining portion of the distribution (if any) will likewise be treated under Section 1368(d). In other words, it will be tax-free, reducing the basis of the stock in the S corporation, with any balance being treated as capital gain. I.R.C. §1368(c)(3).

Isn't Boot Boot?

Looking at boot distributions under the C vs. S regimes should point out a significant difference. If the distribution of boot can be treated as a distribution from an S corporation under Section 1368, rather than as boot under Section 356, the shareholder may receive tax-free an amount equal to the shareholder's accumulated adjustments account.

If Section 356 applies, on the other hand, the boot will be treated as gain (or as a dividend) up to the amount of gain realized by the target shareholder.

Interestingly, the authors take the position that there is no authority that definitely determines that a boot distribution is to be treated in this context either under Section 1368 or under Section 356. Of course, the wording of the statute suggests that Section 356 must surely apply.

Arguments Advanced

Although it seems relatively clear that the Service would apply Section 356 to the above situation, Indenbaum and Stead in their article argue that there are good reasons why Section 1368 should apply.

In a sense, though, their theory may prove too much. They note that one can make a pre-reorganization distribution that would definitely receive the more favorable treatment provided by Section 1368. Pre-reorganization distributions by either an acquired or acquiring S corporation are generally governed by the normal distribution rules set forth in Section 1368. See Revenue Ruling 71-266, 1971-1 C.B. 262.

Sometimes this kind of analysis may be too simplistic. It is conceivable, after all, that if an S corporation is a target and makes a substantial distribution prior to a merger, only to be followed by a cash infusion by the acquiring corporation in the merger, the step transaction doctrine could be applied. Were this to occur, the pre-merger distribution might be viewed as taxable under the rules of Section 356. ■

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