Tax Tip

By Stephen R. Looney

The Case of the Disappearing Basis: Stock Acquisitions by S Corporations Followed by QSub Election

Stephen R. Looney is a Shareholder in Dean Mead's Orlando, Florida, office.

Subchapter S corporations have been major participants making effective use of wholly owned disregarded subsidiaries in business and tax planning since 1996. However, tax and corporate practitioners need to be aware of the potential pitfalls that are lurking when an S corporation acquires the stock of another corporation (whether it be a C corporation or an S corporation) and then makes a QSub election for the acquired/target corporation.

An S corporation has been permitted to own 100 percent of the stock of an S corporation subsidiary since the enactment of the Small Business Job Protection Act of 1996[1] ("SBJPA"). Prior to the SBJPA, an S corporation was not permitted to own stock in another corporation because the second corporation would have had another corporation as a shareholder.[2] A second limitation barred an S corporation from owning 80 percent or more of the voting and value of the issued and outstanding stock in a C corporation.[3] As a result of the changes made by the SBJPA, since 1997 an S corporation is allowed to own any percentage of stock in a C corporation without causing the termination of the parent corporation's S election. Additionally, an S corporation is permitted to own all, but not less than all, of the stock of an electing "qualified subchapter S subsidiary" ("QSub").

Code Sec. 1361(b)(3)(B) defines the term QSub generally as any domestic corporation that is not an ineligible corporation if, (1) an S corporation holds 100 percent of the stock of the corporation, and (2) that S corporation elects to treat the subsidiary as a QSub. An "ineligible corporation" includes a financial institution that uses the reserve method of accounting for bad debts under Code Sec. 585, an

insurance company subject to tax under Subchapter L, a possessions tax credit entity described in Code Sec. 936 or a DISC or former DISC.[4]

Except as otherwise provided in the regulations, a corporation for which a QSub election is made is ***not*** treated as a separate corporation, and all assets, liabilities and items of income, deduction and credit of the QSub are treated as assets, liabilities and items of income, deduction and credit of the parent S corporation.[5] Thus, the QSub rule removes not only the controlled subsidiary impediment, but also serves as an important exception to the prohibition on a corporation from owning stock of an S corporation (although a QSub is not an S corporation, rather it provides flow-through treatment by reason of its disregarded status). The final regulations addressing QSubs were issued on January 20, 2000.[6]

Although the relevant statutory language does not specifically provide so, a QSub election is treated as a deemed liquidation of a wholly owned subsidiary into its electing S corporation parent.[7] Consequently, under Code Sec. 337, generally no gain or loss will be recognized by the liquidating subsidiary. Similarly, no gain or loss will generally be recognized by the parent corporation under Code Sec. 332. Note that the regulations provide that the tax treatment of the deemed liquidation and of any larger transaction that includes the liquidation will be determined under the Internal Revenue Code ("the Code") and general principles of tax law, including the step-transaction doctrine, if applicable.[8]

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Under Code Sec. 334(b), the acquiring/parent S corporation will acquire the assets of the subsidiary with a "carryover" or "transferred" basis, except to the extent that gain or loss is recognized by the subsidiary on the liquidating transfer. Additionally, the acquiring/parent S corporation will inherit the tax attributes of the subsidiary under Code Sec. 381. As will be discussed in more detail below, these attributes include any net operating loss carryovers, positive or negative earnings and profits, any capital loss carryovers, and other attributes described in Code Sec. 381(c). Since the parent is deemed to have liquidated the subsidiary, any stock issued to the parent will be treated as surrendered and cancelled in the course of the liquidation, which is the root of the so-called disappearing basis problem discussed below.

In addition to the issues generated as the result of inheriting the tax history of the acquired/target corporation in the deemed liquidation, perhaps the most immediate drawback to the QSub election is the disappearing basis problem. Suppose, for example, that an S corporation purchases all of the stock of a target corporation (whether C or S) in a transaction in which no Code Sec. 338 election is made for a purchase price of $2,000. Assume the target's basis in its assets is $500. By purchasing all of the target's stock and making the QSub election, the parent's $2,000 cost basis in the subsidiary's stock disappears. The only relevant basis to the parent is the adjusted basis of the subsidiary's assets. The $2,000 basis is not reinstated if there is a termination of the QSub election because the subsidiary is treated as a newly formed corporation at that time under Code Sec. 1361(b)(3)(C). Consequently, if the acquiring S corporation turns around and sells the stock of the QSub to a third party for $2,000, the acquiring S corporation will recognize a gain of $1,500, the difference between the $2,000 purchase price and its $500 basis in the assets of the acquired/target corporation, even though it paid $2,000 for the stock of the acquired/target corporation. This creates a significant trap for the unwary and exposes the practitioner to malpractice liability in the event the practitioner has not planned around the disappearing basis issue or at least advised his or her client of this issue.

On the other hand, if the acquiring/parent S corporation had not elected QSub status for the acquired/target corporation and subsequently sold 100 percent of the stock of the acquired/target corporation to a third party, the S corporation would recognize capital gain only to the extent the sales price for the stock exceeded the purchase price the acquiring/parent S corporation paid for the acquired/target stock (*i.e.*, in the example, if the acquiring/parent S corporation sold the stock of the acquired/target corporation to a third party for $2,000, it would recognize no gain on the sale of the stock of its subsidiary, as opposed to recognizing $1,500 of gain where the QSub election was made).

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In order to avoid the disappearing basis problem, the acquiring/parent S corporation could make an election to treat the stock acquisition as an asset acquisition for tax purposes under Code Sec. 338(h)(10) in the event that the acquired/target corporation is an S corporation.[9] Although the tax results may be somewhat less favorable to the shareholders of the acquired/target corporation in the case of a Code Sec. 338(h)(10) election, the buyer and seller can usually reach an agreement on the purchase price that takes into account the increased taxes that the shareholders of the acquired/target corporation will recognize as a result of treating the stock sale as an asset sale under Code Sec. 338(h)(10).

The effect of the Code Sec. 338(h)(10) election for the acquiring/parent S corporation will be that it receives a basis in the acquired/target corporation's assets equal to the purchase price it paid for the acquired/target corporation's stock. When the acquiring/parent S corporation subsequently makes a QSub election for the acquired/target corporation, the assets of the acquired/target corporation will already have a stepped-up purchase price basis, so that the acquiring/parent S corporation's basis in the assets in the Code Sec. 337/332 liquidation will be equal to the purchase price paid for the acquired/target corporation's stock.[10]

Another potential solution to the disappearing basis problem would be to have the shareholders of the acquiring/parent S corporation themselves acquire the stock of the acquired/target corporation. In this manner, if they were to subsequently sell the stock of the acquired/target corporation, their gain or loss would be equal to the difference between the proceeds received on the sale of the stock and their cost basis in the acquired/target corporation's stock. This alternative does not, however, allow the acquired/target corporation to step-up the inside basis of its assets to the amount paid for the stock. However, under the recently finalized regulations under Code Sec. 336(e), the individuals could make a Code Sec. 336(e) election to treat the acquisition of stock of the S corporation by the individual shareholders as an asset sale and therefore receive a stepped-up basis in the assets of the corporation.[11]

In the event the acquired/target corporation is a C corporation, although a Code Sec. 338 election could be made in connection with the acquisition of the C corporation stock, it is unlikely that the parties would agree to this election since it would result in double taxation as if the assets of the C corporation were sold and the corporation was then liquidated.

In addition to the disappearing basis problem, a host of other issues can be associated with the acquiring/parent S corporation's inheritance of the tax attributes of the acquired/target corporation because of the liquidation deemed to occur as a result of the QSub election. The tax attributes that will carry over under the deemed liquidation pursuant to Code Sec. 381(c) will include net operating losses, Subchapter C earnings and profits (CE&P), capital loss carryovers, suspended losses of the acquired/target corporation shareholders (where the acquired/target corporation was an S corporation) and the accumulated adjustments account (AAA) of the acquired/target corporation, if any. The inheritance of some of these tax attributes can actually be favorable for the acquiring/parent S corporation (such as positive AAA, suspended losses, NOLs, *etc.*), whereas other tax attributes can have a very unfavorable impact on the acquiring/parent S corporation.

Additionally, if the acquired/target corporation is a C corporation, although the deemed liquidation as a result of the QSub election will not itself trigger the built-in gain tax,[12] the S corporation parent will be deemed to have acquired assets subject to the built-in gain tax imposed under Code Sec. 1374[13] and will recognize a tax at the maximum corporate tax rate on any net recognized built-in gain attributable to such assets if it disposes of those assets during the recognition period.[14] Likewise, if the acquired/target corporation is a C corporation that used the LIFO method of inventory accounting, the parent S corporation will be subject to the LIFO recapture tax imposed under Code Sec. 1363(d) when the amount of inventory determined under the first in/first out (FIFO) method exceeds that determined under the last in/first out (LIFO) method.

Post-QSub election problems may also be attributable to inheriting the acquired/target corporation's CE&P in the deemed liquidation as a result of the QSub election. First, this will have an impact on characterizing post-QSub election distributions by the parent S corporation to its shareholders, since S corporations having CE&P are subject to a five-tier system of taxation on their distributions as follows:

- that portion of the distribution that does not exceed AAA is tax-free to the extent of the shareholder's stock basis[15];
- that portion of the distribution that does not exceed AAA, but that does exceed the shareholder's stock basis, is capital gain[16];

- that portion of the distribution that exceeds AAA is a dividend to the extent of the S corporation's CE&P[17];
- that portion of the distribution that exceeds AAA and the CE&P of the S corporation is tax-free to the extent of the shareholder's residual stock basis (the shareholder's adjusted basis in his or her S corporation stock less any reductions made in his or her stock basis for any first-tier distributions)[18]; and
- that portion of the distribution that exceeds AAA, the CE&P of the S corporation, and the shareholder's residual stock basis, is capital gain.[19]

Additionally, where the acquiring/parent S corporation has a significant amount of passive investment income, the carryover of the acquired/target's CE&P may result in an entity-level tax under Code Sec. 1375 on excess net passive investment income and/or eventually pose an S election termination risk under Code Sec. 1362(d)(3) where the parent S corporation has excess net passive investment income for three consecutive tax years.

Additional complications may arise where there is a stock acquisition of a consolidated group pursuant to which the common parent corporation converts to S corporation status and makes a QSub election for each of its subsidiaries. Although there should be no income recognition with respect to excess loss accounts (ELAs) that the parent corporation has in a subsidiary resulting from the deemed liquidation under Code Sec. 332 or from any deferred gain and income from intercompany transactions arising under the old intercompany regulations ("Old DITs") where the buying and selling corporations are liquidated tax free into the common parent under Code Sec. 332 prior to the group's ceasing to file consolidated returns, under the new intercompany regulations, gain or income from deferred intercompany transactions ("New DITs") must be included in income when the common parent becomes an S corporation.[20]

Consequently, it may be preferable not to make a QSub election under circumstances where it is necessary to avoid the adverse impact associated with tax attributes resulting from the acquisition and conversion of a corporation into a QSub, such as the built-in gain, the LIFO recapture rules and the inheritance of CE&P which may cause passive investment income problems as well as subject the parent S corporation to the distribution rules to which S corporations having CE&P are subject.

In order to avoid the disappearing basis problem, whenever an S corporation acquires the stock of an S corporation, the acquiring/parent S corporation should consider making a Code Sec. 338(h)(10) election or a Code Sec. 336(e) election in connection with such acquisition or have the parent S corporation's individual shareholders acquire the stock of the acquired/target corporation directly, and make a Code Sec. 336(e) election in connection with the purchase of the stock of the acquired/target corporation. Alternatively, the acquiring/parent S corporation can simply forego making a QSub election for the subsidiary in the event it plans to resell the stock of the subsidiary in order to avoid the disappearing basis problem.

Even where there is no disappearing basis issue, the practitioner needs to give careful consideration as to whether to make the QSub election by evaluating the tax attributes that will be inherited by the acquiring/parent S corporation from the acquired/target corporation in the deemed liquidation resulting from the QSub election, and the effect those inherited tax attributes will have on the operations of the acquiring/parent S corporation.

Endnotes

1 Small Business Job Protection Act of 1996 (P.L. 104-188).

2 Code Sec. 1361(b).

3 Former Code Sec. 1361(b)(2)(A).

4 Code Sec. 1361(b)(2).

5 Code Sec. 1361(b)(3)(A). Although a QSub is generally disregarded for federal income tax purposes, it is recognized for certain federal tax purposes, including federal payroll taxes and certain federal excise taxes. See Reg. §§1.1361-4(a)(6), (7) and (8).

6 65 FR 3843.

7 Reg. §1.1361-4(a)(2)(i).

8 *Id.*

9 Note that a Code Sec. 338(h)(10) election requires the consent of the acquiring corporation as well as the consent of all of the shareholders of the target S corporation. Reg. §1.338(h)(10)-1(c)(3).

10 In lieu of a Code Sec. 338(h)(10) election, an election under Code Sec. 336(e) could be made to treat the stock sale as an asset acquisition to achieve the same results as a Code Sec. 338(h)(10) election.

11 Code Sec. 336(e), which was enacted in 1986, authorized regulations for an election to treat the sale, exchange, or distribution of at least 80 percent of the voting power and value of the stock of the target corporation as a sale of all the corporation's underlying assets. The preamble to the recently issued final regulations notes that the rules under Code Sec. 336(e) were always intended to operate in a manner similar to an election under Code Sec. 338(h)(10) with respect to certain purchases of stock. There are, however, some basic differences in the rules under Code Sec. 336(e) and those under Code Sec. 338(h)(10). One of the most significant differences is that, unlike Code Sec. 338 generally, Code Sec. 336(e) does not require that the acquirer of target stock be a corporation. Consequently, individuals or partnerships can be purchasers and get the indirect benefit of the basis step-up in corporate assets resulting from the election. Although the proposed regulations did not include sales of stock of S corporations within the scope of transactions for which elections could be made under Code Sec. 336(e), the final regulations extended the

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Endnotes

ability to make a Code Sec. 336(e) election to S corporation targets. Note that in order to make a Code Sec. 336(e) election, all of the shareholders of the S corporation must consent to the election. Reg. §1.336-2(h)(3).

[12] LTR 199924008 (Mar. 12, 1999).

[13] Code Sec. 1374(d)(8).

[14] Under Code Sec. 1374(d)(7)(A), the "recognition period" is generally the 10-calendar year period following the date of the corporation's conversion to S status. However, the recognition period is the 7-tax year period following conversion to S status for dispositions made in 2009 or 2010, and the 5-calendar year period for dispositions made in 2011, 2012 and 2013. See Code Sec. 1374(d)(7)(B).

[15] Code Sec. 1368(c)(1) and 1368(b)(1)

[16] Code Sec. 1368(c)(1) and 1368(b)(2)

[17] Code Secs. 1368(c)(2) and 301

[18] Code Sec. 1368(c)(3) and 1368(b)(1)

[19] Code Sec. 1368(c)(3) and 1368(b)(2)

[20] *See* Code Sec. 1504(b) and Reg. §1.1502-13(g)(6). The new deferred intercompany transaction rules apply to intercompany transactions occurring in tax years beginning on or after July 12, 1995.

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