



presents

# Tax Strategies for S Corporations in Financial Distress

## Mastering Complex S Corp Regulations to Protect Your Tax Position

### A Live 100-Minute Audio Conference with Interactive Q&A

#### Today's panel features:

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### Wednesday, July 29, 2009

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# Tax Strategies For S Corporations In Financial Distress

## *Cancellation Of Debt Income Issues*

July 28, 2009

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# Agenda

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General tax rules when an S corporation is in financial distress

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Transactions that create COD income

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Section 108 and S corporations

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Application of rules to QSubs

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Issues with financially distressed shareholders

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# General Tax Rules

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- An S corporation must meet certain eligibility requirements under Section 1361 or its S status will terminate
  - The S corporation must be a domestic corporation; the corporation may have no more than 100 shareholders; only individuals, certain trusts and estates, and certain tax-exempt organizations may be shareholders; and the corporation may have only one class of stock
- These requirements may be threatened by bankruptcy proceedings, debt restructurings, or reorganizations when an S corporation is financially distressed

# General Tax Rules (Cont.)

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- Qualification - An insolvent corporation or a corporation contemplating bankruptcy may elect to be an S corporation
- Termination - Termination of S status may occur if an impermissible shareholder is allowed, or a second class of stock is inadvertently created
- Revocations – Generally, courts have rejected revocations made before or after filing for bankruptcy

# General Tax Rules (Cont.)

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- Section 1366(d) limits the aggregate amount of losses and deductions taken into account by a shareholder to the extent of their stock and debt basis
- Any disallowed losses or deductions may be carried forward indefinitely for the life of the S corporation
- Shareholders of financially distressed S corporations will often have losses generated from corporate loans from third parties that exceed the shareholder's stock and debt basis

# General Tax Rules (Cont.)

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- Upon ultimate failure of S corporation, shareholders generally may deduct remaining basis for corporation's stock and debt
  - However, S corporation losses that previously passed through may have already reduced the basis to zero
- In the year of worthlessness:
  - Pass through of losses will use basis before any deduction may be claimed for worthlessness under Sections 165(g) or 166(d)
  - Section 1244 may allow an ordinary loss for any remaining basis

# General Tax Rules (Cont.)

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- Insolvency liquidations
  - Corporate-level aspects
    - Typical liquidation consequences – distribution of any property treated as sale with any gain passing through to shareholders
    - If corporation subject to Section 1374, distribution of appreciated property could trigger BIG tax at corporate level
  - Shareholder-level aspects
    - Corporation likely will not have any property to distribute to shareholders. However, any gain or loss property used to satisfy debts will pass-through to shareholders
    - If shareholders have guaranteed part or all the corporation's debts, payments on those guarantees will augment the amount of their Section 165(g) worthless stock loss deductions, which typically will be capital losses

# Transactions That Create COD Income

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- Cancellation of debt (COD) income is created through:
  - Discharge of indebtedness due to Chapter 11 bankruptcy proceedings
  - Discharge of indebtedness due to insolvency
  - Debt modification
  - Debt restructuring
  - Transfer of property in satisfaction of debt

## **Transactions That Create COD Income (Cont.)**

- Section 108 provides special rules for bankrupt or insolvent S corporations, excluding from income discharge of indebtedness to the extent of the taxpayer's insolvency or discharge in Chapter 11 bankruptcy proceedings
- Per Section 108(d)(7)(A), insolvency/bankruptcy is determined at S corporation level
- The shareholders' stock basis and AAA may not be increased by the amount of excluded COD income

## **Transactions That Create COD Income (Cont.)**

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- Creditors may choose to forgive all or a portion of a loan. Discharge of indebtedness, in whole or in part, is taxable income under Section 61(a)(12) except otherwise provided under Section 108
  - Note that discharge of indebtedness used as a medium of payment for goods or services is treated as a payment, not as COD income. See Rev. Rul. 84-176
- Because an S corporation is a pass-through entity, COD income is passed through ratably to the shareholders under Section 1366(a)(1). This income increases the shareholder's basis under Section 1367. The COD income recognized also increases the S corporation's AAA

## Transactions That Create COD Income (Cont.)

- Debt modification and restructuring includes debt for debt exchanges, equity for debt exchanges, contribution of debt to capital, debt repurchases, acquisition of debt by related party, and forgiveness of debt
- Debt modification as a deemed exchange
  - To the extent of a material modification
- New debt for old debt recapitalizations – tax free if:
  - Exchange of debt for debt, no step-up in face amount of new over old debt, and no accrued, but untaxed, interest on the old debt
- New equity for old debt recapitalizations
  - May result in termination of S election if creditor is ineligible shareholder. If creditor is an eligible shareholder must consider 2<sup>nd</sup> class of stock

## **Transactions That Create COD Income (Cont.)**

- COD income from the transfer of property in satisfaction of debt of a solvent S corporation may produce income without the receipt of cash
  - Even if S corporation receives cash in connection with the income, the S corporation's creditors may not allow the S corporation to make shareholder distributions
  - Thus, shareholders may have to pay taxes on income without being able to get cash from S corporation

# Section 108 And S Corporations

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- Section 108 excludes from income discharge of indebtedness to the extent of the taxpayer's insolvency or discharge in Chapter 11 bankruptcy proceedings
  - In the case of a discharge of indebtedness excluded due to insolvency, the amount excluded may not exceed the amount by which the taxpayer is insolvent under Section 108(a)(3)
- The trade off for non-recognition of COD income is that certain attributes must be reduced at the corporate level under Section 108(b)(2)

# **Section 108 And S Corporations (Cont.)**

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- Since an S corporation does not have tax attributes at the entity level (unless it was previously a C corporation), there are special rules applicable to S corporations under Section 108(d)(7)
  - It is unclear whether S corporation NOLs from a former C corporation period are available for tax attribute reduction
- Alternatively, the S corporation may elect under Section 108(b)(5) to first reduce the basis of depreciable property before reducing any tax attributes

# **Section 108 And S Corporations (Cont.)**

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- Section 108(d)(7)(B) provides that in the case of an S corporation, any loss or deduction that is disallowed for the taxable year of the discharge under Section 1366(d)(1) is treated as a NOL of the S corporation
- Any loss or deduction that is disallowed because it exceeds the shareholder's basis in stock and debt of the corporation is treated as a NOL that is reduced by amounts excluded from gross income arising from the discharge of indebtedness

# Section 108 And S Corporations (Cont.)

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- Proposed regulations under Section 1.108(d)(7) provide guidance on the manner in which an S corporation reduces its tax attributes under Section 108(b) for tax years in which the S corporation has COD income that is excluded under Section 108(a)
- In particular, the regulations address situations in which the aggregate amount of the shareholders' disallowed Section 1366(d) losses exceeds the amount of the S corporation's excluded discharge of indebtedness income
- The regulations also have an ordering rule for the character of the suspended losses that are reduced. Suspended losses are reduced in the following order: ordinary, Section 1231, then capital

# Section 108(i) - Deferral

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- The American Recovery and Reinvestment Act of 2009 added new Section 108(i). Under this section, an S corporation may make an election to defer the recognition of COD income. Income incurred in connection with the reacquisition of a debt instrument may be included ratably over a five-tax-year period
- Applies to:
  - Acquisition of debt in exchange for cash
  - Debt for debt exchange
  - Equity for debt exchange
  - Contribution of debt to capital
  - Complete forgiveness of debt by the holder of the indebtedness

## **Section 108(i) – Deferral (Cont.)**

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- The five-year period ends with the fifth tax year following the tax year in which the reacquisition occurs for a reacquisition occurring in 2009, or in the fourth tax year following the tax year in which the reacquisition occurs for a reacquisition occurring in 2010
- The election is made by the S corporation on a debt by debt basis, and is irrevocable

## **Section 108(i) – Deferral (Cont.)**

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- The debt instrument must be reacquired by the S corporation, or a person related to the debtor through a relationship specified in Section 267(b). The reacquisition must occur after December 31, 2008, and before January 1, 2011 to qualify
- Certain events may trigger accelerated recognition of the deferred COD income. These include the death of the taxpayer (shareholder), the liquidation or sale of substantially all the assets of the taxpayer (including bankruptcy), cessation of business by the taxpayer, or the sale, exchange, or redemption of S corporation stock

# Application Of Rules To QSubs

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- If an S corporation has a qualified subchapter S subsidiary (QSub) or a single-member limited liability company (SMLLC) that is disregarded for federal tax purposes and that has COD income, the determination of whether COD income is excluded depends upon whether the S corporation rather than the disregarded entity is insolvent or in bankruptcy

# **Application Of Rules To Qsubs (Cont.)**

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- If an S corporation is insolvent or in bankruptcy, COD income may be excluded
- If an S corporation is solvent, COD income will be recognized but income will flow through to shareholders who will be able to increase stock basis
  - The IRS and Treasury Department are considering guidance
- If an S corporation is considering making a QSub election for an insolvent subsidiary, the liquidation will not qualify as tax free under Section 332 and gain or loss must be recognized on the assets distributed

# Issues With Financially Distressed Shareholders

- The insolvency or bankruptcy of a shareholder does not terminate S status. A bankruptcy estate is an eligible S corporation shareholder
- If a shareholder files for bankruptcy:
  - The bankruptcy estate is a separate taxpayer and a permissible shareholder
  - The transfer of S stock from the shareholder to the bankruptcy estate is not a taxable event, and the bankruptcy estate is treated as the owner of the stock. Section 1398(f)
  - Generally, even if the shareholder files for bankruptcy before the end of the S corporation's taxable year, all of the passthrough items for the entire taxable year are allocable to the bankruptcy estate and no part of the passthrough items are allocable to the shareholder

# Issues With Financially Distressed Shareholders (Cont.)

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- Under the bankruptcy rules, the individual may elect to terminate the individual's taxable year upon filing for bankruptcy. Section 1398(d)(2)
- If the election is made, the gross income of the estate for each tax year will include the gross income of the debtor to which the estate is entitled under title 11, but excluding any amount received or accrued by the debtor before the commencement of the bankruptcy. Section 1398(e)(1)
- If S corporation stock has been transferred to a creditor, and the shareholder is not an eligible shareholder, then S status will terminate. This issue can be addressed in advance in a shareholder agreement

# Issues With Financially Distressed Shareholders (Cont.)

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- If a shareholder made any direct loans to the S corporation, the straight debt safe harbor rules of Section 1361(c)(5) should be met to ensure that the debt will not be treated as a second class of stock. The fact that an obligation is subordinated to other debt of the S corporation does not prevent the obligation from qualifying as straight debt
- The debt owed to the shareholder must bear adequate interest. If not, interest or original issue discount will be imputed under Section 7872

# Issues With Financially Distressed Shareholders (Cont.)

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- Shareholders borrowing from an unrelated third party and then lending to the S corporation will generally produce shareholder debt basis. When the third party lender is related, the IRS may question the transaction. The substance of all transactions (e.g., repayments, flow of cash, etc.) should match the form
- The IRS generally will not accept back-to-back loans between related parties as debt basis. However, the IRS is working on guidance in this area and the client may be able to judicially prevail

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# Tax Strategies For S Corporations In Financial Distress Teleconference

July 29, 2009

## *Restructuring, Reorganization And Planning Strategies*

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### **I. Restructuring, Reorganization And Planning Strategies For Distressed S Corporations**

#### **A. Sect. 368 reorganizations**

An important advantage of conducting business operations in corporate solution is that stock and equity interests in a corporation may be exchanged on a non-taxable basis between the parties to the transaction at both the corporate and shareholder levels (a “tax-free reorganization”).<sup>1</sup> In addition to satisfying certain requirements under Sect. 368 of the Internal Revenue Code of 1986 (the “Code”),<sup>2</sup> a tax-free reorganization must have a business purpose, continuity of proprietary interest, a plan of reorganization and continuity of business enterprise. The tax-free reorganization provisions have application for financially distressed corporations as well as profitable corporations

#### **1. Application of reorganization provisions to S corporations**

An S corporation is treated as a corporation for purposes of the tax-free reorganization provisions under Subchapter C.<sup>3</sup> Similarly, qualified S corporation subsidiaries (“QSubs”) can be part of tax-free reorganizations, including a Sect.

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<sup>1</sup> See, e.g., §354(a).

<sup>2</sup> Unless otherwise specified, all “Sect.” and “§” references are to the Code and all “Regulation and “Reg. §” references are to the Treasury regulations promulgated thereunder.

<sup>3</sup> §1371(a)(1).

368(a)(1)(A) merger or consolidation.<sup>4</sup> However, there may be important differences in the consequences to the corporation and its shareholders where an S corporation or QSub is involved. Distressed S corporations and QSubs are no exception

## **2. The alphabet soup of tax free reorganization patterns**

The types of tax free reorganizations under Sect. 368 include the following:

Type A- Statutory merger/consolidation. Sect. 368(a)(1)(A)<sup>5</sup>

Type B- Stock “solely” for voting stock. Sect. 368(a)(1)(B)

Type C- All or “substantially all” assets for voting stock. Sect. 368(a)(1)(C)

Type D-All or “substantially all” assets (or part of the assets in connection with a divisive reorganization) transferred to corporation controlled by transferor. Sect. 368(a)(1)(D)

Type E- Recapitalization. Sect. 368(a)(1)(E)

Type F- Mere change in form, identity, place of reorganization. Sect. 368(a)(1)(F)

Type G- Bankruptcy reorganization. Sect. 368(a)(1)(G)

The transfer of assets to a corporation and the liquidation of a corporate subsidiary may also be tax-free under Sect.s 351 and 332

Type E, F, and G reorganizations are most commonly involved in creditor workouts by financially distressed corporations

## **3. The Type E reorganization**

A Type E reorganization involves a recapitalization of a corporation and contemplates a reshuffling of the capital structure within the framework of an existing corporation. Notably, the continuity of business and continuity of interest requirements do not apply to Type E recapitalizations.<sup>6</sup> A Type E recapitalization may be the first step in a two step, two company Type A, B, C, D or F reorganization<sup>7</sup>

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<sup>4</sup> See Temp. Reg. §1.368-2T(b); see also Prop. Reg. §1.368-2(b), 70 Fed. Reg. 749-01 (Jan. 5, 2005) (proposing rules identical to Temp. Reg. §1.368-2T(b) with respect to QSubs and rules generally permitting mergers and consolidations effected pursuant to foreign laws). See Temp. Reg. §1.368-2T(b)(1)(iv) ex. 2.

<sup>5</sup> See also §§368(a)(2)(D), 368(a)(2)(E).

<sup>6</sup> Reg. §1.368-1(b)

<sup>7</sup> See Rev. Rul. 59-222, 1959-1 C.B. 80 (E followed by B); Rev. Rul. 61-156, 1961-1 C.B. 62. (E followed by F); Rev. Rul. 77-227, 1977-2 C.B. 120 (E followed by A). The Service has also issued a number of private letter rulings involving E recapitalizations coupled with F reorganizations.

A common application of a Type E reorganization in the case of a financially distressed corporation would include converting securities or debt to equity to avoid violating a loan covenant, moving shareholder debt from a senior to a junior class, or subordinating shareholder debt to debt held by other lenders. Such transactions would not result in the recognition of gain or loss by the shareholders as Type E reorganizations, subject to the rules dealing with cancellation of indebtedness discussed further below

#### **4. The Type F reorganization**

A Type F reorganization occurs where there is a “mere change in identity, form, or place of organization of one corporation, however effected.” A liquidation-reincorporation will generally constitute an F reorganization

There are various overlap issues between a Type F and a Type A, Type C or Type D reorganization. For example, both a Type F and a Type A reorganization may occur when a corporation merges into a corporation newly created in another state by the same shareholders.<sup>8</sup> Another application of a Type F reorganization would be where an S corporation merges into a QSub<sup>9</sup> or where an S corporation transfers its assets to a newly organized corporation. The “new” corporation is simply a continuation of the old S corporation which has merged into the new corporation<sup>10</sup>

As in the case of a Type E recapitalization, the continuity of business and continuity of interest requirements do not apply to a Type F reorganization

#### **5. The Type G reorganization**

The Bankruptcy Tax Act of 1980 repealed the former insolvency reorganization provisions of Sect.s 371-374 and replaced them with the new Type G reorganization, effective generally for bankruptcy and similar proceedings commenced after 1980. The Senate Report stated that the new provision was intended “to facilitate the rehabilitation of corporate debtors in bankruptcy” and was “designed to eliminate many requirements that would have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law<sup>11</sup>

A Type G reorganization must satisfy the continuity-of-interest and continuity of business enterprise tests as well as the technical statutory requirements of the G reorganization under Sect. 368(a)(1)(G), which require:

A transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of

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<sup>8</sup> See Rev. Rul. 64-250, 1964-2 CB 333 (Type F reorganization occurred when S corporation merged into new corporation set up by same shareholders in another state; corporation's S status did not terminate).

<sup>9</sup> Reg. §1.1361-5(b)(3), Ex. 8.

<sup>10</sup> See PLR. 8843026 (Aug. 1, 1988).

<sup>11</sup> S. Rep. No. 1035, 96<sup>th</sup> Cong., 2d Sess. 35 (1980)

the corporation to which the assets are transferred are distributed in a transaction which qualifies under Sect. 354, 355, or 356

A “title 11 or similar case” is defined by Sect. 368(a)(3) as a case under the Bankruptcy Code or “a receivership, foreclosure, or similar proceeding in a Federal or State court.”

Sect. 368(a)(3)(C) provides that if a transaction qualifies as a G reorganization and would also qualify as a reorganization under the other regular reorganization provisions or under Sect. 332 or Sect. 351, then the transaction will be treated as qualifying only under Sect. 368(a)(1)(G), except for purposes of 357(c)(1) in the case of the transfer of liabilities in excess of basis<sup>12</sup>

The formal requirements of a Type G reorganization, a transfer of assets from one corporation to another pursuant to a plan of reorganization approved by a bankruptcy court that has jurisdiction over at least one of the parties to the transaction, are not difficult to satisfy. However, the transaction must also satisfy Sect. 354 which requires: (i) a distribution of stock or securities issued by the acquiring corporation by the old corporation to someone who held stock or securities in the old corporation, and (ii) the transfer of “substantially all” of the assets of the old corporation to the new corporation<sup>13</sup>

It is possible for a failing company with trade debt or short term loans (not constituting securities) that exceeds the value of the assets to undergo a reorganization that wipes out the stockholders of the company, and issue stock or debt to the creditors, without satisfying the distribution requirement of Sect. 354. It appears to be sufficient that at least one person or entity that holds a security in the old company will receive stock in the new company<sup>14</sup>

The “substantially all” requirement is similar to the “sub-all” requirement for a Type C, D or the reverse merger (Sect. 368(a)(2)(E)) reorganization provisions. Generally, the “sub-all” test involves a 70 percent of gross assets test and a 90 percent of net assets test. An insolvent company, of course, will not have any net assets, so this part of the test will be irrelevant. The 70 percent of gross assets test may be a problem for a failing company which may have been disposing of assets to survive and reduce its debt prior to the reorganization

The Senate Report indicated that the sub-all test in a G reorganization should be interpreted in light of the underlying intent of the new G provisions,

namely, to facilitate the reorganization of companies in bankruptcy, or similar cases for rehabilitative purposes. Accordingly, it is intended that facts and

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<sup>12</sup> On the other hand, a failed Type G should be able to be tested as a reorganization under one of the other reorganization provisions.

<sup>13</sup> §354(b)

<sup>14</sup> See PLR 8503064 (Oct. 24, 1984); PLR 8521083 (Feb. 27, 1985); PLR 8909007 (Nov. 30, 1988); PLR 9335029 (Sep. 3, 1993); PLR 9629016 (Apr. 22, 1996).

circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditor or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction is not precluded from satisfying the "substantially all" test for purposes of the new "G" category merely because, prior to a transfer to the acquiring corporation, payments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue the business<sup>15</sup>

As with other tax-free reorganizations, the acquiring or surviving entity in a G reorganization will receive a carryover basis in the assets of the failed or target corporation as well as its other tax attributes, subject to applicable limitations provided under Subchapter C or the consolidated return regulations. The shareholders of the failed or target corporation will maintain their historical cost basis in the target stock with regard to their newly acquired stock ownership in the surviving corporation, without the triggering of loss recognition. A G reorganization may be partially taxable to the transferor corporation or the shareholders of the target, such as where cash or other property is received in addition to the stock or securities of the acquiring corporation

#### **B. Issuance of equity in satisfaction of debt**

If a shareholder-creditor of a corporation contributes his or her debt to the capital of the corporation, the debtor corporation is treated as having satisfied the debt with an amount of money equal to the shareholder's adjusted basis in the debt, under Sect. 108(e)(6)

On the other hand, when a debtor corporation transfers its stock to a creditor in satisfaction of its recourse or nonrecourse indebtedness (a debt-for-equity exchange), the debtor will be treated as having satisfied the debt with money equal to the fair market value of the stock under Sect. 108(e)(8), with the balance of the debt cancellation treated as cancellation of indebtedness ("COD") income. In the event of an S corporation, the COD income is generally passed through to the shareholders.<sup>16</sup> Special rules apply in the event the creditor claims a deduction under Sect. 166 as a result of the worthlessness of the debt.<sup>17</sup> The amount of the ordinary loss allowed to the creditor "taints" the stock received by the creditor, which is treated as Sect. 1245 property (i.e., subject to recapture similar to deductions for depreciation). The recapture rules apply to stock held by a creditor even if the subsequent "recapture" transaction would be treated as qualifying for carryover basis under Sect.s 354, 355 or 356

Partnerships are subject to similar rules. While Sect. 108(g)(6), involving the contribution of debt to the capital of a corporation as described above, does not apply to partnerships, the transfer by a debtor partnership of a capital or profits interest in the

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<sup>15</sup> S. Rep. No. 1035, 96<sup>th</sup> Cong., d Sess. 35-36 (1980)

<sup>16</sup> The Sect. 108 exclusion is applied as the S corporation level, depending on whether the S corporation is insolvent or in bankruptcy.

<sup>17</sup> §108(e)(7)

partnership to a creditor, in satisfaction of the partnership's recourse or nonrecourse indebtedness, is treated as if the debtor has satisfied the indebtedness with money equal to the fair market value of the partnership interest under Sect. 108(e)(8)(B), with the balance of the debt cancellation treated as COD income. Any COD income recognized under this provision is included in the distributive shares of the partners in the partnership immediately before the debt was discharged

## **II. Implications Of Workouts With Creditors On The S Election And The QSub Election**

### **A. In general**

Under current law, Sect. 1361(b)(1) provides that an S corporation is: (i) a domestic corporation; (ii) which does not have more than 100 shareholders; (iii) does not have a shareholder who is not an individual (other than an estate, certain trusts or charitable or tax-exempt organizations); (iv) does not have a nonresident alien as a shareholder; (v) does not have more than one class of stock which is issued and outstanding; and (vi) is not otherwise an ineligible corporation. Accordingly, an entity taxable as a partnership can not own stock in an S corporation. A regular or C corporation is not permitted to own stock in an S corporation

In 2004, the American Jobs Creation Act of 2004 (the "2004 Act") added Sect. 1361(c)(1)(D) to the Code, providing that for purposes of the shareholder numerical limitation, members of a family will be treated as 1 shareholder. The term "members of a family" means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant. The so-called common ancestor must not be more than 6 generations removed from the youngest generation of shareholders who would (but for this subparagraph) be members of the family<sup>18</sup>

These restrictive S corporation ownership limitations not only affect the organization of an S corporation, but will greatly impact the structure of the acquisition of or by an S corporation or the transfer of an interest in an S corporation in connection with an arrangement with creditors or bankruptcy

### **B. Consequences of termination of the S election**

A debt workout may result in the cancellation of some or all of the debtor corporation's old stock and issuance of new stock to the creditors. Most lenders, especially banks and institutional creditors, will not be permitted shareholders under Sect. 1361(b)(1)(B). Consequently, an issuance of stock to creditors in connection with a workout poses particular risk for S corporation interest holders as the corporation could

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<sup>18</sup> See Truskowski, "AJCA Changes to Subchapter S Broaden the Availability of the S Election," 101 J. Tax'n 327 (December 2004). Under the Gulf Opportunity Zone Act of 2005 (the "2005 Act"), an election is no longer required for a family to be treated as one shareholder, as originally required under the 2004 Act.

lose its S corporation status. Once lost, a corporation generally may not re-elect S status for five years<sup>19</sup>

Should an S corporation cease to be a small business corporation, its S election is treated as terminating on the date of cessation. The last taxable year of an S corporation (the “S termination year”) is divided into (i) a short taxable year which ends on the day before the termination date (the “S short year”), and (ii) a short taxable year beginning the day on which the termination is effective (the “C short year”)<sup>20</sup>

The former S corporation’s items of income, loss, deduction, or credit, and nonseparately computed income or loss for the S termination year are allocated pro rata by the number of days in the S short year and the C short year.<sup>21</sup> Items of income, loss, deduction, and credit may be taken into account when earned under normal tax accounting rules (i.e., a closing of the books) if all persons who are shareholders at any time during the S short year and all persons who are shareholders on the first day of the C short year consent.<sup>22</sup> However, if, in the course of a workout, creditors exchange debt for more than 50% of the corporation’s stock, the closing-of-the-books approach applies<sup>23</sup>

Items of income, loss, deduction, or credit and nonseparately computed income or loss for the S short year are passed through to the shareholders under Sect. 1366. Income, gain, loss, deduction, and credits for the C short year will be subject to double taxation. Taxable income for the C short year is annualized by multiplying the taxable income by the number of days in the S termination year and dividing such product by the number of days in the C short year.<sup>24</sup> Taxable income is annualized also for purposes of calculating any alternative minimum tax for the C short year<sup>25</sup>

Generally, no carryovers are allowed between S corporation taxable years and C corporation taxable years.<sup>26</sup> However, if a shareholder incurs losses or deductions that are disallowed under Sect. 1366(d)(1) in the S short year, these suspended losses and deductions may be carried over to the end of the post-termination transition period.<sup>27</sup> Where the S corporation ceases to be a small business corporation under Sect. 1362(d)(2), the post-termination transition period generally means the period beginning on the first day of the C short year and ending on the later of (i) one year after the last day of the S short year, or (ii) the due date for filing the S short year return, including

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<sup>19</sup> §1362(g).

<sup>20</sup> §1362(e)(1),(4); Reg. §1.1502-76(b)(1)(ii)(A) (2).

<sup>21</sup> §1362(e)(2).

<sup>22</sup> §1362(e)(3).

<sup>23</sup> §1362(e)(6)(D).

<sup>24</sup> §1362(e)(5).

<sup>25</sup> §§443(d), 1362(e)(5).

<sup>26</sup> §1371(b).

<sup>27</sup> §1366(d)(3).

extensions.<sup>28</sup> Any distributions of money by the corporation with respect to its stock during the post-termination transition period may be tax-free, causing a reduction in the shareholder's outside basis, to the extent the distribution does not exceed the accumulated adjustments account.<sup>29</sup> If all the affected S corporation shareholders consent, the corporation may make distributions out of earnings first, thereby preserving the shareholders' outside basis<sup>30</sup>

An S corporation cannot apply an NOL or other carryforward from a prior taxable year during which it was a C corporation,<sup>31</sup> except with respect to any Sect. 1374 tax.<sup>32</sup> However, if a former C corporation with an NOL or other carryforward converts back into a C corporation, the carryforwards appear to be available. However, the S corporation taxable years count in determining the remaining taxable years for a carryforward.<sup>33</sup> For example, if a C corporation incurs an NOL in its first taxable year and then elects S corporation status for the next fifteen taxable years, the NOL could only be carried forward for five more years (twenty years less fifteen) after converting back to C status

### **C. Single class of stock requirement for S corporation status**

The eligibility requirements of Sect. 1361(b) may significantly restrict the structure of an arrangement or workout between an S corporation and its creditors. The Subchapter S rules prohibit the issuance of more than one class of stock, i.e., stock which has a preference on distributions during either the operational or liquidation phase.<sup>34</sup> A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.<sup>35</sup> Shareholder covenants contained in buy-sell agreements generally will not result in a second class of stock.<sup>36</sup> This limitation has made it difficult for S corporations to obtain a debtor in possession ("DIP") loan, or to raise funds and venture capital since many lenders seek hybrid forms of payment or "kickers" in addition to receipt of a pure interest stream of payments for the use of borrowed funds

A detailed discussion of the one class of stock requirement for S corporations is set forth below

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<sup>28</sup> §1377(b)(1).

<sup>29</sup> §1371(e)(1).

<sup>30</sup> §1371(e)(2).

<sup>31</sup> §1371(b)(1)

<sup>32</sup> §1374(b)(2)

<sup>33</sup> §1371(b)(3).

<sup>34</sup> §1361(b)-(1)(D). Reg. §§1.1361-1(l)(2)(i)(differences in timing of distributions as a second class), 1.1361-1(l)(2)(ii)(effect of state income tax withholding regimes).

<sup>35</sup> Differences in common stock voting rights are disregarded under §1361(c)(4).

<sup>36</sup> See Reg. §1.1361-1(l)(2)(iv); Rev. Rul. 85-161, 1985-2 C.B. 191.

## **1. Differences in voting rights**

Reg. §1.1361-1(1)(1) provides that differences in voting rights among shares of stock of the corporation will be disregarded in determining whether a corporation has more than one class of stock. Consequently, an S corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members to the board of directors, as long as such shares confer identical rights to distribution and liquidation proceeds

## **2. Non-conforming distributions**

The original proposed second class of stock regulations provided that even where all outstanding shares of stock conferred identical rights to distribution and liquidation proceeds, the corporation still would be treated as having more than one class of stock if the corporation made “non-conforming distributions.” Non-conforming distributions were defined as distributions which differed with respect to timing or amount as to each outstanding share of stock, with certain limited exceptions. Thus, under the original proposed regulations, excessive or inadequate compensation from an S corporation to a shareholder, shareholder loans, fringe benefits to shareholders, and other constructive distributions such as excessive rental payments between a shareholder and an S corporation could cause the inadvertent termination of an S corporation’s election under the non-conforming distribution rule. Under the final second class of stock regulations, non-conforming distributions will not cause a corporation to be treated as having more than one class of stock, but such distributions (including actual, constructive or deemed distributions) that differ in timing or amount will be given the appropriate tax effect in accordance with the facts and circumstances. Thus, the Service has the power to recharacterize such distributions<sup>37</sup>

## **3. Stock Taken into Account**

Under Reg. §1.1361-1(1)(3), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account, except for: (i) restricted stock within the meaning of Reg. §1.1361-1(b)(3) with respect to which no Sect. 83(b) election has been made; (ii) deferred compensation plans within the meaning of Reg. §1.1361-1(b)(4); and (iii) straight debt under Reg. §1.1361-1(b)(5) and -1(l)(5)

## **4. Governing provisions**

Reg. §1.1361-1(1)(2) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based upon the corporate charter, articles of incorporation, bylaws, applicable state law, and “binding agreements relating to distribution and liquidation proceeds” (the “Governing Provisions”). Thus, with respect to an S corporation’s outstanding shares of stock, only

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<sup>37</sup> Reg. §1.1361-1(1)(2)(i).

Governing Provisions can cause the corporation to be treated as having a second class of stock

## **5. Routine commercial contractual arrangements**

Reg. §1.1361-1(1)(2) provides that routine commercial contractual arrangements, such as leases, employment agreements and loan agreements, will not be considered binding agreements relating to distribution and liquidation proceeds, and consequently will not be considered Governing Provisions, unless such agreements are entered into to circumvent the one class of stock requirement

## **6. State law requirements for payment and withholding of income tax**

Reg. §1.1361-1(1)(2)(ii) provides that state laws requiring a corporation to pay or withhold state income taxes on behalf of some or all of its shareholders will be disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds if, when the constructive distributions resulting from the payment of such taxes by the corporation are taken into account, the outstanding shares otherwise confer identical rights to distribution and liquidation proceeds. Consequently, a difference in timing between constructive distributions attributable to withholding and payment of taxes with respect to some of an S corporation's shareholders and actual distributions to other shareholders will not cause the corporation to be treated as having more than one class of stock

## **7. Distributions that take into account varying interests**

Reg. §1.1361-1(1)(2)(iv) provides that an agreement will not be treated as affecting the shareholders' rights to liquidation and distribution proceeds conferred by an S corporation's stock if the agreement merely provides that, as a result of a change in stock ownership, distributions in one taxable year will be made on the basis of the shareholders' varying interests in the S corporation's income during the immediately preceding taxable year. If, however, such distributions are not made within a "reasonable time" after the close of the taxable year in which the varying interests occur, such distributions may be re-characterized depending upon the facts and circumstances, but still will not result in the corporation being treated as having a second class of stock

## **8. Buy-Sell, redemption and other stock restriction agreements**

Reg. §1.1361-1(1)(2)(iii) sets forth rules regarding when buy-sell, redemption and other stock restriction agreements will be disregarded in making the determination as to whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds

**a) Agreements triggered by death, divorce, disability or termination of employment**

A bona fide agreement to redeem or purchase stock at the time of death, divorce, disability or termination of employment will be disregarded in determining whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds<sup>38</sup>

**b) Non-vested stock**

If stock that is substantially non-vested is treated as outstanding, the forfeiture provisions that cause the stock to be substantially non-vested will be disregarded

**c) Buy-Sell agreements, stock restriction agreements and redemption agreements**

Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements will be disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless: (i) a principal purpose of the agreement is to circumvent the one class of stock requirement; and (ii) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock

**d) Determination of value**

Reg. §1.1361-1(1)(2)(iii) provides that a price established at book value or at a price between fair market value and book value will not be considered to establish a price significantly in excess of or below the fair market value of the stock. A determination of book value will be respected if the book value is determined in accordance with GAAP; or the book value is used for any substantial non-tax purpose

Additionally, the regulations provide that a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of value was not performed with reasonable diligence

**9. Use of options and warrants**

Stock options or stock warrants are often important tools in structuring either an arrangement with creditors or obtaining new financing by a financially distressed corporation.<sup>39</sup> Under the final regulations to Sect. 1361, a call option, warrant or similar instrument will constitute a prohibited second class of stock if the option is substantially certain to be exercised by the holder or a potential transferee, and the option has a strike price substantially below the fair market value of the underlying stock on the date that the

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<sup>38</sup> Reg. §1.1361-1(1)(2)(iii)(B).

<sup>39</sup> Reg. §1.1361-1(1)(4).

call option is issued, transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder or materially modified<sup>40</sup>

The regulations provide a safe harbor whereby a call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. The failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock

**a) Options issued to commercial lender**

An additional exception is provided for options that are issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation as described by the regulations. The exercise of the option, however, by a lender who or which is not a permitted S corporation shareholder, however, would result in the termination of the S election

**b) Options issued for services**

The regulations provide that a call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock under Subchapter S if the call option is not transferable under Reg. §1.83-3(d) and the call option does not have a readily ascertainable fair market value as defined in Reg. §1.83-7(b) at the time the option is issued

**10. Use of convertible debt**

The regulations provide that convertible debt will be considered a second class of stock if: (i) it would be treated as a second class of equity under general tax principles, i.e., Sect. 385, and (ii) it embodies rights equivalent to those of a call option that would be treated as a second class of stock under the portion of the regulations pertaining to options. In various instances involving a workout with creditors, the handling of unretired debt, including convertible debt, of the target corporation will have substantial tax implications including (i) possible termination of S status; (ii) debt cancellation income under Sect. 108; (iii) original issue discount issues; (iv) creation of market discount or bond issue premium; or (v) dividend issues under Sect. 305(b)<sup>41</sup>

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<sup>40</sup> Reg. §§1.1361-1(1)(4)(iii)(A), (iv)(B).

<sup>41</sup> See Reg. §1.1001-3; Rev. Rul. 89-122, 1989-2 CB 200 (change in interest rate or reduction in face material modification, resulting in exchange); Rev. Rul. 79-155, 1979-1 CB 153 (same); Rev. Rul. 73-160, 1973-1 CB 365 (postponement of maturity date not exchange); Rev. Rul. 72-265, 1972-1 CB 222 (conversion of debt into stock of same debtor was tax-free); See also landmark Supreme Court's decision in Cottage Savings Association v. Comm'r, 499 US 554 (1991) (swap of economically equivalent mortgage pools created deductible losses).

**a) Short term unwritten advances**

Reg. §1.1361-1(l)(4)(ii)(B)(1) provides that unwritten advances by a shareholder that do not exceed \$10,000 in the aggregate at any time during the year, which are treated as debt by the parties and are expected to be repaid within a reasonable time, are not treated as a second class of stock

**b) Proportionately held debt**

Reg. §1.1361-1(l)(4)(ii)(B)(2) provides that obligations of the same class owned proportionately by the shareholders are not treated as a second class of stock. An obligation held by the sole shareholder is always held proportionately to the outstanding stock

**11. Straight debt**

Sect. 1361(c)(5)(b) provides that certain debt, which qualifies as “straight debt,” will not result in a second class of stock despite its equity features or characteristics. The definition of straight debt requires, among other things, that the holder be an individual (other than a non-resident alien), or an estate or trust eligible to own S stock, or an institution actively engaged in the business of lending money. Under the straight debt safe harbor, indebtedness of an S corporation will not be treated as a second class of stock if it is (i) in writing; (ii) contains an unconditional promise to pay a sum certain in money on demand or at a specified date; (iii) does not bear interest contingent on corporate profits, the corporation’s discretion or similar factors, (iv) is not convertible into stock and (v) is owned by a person who is eligible to be an S corporation shareholder. The regulations provide that the fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt. The regulations further provide that where an obligation qualifies as straight debt it will lose its status under the safe harbor where (i) the obligation is materially modified so that it no longer satisfies the definition of straight debt; or (ii) is transferred to a third party who is not an eligible shareholder. Where an obligation of an S corporation satisfies the definition of straight debt it still may be treated as equity for other tax purposes. Thus, for example, where a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest

As a reform introduced by SBJPA, after 1996 a financial institution qualifies for holding safe harbor debt provided such institution is actively engaged in the business of lending money.<sup>42</sup> Still, the non-convertibility requirement of safe harbor debt, as well as the restriction that interest payments not be contingent on profits, remain impediments for S corporations in the workout context

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<sup>42</sup> §1361(c)(5)(iii).

## **12. Use of stock appreciation rights and phantom stock**

### **a) Stock appreciation rights**

A stock appreciation right (SAR), which is similar to a phantom stock arrangement, is basically a contractual right to receive cash, stock, or a combination of both, measured by the appreciation in a corporation's stock from the date of grant to the date of exercise. SARs allow the recipient, typically a corporate executive or a key employee, to participate in the future growth of the corporation without having to commit any resources or undertake any real economic risk. If properly structured, the SAR will not constitute a prohibited second class of stock under Subchapter S

### **b) Phantom stock plans**

A phantom stock plan works similarly to an SAR by rewarding the employee based on the performance of the employer's stock. In a phantom stock plan, however, the compensation is based on appreciation of units, the value of which are tied to the value of the employer's stock. For example, the value of one unit at the date of grant can be 75% of the then current market value of one share of stock, or it may be tied to book value. As with the SAR, if properly structured, the phantom stock plan will not constitute a prohibited second class of stock under Subchapter S

## **13. Use of partnership or joint venture**

Where the Subchapter S limitations concerning the one class of stock requirement or the shareholder eligibility limitations pose a formidable obstacle in structuring workouts between S corporations and creditors, consideration should be given to the use of a partnership or joint venture. An example would be the transfer of encumbered assets to a limited liability company taxable as a partnership with the creditors as equity members. The Service has backed off to a certain extent its concern that a joint venture involving an S corporation may not be used to end run the Subchapter S limitations<sup>43</sup>

### **a) Application of disguised sales provisions**

Sect. 707(a)(2)(A) applies to an allocation and distribution to a partner who has transferred property to a partnership if (1) the allocation and distribution are "related" to the property transfer and (2) the property transfer and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership. The principal targets of this aspect of the provision are situations in which all or a portion of the purchase price of property is paid through partnership allocations in order to give other partners the practical equivalent of immediate deductions for payments of the purchase price. Sect. 707(a)(2)(B) provides that a partner's transfer of money or other property to a partnership is deemed made in a nonpartner capacity if (i) the partnership

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<sup>43</sup> See Rev. Rul. 94-43, 1994-2 C.B. 198; Reg. §1.701-2(d), Example 2. Compare Rev. Rul. 77-220, 1977-1 C.B. and GCM 36966 (12/27/76).

makes a “related” transfer of money or other property to the partner or another partner and (ii) the transfers of the partner and partnership, “when viewed together, are properly characterized as a sale or exchange of property.” This rule is “intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership and thereby to defer or avoid tax on the transaction.”<sup>44</sup> Reg. §1.707-3(c) provides that if within a two-year period, a partner transfers property to a partnership and the partnership transfers money (or other consideration) to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish otherwise. Reg. §1.707-5(b)(1) provides that, for purposes of the disguised sale rules, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Reg. §1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner’s allocable share of the partnership liability<sup>45</sup>

#### **b) Conversion of disregarded entity to partnership**

Rev. Rul. 99-5<sup>46</sup> provides: (1) where original member of single member domestic LLC, holding only capital assets or Sect. 1231 property, that is disregarded for tax purposes as entity separate from the owner under Reg. §301.7701-3, and converted to partnership when a new non related member purchases a 50% interest in the LLC, recognizes gain or loss from deemed sale of 50% interest in each asset to new member under Sect. 1001; but (2) upon the conversion of the disregarded entity to a partnership where the new member’s cash contribution to LLC, which converts it from disregarded entity to partnership, is treated as contribution in exchange for ownership interest, the transferring partners recognize no gain or loss due to conversion under Sect. 721(a)

In both situations, under Sect. 722, the new member’s basis in the partnership interest is equal to the amount paid for the assets which the new member is deemed to contribute to the newly-created partnership. The original member’s basis is equal to his basis in his share of the assets in the LLC. In situation one, under Sect. 723, the basis of the property treated as contributed to the partnership by both partners is the adjusted basis of that property in their hands immediately after the deemed sale. In situation two, under Sect. 723, the basis of the property contributed to the partnership by the original member is the adjusted basis of that property in his hands, and the new members basis is equal to the amount of cash contributed. In both situation one and two, under Sect. 1223(1), the original member’s holding period for the partnership interest received includes his

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<sup>44</sup> Staff of Joint Comm. on Tax’n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 231 (Comm. Print 1984).

<sup>45</sup> See Rubin, “Here Comes the Kitchen Sink: IRS Throws “Everything But” at Two Partnership Tax Deferral Structures,” PLI Tax Law and Practice, June, 2006.

<sup>46</sup> 1999-1 C.B. 434

holding period in the capital assets and property described in Sect. 1231 held by the LLC prior to converting to a partnership. The new partners holding period for the partnership interest begins on the day following the date of his purchase of the LLC interest

## **14. Implications of workouts for QSubs**

### **a) In general**

A qualified subchapter S subsidiary (“QSub”) is defined by Sect. 1361(b)(3)(B) generally as any domestic corporation that is not an ineligible corporation if, (i) an S corporation holds 100 percent of the stock of the corporation, and (ii) 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; an insurance company subject to tax under Subchapter L; a possessions tax credit entity described in Sect. 936 or a DISC or former DISC. Except as otherwise provided in 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.<sup>47</sup> For state law purposes, and in determining the legal liability of the entity to its creditors, the QSub is recognized as a separate legal entity

Once effective, the QSub election requires that the assets, liabilities, tax items, tax history, etc., of the QSub are treated as directly owned and realized by the S corporation parent for federal income tax purposes. All intercompany transactions presumably will be eliminated for federal tax purposes.<sup>48</sup> A similar rule is contained in Sect. 856(i), permitting a REIT’s ownership of a 100% subsidiary. As to the QSub, it would no longer add/subtract to its tax history, e.g., earnings and profits, AAA, etc., during the applicable period. Where the subsidiary uses the LIFO method of inventory accounting, the making of the QSub election triggers the four year LIFO recapture rule

### **b) Tax treatment of QSub election**

Although the relevant statutory language does not specifically provide, the QSub election is treated as a deemed liquidation of a wholly owned subsidiary into its electing S corporation parent.<sup>49</sup> Under Sect. 337, no gain or loss is generally recognized by the liquidating subsidiary. Similarly, no gain or loss is recognized by the parent.<sup>50</sup> In accordance with Sect. 381, the S corporation parent will succeed to the QSub’s entire tax history as well as the adjusted basis in its assets. Where the subsidiary has been a C corporation, the liquidation will cause the parent S corporation to become subject to the built-in gains tax under Sect. 1374 with respect to the target’s assets. If the target C

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<sup>47</sup> §1361(b)(3).

<sup>48</sup> See S. Rep. No. 104-281, 104th Cong., 2d Sess. 54-55 (1996). There is a carryover of tax basis, which in turn triggers application of Sect. 1374 with respect to transferred basis assets, §1374(d)(8).

<sup>49</sup> See Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted by the 100<sup>th</sup> Cong., supra. Reg. §1.1361-4(a)(2).

<sup>50</sup> §332.

corporation used the LIFO method of inventory accounting, the special recapture rule in Sect. 1363(d) comes into play. Post-QSub election problems may also be attributable to inheriting the target's C earnings and profits. Obviously, such will have an impact on characterizing post-QSub election distributions by a parent S corporation to its shareholders.<sup>51</sup> Where there is a significant amount of passive investment income, the carryover of the target's earnings and profits may result in an entity level tax under Sect. 1375 and/or eventually pose a termination risk under Sect. 1362(d)(3)

**c) QSub obligations**

Debt instruments issued by a QSub to a shareholder of the S corporation-parent are treated as debts of the parent under Sect. 1366(d)(1)(B). Debts of the QSub to the parent S corporation are disregarded, as are other arrangements that are not considered to be stock under the one class of stock rules set forth in Reg. §1.1361-1(l)

**d) QSub election involving insolvent subsidiary**

The final regulations treat insolvent subsidiary liquidations, even as part of a QSub election, as outside of Sect. 332. In general, Sect. 332 does not apply to the liquidation of an insolvent corporation, because the parent corporation does not receive at least partial payment for the stock of its subsidiary.<sup>52</sup> Accordingly, such liquidations are treated as taxable distributions under Sect.s 331 and 336, rather than nontaxable dissolutions under Sect.s 332 and 337

**e) Effect of QSub election on S corporation's basis in subsidiary stock**

Aside from the tax history issues generated by a deemed liquidation, perhaps the most immediate drawback to the QSub is the disappearing basis problem. Suppose, for example, that an S corporation purchases all of the stock of a target C corporation (in a non-Sect. 338 transaction) at a purchase price of \$2,000x. Assume the target's basis in its assets is \$500x. By purchasing all of the target's stock and making the QSub election (or, alternatively, by immediately liquidating the target into the purchaser), the parent's cost basis in the subsidiary stock, i.e., \$2,000x, disappears. The only relevant basis to the parent is the adjusted basis of the subsidiary's assets. The \$2,000x 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 Sect. 1361(b)(3)(C). Again, the inside versus outside value differential may present built-in gains tax problems to the purchaser with respect to the QSub's assets. The total net unrealized built-in gain is allocated on an asset-by-asset basis including goodwill and going concern value<sup>53</sup>

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<sup>51</sup> §1368(c).

<sup>52</sup> In such instances, the tax attributes and adjusted basis will not carry over to the parent. Reg. §1.332-4(d), Ex. 5.

<sup>53</sup> §§334(b)(1), 1374(d)(8), 1374(d)(1). Regs. §§1.334-1(b), 1.1361-4(a)(4)(except for purposes of §1361(b)(3)(B)(i) and Reg. §1.1361-2(a)(1), the stock of a QSub is disregarded for federal tax purposes).

#### **f) Termination of QSub status**

A QSub election may be terminated: (i) by revocation; (ii) by reason of the parent no longer being an S corporation; or (iii) by the subsidiary's failing to meet the QSub eligibility requirements. Where a QSub election is terminated due to a disqualifying event, Reg. §1.1361-5(a)(2) requires the S corporation to attach a statement to its return for the tax year in which the termination occurs, notifying the IRS that a QSub election terminated. This notification also must include the date of the termination and the names, addresses, and employer identification numbers of both the parent S corporation and the QSub. Reg. §1.1361-5(a)(3) provides, alternatively, that where a QSub election terminates because the S corporation becomes a member of a consolidated group (and no election under Sect. 338(g) is made), principles contained in Reg. §1.1502-76(b)(1)(ii)-(A)(2)(special rules for S corporations joining consolidated groups) apply. This regulation eliminates the "one-day return problem" by providing that an S corporation that is acquired by a consolidated group in a transaction other than a Sect. 338 transfer, becomes a member of the consolidated group at the beginning of the day on which termination of its S election is effective<sup>54</sup>

The final regulations provide that the effective date of a QSub termination is: (i) on the effective date contained in the revocation statement if a QSub election is revoked under Reg. §1.1361-3(b); (ii) at the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under Reg. §1.1362-2; or (iii) at the close of the day on which a disqualification event occurs that results in the QSub not being described under Sect. 1361(b)(3)(B)<sup>55</sup>

#### **g) Effective date of termination for tiered QSub subsidiaries**

Under the final regulations, where a tier of QSubs have their elections terminated on the same day, the formation of any higher tier subsidiary is deemed to have occurred prior to the formation of a lower tier subsidiary, a so-called "top to bottom" approach<sup>56</sup>

#### **h) Tax effect of QSub termination**

In the event of a termination of the QSub's election, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the

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<sup>54</sup> See, however, Rev. Rul. 2004-85, 2004-2 C.B. 189 which provides that (i) an election to treat a wholly owned subsidiary of an S corporation as a QSub, does not terminate solely because the S corporation engages in a transaction that qualifies as a reorganization under §368(a)(1)(F); (ii) an election to treat a subsidiary as a QSub terminates if the S corporation transfers 100 percent of the QSub stock (whether by sale or reorganization under §368(a)(1)(A), (C), or (D)), to another S corporation in a transaction that does not qualify as a reorganization under §368(a)(1)(F); and (iii) an entity classification election of an eligible entity, as described in Reg. §301.7701-3(b), does not terminate solely because the owner (whether by sale, reorganization under §368(a)(1)(A), (C), (D), or (F), or otherwise) transfers all of the membership interest in the eligible entity to another person.

<sup>55</sup> Reg. §§1.1361-5(a)(1),-5(a)(2)(information required to be filed upon failure to qualify as QSub).

<sup>56</sup> Reg. §1.1361-5(b)(1)(ii).

parent S corporation in exchange for stock of the new corporation immediately before the termination.<sup>57</sup> Reg. §1.1361-5(b)(1) provides that the tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. Prior to the Small Business and Work Opportunity Tax Act of 2007 (the “2007 Act”), it was necessary to consider the control requirement (80% transferor group) in Sect. 368(c) for the termination of a QSub election, for example upon the sale of some or all of the shares, as well as assessing the potential impact of Sect. 357(c) as well as the other potential exceptions to tax free treatment. Under the 2007 Act, if a QSub election terminates because QSub stock is sold, the sale is treated as a sale of an undivided interest in the assets of the QSub followed by a deemed Sect. 351 transfer of the assets to the new corporation by the purchaser (and the seller to the extent of unsold shares)<sup>58</sup>

#### **i) Election after termination of QSub election**

Upon termination of QSub status, the former QSub is prohibited from re-electing S status or QSub status for 5 years unless permission is received from the Service<sup>59</sup>

### **III. Change Of Ownership Of An S Corporation And Application Of Sect. 382**

#### **A. Sect. 382 - Introduction**

Sect. 382 limits the ability of a corporation to use NOLs, capital losses, and certain tax credits (the “Sect. 382 limitation”) after an “ownership change.” Sect. 382 applies to “corporations” in general,<sup>60</sup> without any exclusion for S corporations. There is little judicial, regulatory, or administrative guidance as to how Sect. 382 applies to S corporations, other than with respect to the Sect. 1374 tax on built-in gains and limitations on net unrealized built-in losses (“NUBILs”)

The foregoing discussion of Sect. 382 would apply in the context of a transfer of an S corporation and the conversion of an S corporation into a C corporation in connection with a workout of a financially distressed S corporation with its creditors

#### **B. Ownership change**

An ownership change occurs under Sect. 382(g) if a loss corporation has a cumulative owner shift of greater than 50 percentage points over a three-year period

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<sup>57</sup> §1361(b)(3)(C)(i).

<sup>58</sup> §1361(b)(3)(C)(ii), added by §8234(a)(1)-(2) of the 2007 Act.

<sup>59</sup> §1361(b)(3)(D). The final regulations provide some relief. For S and QSub elections effective after 1996, where a QSub election terminates, the corporation may, without obtaining IRS consent, make an S election or be subject to a new QSub election prior to the end of the five year waiting period provided: (i) immediately following the termination, the corporation (or its successor) is otherwise eligible to make an S election or be subject to a QSub election, and (ii) the relevant election is made effective immediately following the termination of the QSub election. Reg. §1.1361-5(c)(2).

<sup>60</sup> §§382(k)(1)-(3).

testing period. The cumulative owner shift is determined by comparing the percentage of stock owned by 5 percent shareholders on a “testing date” with the lowest percentage owned at any time during the testing period. A testing date occurs generally when the corporation issues or redeems stock or when certain shareholders transfer such stock.<sup>61</sup> The cumulative owner shift equals the sum of increases in ownership by 5 percent shareholders, with decreases in percentage ownership being ignored<sup>62</sup>

A determination as to whether an ownership change has occurred is made at the end of any testing date. To determine whether an ownership change has occurred on a testing date, the corporation determines the 5 percent shareholders whose ownership percentage has increased. This is done by first determining the percentage of stock owned by each 5 percent shareholder throughout the testing period. The percentage owned at the close of the testing date is compared to the lowest percentage owned during the testing period. The 5 percent shareholder’s increase equals the percentage owned at the close of the testing date over the lowest percentage owned during the testing period. Shareholders whose interest has not changed or has decreased are treated as having an increase of zero<sup>63</sup>

The foregoing analysis is performed separately for each 5 percent shareholder. Each 5 percent shareholder’s increase is added together to determine the cumulative owner shift. If the cumulative owner shift is greater than 50 percentage points, then an ownership change has occurred.<sup>64</sup> Sales of stock between persons that hold, directly or indirectly by attribution, less than 5 percent of the stock of the loss corporation are not taken into account in determining the cumulative owner shift<sup>65</sup>

The determination as to whether an ownership change has occurred involves complicated rules regarding constructive ownership, grouping of less than 5 percent shareholders, and fluctuations in value among multiple classes of stock. Of course, many of these complicated rules will not come into play in the case of an S corporation due to the limitation on the number of shareholders and the one class of stock limitation

In the context of a debt workout in which creditors receive stock of an S corporation, an ownership change will occur for Sect. 382 purposes if the creditors receive more than 50 percent of the stock of the corporation (by value), assuming that the creditors did not previously own any of the stock of the corporation. If the creditors receive 50 percent or less of the stock in the transaction, certain shifts in stock ownership over the previous three years would need to be analyzed to determine whether an ownership change of more than 50 percentage points has occurred

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<sup>61</sup> Reg. §1.382-2(a)(4).

<sup>62</sup> §382(g)(1); Temp. Reg. §1.382-2T(a)(1), (c)(1), (4) Ex.

<sup>63</sup> Temp. Reg. §1.382-2T(c)(1).

<sup>64</sup> §382(g)(1); Temp. Reg. §1.382-2T(a)(1), (c)(1).

<sup>65</sup> Temp. Reg. §1.382-2T(e)(1)(ii), (iii) Ex. (3).

In the case of an ownership change pursuant to a bankruptcy proceeding, certain special rules apply, which may permit the corporation to avoid an ownership change or to mitigate its effect<sup>66</sup>

If an S corporation does not experience an ownership change until after the day it converts into a C corporation, the ownership change rules should be applied at that time. It is possible that an ownership change that occurred while the corporation was an S corporation would subject the converted C corporation to a Sect. 382 limitation

In certain cases, an ownership change may result from a worthless stock deduction that is taken into account by a shareholder. A deemed interest increase occurs if a 50% shareholder treats stock as worthless and the shareholder holds the stock at the end of the shareholder's taxable year that includes the worthlessness event<sup>67</sup>

### **C. Sect. 382 limitation**

The Sect. 382 limitation is generally the unused amount of "base annual Sect. 382 limitations," which may be increased in certain circumstances. The base annual Sect. 382 limitation equals the adjusted fair market value of the stock of the loss corporation before the ownership change times the "long-term tax-exempt rate."<sup>68</sup> The long-term tax-exempt rate is a rate published monthly by the IRS and is designed to mimic the rate of long-term municipal bonds<sup>69</sup>

The base annual Sect. 382 limitation is computed with reference to the fair market value of the stock of the loss corporation. Generally, the value is determined immediately before the events that caused the ownership change.<sup>70</sup> As a result, any increase in value from the transaction is not taken into account. For instance, if the issuance of new shares by the loss corporation causes an ownership change, the value of the new shares is not taken into account

Obviously, if the stock of the corporation has a substantial fair market value at the time of the ownership change, the Sect. 382 limitation applicable to each subsequent year may not be substantial and the tax attributes may be utilized in a short time frame. The unused limitation is carried forward to succeeding years. On the other hand, in the case of a corporation with a small fair market value and substantial NOLs or NUBILs at the time of the ownership change, the Sect. 382 limitation can significantly reduce the present value of the tax attributes

Sect. 382 provides for several adjustments to the corporation's stock value (all negative) for purposes of the base annual Sect. 382 limitation. These adjustments

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<sup>66</sup> §§382(1)(5) and (6), discussed further below.

<sup>67</sup> §382(g)(4)(D).

<sup>68</sup> §382(b)(1), (e)(1), (k)(5); Reg. §1.382-5(a).

<sup>69</sup> §382(f).

<sup>70</sup> §382(e)(1).

include: (i) capital contributions with a principal purpose of tax avoidance, (ii) redemptions and other corporate contractions, (iii) substantial nonbusiness assets, and (iv) the value of any domestic or foreign subsidiary owned by the corporation.<sup>71</sup> In addition, the base annual Sect. 382 limitation is reduced to zero if the corporation does not continue the business enterprise during the two-year period beginning on the change date<sup>72</sup>

Sect. 382 only applies to limit the use of tax attributes in a “post-change year.”<sup>73</sup> A post-change year is any taxable year ending after the ownership change date.<sup>74</sup> If an ownership change occurs in the middle of a taxable year, the portion of the year after the change is a post-change year<sup>75</sup>

To the extent the base annual Sect. 382 limitation is not used in a taxable year, such unused limitation can be carried over to a later tax year<sup>76</sup>

#### **D. Tax attributes subject to 382 limitation**

NOLs, capital losses, and tax credits generally do not carryforward from the period that the corporation is an S corporation to a C corporation taxable year.<sup>77</sup> As a result, the only carryforwards subject to Sect. 382 in the context of an ownership change for an S corporation (or an S corporation converting to C corporation status) will be with respect to pre-S corporation-status C corporation taxable years

An S corporation tax attribute subject to Sect. 382 includes a net unrealized built-in loss (“NUBIL”), which is an excess of the aggregate basis of assets over their fair market value of the assets

Generally, if the old loss corporation has a NUBIL, the subsequent recognition of built-in losses (“recognized built-in losses” or “RBILs”) are treated as deductions subject to the Sect. 382 limitation.<sup>78</sup> RBILs are generally deductions and losses that are “built-in” at the change date and that are taken into account by the new loss corporation during

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<sup>71</sup> §382(1).

<sup>72</sup> §382(c)(1).

<sup>73</sup> §382(a); Reg. §1.382-5(a).

<sup>74</sup> §382(d)(2).

<sup>75</sup> If a post-change year has fewer than 365 days, the base annual Sect. 382 limitation is reduced. This will generally occur where the termination of S status occurs in the middle of the taxable year and the C short year has fewer than 365 days. The amount is reduced by the ratio of (i) the number of days in the taxable year, over (ii) 365. No reduction is required if the taxable year has fewer than 365 days due to the use of a 52-53 week taxable year (unless a return is required under Sect. 443). Reg. §1.382-5(c).

<sup>76</sup> §382(b)(2).

<sup>77</sup> §1371(b)(2).

<sup>78</sup> §382(h)(1)(B).

the recognition period. The recognition period is the five-year period beginning on the change date<sup>79</sup>

The NUBIL rules generally apply to RBILs that are taken into account in a recognition period taxable year. A recognition period taxable year is a taxable year a portion of which is in the recognition period.<sup>80</sup> The amount of RBILs that are subject to the Sect. 382 limitation in any recognition period taxable year is limited to the excess of (i) the NUBIL, over (ii) the total RBILs in prior taxable years (the “remaining NUBIL balance” limitation)<sup>81</sup>

Any deduction (or portion thereof) of an RBIL that is disallowed because it exceeds the Sect. 382 limitation can be carried forward.<sup>82</sup> The carried forward deduction is treated as a deduction that is subject to the Sect. 382 limitation in subsequent years.<sup>83</sup> Ordinary deductions and losses can be carried forward generally for [twenty] taxable years under carryforward rules that are similar to the rules for NOLs.<sup>84</sup> Capital losses can be carried forward generally for five taxable years under carryforward rules that are similar to the rules for net capital losses<sup>85</sup>

In 2003, the Service issued interim guidance on the correct application of the NUBIL rules. Notice 2003-65<sup>86</sup>, generally allows loss corporations to adopt one of two safe harbor approaches to applying the rules. The two approaches are (i) the Sect. 338 approach, and (ii) the Sect. 1374 approach

Taxpayers can apply either (or neither) of the approaches described in Notice 2003-65. Taxpayers are permitted to apply the notice retroactively to ownership changes that occurred before the issuance of the notice. If a taxpayer applies one of the approaches described in the notice, they are generally required to apply the approach in its entirety. The Service does not permit using elements of each approach and has stated that it will not assert an alternative interpretation of the NUBIG or NUBIL rules with respect to a loss corporation that consistently applied either of the two approaches

The Sect. 338 approach generally compares the actual treatment of items of income, gain, deduction, and loss by the loss corporation with the treatment of such items under a hypothetical Sect. 338 election. The hypothetical Sect. 338 election treatment is determined by assuming a hypothetical purchase of 100% of the stock of the loss

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<sup>79</sup> §382(h)(7)(A).

<sup>80</sup> §382(h)(7)(B).

<sup>81</sup> §382(h)(1)(B)(ii).

<sup>82</sup> §382(h)(4)(A).

<sup>83</sup> §382(h)(4)(B).

<sup>84</sup> §§172(b)(1)(A)(ii), 382(h)(4)(A).

<sup>85</sup> §§382(h)(4)(A), 1212(a)(1)(B).

<sup>86</sup> 2003-2 CB 747

corporation on the change date for which a Sect. 338 election was made.<sup>87</sup> As a result, the hypothetical treatment is determined as if (i) the new loss corporation was a newly-created corporation that is unrelated to the old loss corporation, and (ii) the new loss corporation acquired all of the assets of the old loss corporation in a taxable transaction<sup>88</sup>

The Sect. 1374 approach generally applies regulations that were issued under Sect. 1374(d) (NUBIG rules for S corporation conversions). The basis for this approach can be found in Reg. §§1.1374-3, -4, and 7.<sup>89</sup> Loss corporations that have a NUBIL are generally applying the Sect. 1374 approach. The Sect. 1374 approach allows for more favorable treatment of contingent liabilities under the built-in deduction item provisions. This generally allows for a smaller amount of RBILs than would be available under other approaches

If a loss corporation adopts either the Sect. 338 approach or the Sect. 1374 approach, the amount of NUBIL is determined based upon the rules described in subSect. (a) of Sect. 1.1374-3 of the Treasury regulations.<sup>90</sup> The amount of NUBIL generally equals the net loss that would be recognized on a hypothetical sale of assets to an unrelated party immediately before the ownership change

Sect. 1.1374-3(a) provides for a formula for determining the amount of NUBIL. The amount of NUBIL (before application of the threshold requirement) equals (i) the amount realized from a hypothetical asset sale, less (ii) deductible liabilities, less (iii) the adjusted basis of the loss corporation's assets, adjusted by (iv) Sect. 481 adjustments that would be taken into account in a hypothetical sale, and increased by (v) any RBIL that would be disallowed as a deduction in a hypothetical sale under Sect.s 382, 383, or 384<sup>91</sup>

The above formula is applied on the basis that the loss corporation sold all of its assets to an unrelated third party immediately before the ownership change. The amount realized from the hypothetical asset sale is based on a sale of assets (including goodwill) for fair market value. The buyer is treated as assuming all of the liabilities of the loss corporation in the sale<sup>92</sup>

An RBIL is a loss recognized during the recognition period on the disposition of any asset that was held by the S corporation immediately before the change date.<sup>93</sup> The amount of the RBIL with respect to the disposition is limited to the unrealized built-in loss ("UBIL"). The UBIL equals the excess of the adjusted basis of the assets over its

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<sup>87</sup> Notice 2003-65, pt. IV.

<sup>88</sup> Reg. §1.338-1(a)(1), (b)(1)(i).

<sup>89</sup> Notice 2003-65, pt. III.

<sup>90</sup> Notice 2003-65, pts. IIIA, IV.A.

<sup>91</sup> Reg. §1.1374-3(a).

<sup>92</sup> Notice 2003-65, pt. III.A; Reg. §1.1374-3(a)(1).

<sup>93</sup> §382(h)(2)(B)(i).

fair market value. The UBIL is determined as of the change date.<sup>94</sup> If the loss recognized is less than the amount of the UBIL, the entire loss is an RBIL. If the asset had an unrealized built-in gain, then none of the loss is considered an RBIL

Under the Sect. 1374 approach, the amount of RBILs is determined based upon the rules described in Reg. §§1.1374-4 and 7. Generally under this approach, the amount of built-in income and deductions are determined by comparing the actual treatment of items of income and deduction by the loss corporation with the treatment of such items by an accrual method taxpayer

Under the NUBIL rule, some or all of the depreciation, amortization, or depletion deductions with respect to assets with a UBIL are treated as RBILs. Under the Sect. 1374 approach, a loss corporation can use any reasonable method to determine the amount of a deduction that is treated as a UBIL<sup>95</sup>

If a C corporation with a NUBIL undergoes an ownership change, a special rule applies with regard to the adjusted current earnings (“ACE”) regime for purposes of computing taxable income for alternative minimum tax (“AMT”) purposes.<sup>96</sup> In such case, the basis of the assets for ACE purposes is generally marked-to-market<sup>97</sup>

Special rules apply if an ownership change occurs in a bankruptcy or similar proceeding. In such instance, one of two alternative regimes may apply to the ownership change. If Sect. 382(1)(5) applies to the ownership change in connection with a Title 11 bankruptcy or similar case, the Sect. 382 limitation generally does not apply. Alternatively, if Sect. 382(1)(6) applies in connection with a Type G reorganization or an exchange of stock for debt to which Sect. 382(1)(5) does not apply, the base annual Sect. 382 limitation is enhanced and is generally determined based upon the value of the stock immediately after the transaction. If a transaction would otherwise meet the requirements of both paragraph (1)(5) and (1)(6) of Sect. 382, the transaction will be treated as meeting only the requirements of paragraph (1)(5).<sup>98</sup> In such instance, an S corporation can make an election not to have paragraph (1)(5) apply<sup>99</sup>

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<sup>94</sup> §382(h)(2)(B)(ii).

<sup>95</sup> Notice 2003-65, pt. III.B.2.a(ii), Ex. (7).

<sup>96</sup> §56(g).

<sup>97</sup> §56(g) (4)(G).

<sup>98</sup> §382(1)(6); Reg. §1.382-9(j).

<sup>99</sup> §382(1)(5)(H); Reg. §1.382-9(i). The election is made by attaching a statement to the tax return for the year that includes the change date. To be valid, the election must be made by the extended due date of the return. The election, once made, is irrevocable.

## DISTRESSED S CORPORATION FACT PATTERN

**D. Gitlitz, Jr. and P. Winn, Jr.**, sons of the taxpayers in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), formed **GW Enterprises, Inc.** as an S corporation as 50-50 shareholders in 1998. Their core business, **Profits 4 Ever, Inc.**, a wholly-owned subsidiary of GW Enterprises, Inc., has been operated as a QSub from inception. Profits 4 Ever has a fair market value of \$10 million, current basis in its assets of \$2 million, no debt, and current annual cash flow of \$1.7 million.

GW Enterprises also owns all of the outstanding stock of **Old Distressed, Inc.**, formed in 2000 as a QSub to acquire the assets of a business from unrelated parties in exchange for subordinated promissory notes in the aggregate amount of \$20 million. The terms of the subordinated notes require annual interest payments of \$1.2 million and a balloon payment of \$20 million due in 2010. Old Distressed also has a liability of \$10 million under its senior credit facility with **Money Center Bank** (in addition to the \$20 million subordinated notes). The interest payments to Money Center Bank (\$750,000 per year) are current. Old Distressed has a tax basis of its assets of \$15 million and a fair market value of its assets of \$10 million. The cash flow of Old Distressed is insufficient to cover the interest payments on the senior credit facility and the subordinated notes, and the satisfaction of the \$20 million balloon payment in 2010 is not likely without a major refinancing or restructure of the debt through an arrangement with the subordinated noteholders.

In 2003, GW Enterprises acquired all of the stock of **New Distressed, Inc.** for \$20 million. The acquisition was financed by **Local Bank** and secured by a pledge of the stock and a security interest in the assets. At the time of the acquisition, New Distressed was a C corporation with an inside basis of \$10 million in its assets. GW made a QSub election for New Distressed effective February 1, 2003, eliminating the \$20 million in stock basis. The assets of New Distressed, valued at \$20 million, acquired in a carryover basis transaction subject to section 1374(d)(8) of the Code, are subject to the built-in gains tax if disposed of in a taxable transaction during the 10-year recognition period. The interest on the Local Bank debt is accruing at the rate of \$1.6 million per year, payable monthly. The loan is out of covenants and Local Bank is pressing GW Enterprises for payment in full or the deposit of additional collateral as security under a forbearance agreement. The pledge by GW Enterprises of the stock and assets of Profits 4 Ever has been suggested by Local Bank, a suggestion received with little enthusiasm by GW Enterprises and its shareholders.

Gitlitz and Winn recognize that both of the Distressed ventures are probably not going to make it. Profits 4 Ever is the crown jewel, and has a bright future, provided it can survive a workout or bankruptcy of Old and New Distressed. The shareholders believe the cash flow from Profits 4 Ever can be used to meet the debt service requirements of the lenders to Old and New Distressed, at least until 2010, provided some accommodation can be made with Local Bank.

The net income of each subsidiary and combined GW Enterprises for the past 3 years are summarized below:

	<b>Profits 4 Ever</b>	<b>Old Distressed</b>	<b>New Distressed</b>	<b>GW Combined</b>
<b>2006</b>	\$1,500,000	(\$800,000)	(\$500,000)	\$200,000
<b>2007</b>	1,600,000	(1,000,000)	(800,000)	(200,000)
<b>2008</b>	1,700,000	(1,500,000)	(1,000,000)	(800,000)

Gitlitz and Winn each has a zero basis in his shares in his GW shares and disallowed losses of \$1 million attributable to losses and deductions disallowed in 2007 and 2008 under section 1366(d)(1), carried forward to succeeding years under section 1366(d)(2).

The tensions brought about by the financial problems of Old and New Distressed have adversely affected the personal and financial relationship between Gitlitz and Winn. Winn has told Gitlitz he wants out. Gitlitz has offered to purchase Winn's 50% interest in GW Enterprises for \$1 million, subject to the satisfactory restructure of the debt of Old and New Distressed, with or without bankruptcy filings, and subject to confirmation of certain tax issues for the shareholders. Winn thinks the GW Enterprises situation is hopeless, notwithstanding the promise of Profits 4 Ever, and is eager to finalize the deal. His personal accountant, unfamiliar with the precarious financial position of GW Enterprises, advised him that the sale of his stock for \$1 million would be tax free because of his suspended losses under section 1366(d).

### **ISSUES FOR DISCUSSION**

1. Basic Section 108 rules relating to S corporations.
2. Attribute reduction under sections 108(b) and 1017, including Proposed Regulations §1.108-7(d) (special rule for attribute reduction for S corporations).
3. COD income at the QSub level.
4. Bankruptcy of QSub when S corporation is not in bankruptcy.
5. Revocation of S election or QSub election before or during bankruptcy.
6. G reorganization in bankruptcy.
7. Application of Section 382 to S corporations.

# DISTRESSED S CORPORATION FACT PATTERN

