Tax Aspects of Corporate and Business Acquisitions and Dispositions

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Tax Aspects of Corporate and Business Acquisitions and Dispositions

1. **Overview.** The form of the transaction with its tax consequences will drive the pricing of the transaction between knowledgeable buyers and sellers just as surely as the income flow and asset value of the business being sold. The interests of the parties in the structure of the transaction are unlikely to be reconcilable except by adjustment to price.

   A. **Big Issues.** Some of the big issues are:

   1. **Gain or Loss and Income Recognition.** Who recognizes gain or loss? Stockholders? Target corporation? Both? Neither? What will the net after-tax proceeds of the transaction be to the seller? Can the tax be reported and paid overtime? Will some of the payments be deemed to be interest in the transaction and taxable as ordinary income?

   2. **Basis.** What will be the effect on the “inside” basis of the target corporation’s assets? Will the buyer obtain a stepped-up basis and thus future depreciation deductions, or not? Who pays tax on the existing built-in gain in the acquired corporation’s assets? If the seller receives consideration other than cash, what will its basis be for future taxation?

   3. **Continuity of Interest.** Should (or must) the transferring shareholders become stockholders in the acquiring corporation?

   4. **NOLs and Tax Attributes.** Will any net operating losses or other tax attributes of the acquired corporation be available for use by the acquiring corporation (or its corporate group)?

B. **Forms of Transactions.** The most significant forms of transaction are:

   1. **Sale of Stock.** With no IRC § 338 election (which would cause a stock transaction to be treated much like an asset transaction), the result is generally:

      a. Recognition of gain or loss to selling shareholders;

      b. If shareholders receive consideration other than cash, they will have a fair market value basis in it.

      c. The corporation retains its historic basis in its assets, so there will be no increase in depreciation deductions, and there will be possible recognition in the future of any gain existing in such assets with a tax cost to the acquirer’s interest in the acquired corporation.
(d) The buyer receives a cost basis in the stock acquired.

(e) The acquired corporation does not recognize gain or loss on its assets.

(f) Tax attributes (e.g., NOLs) of the acquired corporation remain with it but are subject to certain limitations and restrictions on use.

(g) Need have no continuity of interest by shareholders of the acquired corporation.

(2) **Taxable Sale of Assets.** On either (i) the taxable sale of the assets of an acquired business owned by a corporation, or (ii) the taxable sale of stock in an acquired corporation where the IRC § 338 election is made, the result is generally:

(a) The shareholders recognize gain or loss, upon the distribution of consideration on the subsequent liquidation of the selling corporation.

(b) If consideration other than cash is received, it will have a fair market value basis.

(c) The basis of the assets acquired will be cost basis, with the potential to increase the buyer’s depreciation deductions.

(d) If the transaction is a stock purchase with an IRC § 338 election, the basis of the stock acquired will be its cost.

(e) The corporation, the assets of which are acquired, will recognize gain or loss on the sale; in a straight asset sale, this creates a “double tax” for the corporation’s shareholders. In a stock purchase with IRC § 338 election, this corporate level of tax is usually allocated as the buyer’s burden. The character of the gain or loss (i.e., capital gain or ordinary income) recognized by the selling corporation is determined on an asset-by-asset basis.

(f) Tax attributes generally stay with the selling (or, if IRC § 338, the sold) corporation (but may be affected by other code sections for corporate group); in a liquidation, all tax attributes die with the corporation.

(g) The acquiror need not provide any stock or other consideration which allows a continuity of interest by stockholders of the selling corporation.

(3) **Tax Deferred Reorganizations.** There are a number of forms of tax deferred reorganizations, each with separate technical requirements which must be met. Some forms are stock acquisitions and others are essentially asset acquisitions, however, the ultimate results are generally similar.
(a) Shareholders of the target corporation generally recognize no gain or loss. Certain nonstock consideration may be taxable “boot.”

(b) The shareholders of the target corporation generally receive stock and sometimes some other forms of consideration (called “boot” in tax jargon); their basis in the stock will be a substituted basis (i.e., the same as their stock in the target corporation) and their basis in the boot will be fair market value.

(c) The target corporation’s “inside” basis in its assets will be its historic basis in the case of stock acquisitions, and a carryover basis from the target in the event of asset acquisitions.

(d) The basis to the acquiror of the stock acquired will generally be a carryover basis in the event of a stock acquisition (except for a reverse triangular merger where this basis will be the target’s asset basis); the target’s stock will generally retain historic basis in an asset acquisition.

(e) The target corporation will not recognize gain or loss.

(f) Tax attributes will remain with the acquired corporation in a stock acquisition; in an asset acquisition, the tax attributes may be inherited by the acquiror. In both types of acquisition, certain limitations and restrictions on NOLs will apply.

(g) In all reorganizations, a certain amount of continuity of interest by the target’s shareholders will be required.

(4) Substance Over Form. In all forms of transaction, judge made and statutory or regulatory rules may apply to prevent perceived abuses. Generally, the form of the transaction will be respected, but if the purported form is different from the real economic substance of a transaction, particularly where there are no nontax business reasons for the form and the form does not create real economic risks or incentives among the parties, the transaction may be recharacterized for tax purposes. One special type of substance over form analysis is known as the step transaction doctrine which collapses and integrates into one transaction intermediate steps which purport to be separate transactions. Tax consequences can change dramatically with the application of these rules and, thus, great care should be take in structuring any transaction which does not fit clearly into a well-recognized pattern. The corporate merger and acquisition area is one of the areas most affected by these doctrines.

2. Taxable Stock Sale Transaction Variations. There are some variations to the simple sale of stock by shareholders to a purchaser for cash.

A. Bootstrap Acquisitions. Prior to the sale to the buyer of the stock, the target corporation could redeem part of its stock, for example, to take out cash and leave operating assets for the acquirer. Also, a dividend could be distributed to the stockholders. Dividends create ordinary income to the shareholders where the corporation has “earnings and
profits’ in its special tax earnings and profits account. IRC § 301. Redemptions may or may not create ordinary income as a disguised dividend or qualify for capital gain treatment. IRC § 302.

(1) Avoidance of Dividend. The redemption will be a dividend unless one of the exceptions under IRC § 302(b) apply, in which event capital gain treatment may be available. The exceptions to dividend treatment on a redemption are where the distribution in the redemption:

   (a) Not Essentially Equivalent. The distribution is “not essentially equivalent to a dividend.” IRC § 302(b)(1). This is a vague standard hard to apply; however, the shareholder must have some meaningful reduction in proportionate interest in the target corporation. The amount of reduction that is meaningful may be more in a closely held corporation than in a large, publicly traded corporation. See U. S. v. Davis, 397 U. S. 301 (1969), reh’g denied, 397 U. S. 1071 (1970); see also Rev. Rul. 76-385, 1976-2 C.B. 92.

   (b) Substantially Disproportionate. The distribution is “substantially disproportionate” with respect to the shareholder. IRC § 302(b)(2). To qualify, a shareholder must own, after the redemption:

     (i) less than 50% of the total voting power of all classes of stock;

     (ii) less than 80% of the percentage of the voting stock owned by the shareholder before the transaction; and

     (iii) less than 80% of the percentage of common stock owned by the shareholder before the transaction.

     (iv) The result is that a minority shareholder who has a 20% diminution in voting and common stock can receive exchange treatment which could qualify for capital gain treatment.

     (v) These tests are calculated after applying constructive ownership rules which could treat as owned by the stockholder taxpayer shares of stock “attributed” to the stockholder from family members, from partnerships or other corporations in which the stockholder has an interest, or (if the shareholder is an entity such as a corporation, partnership, trust, estate) from persons owning certain interests in the shareholder entity (IRC §318).

   (c) Complete Termination of Interest. The distribution completely terminates the shareholder’s interest, again after applying the IRC § 318 constructive ownership rules, except that the shareholder may elect not to have family attribution rules apply (as opposed to attribution to or from an entity where no such election is available). To qualify to waive family attribution, the shareholder cannot retain any directorship, employment, office, or other, even nonequity, interest other than solely as a creditor. Also, no such proscribed interest may be acquired within 10 years or the waiver will retroactively fail.
(d) **Partial Liquidation.** The distribution constitutes a partial liquidation where the shareholder is not a corporation. This is usually not helpful in an acquisition transaction.

(e) **Estate Redemption.** The distribution is an IRC § 303 redemption to pay estate taxes and administrative expenses. This may be useful in some acquisitions.

(2) **Zenz v Quinlevan.** The two most important exceptions are the “substantially disproportionate” and “complete termination of interest” exceptions. The case of *Zenz v. Quinlevan*, 213 F.2d 914 (6th Cir. 1954) may allow these exceptions to be met in an acquisition immediately followed or preceded by a redemption. See Rev. Rul. 75-447, 1975-2 C.B. 113. Both the redemption and the third-party sale are considered in determining whether the redemption is substantially disproportionate or results in a complete termination of interest. This makes avoidance of dividend treatment possible in many acquisition situations.

**B. Section 338 Elections.** A stock sale may be treated by the acquirer under IRC § 338 as if it were an asset sale, and thus receive a stepped-up basis in the target’s assets if the acquirer is willing to recognize gain. Also, a target which is owned by another corporation can be made subject to an election under IRC § 338(h)(10) to remove one tier of corporate tax where the subsidiary target (the stock of which is sold to the acquirer) is treated as if it had sold assets.

(1) **Regular Section 338 Election.** Generally, there is no tax effect on the target corporation in the event of a stock sale, unless a regular Section 338 election is made (as opposed to an IRC § 338(h)(10) election). In this event, the transaction is treated as a stock sale for purposes of the seller, but the target is deemed to sell its assets after the stock sale to a new corporation and then liquidate. Thus, the stock sale is followed by an asset sale so the target recognizes gain on its assets. This is not a good idea unless, for example, the target has NOLs or carryovers about to expire.

(2) **Section 338(h)(10) Election.** There is an election available (and commonly used) under IRC § 338(h)(10), which allows a stock sale to have the tax effect of an asset sale. It only applies to targets which are members of consolidated groups or which are S-corporations.

(a) **C-Corporation Effect.** If the stock of a target subsidiary which is owned 80% or more by its parent (*i.e.*, the stock is sold out of a selling consolidated group), a joint election may be made by the purchaser of the target stock and the corporate parent seller of the stock under IRC § 338(h)(10). The election causes the target to be treated as if it had sold its assets to a hypothetical “New Target” subsidiary of the consolidated group, and as if the target then liquidated up into the parent tax free under IRC § 332. The selling parent does not recognize gain on the sale of the stock, but the target subsidiary recognizes gain as part of the consolidated group, on the deemed sale of its assets. There is, thus, only one corporate level tax, not two, as there would be if the target subsidiary sold assets (first taxable event) and then was liquidated by the parent in a taxable transaction and not under IRC § 332 (second taxable event).
The consolidated group (seller) may find the election acceptable where the group has losses which can be offset before they expire.

(b) S-Corporation Effects. This election under IRC § 338(h)(10) can also apply to an S-corporation target. The sellers may find the election acceptable because the corporate level gain will pass through the corporation to the shareholders, increasing the basis in their stock, thus reducing the gain (or increasing the loss) on the deemed liquidation of the corporation. However, there are two major danger areas for S-corporations:

(i) There may be recapture income in certain cases on assets which have been depreciated or amortized where the price for the item is in excess of its depreciated basis. If so, the recapture income will be ordinary income.

(ii) There may be a tax on built-in gains (IRC § 1374) where the corporation had at one time been a C-corporation and made the S-corporation election at a time its assets had a value in excess of basis (and ten years have not expired since the election). There will in such a case be corporate level gain taxed as the corporation’s income to the extent of the built-in gain; this tax will be in addition to the income recognized by the shareholders on the transaction.

C. Acquirer Variations. If the target pays part of the consideration, by redemption or other distribution, the buyer receives no basis for such amounts. If the target is immediately liquidated into the acquiring corporation under IRC § 332 (without a § 338 election), the stock basis disappears and the acquirer’s basis in the assets received on the liquidation will be the target’s historic basis in the assets. A liquidation under IRC § 332 can pass the tax attributes of the target (such as NOLs or credit carryovers) to the acquirer pursuant to IRC § 381. The liquidation into the parent may make these tax attributes available to a corporate group where they would otherwise be limited. However, IRC § 269(b) provides that if the principal purpose of the transaction is tax avoidance, the deductions or credits may be disallowed. Further, the legislative history indicates that in the absence of evidence to the contrary, a stock purchase followed by such a liquidation “is ordinarily indicative that the principal purpose of the liquidation is tax avoidance.” H.R. Rep. No. 432, 98th Cong. 2d Sess. 1623 (1984). Some nontax avoidance purposes may include such things as operating efficiencies, state tax savings, and financing requirements.

D. Collapsible Corporations. In order to prevent corporate level ordinary income from being turned into shareholder level capital gain, IRC § 341 provides restrictions applicable to what are called “collapsible corporations.” The existence of IRC § 336 in its present form (taxing liquidations as sales of assets at the corporate level) has made the collapsible corporation provisions of less significance than in the past, but they still exist and may create significant problems in companies, for example, high-tech companies created with a view to a quick sellout.

Example: A real estate or movie deal is incorporated and developed to the point when it is about to produce an income stream. The shareholders sell out and receive the value of the income stream as capital gain.
Example: A software or internet company pumps money and resources to develop its product and has had no taxable income when the shareholders sell out to an acquirer for a large value justified by the prospect of large future earnings.

These examples, the first the classic case, the second the more contemporary case, are the sorts of transactions to which the collapsible corporation provisions might apply.

(1) **Effect of Rules.** The effect of the application of the collapsible corporation rules is that any gain to the shareholder is taxed as ordinary income if it arises from a sale of the corporation’s stock, a distribution in partial or complete liquidation, or a distribution treated as a sale or exchange (see IRC § 301(c)(3)(A)) to the extent it exceeds the basis of the stock.

(2) **Key Tests.** The key tests for the applicability of the collapsible corporation rules are:

- (a) The corporation is “formed or availed of” principally for the production of property or the purchase of “Section 341 assets” (these are inventory, property for sale to customers in the ordinary course, depreciable property used in trade or business, or unrealized fees or accounts receivable pertaining to these things);
- (b) With a view to sale, liquidation, or distribution before the corporation recognizes two-thirds of the taxable income from the property.
  - (i) The view of the shareholders (even a minority) in a position to affect policy is critical. Regs. § 1.341-2(a)(2).
  - (ii) It may be hard to predict what two-thirds of the income would be in many situations.

(3) **Exceptions.** There are exceptions which may apply; the most significant are:

- (a) Section 341(d) protects the gain where:
  - (i) the taxpayer is a 5% or smaller shareholder (after the application of ownership attribution rules),
  - (ii) 70% of the gain is attributable to noncollapsible property (this exception is thus of no help to a single asset enterprise), and
  - (iii) the gain is not realized for more than three years after completion or purchase of the property.
- (b) If no 20% or greater shareholder is a dealer, and if technical rules are met such that “ordinary income assets do not exceed 15% of the corporation’s net worth,” Section 341(e) will protect the gain. Attribution of ownership rules apply.
(c) Section 341(f) will protect the gain if the corporation consents to recognize gain on a later disposition of its assets (other than certain capital assets) owned or held on the date of the sale. This prevents the use of tax-free liquidation provisions, or the use of tax-free reorganizations, unless the acquirer in the reorganization agrees to take the assets subject to the tax taint.

3. **Taxable Asset Sale Transaction Variations.** A number of variations can affect an asset acquisition transaction.

   A. **Liquidations.** Usually, but not always, an asset sale by a corporation is followed by a liquidation where the shareholders will recognize gain or loss on the distribution of the net proceeds (after corporate level taxes, etc.) of the sale.

      (1) **No liquidation.** If there is no liquidation, the shareholder’s day of reckoning is postponed and the corporation reinvests the after-tax sale proceeds. (If the corporation invests in something other than an active business, care must be taken to avoid personal holding company treatment. IRC § 545(a).)

      (a) **Partial Distribution.** If a partial distribution is made, there may be a taxable dividend (which is ordinary income) to the shareholders unless one of the exceptions to dividend treatment for redemptions applies. IRC § 301.

      (b) **Installment Reporting.** If the installment reporting provisions apply, the corporation could spread its gain over the payment period of an installment obligation. IRC § 453. Installment treatment is not available for the sale of inventory. IRC § 453(b)(2). Recapture items are included in income in the year of sale even where this exceeds the gain otherwise recognized that year under the installment method. IRC §453(i). Otherwise, installment treatment, contingent payment treatment, and open transaction treatment would be very similar for a corporation selling assets as described above (section 2.B. of this outline) for a shareholder selling stock. Disposition of an installment note (including on a later liquidation) will require inclusion of at least the fair market value of the note (and perhaps full face under the principles behind the repeal of the doctrine of the General Utilities case; the Service has broad regulatory authority here. See e.g., IRC § 337(d) and 1986 TRA Bluebook 345. Pledging an installment obligation for a loan or having the right to “put” the installment obligation to repay a loan, where the sales price is over $150,000, will cause the loan proceeds to be treated as a receipt of payment on the installment obligation. IRC § 453A(d)(4).

      (2) **Liquidating Trusts.** If the corporation has actual or contingent obligations to be covered by maintaining a reserve fund, or has unsold assets not easily distributable in kind, then a liquidating trust may be useful in order to obtain liquidation treatment by distributing the reserve and remaining assets into trust for the benefit of shareholders. The key is that the trust must be recognized as such and not treated as an association taxable as a corporation. SeeRegs. § 301.7701-4(d). This may allow the avoidance of dividend treatment to the shareholders, permit the recognition of loss to the corporation on the distribution of the unsold remaining assets, and avoid double taxation on transactions made by the trust itself.
(3) **80% Subsidiaries.** If a stockholder is a corporation owning 80% or more of the voting power and value of the stock of the liquidating corporation at all times from the time of the adoption of a plan of complete liquidation until the actual liquidating distribution, then under IRC § 332, the shareholder will not recognize gain or loss on receipt of a distribution pursuant to the liquidation. Rather, it receives a carryover basis in the assets received (IRC § 334(b)(1)) and will succeed to certain tax attributes of the liquidated corporation (IRC § 381). Also, the liquidating subsidiary will not recognize gain or loss on the distribution in kind of assets to its parent (the subsidiary will, of course, recognize gain on assets sold to a third party including where it distributes the cash proceeds to its parent). IRC § 337.

B. **Character of Gain or Loss to Corporation.** The gain or loss to the selling corporation is characterized as capital gain or ordinary income on an asset-by-asset basis. IRC § 1231. Recapture rules (e.g., on fast depreciation) will apply to treat as ordinary income gain which would otherwise be capital in nature. Also, other previous tax benefits may be recaptured where the reason for the benefit ceases. See *Hillsboro National Bank v. Com’r.*, 460 U.S. 370 (1983). Amounts which are treated as interest under the OID rules or IRC § 483, would not be an amount realized, but the “issue price” of the deferred payment right would be. Regs. § 1.1001-1(g).

C. **Tax Accounting Problems.** There may be problems in determining the proper tax treatment of income or deduction items attributable in whole or in part to presale activities but which are not yet includible or deductible under the selling corporation’s tax accounting method:

(1) **Accrual.** An accrual method taxpayer having performed most services on a contract which is completed and paid after the sale will want the purchase price to reflect the buyer’s right to receive the payment, resulting in more gain (or lower loss) to the seller at the time of the sale.

(2) **Cash.** Where a cash method taxpayer has accrued but unpaid deductible expenses, the buyer assuming the obligation will not be able to deduct it but must capitalize it, as part of the price paid. See *Pacific Transport Co. v. Com’r*, 483 F.2d 209 (9th Cir. 1973). If treated as the price for goodwill, it will be amortized, if at all, over 15 years. If there is a lower purchase price, the seller effectively pays the expenses and, instead of having the deduction disappear altogether, the seller may be able to take the deduction for such expenses in the year of sale. *Commercial Security Bank v. Com’r*, 77 T.C. 145 (1981), acq. on this issue, 1986-1 C.B. 1. A similar rule applies to an IRC § 338 election transaction. Regs. § 1.338(b)-3T(h).

(3) **Compensation.** Compensation deductions raise special concerns. An accrual method taxpayer should be able to meet the “economic performance” standard which is a condition to the deduction under IRC § 461(h). Regs. § 1.461-4(g)(1)(ii)(c). On the other hand, the Service has strongly resisted allowing the deduction where under IRC §§ 83 and 404(a)(5) the employer is unable to take the deduction until the employee takes the item into income (e.g., in the case of certain not yet vested deferred compensation, stock bonus, or similar arrangements); the result if this approach stands, is the elimination of the deduction altogether.
See TAM 8939002; but compare Foelt v. Com’r, 68 T.C. 223 (1977), and IRC § 357(c)(3)(A)(I) which may imply by analogy that a liability insufficiently ripe to be deductible is also insufficiently ripe to be an amount realized on sale (this would change an ordinary deduction to reduced capital gain).

D. **Assumption of Debt at Discount.** If the buyer assumes, or takes property subject to, debt issued at a discount, then seller realizes the adjusted issue price (which could be its face amount) of the debt as of the sale, and the buyer will receive basis in this same amount. Thus, buyer’s basis may be more than the actual worth of the debt assumed.

   (1) The price for the business may reflect the value of the below-market interest.

   (2) Is the premium paid amortizable as an intangible over the 15 years provided by IRC §197?

   (3) Is the premium paid not amortizable at all by the buyer where it would be like an OID deduction where OID is not created? See Regs. § 1.197-2(c)(9). The buyer would be entitled to interest deductions based on the original terms of the debt, not its discounted value. See Regs. § 1.1274-5(a).

E. **Shareholder Goodwill.** One way which might be available to ameliorate the adverse effects of two-layer taxation on the sale of corporate assets would be to treat some or all the goodwill associated with the business as that of the shareholder rather than the corporation. This may be the case where personal relationships and contacts are critical and there are no restrictions against competition. See Martin Ice Cream Company v. Com’r, 110 T.C. 189 (1998) (the shareholder’s personal relationship with a supermarket chain was separately sold by the shareholder at the time of the sale of the corporation’s ice cream distribution business); H&M, Inc. v. Com’r, TC Memo 2012-290 (insurance broker’s good will personal not corporate); MacDonald v. Com’r, 3 TC 720 (1944). See, however, Howard v. U.S., 106 AFTR 2d 2010-5533, 2010 WL 3061626 (D.C. Wa. 2010), aff’d by U.S. v. Howard, 108 AFTR 2d 2011-5993, 448 Fed.Appx. 752, 2011 WL 3796723 (9th Cir. 2011) (goodwill of dentist with covenant not to compete with practice was with practice, not dentist).

F. **Allocation of Price to Assets for Basis.** There is usually no real adversity between sellers and buyers in the allocation of price, and their allocations are given reduced evidentiary weight after the 1986 Tax Reform Act.

   (1) **Recovery of Price.** Recovery of the price paid by the buyer is generally:

<table>
<thead>
<tr>
<th>Asset allocated to</th>
<th>Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>inventory</td>
<td>as sold (if § 337 applies)</td>
</tr>
<tr>
<td>depreciable or amortizable assets</td>
<td>allowable depreciation or amortization deductions</td>
</tr>
<tr>
<td>other property</td>
<td>when disposed of or abandoned</td>
</tr>
</tbody>
</table>
(2) Residual Method. A residual method of price allocation applies to all § 338 transaction, and to asset sales of any “active trade or business.” See Regs. §§ 1.338-6 and -7; IRC § 1060(c). There is an order of priority:

(a) Aggregate purchase price is reduced by cash and demand deposits (Class I).

(b) Basis is allocated by relative market value to actively traded personal property (e.g., securities, not including target affiliates), certificates of deposit, and foreign currency (Class II).

(c) Then basis is allocated to accounts receivable, mortgages, and credit card receivables, assets that the target marks to market at least annually, but excluding certain items which are debt from related persons, contingent debt, or convertible debt (Class III).

(d) Then basis is allocated to inventory and related assets (Class IV).

(e) Then to all assets not in any other class, such as tangible business assets, target affiliate stock (Class V).

(f) Then to IRC § 197 intangibles other than goodwill or going concern value, such as covenants not to compete, customer lists, etc. (Class VI).

(g) Then whatever is left is treated as goodwill or going concern value, whether or not it qualifies as a section 197 intangible (Class VII). The allocation in a class generally is by fair market value, never to exceed the fair market value of any particular item.

(3) IRC Section 197 Intangibles. Intangibles described in IRC § 197 are recovered over 15 years. Some items included and excluded are:

<table>
<thead>
<tr>
<th>Included Under § 197</th>
<th>Excluded From § 197</th>
</tr>
</thead>
<tbody>
<tr>
<td>goodwill, going concern value</td>
<td>interests in organizations (corporations, partnerships, trusts, or estates)</td>
</tr>
<tr>
<td>work force in place</td>
<td>futures contracts, foreign currency contracts, interest rate swaps, etc.</td>
</tr>
<tr>
<td>information base</td>
<td>interests in land</td>
</tr>
<tr>
<td>know-how</td>
<td>certain software</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
customer and supplier information  
interests under tangible property leases
relationships  
sports franchises
licenses and permits  
certain transaction costs
covenants not to compete  
self created intangibles (except those created in the acquisition itself)
franchises
trademarks or trade names

See Regs. §§ 1.197-2(b) through (e).

4. Deferred Payment Arrangements. If the price for the stock or assets is paid over a period of time, some additional rules will apply.

A. Open Transaction. If the payment is so contingent or speculative that it can’t be valued, the realization of gain is postponed until received under the “open transaction doctrine.” This is a very rare circumstance. Temp. Regs. § 15A.453-1(d)(2)(iii). If the doctrine applies, the payments to the seller are treated so the seller first receives back basis and only after basis is recovered are the payments treated as gain. Burnet v. Logan, 283 U.S. 404 (1931). The essence of the rule (where a discounted obligation is acquired) is uncertainty whether the taxpayer will recover the full amount of its basis. Premji v. Com’r, TC Memo 1996-304, aff’d on other issues 139 F.3d 912 (10th Cir. 1998); see also Guaderrama v. Com’r, TC Memo 200-104 aff’d 88 AFTR 2d 2001-6620 (unpublished) (10th Cir. 2001) (obligation found not speculative). Under no circumstance will an installment sale for a fixed amount obligation be considered an open transaction, and remote or incidental contingencies are ignored. Temp. Regs. § 15A.453-(d)(2)(ii).

B. Interest and Principal. Deferred payments carry with them taxable interest, whether or not stated. The determination of what is to be the amount of interest when the stated rate is not economically sufficient, is made under complicated deemed interest and original issue discount rules.

(1) Adequate Interest. Most transactions will be subject to the rules of IRC § 1274, but there are a number of exceptions, and if those exceptions apply, IRC § 483 will generally apply.

(a) Section 483. Section 483 is now generally restricted to testing for adequate interest in seller financed transactions not otherwise governed by IRC § 1274. IRC § 483 is likely to apply only in acquisitions where the total consideration for the sale plus interest to be paid does not exceed $250,000. Even under IRC § 483, the amount of imputed interest is determined in a very similar manner to the method used under IRC § 1274,
which is discounting payments at the Applicable Federal Rate. However, under IRC § 483, the interest component is separately accounted for in accordance with the taxpayer’s normal method of accounting.

(b) **Test.** Generally, under both IRC §§ 1274 and 483, the interest is tested against the Applicable Federal Rates issued monthly by means of Revenue Rulings. These rates come in three varieties, short term (3 years or less), mid-term (9 years or less, but over 3 years), or long term (over 9 years), and each variety is applied based on the compounding period (monthly, quarterly, semi-annually, annually) used in the debt instrument. The Applicable Federal Rate for a demand loan is the short term rate but it fluctuates monthly as long as any of the note remains unpaid. Reg. § 1.482-2(a)(2)(iii)(C).

(2) **Original Issue Discount.** Whether there is original issue discount (“OID”) must often be determined. For example, if principal is deferred, or if some of the interest accruing on the deferred principal is or is deemed to be, deferred, this might create original issue discount income to the lender (seller), and a corresponding current interest deduction to the borrower (buyer) (determined under the “constant yield method” of IRC § 1272(a)(1)). The following explanation will seem complex and technical, and this it certainly is, although it has been greatly simplified where possible. The OID rules are, as you will see, hideously complex.

(a) **What is OID?** Original issue discount is the excess, if any, of the stated redemption price at maturity of a debt instrument over its issue price. The stated redemption price at maturity is the sum of all payments other than qualified stated interest. The qualified stated interest is the stated interest that is unqualifiedly due at least annually at a single fixed rate. The issue price for nonpublicly traded debt bearing adequate interest is its face amount; for publicly traded debt it is the market price at issue (or at deemed issue in the case of a material modification of the debt).

Example: If the entire obligation is $100X payable at maturity and it is issued for $90X, the OID is $10X:

\[
\begin{align*}
$100X & \text{ redemption price at maturity} \\
- & 90X \text{ issue price} \\
\hline
$ 10X & \text{ OID}
\end{align*}
\]

Example: If property worth $70X is bought with an obligation payable in installments over time where the total of all installments payable is $100X, and where if this $100X a $20X part is qualified stated interest, the OID will be $10X:

\[
\begin{align*}
$100X & \text{ total of all payments to maturity} \\
- & 20X \text{ payments which are qualified stated interest} \\
\hline
$ 80X & \text{ the redemption price} \\
\hline
$ 80X & \text{ the redemption price} \\
- & 70X \text{ the price for the property (issue price)}
\end{align*}
\]
$10X OID

(b) **Adequate Stated Interest.** For OID purposes, adequate stated interest exists if the stated principal amount of the debt is less than or equal to the imputed principal amount. IRC §§ 1274(c)(2) and 1274(b). The imputed principal amount is the sum of the present values of all payments due under the instrument using a discount rate equal to the Applicable Federal Rate compounded semi-annually with respect to the period (i.e., short term (3 years or less), mid-term (9 years or less, but over 3 years), or long term (over 9 years)) determined by the weighted average maturity of the installment obligation. The weighted average maturity is the sum of the following amounts determined for each payment other than a payment of qualified stated interest: (1) the number of complete years from the issue date until the payment is made multiplied by (2) a fraction the numerator of which is the amount of the payment and the denominator which is the stated redemption price at maturity.

(c) **Possible Exceptions.** Even if there were to otherwise be original issue discount, three possible general exceptions may apply (there are some other more specialized exceptions, too).

(i) **All Qualified Stated Interest.** The first exception arises under Regs. § 1.1274-1(b)(1) which makes the OID issue price rules inapplicable (resulting instead in the application of IRC § 1273(b)(4)) so that the issue price will, by legislative fiat, equal the stated redemption price at maturity. This exception applies if all interest is qualified stated interest, the rate at least equals the test rate that applies, the debt is not issued in a potentially abusive situation, and the borrower does not pay lender points or interest at the time of the issuance of the debt. Thus, this exception essentially puts the debt outside the OID rules.

(ii) **De Minimis Rule.** Secondly, there is a de minimis rule under IRC § 1273(a)(3) that ignores OID if the excess of the stated redemption price at maturity over its issue price is less than 0.25% (or alternatively, 0.167% may be used where payments of principal are no more rapid than under a self-amortizing installment obligation) of the stated redemption price at maturity, multiplied in the usual case by the number of complete years to maturity, but in the case of an installment obligation multiplied by the weighted average maturity.

(iii) **Cash Method Election.** The third exception would be to elect cash method treatment for the obligation under IRC § 1274A. The election may be available unless the principal purpose of the modification is to defer interest income or deductions. To qualify for the election, the stated principal must (in 2011) not exceed $3,715,200, the lender must not use the accrual method of accounting or be a dealer with respect to the property sold or exchanged, the issue price rules of IRC § 1274 would otherwise have applied (this apparently makes the election an alternative exception, not an additional exception, to the first exception), and the borrower and lender together elect to have the debt treated on the cash basis by means of a joint statement signed not later than the due date (including extensions) for filing the return of the borrower or the lender for the tax year of the issuance. A copy should be the timely filed returns of the borrower and the lender.
(iv) Specialized Exceptions. The more specialized exceptions to the OID rules may apply where nonpublicly-traded debt is issued for nonpublicly-traded property. However, the imputed interest rules of IRC § 483 would apply. Subject to various conditions and requirements, these exceptions involve: total payments of $250,000 or less (IRC § 1274(c)(3)(C)), principal residence of an individual (IRC § 1274(c)(3)(B)), farms with a sales price not exceeding $1,000,000 (IRC § 1274(c)(3)(A)), sales of patents (IRC § 1274(c)(3)(E)), transfers of land between family members where all land sales aggregate not more than $500,000 (IRC § 1274(c)(3)(F)), property that is personal use property to the debt issuer that evidence a below-market loan or transactions involving a demand below-market loan (Regs. § 1.1274-1(b)(3)(i) and (ii), IRC § 7872), or transfers between spouses incident to divorce (Regs. § 1.1274-1(b)(3)(iii)).

C. Installment Method. If applicable, reporting gain on the installment method by a taxpayer results in no gain being recognized on receipt of the debt instrument. Rather, as each payment is received, the seller will recognize the part of the principal payment that is proportionate to the gross profit ratio. The principal payment is multiplied by the gross profit ratio, which is the ratio of the total gain realized in the transaction to the total contract price. IRC § 453.

(1) Postpone Gain. Thus, basis and gain are treated as being received proportionately, and gain is postponed, and so is the tax on that gain.

(a) Interest Charge. There may be an interest charge on the deferred tax, which will eliminate the benefit of installment reporting as an interest-free loan of the deferred tax. IRC § 453A(c). Unless the interest rate charged by the government is less than that commercially available, much of the benefit of the installment method is lost. The interest charge on the deferred tax will apply:

(i) The charge applies to the extent the face amount of all the installment obligations held by the taxpayer outstanding at the end of a year is over $5 Million. IRC § 453A(b)(2)(B).

(ii) The charge only applies to transactions with a sales price in excess of $150,000. IRC § 453A(b)(1).

(iii) Personal use and farm property are excepted. IRC § 453A(b)(3).

(b) Borrowing or Disposition. Borrowing against the obligation will accelerate the recognition of gain because the loan proceeds are treated as payments on the obligation. IRC § 453A(d). Other dispositions of the obligation will trigger gain recognition as well, with some exceptions for transfers on death or divorce. See IRC § 453B(a), (c), and (g).

(2) Requirements. The requirements to qualify for installment reporting are:
(a) At least one payment is due after the end of the tax year of the sale. IRC § 453(b)(1).

(b) The sale must not be of marketable stock or securities (e.g., bonds). Restricted stock of a public company may meet this requirement, but generally only private company stock sales will qualify. IRC § 453(k)(2)(A).

(c) The obligation must not be a demand obligation or one which is readily tradeable. IRC § 453(f)(4).

(d) The obligation must not be secured by cash or a cash equivalent. Regs. § 15a.453-1(b)(3)(i).

(e) The obligation must be that of the actual purchaser, not its parent or another (except for certain liquidations). Regs. § 15a.453-1(b)(3)(i).

(f) Installment reporting may be available, however, to target shareholders who receive the debt of the acquirer after liquidation of the target in an asset sale transaction if the sale and liquidation all occur within 12 months of adoption of a plan of complete liquidation.

(3) Where Inapplicable. If installment reporting does not apply, either because of a failure to be eligible for it, or because the tax payer elects (under IRC § 453(d)) not to use it:

(a) Accrual Method. An accrual method taxpayer not using installment reporting takes the full principal amount of the debt as the amount realized at the time of the sale. (However, OID, if any, is treated separately, not as an amount realized.)

(b) Cash Method. For a cash method taxpayer not using installment reporting, the amount realized at the time of sale is the fair market value of the obligation. (The fair market value is the issue price if OID rules apply.) However, in determining the market value of the obligation:

(i) transferability restrictions are ignored;

(ii) the value of the debt will never be less than the value of the property sold, less any other consideration received.

(c) Publicly Traded Securities. If a cash basis taxpayer sells publicly traded stock on an established securities exchange, then all payments to be received are treated as received in the year of disposition. IRC § 453(k). This is like the treatment of an accrual method taxpayer.

D. Contingent Payments. Contingent payment arrangements, such as an earn-out where the seller receives an additional price based on the target corporation’s earnings, need to be analyzed for economic substance. Is the debt essentially such a strong continued
interest that it is an equity interest in the target or the acquirer? Is the arrangement a partnership between the buyer and the seller? Is it a rent or royalty arrangement? Assuming the contingent payment arrangement is treated as debt:

(1) **Original Issue Discount.** OID rules may apply, with certain exceptions, including an exception for variable rate debt. The treatment under the OID rules differs between sales for cash or publicly traded property (including debt) and sales for nonpublicly traded property (including debt).

(2) **Installment Treatment.** If installment treatment applies to the contingent payments,

(a) It is assumed maximum payments under any cap will be made (tending to accelerate recognition of gain, *i.e.*, a seller shouldn’t negotiate an unrealistically high cap).

(b) If there is no cap, but there is a time limit, basis will be recovered ratably over the term of the contingent obligation. If the amount actually received in a year is less than the allocated basis for that year, no loss is recognized, but the unrecovered basis is carried forward to the next year. Regs. § 15a.453-1(c)(3). This is good for the seller where payments are back-end loaded, and bad where payments are front-end loaded.

(c) Without any limit on amount or time, the obligation must be analyzed to see whether or not it is true debt; if it is debt, basis is generally recovered ratably over 15 years and any unrecovered basis remaining after the 15 years is carried forward until the right to future payments is established as worthless. Regs. § 15a.453-1(c)(4). The time period of deferral may be varied by the Service on request for a ruling or if the Service deems the period inappropriate. Regs. § 15a.453-1(c)(7)(ii) and (iii).

(d) The acquirer does not obtain basis on the contingent payment until it becomes fixed. *Albany Car Wheel Co., Inc. v. Com’r*, 40 T.C. 831 (1963), aff’d 333 F.653 (2d Cir. 1964).

(3) **No Installment Treatment.** If installment treatment does not apply because the taxpayer elects out, the market value of the contingent right is included as an amount realized at the time of the sale. If installment treatment does not apply because the requirements for eligibility are not met, the fair market value of the contingent right is the amount realized. If more or less is ultimately actually received, then additional gain or loss is recognized at that time. This is in accordance with the general rule of IRC § 1001(b).

E. **Escrows.** If part of the price is held in escrow contingent on future events:

(1) **Secure Contingent Payment.** If the escrow secures contingent payments, the general rules for contingent payments would apply.
Secure Indemnity. If the escrow is to secure an indemnification by the seller, the treatment is unclear and could be treated like a contingent payment arrangement, or could be treated in the same way indemnities without an escrow is treated, as full present receipt with a possible future repayment obligation if an indemnifiable event occurs. See F below.

Escrow Earnings. The interest or other earnings on the escrow fund are apparently taxed currently (IRC § 468B(g)) at the highest trust rate in effect under IRC § 1(e). Regs. § 1.468B-2(a). The party to whom the earnings are taxed seems to depend on how the escrow itself is treated: if treated as a contingent payment arrangement, the buyer would be taxed; if the escrow is treated as having been paid to the seller, the seller would be taxed. Another possibility is to treat the escrow as a fixed deferred payment in which event the buyer is taxed.

Claim of Right. Indemnities, escrowed amounts, payments made under contingencies, all may require analysis under the claims of right doctrine as to the inclusion, and timing of inclusion, in income, and as to the consequences of a later payment back of amounts received earlier.

(1) Inclusion. If unrestricted payments are received (or constructively received) under a claim of right, whether erroneous or even wrongful, the income relating to the payment must be included by the taxpayer receiving it. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). A bona fide escrow of funds which restricts the funds may prevent constructive receipt. See Com’r v. Tyler, 72 F.2d 950 (3d Cir. 1934), Carnahan v. Com’r, 21 BTA 893 (1930). However, if the person can use or benefit from the funds the claim of right doctrine will apply to include the income in the year of receipt. Restrictions which do not prevent use for the taxpayer’s benefit will not prevent income inclusion under the claim of right doctrine. Field Service Advice 912, Vaughn No. 912. The income needs to be treated by the recipient as belonging to the recipient, not as an unconditional liability. See Smarthealth Inc. v. Com’r, 81 TCM 1777 (2001); Lashells Est. v. Com’r, 208 F.2d 430 (6th Cir. 1953). However, the mere possibility of having to repay amounts will not preclude constructive receipt or the application of the claim of right doctrine. Schmitt v. Com’r, TC Memo 1998-269; Rosenberg v. Com’r, TC Memo 1956-68; Nordberg v. Com’r, 79 T.C. 655 (1982) aff’d by order 720 F.2d 658 (1st Cir. 1982). A reserve for repayment set up by the recipient does not prevent inclusion income because there is no involuntary restriction on use. Etoll Est. v. Com’r, 79 T.C. 676 (1982). The doctrine will apply even where the total amount of the income has not been determined (R.A. Steward & Co., Inc. v. Com’r, 57 T.C. 122 (1971)) or the amount which may need to be repaid has not been determined (Bates Motor Transport Lines, Inc. v. Com’r, 200 F.2d 20 (7th Cir. 1952). Compare, however, Adapour v. Com’r, T.C. Memo 1999-9, acq. result only, 2000-7 IRB (funds released from escrow while escrow still open, repayable if escrow does not close, not taxed; this result appears to be an anomaly and is in a memorandum decision which is not reliable precedent).

(2) Deduction on Repayment. If an amount received and taxed under the claim of right doctrine must later be repaid, a deduction in the year of repayment may be available. There must be a statutory basis for the deduction, however; deductions are matters of
legislative grace and are not created by courts. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *National Life and Accident Ins. Co. v. U.S.*, 244 F. Supp. 135 (M.D. Tenn. 1965), aff’d, 385 F.2d 832 (6th Cir. 1967). The typical statutory basis for a deduction is IRC § 162 (trade or business expense) or § 165(c)(2) (a nonbusiness loss). If these do not apply, the chances of a deduction are about nil. See SCA 200235030 (Service advice that there is no deduction for later payment of personal loan where the loan was earlier cancelled and forgiveness of the debt income was taxed).

(3) **Special Mitigation Relief.** A deduction in a later year may not be sufficient to offset the tax in the prior year, so IRC § 1341 provides a mitigation rule allowing either a deduction or a reduction in tax liability by the amount of the earlier inclusion. The result is like a refund of the prior tax without interest. However, the technical requirements of the section must be established, one of which is that the deduction must be over $3,000. At or below $3,000 a deduction may be available (subject to the 2% floor for miscellaneous itemized deductions), but the mitigation choice will not be available. Above $3,000 the choice is available and the miscellaneous itemized deduction floor does not apply. IRC § 67(b)(9); Regs. § 1.65-1T(b)(14). Where the nonbusiness loss rule of IRC § 165 is the basis for the deduction, the loss may be a capital loss and thus, generally subject to the $3,000 capital loss limitation of IRC § 1211; however, if IRC § 1341 applies, the capital loss limitation does not affect the deduction. Regs. § 1.1341-1(c).


(4) **Burden of Proof.** The burden initially (subject to burden shifting rules) is on the taxpayer to show that the income is not includible under a claim of right (*Knitten v. Com’r*, 39 T.C. 553 (1962); see *Hamlett v. Com’r*, 87 T.C.M. 1129 (2004)) and, where included, to show entitlement to the later deduction on repayment and to show that the deduction exceeds $3,000 for the mitigation rule. *Schwartz v. Com’r*, 68 TCM 63 (1994), aff’d 80 F.3d 558 (D.C. Cir. 1996).

5. **Tax-Deferred Reorganizations.** Some transactions may meet the requirements for a reorganization under the Code and thus enable the parties to the reorganization to avoid (at least to a large extent) immediate taxation by reason of the transaction. The forms of such reorganization (sometimes called “tax-free” reorganizations) are described in IRC § 368. The
basic forms are described in IRC § 368(a)(1), and the subprovisions of this part of § 368 are lettered A through G (i.e., § 368(a)(1)(A) - § 368(a)(1)(G)). These letters have become the names of these basic forms in tax parlance. There are also special provisions for what are known as triangular reorganizations, a variation on the usual forms of reorganization in which the consideration is supplied by a parent of a subsidiary which is the direct party to the reorganization. Triangular mergers may be “forward” where the target corporation is not the survivor or “reverse” where the target corporation is the survivor. See IRC § 357(a)(2)(D) and (E). Each form of reorganization has its own technical requirements under the Code, and in addition to these, there are the judicially created requirements of continuity of proprietary interest, business purpose, and continuity of business enterprise.

A. **Summary of Reorganization Types.** The following is a comparative summary of the types of tax-deferred reorganizations:

<table>
<thead>
<tr>
<th>Type</th>
<th>Consideration from Acquirer</th>
<th>Special Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-Reorg Statutory Merger</td>
<td>Any (still must meet general continuity of interest requirements)</td>
<td>(Compare Forward and Reverse Triangular Mergers)</td>
</tr>
<tr>
<td>§ 368(a)(1)(A)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B-Reorg Stock for Stock</td>
<td>Solely Voting Stock of Acquirer or Its Parent</td>
<td>Acquirer must be in control immediately after</td>
</tr>
<tr>
<td>§ 368(a)(1)(B)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C-Reorg Stock for Assets</td>
<td>Solely Voting Stock of Acquirer or Parent</td>
<td>substantially all assets must be transferred by Target Target must liquidate</td>
</tr>
<tr>
<td>§ 368(a)(1)(c)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D-Reorg Divisive (split-</td>
<td>Not generally used in acquisitions; requires control immediately after transaction of</td>
<td>requires a stock distribution under 354, 355, or 356, requires a stock distribution</td>
</tr>
<tr>
<td>ups, spin-offs) § 368(a)</td>
<td>corporate transferee receiving substantially all assets for stock; (IRC § 355 may be</td>
<td>to a controlled corporation acquiror under § 354 is used in an acquisitive transaction</td>
</tr>
<tr>
<td>(1)(D)</td>
<td>useful in trimming corporation prior to an acquisition; more often used to divide corporation</td>
<td>(e.g., one corporation under common control acquires for stock substantially all the</td>
</tr>
<tr>
<td></td>
<td>among groups of shareholders)</td>
<td>all the assets of another corporation under the common control, then</td>
</tr>
<tr>
<td></td>
<td></td>
<td>transferor dissolves</td>
</tr>
<tr>
<td>E-Reorg Refinancing</td>
<td>Not used in acquisitions</td>
<td></td>
</tr>
<tr>
<td>§ 368(a)(1)(E)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F-Reorg Mere change in</td>
<td>Not used in acquisitions</td>
<td></td>
</tr>
<tr>
<td>form § 368(a)(1)(F)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>G-Reorg Bankruptcy Reorganization § 368(a)(1)(G)</td>
<td>Stock or Securities which must then be transferred by Target</td>
<td>under jurisdiction of court in insolvency proceeding substantially all assets (under flexible standard) or assets constituting trade or business must be transferred by Target divisive transaction possible forward and reverse triangular mergers possible</td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td>-------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Forward Triangular Merger § 368(a)(2)(D)</td>
<td>Any (continuity of interest applies), but not subsidiary stock</td>
<td>substantially all assets must be transferred (compare to a C-Reorg)</td>
</tr>
<tr>
<td>Reverse Triangular Merger § 368(a)(2)(E)</td>
<td>Voting Stock for Control; any for remainder</td>
<td>substantially all assets must be transferred must acquire control of Target in the transaction (compare to a B-Reorg)</td>
</tr>
</tbody>
</table>

### B. **Judicially Created Requirements**

Courts have developed tests to distinguish real reorganizations deserving of tax-deferred treatment from sales or exchanges which should be taxable. These tests apply in addition to statutory requirements. To some extent, these doctrines have been codified in some provisions of the Code and Regulations but retain independent vitality.

1. **Continuity of Interest.** The single biggest difference between a sale and a reorganization is that some substantial part of the proprietary interest in the target continues after the transaction. The continuity must be provided through stock of the acquirer, whether voting or nonvoting, common or preferred; long-term debt, warrants, convertible debt, etc., are not sufficient. The issue is how large a proportion of Target shareholder’s equity is acquired for stock. It must be a “substantial portion” of the total consideration. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935). The Service wants 50% of the total equity value of the Target to be acquired with stock. Courts have allowed lower proportions. See *Nelson v. Helvering*, 296 U. S. 374 (1935) (38% allowed), *Miller v. Com’r*, 84 F.2d 415 (6th Cir. 1936) (25% allowed, but this case appears to be an aberration). Where the statutory requirements require a greater proportion (100% in a B-Reorg), the statutory rule governs. Under recent regulations, the historic shareholders of the Target need not be the shareholders and may transfer to others their Target shares just before or their acquirer shares just after the transaction without destroying reorganization treatment, so long as the transferor is not the acquirer or a related party (*i.e.*, the stock issuance by the acquirer must be real). Regs. § 1.368-1(e).

2. **Business Purpose.** The reorganization must be “undertaken for reasons germane to the continuance of the business of a corporation.” Regs. § 1.368-2(g); see also Regs. § 1.368-1(c). The business purpose doctrine is a variation on the general substance
over form concerns throughout tax law. If there is no purpose other than tax avoidance, the transaction may be recharacterized. However, in the reorganization area in particular, the Service wants more than this, it wants an affirmative statement of a valid nontax business purpose for any private letter ruling. If there is such a purpose, the transaction may be structured to increase its after-tax value.

(3) Continuity of Business Enterprise. For a reorganization, the target corporation’s shareholders should retain an interest in what is fundamentally the same business enterprise. The transferee corporation (or Target in a B-Reorg) needs to continue a line of the Target’s historic business or use a significant portion of the Target’s historic business assets, even if in a different line of business. Regs. § 1.368-1(d)(2); Cf. Rev. Proc. 99-3, 1999-1 IRB 103. The required continuity may be accomplished directly by the acquirer or through one or more subsidiaries which are part of a qualified group (e.g., chains of 80% owned subsidiaries). Rev. Rul. 81-247, 1981-2 C.B. 87; Regs. § 1.368-1(d)(4)(ii).

C. The A-Reorg. An A-Reorg is a statutory merger or consolidation valid under state law; as such, it is as flexible as state law will allow with respect to consideration used and other features. However, the judicially created requirements described above must still be met. Where it is not desirable to merge the Target directly into the acquirer, for example, to insulate the acquirer from possible liabilities, a triangular form may be used, but, as described below, such forms have additional specific statutory requirements which are less flexible than a simple A-Reorg.

D. The B-Reorg. Stock of the Target constituting 80% control is acquired in exchange for voting stock of the acquirer, or if a triangular form is used, of the controlling parent of the acquirer. Unlike other forms of reorganization, in a B-Reorg, the Target is neither a transferor nor a transferee; its stock changes hands among other parties.

(1) Solely Voting Stock. The exchange must be solely for voting stock; this means what it says and is strictly applied. If there has been an earlier acquisition by the acquirer or related party of Target stock using some other consideration, the reorganization treatment may be destroyed if the earlier transaction is integrated with the purported B-Reorg. If there is more than one class with varying voting rights, these must be reviewed carefully to confirm the stock being used will be respected as being voting stock.

(2) Control. Control means owning stock with (I) at least 80% of the combined voting power of all classes of voting stock and (ii) at least 80% of the total number of shares of all nonvoting stock. IRC § 368(c). The Service requires 80% ownership of each class of nonvoting stock. Rev. Rul. 59-259, 1959-2 C.B. 115. The requisite control needs to exist immediately after the acquisition and does not need to be acquired in the acquisition itself; thus, some restructuring of the Target (such as redeeming some of the outstanding shares) may help meet the control requirement. Rev. Rul. 55-440, 1955-2 C.B. 226.

(3) Subsequent Liquidation. If the transaction is too closely followed by a liquidation of the Target, it will not be a B-Reorg but will be an asset acquisition and if it is
to keep reorganization treatment, must meet the C-Reorg tests (or possibly A-Reorg if a merger is used to eliminate the Target).

(4) **Cash from Target.** The stock acquisition itself is rather narrowly defined, allowing for other transactions such as dividends and redemptions to surround the B-Reorg without disqualifying it. However, any cash to the Target shareholders must come from the Target itself.

E. **The C-Reorg.** The C-Reorg involves the exchange of solely-voting stock for substantially all the assets of the Target followed by the liquidation of the Target.

(1) **Substantially all Assets.** For ruling purposes the Service requires 90% of net and 70% of gross assets be acquired. The character of the assets is a key consideration. Assets critical to the business are more significant than nonoperating assets. The “substantially all” test may be failed if a significant part of the Target’s assets are disposed of prior to or after the acquisition and the disposition is treated as integrated with the acquisition. However, if the proceeds of an asset disposition prior to the acquisition are not distributed to the Target shareholders but pass to the acquirer, the transaction could still qualify. See Rev. Rul. 88-48, 1988-1 C.B. 117.

(2) **Exceptions to Solely-for-Voting Stock.** Unlike a B-Reorg, there are for a C-Reorg two exceptions to the strict solely-for-voting stock requirement.

   (a) The assumption of liabilities of the Target will be disregarded. This is of great importance.

   (b) Up to 20% of the consideration may be other than voting stock, but only if the assumption of liabilities is not disregarded; thus, the liabilities assumed and other consideration paid must be below 20% of the consideration.

(3) **Target Stock Owned by Acquirer.** If the acquirer owns Target stock, some of the assets acquired are deemed acquired not for acquirer stock but for Target stock. Thus, to qualify, the tests for the 20% exception described above must be met with the Target stock being part of the 20%.

(4) **Liquidation.** The target must be liquidated, but it need not be dissolved under state law.

(5) **Creating a Triangular Result.** Triangular forms of acquisition are used to isolate the acquired assets in a separate subsidiary for important business reasons.

   (a) Corporation X may contract to acquire the assets of Target and on the closing date direct the Target to transfer the assets to X’s subsidiary, S. Rev. Rul. 70-224, 1970-1 C.B. 79.

   (b) Corporation X may create and control (under the IRC § 368(c) 80% tests) subsidiary S which acquires Target’s assets using the stock of corporation X.
If, however, X assumes any of the debt of S, the transaction will involve consideration other than voting stock and would need to meet the 20% exception; this is because only the transferee, here S, may assume liabilities.

(c) Corporation X may acquire the assets of Target then create (under IRC § 351) subsidiary S, dropping the assets from Target into S.

F. **Forward Triangular Merger.** In this transaction a merger is used and the A-Reorg provisions can be met even though the consideration comes from the acquirer’s parent, if certain additional requirements are met. If in such a transaction the survivor of the merging corporations is the acquirer, it is a forward triangular merger and IRC § 368(a)(2)(D) applies.

1. **Substantially All.** Like a C-Reorg, substantially all of the assets of the Target must be acquired.

2. **Consideration.** There is considerable flexibility in the type of consideration, but no stock of the acquirer (i.e., the subsidiary which is the merger partner) can be used. Stock of the parent is fine, and by implication counts for purposes of the continuity of interest test.

3. **Liabilities.** The assumption of liabilities is not specifically dealt with in IRC § 368(a)(2)(D) but is covered by § 368(a)(1)(A) because on a merger there is always an assumption of liabilities.

4. **Like Merger.** The transaction must be one which would have qualified under IRC § 368(a)(1)(A) if the Target would have merged directly into the parent under the continuity of interest and business enterprise and business purpose rules. That the parent may be a foreign corporation or that applicable state law might not have allowed the merger can, for this purpose, be disregarded. See Rev. Rul. 74-297, 1974-1 C.B. 84;Regs. § 1.368-2(b)(2).

G. **Reverse Triangular Merger.** In this form of merger, the Target is the surviving corporation. The acquiring subsidiary is merged into the Target using its parent’s stock as consideration. For example, X wants to acquire Target. X creates S, a wholly-owned subsidiary. (Sometimes X will buy up a good deal of T stock first to help ensure shareholder approvals, etc., and may contribute these Target shares to S.) S merges into Target and the S stock by operation of law becomes T stock, and X holds this new T stock, which under the plan could be 100% of the T stock. The former T shareholders (other than S if it owns T shares) get a package of consideration consisting mostly of X stock. X ends up in the same position as if it had bought all the stock of T but has been able to force the sale on all the original T stockholders (subject to any state law dissenters’ rights). This is similar to the result of a B-Reorg and might possibly be tested as a B-Reorg. IRC § 368(a)(2)(E) provides the special requirements which need to be met for this transaction to qualify as an A-Reorg under IRC § 368(a)(1)(A).
(1) **Substantially All.** The surviving Target must continue to hold substantially all the assets of both itself and the subsidiary merged into it. If a newly formed subsidiary is used (as they often are), its assets will likely be minimal. This requirement is analogous to the substantially all requirement for a C-Reorg.

(2) **Control.** The acquirer must acquire in the transaction, control (under the 80% rules of IRC § 368(c)) of the Target in exchange for voting stock of the acquirer.

(a) The acquirer cannot prior to the transaction already own more than 20% of the Target’s stock.

(b) If the parent has earlier purchased stock of Target, the qualification will depend on whether that purchase is integrated with the triangular merger. If the purchase and the merger are integrated, then it may be possible to meet the requirement of control being acquired in the transaction; if not integrated, the transaction may fail under IRC § 368(a)(2)(E).

(c) On the other hand, if not integrated, the transaction could possibly meet the requirements of a B-Reorg under IRC § 368(a)(1)(B). However, the use of any consideration other than voting stock may cause the reorganization to be treated as a failed B-Reorg.

(i) IRC § 368(a)(1)(B) has a 12-month rule on integrating earlier acquisitions with the final step of the reorganization.

(ii) However, the step transaction doctrine could be separately applied to question the qualification of the reorganization.

(iii) Where the qualification under the A-Reorg reverse triangular merger provisions or under the B-Reorg provisions turns on whether two steps (purchase, then merger) are integrated, the tax results become hard to predict.

(iv) If the acquirer has held even a large portion (say 50%) of the Target stock long enough to be deemed old and cold, it could proceed to acquire the 30% needed for control with a B-Reorg. This could not be done with an A-Reorg reverse triangular merger because control must be acquired in the transaction itself.

(d) The Target may redeem some of its shares so that after the redemption, the acquirer can obtain control in exchange for voting stock. For example, the Target could redeem a class of nonvoting stock so sufficient voting stock for control, may be obtained for voting stock of the acquirer’s parent.

**H. G-Reorganizations.** The G-Reorganization provisions were adopted in the Bankruptcy Tax Act of 1980 in order to bring insolvency reorganizations more in line with other reorganization provisions. The “G” reorganization is similar to a “D” reorganization in
many ways and is intended to be flexible (see e.g. Ways & Means Comm. Rep., H. Rep. No. 96-833, 96th Cong., 2d Sess., p. 30).

(1) **Overlaps.** IRC § 368(a)(3)(c) provides that the “G” Reorganization takes precedence over other forms of reorganization under IRC § 368(a)(1) and over IRC § 351 (transfers to controlled corporations - see also § 351(e)(2) making that section not applicable to a transfer by a debtor in an insolvency proceeding to the extent stock or securities received are used to satisfy the debtor’s liabilities) and over IRC § 332 (liquidation of subsidiary into parent). If the transaction does not qualify as a “G” reorganization, there is no necessary preclusion from qualifying as another form of reorganization (e.g. type “B” (acquisition of stock for voting stock) or type “E” (recapitalization)). S. Rep. 96-1035 at p. 36.

(2) **Definitions and Basic Requirements.** In order to qualify as a “reorganization” IRC § 368(a)(1)(G) requires:

(a) **Transfer.** A transfer by a corporation of all or part of its assets to another corporation is required. (Note: under IRC § 368(a)(3)(B) the debtor corporation must be under the jurisdiction of the court in an insolvency proceeding (although not necessarily a Title 11 bankruptcy proceeding) and the transfer must be pursuant to a plan or reorganization approved by the court);

(i) Although a G-Reorg does not usually require “substantially all” assets be transferred, where an IRC § 354 (acquisitive) transaction is involved, the substantially all requirement will apply. Thus, in an acquisition, the substantially all requirement will need to be met.

(ii) H. Rep. No. 96-833 at p. 30 states that intent is for substantially all assets of debtor or assets consisting of active trade or business under IRC § 355 to be transferred to acquiring corporation. But the Report says the test is to be applied “flexibly”. See also S. Rep. No. 96-1035 at p. 35-36.

(iii) Strip-offs for the benefit of creditors are not necessarily fatal (cf. Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937)). The debtor could sell one group of assets and then reorganize. It is not clear how far one can go.

(b) **Insolvency Proceeding.** The transaction must occur in a Title 11 or similar case (i.e., a state or federal court insolvency proceeding, including bankruptcy, receivership, foreclosure, and similar cases, IRC § 368(a)(3)(A)(ii)).

(c) **Stock or Securities.** In pursuance of the plan, stock or securities of the corporation (note: no requirement of “solely stock”, whether voting or nonvoting, and “securities” includes debt instruments like debentures), to which the assets are transferred must be distributed in a transaction which qualifies under IRC §§ 354, 355, or 356.

(i) **Acquisitive.** IRC § 354 provides for no gain or loss if stock or securities in a corporation a party to a reorganization are exchanged solely (except for
§ 356) for stock or securities in such corporation or another corporation a party to the reorganization, only if: the transferee (i.e., the acquiring) corporation acquires substantially all of the assets of the transferor (debtor) and the stock, securities, and property received are distributed pursuant to plan of reorganization. The distribution is usually to creditors.

A) Boot results under IRC § 354(a)(2)(A) if the principal amount of securities received is in excess of the principal amount exchanged (by creditor).

B) Boot is taxed under IRC § 356 and includes property received by a creditor transferee (i.e., “solely” does not necessarily really mean solely).

(ii) Divisive. IRC § 355 provides for no gain or loss to a shareholder or security holder on distribution by one (distributing) corporation (e.g., debtor) of stock or securities of another corporation to shareholders or security holders in exchange for their stock or securities, if immediately before distribution the distributing corporation (debtor) has 80% control of the distributed corporation, immediately after the distribution both the controlled and distributing corporations are in an active trade or business, which business has been active five years and not acquired within five years, the distributing corporation distributes all its stock or securities in the controlled corporation (or distributes an 80% controlling interest and no tax avoidance purpose exists, and the transaction is not a device to distribute earnings and profits).

A) Stock of an existing subsidiary may be distributed.

B) Boot is taxable under IRC § 356 and if the principal amount of securities received exceeds those surrendered, the excess is treated as boot.

C) The transaction may qualify even if the distribution is not pro-rata.

D) If the distributing corporation first transfers assets to a controlling corporation, it may qualify as a reorganization under IRC § 368(a)(1)(D) with the transferor corporation not recognizing gain or loss (IRC § 361) and with a carryover basis from transferor to transferee (IRC § 362(b)).

(iii) Accrued Interest. Any consideration received by a creditor security holder attributable to accrued but unpaid interest on the creditor’s security is excluded from the rules of IRC §§ 354, 355, or 356, (and from § 351 as well). See IRC § 354(a)(2)(B), § 355(a)(3)(c), § 351(d)(3).

A) If accrued interest has not been reported by the creditor, ordinary income will result; if interest has been previously reported by the creditor, creditor gets a loss for the unpaid portion. Interest includes original issue discount.
B) The allocation of consideration between principal and income in the plan or reorganization will generally be controlling for tax purposes as to the creditor and debtor. (E.g., principal first then interest or pro rata between principal and interest, etc.) However, allocation to principal cannot exceed the face amount of the debt security until after full allocation to accrued interest.

(iv) Surviving Shareholders. Under IRC § 357(c), in a G-Reorganization to which §§ 351 or 361 also applies, the survival in the reorganization by any former shareholders will expose the transaction to taxation to the extent liabilities assumed by the transferee exceed the basis of the property transferred. See IRC § 357(c)(2)(B).

(3) Triangular Reorganizations. A triangular reorganization generally involves a merger with a subsidiary paid for by the parent. It may be very important to “quarantine” the debtor company in case the business does not work out or in case of an unexpected creditor who did not receive proper notice (see Mullane v. Central Hanover Bank, 339 U.S. 306 (1950)) or is otherwise not subject to discharge. See 7 Collier on Bankruptcy, ¶ 1141.01 (16th Ed). IRC § 368(b) defines party to a reorganization to include a parent corporation in a “G” reorganization.

(a) Forward Triangular Merger. IRC § 368(a)(2)(D) applies to a “G” Reorganization and allows a controlled subsidiary of a solvent parent to acquire the debtor by merger of the debtor into the subsidiary with stock of the parent given as consideration. Requirements:

(i) “Substantially all” of the properties of the transferor (debtor) must be acquired by the subsidiary;

(ii) Transferor (debtor) is “merged” (not “consolidated”) into the subsidiary;

(iii) The merger would have qualified under IRC § 368(a)(1)(A) (“A” Reorganization definition: statutory merger) had it been made directly with parent.

(iv) No stock of the subsidiary is used in the transaction.

(b) Reverse Triangular Merger. IRC § 368(a)(3)(E) allows (in an insolvency proceeding) a controlled subsidiary to merge into the debtor (surviving) corporation if:

(i) No former shareholder of the surviving (debtor) corporation receives any consideration for its stock (i.e., cannot buy off a dissenting minority in a reverse merger, unlike other G Reorganization techniques);
(ii) Former creditors of surviving (debtor) corporation exchange their claims for voting stock with value equal to 80% of value of debtor’s total liabilities (i.e. treat the creditors as if they were shareholders);

(iii) After the transaction, the surviving (debtor) corporation holds substantially all of its properties and those of the merged corporation (other than stock of the controlling corporation distributed in the transaction). IRC § 368(a)(2)(E)(I).

(c) Drop Down. IRC § 368(a)(2)(c) allows a parent corporation to acquire part or all the assets or stock of the debtor and then transfer them to a controlled subsidiary, if, in a “G” reorganization, the requirements of IRC § 354(b)(1)(A) and (B) are met as to the acquisition of the assets or stock. See above for requirements of IRC § 354. This requires a nondivisive transaction.

(4) Continuity of Interest and Related Requirements. The continuity of interest requirement for tax free reorganizations applies to a “G” reorganization (See H. Rep. No. 96-833 at p. 31 and S. Rep. No. 96-1035 at p. 36-37). This requirement is intended to prevent the qualification both of bankruptcy liquidations and of sales of property to either new or old interests supplying new capital and discharging obligations of the debtor. For a reorganization to be real and not just a sale that should be taxable, something of substance from the past must continue. This is usually shareholder’s interests, but bankruptcy generally eliminates or greatly reduces shareholder interests. However, it is also true that creditors become the basic interest holders, thus in a bankruptcy reorganization they should be taken into account in determining continuity of interest.

(a) Intention. Congress expects that the courts and the Treasury Department will apply the “G” reorganization continuity of interest rules to take into account the modification of the “absolute priority” rule under bankruptcy law as a result of which shareholders or junior creditors (who might have previously been excluded) may retain an interest in the reorganized corporation. S. Rep. 96-1035 at p. 36-37.

(i) No Absolute Priority Rule. Under old Chapter X of the former bankruptcy act, each class of creditors had to receive full satisfaction in descending hierarchy to the extent permitted by the value of the property with the result that the most junior creditors and shareholders might well receive no distributions. In practice this often meant a reorganization was not possible and liquidation resulted. See 7 Collier on Bankruptcy, (16th Ed.) ¶ 1129.03[4][a] discussing the absolute priority rule under old law. See discussion of the bankruptcy doctrine in Allen v. Geneva Steel Co., 281 F.3d 1173 (10th Cir. 2001). See also Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942) which relied heavily on the old absolute priority rule in allowing creditors to be considered in the application of the continuity of interest requirement. Under the new Bankruptcy Code, this is no longer an absolute requirement, and junior creditors and shareholders may end up receiving a distribution, including stock, securities, or other property, under a plan.

(ii) Junior Interests. Thus, junior creditors (and any prior shareholders) who receive stock of the transferee corporation should count for purposes of
determining continuity of interest, and this should be true even through such creditors recognize gain or loss.

(iii) **Possible Sale.** If shareholders receive consideration other than stock of an acquiring corporation, the transaction should be closely examined to see if it is really a purchase rather than reorganization. S. Rep. 96-1035 at 36-3.

(b) **Consideration.** The consideration received for transferred assets is the key; an all debt acquisition is vulnerable since a substantial proportion of the consideration must consist of equity interests. See *Southwest Natural Gas Co. v. Com’r.*, 189 F.2d 332 (5th Cir. 1951); *Helvering v. Minnesota Tea Co.*, 302 U.S. 609 (1938).

(c) **Historic Business.** The continuity of historic business or historic business assets rules of Regs. § 1.368-1(d)(2) apply to “G” reorganizations because they apply to all reorganizations. Application of these rules in “G” reorganization context is unclear.

(i) If the debtor sells all of its assets for cash and then is acquired by another corporation in a Chapter 11 proceeding, this will not qualify.

(ii) The debtor needs to keep some “significant portion” of its historic business assets or its historic business. (Note: to keep the historic money losing business may put the acquirer into a Chapter 11 proceeding as well).

(d) **Business Purpose.** There must be a business purpose for the transaction (Regs. § 1.368-1(c)), a requirement usually easy to meet in a bankruptcy case unless, perhaps, the transaction is structured the way it is solely for tax purposes.

6. **The Carryover of Tax Attributes.** How tax attributes of the Target in an acquisition are affected by the transaction may have a significant effect on the terms of the transaction.

A. **In General.** The key to having tax attributes move from one corporation to another is to meet the requirements of IRC § 381 and avoid limitations under IRC § 382 and under § 269 on the NOL Carryover allowed under IRC § 172. Tax attributes in acquisitions are generally treated:

(1) **Purchase of Loss Corporation’s Assets.** The loss corporation stays alive and retains its tax attributes. If the loss corporation liquidates, its tax benefits are lost. If the loss corporation stays alive and later purchases the assets of a profitable business, it may be able to use its previous losses against the new profit. Rev. Rul. 63-40, 1963-1 C.B. 46; Rev. Rul. 81-25, I.R.B. 1981-4, 11. The step transaction doctrine may apply, however. If on the other hand, the assets are acquired in a tax free reorganization (other than a G Reorganization) the use of losses against built in gains would be limited under IRC § 384 for a five-year period, and IRC § 269 and the other limitations applicable to reorganizations would apply.
(2) **Stock Purchases by a Profit Corporation.** These transactions are subject to the limitations of IRC §§ 382 (restricts use of NOLs in an ownership shift) and 269 (disallowance for tax avoidance) and to the consolidated return limitations (restricting the use of losses against profit of other group members).

(3) **Loss Corporation Purchases Stock of Profitable Corporation.** In this transaction the loss corporation may be able to use its losses against the profit corporation’s profits if the two corporations file consolidated returns but the use of any built in gains of the profit corporation will be limited for five years under IRC § 384. If, however, the loss corporation liquidates the profit corporation or merges down into the profit corporation, the limitations of IRC §§ 381, 382, and 269(a)(2) would apply.

(4) **Bankruptcy Reorganizations.** Tax losses of the debtor (Net Operating Loss “NOL,” Carryover) may provide an important incentive to a corporation to acquire the debtor in a Chapter 11 reorganization, but some bankruptcy practitioners believe it is over emphasized by the tax bar as an incentive. There are two general methods to preserve tax losses remaining after adjustment for cancellation of indebtedness, the “G” acquisitive reorganization under IRC § 368(a)(1)(G) and § 354 (discussed above), or a go-it-alone plan using a recapitalization under IRC § 368(a)(1)(E).

(5) **Tax-deferred Reorganizations.** No attributes shift from one corporation to another in either a B-Reorg (stock for stock) or an E-Reorg (go-it-alone recapitalization). In the other forms of tax-deferred reorganizations, notably A, C, D, F, and G Reorgs, it is sometimes possible under IRC § 381 to have tax attributes shift from one corporation to another.

**B. Section 381.** IRC § 381 is the only provision allowing the transfer of carryovers from one entity to another; it provides that in certain transactions in which one corporation (“transferor”) (e.g., a debtor) transfers its assets to another corporation (“acquiring corporation”) the acquiring corporation succeeds to certain of the corporate tax attributes of the transferor. The affected attributes are set forth in IRC § 381(c) and include NOL carryovers (IRC § 381(c)(1)). There are only certain transactions which qualify for this special treatment:

1. **Liquidation of Solvent Subsidiary.** The liquidation of a solvent subsidiary into the parent under IRC § 332 may qualify, but an IRC § 338 election to step-up the basis of (and recognizing gain on) assets will kill the tax history.

   (a) Liquidation of an insolvent subsidiary is not an IRC § 381 transaction (Regs. § 1.332-2(b)) and NOLs are lost. There may be an ordinary loss to the parent under IRC § 165(g)(3) (and Regs. § 1.165-5(d)) on the worthlessness of stock, or a bad debt deduction if the subsidiary was in debt to the parent.

2. **Tax Free Reorganization.** A reorganization to which IRC § 361 applies under IRC § 368(a)(1) which may qualify for the special attribute carryover tax treatment under IRC § 381 are the “A”, “C”, “D”, “F”, and “G” types. For a “G” reorganization (or a “D”) to qualify, it must meet the tests of IRC § 354(b)(1)(A) and (B):
(a) Transferor (debtor) must transfer “substantially all” its assets (under a “flexible” standard if a “G” Reorganization is involved) to the acquiring corporation. A divisive “G” won’t qualify.

(b) Transferor (debtor) must distribute the consideration received (generally by liquidation) pursuant to the plan of reorganization.

C. Some Selected Loss Carryover Rules. The following are some important rules for the carryover of tax attributes in tax free reorganizations (but not including “F” reorganization rules).

(1) One Corporation Acquiring. The acquiring corporation must be one corporation; in a reorganization it is the corporation which acquires directly or indirectly all the transferred assets of the transferor, or if none, the corporation which directly acquired the assets transferred even if it ultimately retains no such assets. Regs. § 1.381(a)-1(b)(2).

(a) E.g., debtor D transfers all assets to S, a wholly-owned subsidiary of P, for P stock in a merger pursuant to a Chapter 11 plan of reorganization qualifying as a “G” reorganization. S transfers ½ the assets received from D to S’s wholly-owned subsidiary S-1. S is the acquiring corporation.

(2) Close Tax Year. The taxable year of the acquired debtor corporation ends on the close of the date of transfer. IRC § 381(b)(1). A short year can mean that losses expire early. It is possible to avoid this result by having the loss corporation survive (e.g., use an “A” reorganization IRC § 368(a)(2)(E) or “G” reorganization reverse triangular merger). Transferor must file a return for any short year. See Regs. § 1.381(b)-1(b).

(3) Proration of NOL. The acquiring corporation uses only a pro rata portion of the NOL during its first taxable year ending after the date of transfer. Regs. § 1.381(c)(1)-1(d). If there are 16 days left in the taxable year of the acquiring corporation, then it would use the NOLs to offset 16/365th of its earnings during that taxable year.

(4) Limitation on Use of Acquiring Corporation’s NOL. An NOL carryback of the acquiring corporation can be carried back to prior taxable years of the acquiring corporation under IRC § 172 (Regs. § 1.381(c)(1)-1(b). But the acquiring corporation cannot carryback the NOL of the acquiring corporation to the premerger profits of the acquired corporation; it is used only against postmerger profits (i.e., no refund). But see Bercy Industries v. Com’r, 640 F.2d 1058 (9th Cir. 1981), rev’g 70 T.C. 29 (1978)) (in forward triangular merger, postmerger losses of the surviving corporation (former shell) could be carried back and used to offset premerger income of transferor corporation).

(5) Incomplete Acquisition Possible. The carryover of tax attributes to the acquiring corporation is not necessarily prevented by the failure to acquire all the assets of the acquired corporation. For example a controlled corporate subsidiary might not be 100% owned by the acquiring corporation, or the acquired corporation might transfer substantially all (rather than all) of its assets to the acquiring corporation. See Regs. § 1.381(c)(1) - 1(c)(2).
D. **Section 382 Limitation.** Under IRC § 382 the NOL itself is not cut back, but the income against which it may be used is limited in the case of an ownership change. There is, however, a bankruptcy exception to the rule, but a debtor may, if it chooses, elect out of the bankruptcy exception. Let’s examine the general rule first.

(1) **Limitation.** If the rule applies, the amount of post-ownership-change taxable income against which the prechange NOL or built in losses (such losses recognized after the ownership change are limited and treated the same as NOLs; see CCA 201309013) can be used is the value of the corporation’s stock (including preferred stock) immediately before (or after, in the case of a bankruptcy where the bankruptcy exception to the § 382 Limitation does not apply) the change (adjusted for redemptions etc. accompanying the change), times the long term tax exempt rate in effect for the month of the change. IRC § 382(b)(1). Thus losses can be deducted as to a limited return on the value of the stock. Losses that cannot be deducted in one year can be carried forward to the extent they have not expired. If the bankruptcy exception does not apply, there is a favorable valuation rule that will nevertheless apply in a bankruptcy situation (see (6) below) that will tend to increase the usable NOL.

(a) **Antistuffing.** There is an antistuffing rule to prevent capital contributions being made to increase the limitation. Merely having a purpose of avoiding or increasing the limitation is enough to trigger the rule. Also, any capital contribution within the 2 years prior to the change are deemed to be for the proscribed purpose except to the extent such contributions are allowed by regulation. IRC § 382(l)(1)(B). The regulations should allow initial capital contributions, contributions before losses are incurred, and basic working capital contributions. (Conference Report to Accompany H.R. 3838 (H.R. 99-841 (September 18, 1986) at II-189).

(b) **Nonbusiness Assets.** The value of the corporation is cut back for nonbusiness assets if at least one-third of the loss corporation’s assets are nonbusiness assets such as cash, stock, or bonds whether or not held for investment, and other assets held for investment. IRC § 382(l)(4)(c). The rule looks through to the assets of controlled subsidiaries. IRC § 382(l)(4)(E).

(2) **Continuity of Business Enterprise.** If the corporation fails to continue its business enterprise for two years after the change, the NOL is effectively destroyed retroactively because the limitation will be zero. IRC § 382(c)(1). The continuity test is tied to that for tax free reorganizations. See Regs. § 1.368-1(d).

(3) **Ownership Change.** The limitation is triggered by 5% stock holders of the loss corporation increasing their stock ownership by more than 50 percentage points (out of the total 100 percentage points of value of the corporation - not the same as a 50% increase in a shareholder’s personal ownership) as of the testing date over a rolling three year testing period, by reason of either an owner shift or an equity structure shift. There are some rather complex rules associated with the application of every part of the rule, some of which are:

(a) Shorter test period may apply if there has been a previous ownership change; see IRC § 382(I).
(b) Attribution of stock ownership rules apply. IRC § 382 (i)(3).

(c) Less than 5% shareholders are aggregated and treated as one 5% shareholder. IRC § 381(g)(4)(A). This rule is generally applied separately to each group of shareholders a party to the reorganization or other transaction. IRC § 382(g)(4)(B) and (c).

(d) An equity structure shift is a reorganization under IRC § 368 except divisive “G” and “D” reorganizations and “F” reorganizations. Divisive reorganizations are excluded because IRC § 381(a) prevents NOLs from being acquired in these transactions.

(e) Changes in percentage of stock ownership attributable solely to fluctuations in the relative fair market values of different classes of stock are generally not taken into account. IRC § 382(l)(3)(c).

(f) Ownership shifts may occur in any type of corporate transaction such as purchase or disposition of stock by a 5% shareholder, an exchange of property for stock under IRC § 351, a redemption or recapitalization, an issuance of stock, a reorganization that is an equity structure shift. See Regs. § 1.382-2T(e).

(g) The 5% stockholder test is met and a shareholder must be considered, if at any time during the testing period the shareholder had the requisite 5% interest, even if the interest of that shareholder later declines below 5%. IRC § 382(k)(7).

(h) There is a special rule for a 50% shareholder who takes a worthless stock deduction for a given taxable year. If the shareholder continues to hold the stock, it is treated as being newly acquired (and not as continuously owned) as of the next taxable year, thus creating an ownership shift where one would otherwise not exist, and triggering the limit on NOLs. IRC § 382(g)(4)(D).

(i) Options are treated (Regs. § 1.382-4(d)(1) and (2)) as not being exercised unless on the option’s issuance or transfer a principal purpose (under all the facts and circumstances but applying a number of factors prescribed by the regulations) is to avoid or ameliorate the impact of an ownership shift under one of three tests: ownership, control, or income tests.

(i) The ownership test looks at whether the holder of the option is provided with a substantial portion of the attributes of ownership of the underlying stock, and takes into account such matters as the relationship, at time of issuance or transfer, of the option price and the value of the underlying stock, rights to participate in management, the existence of reciprocal options, etc. Regs. § 1.382-4(d)(3) and (6)(ii).

(ii) The control test looks at whether the holder of the option (or related persons) have in the aggregate, a direct or indirect ownership interest in the loss corporation of more than 50%, determined as if the increase in ownership percentage from
exercise of the option (and related options) actually occurred on the issuance or transfer of the option, and takes into account the influence of the option holder or related persons over management.Regs. § 1.382-4(d)(4) and (6)(iii).

(iii) The income test looks at whether the option facilitates the creation of income (including accelerating income or deferring deductions) or value (including unrealized built-in gains) prior to the exercise or transfer of the option. Income acceleration transactions to be taken into account include those outside the ordinary course of business of the loss corporation that accelerate income or gain into the period prior to the exercise of the option, or defer deductions until after the exercise.Regs. § 1.382-4(d)(5) and (6)(iv).

(j) There are some exclusions from the deemed exercise rules and some safe harbors provided for options.Regs. § 1.382-4(d)(11) and (d)(7). The exclusions are for transfers where neither transferor or transferee are 5% shareholders after taking the option into account, the transfer is between members of separate public groups, or the transfer occurs in connection with death, gift, divorce, separation, etc. The safe harbors are for such things as:

(i) commercially reasonable stock purchase agreements with reasonable closing conditions that close in one year (not exempt from income test, however);

(ii) escrow, pledge, and security arrangements subject to customary commercial conditions;

(iii) compensatory options with customary terms and conditions for employees, directors, or independent contractors if they are nontransferable and without a readily ascertainable market value;

(iv) options exercisable only on death, disability, mental incompetency, or retirement;

(v) rights of first refusal between stockholders (or the corporation and stockholders) with customary terms;

(vi) options designated by the Internal Revenue Service as exempt from one or more tests.

(4) Bankruptcy Exception. The bankruptcy exception applies in Title 11 and also in similar cases (IRC § 382(l)(5)(A)(I)). If the exception applies, the price for it is that although the § 382 limitation will not apply to limit the use of NOLs, the NOLs themselves will be cut back to some extent, by interest charges converted to stock. The debtor may, however, elect not to have the exception apply to it.

(a) Creditor and Shareholder Control. In order to qualify for the IRC § 382(l)(5) exception, those who are creditors and shareholders of the debtor (old loss
corporation) immediately before the change must own at least 50% of the value and voting power of the new corporation immediately after the change, and must have such ownership as a result of being shareholders or creditors before the change. Thus, the stock to meet the control test must be received in exchange for a qualifying prior interest in the old loss corporation.

(b) **Old and Cold.** The stock of a creditor used in meeting the 50% test can only consist of stock held by a creditor for at least 18 months, or stock received, on order of the court in the proceeding, in exchange for debt arising in the ordinary course of business of the old loss corporation (typically trade creditors, taxes, employment claims, tort, etc.) where the creditor at all times held the beneficial interest in the debt. Regs. §§ 1.382-9(d). There is a safe harbor for treating debt as continuously owned by the same owner if the owner is not (immediately after the ownership change) either a 5% shareholder, or an entity through which a 5% shareholder owns an indirect interest in the loss corporation, unless the owner’s participation in formulating the reorganization makes it evident that the owner has not held the debt long enough. Regs. § 1.382-9(d)(3)(I). If the safe harbor does not apply, the debtor loss corporation must inquire about the facts necessary to qualify a creditor, and may rely upon a sworn statement. Regs. § 1.382-9(d)(2)(iii). Special procedures apply to widely held debt. There are eight situations in which the transferees of indebtedness will be able to tack on the time it was held by the transferor. Regs. § 1.382-9(d)(5).

(c) **Restriction Against Special Purpose Creditor.** A regulation has been drafted to prevent the creation of special purpose entities to hold the debt and allow ownership to change in an attempt to avoid the old and cold requirements of the bankruptcy exception. Regs. § 1.382-9(d)(4). A debt will not be qualified if the beneficial owner of the debt has an ownership change, determined in a manner similar to a loss corporation (using the principles of IRC § 382), if:

(i) the indebtedness represents more than 25% of the fair market value of the total gross assets of the owner at the date of the change, and

(ii) the owner is a 5% entity immediately after the ownership change of the loss corporation;

(iii) the corporation may rely on a sworn statement. (Regs. § 1.382-9(d)(4)(iv)).

(5) **NOL Cutback.** If the bankruptcy exception applies and the debtor does not irrevocably elect out of the exception under IRC § 382(l)(5)(H) and Regs. § 1.382-9(i), then the NOLs of the debtor loss corporation will be reduced as to postchange years. The NOL is reduced by redetermining it to take out interest deductions for interest payments or accruals converted into stock in the reorganization if the interest was paid or accrued in the three taxable years preceding the change or during the current year for the period ending with the change.

(6) **Bankruptcy Cases Not Covered By Exception.** If a debtor is in a Title 11 or similar case involving the exchange of debt for stock or a G-Reorganization, but the bankruptcy exception does not apply, for example because the debtor elected out of its coverage
or failed the 50% continuity of interest requirement, then there is nevertheless a favorable valuation rule which will be of benefit to the debtor loss corporation. IRC § 382(l)(6) provides that the value of the old loss corporation will reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors’ claims in the transactions. The purpose is to increase the stock value (and thus the § 382 Limitation) by debt canceled for stock, but not increase it for new capital infused into the corporation.

(a) Value. The value (Regs. § 1.382-9(j)) of the loss corporation will be the lesser of:

(i) the value of the stock (including some interests not treated as stock for other purposes, but excluding stock issued to increase the § 382 Limitation without being subject to entrepreneurial risks) immediately after the change (which cannot exceed the amount of cash or other property used to pay for it in order to prevent arguments about the “intrinsic value” of the stock; Regs. § 1.382.9(k)(7)) (See Regs. § 382-9(k) for special rules on valuing the postchange stock), or

(ii) the value of assets (determined without regard to liabilities) of the loss corporation immediately before the change (See Regs. § 1.382-9(l) for special rules on valuing the prechange assets).

(b) Postchange Redemptions. Redemptions or contractions after the change may reduce the value determined. See former Prop. Regs. § 1.382-3(k)(2).

(7) TARP Exceptions. There are special exceptions to § 382 for acquisitions by the U.S. Treasury, and its successors, under the Troubled Asset Relief Program (TARP) designed to allow the use of losses which otherwise would be reduced. Notice 2009-38, 2009-18 IRB 901. See IRC § 382(n) (providing an exception and an exception to the exception).

E. Evasion of Taxes - § 269. An acquisition the principal purpose of which is the evasion or avoidance of income tax will trigger the disallowance of deductions, credits, and other allowances under IRC § 269. However, in applying IRC § 269, it is highly relevant that the use of the NOLs (that presumably are the reason for the acquisition) were cut back under § 382 and thus the avoidance of tax may not be a principal purpose of the transaction. Regs. § 1.269-7.

(1) Application. IRC § 269 applies to the acquisition of at least 50% of the voting power or value of stock, the acquisition of carryover basis property from another corporation (i.e., by tax free reorganization), or the purchase and liquidation within two years of a subsidiary without an IRC § 338 liquidation.

(2) Business Continuity. Ownership changes which qualify under the bankruptcy exception of IRC § 382(l)(5) are presumed to be for the proscribed tax avoidance purpose unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the Title 11 or similar case. The presumption is rebutted by strong evidence to the contrary. Regs. § 1.269-3(d). The Regulations also contain a bootstrap
provision that the failure of the government to seek a determination under the Bankruptcy Code is not taken into account, and any finding by the Bankruptcy Court that the principal purpose is not tax avoidance is not controlling. Regs. § 1.269-3(e).

F. **Built-In Gains Limitation.** The ability of loss corporations to acquire corporations with built-in gains in order to use the loss corporation NOLs is limited by IRC § 384 which provides that built in gains recognized in the 5 years after the acquisition cannot be offset by preacquisition losses except those of the acquired corporation itself. However, this provision only applies to an “A”, “C”, or “D” Reorganization (IRC § 368(a)(1)(A), (C), (D)) and not to a “G” Reorganization. IRC § 384(a)(1)(B).

G. **Consolidated Return Limitations.** The use of carryovers by consolidated groups is limited by the consolidated return rules as well as by the other rules discussed above. The effect of these limiting rules could greatly affect the viability of a reorganization in which the future use of NOLs is important. What follows is a very over simplified summary.

(1) **CRCO.** The consolidated return change of ownership (“CRCO”) rules, Regs. § 1.1502-21(d), require (in general) that the prior loss of the whole group applies only to the identical group (not to any new subsidiaries). This rule does not terminate or reduce the carryover, just limits its use to old group members. It applies when the parent corporation’s ownership changes 50 percentage points and the change results from a purchase or redemption (except an IRC § 303 redemption to pay estate tax).

(2) **SRLY.** The separate return limitation year (“SRLY”) rules, Regs. §§ 1.1502-1(f), and 1.1502-21(c) require (in general) that the NOL of a group member arising in a SRLY which is carried over or back to a consolidated return year is limited to the income of such member.

(a) **Subsidiary.** A subsidiary SRLY exists as to its separate return year if the subsidiary was not a group member each day of the year.

(i) The loss of an acquired insolvent subsidiary would apply to its future income only.

(ii) If the loss corporation is a parent (subject to reverse acquisition rule) it can acquire a new profitable business without subjection to SRLY rules.

(b) **Reverse.** A reverse acquisition occurs if the loss corporation acquires a profit corporation and the acquired (profit) corporation’s shareholders receive 50% in value of shares of the acquiring corporation. This transaction is treated as if the acquired corporation survived and the SRLY rule applies to the loss corporation.

(3) **BID.** The built-in deduction (“BID”) rules, Regs. § 1.1502-15, require (in general) that deductions or losses otherwise deductible in a consolidated return year
which were economically accrued in a SRLY cannot be used against postconsolidation profits of
the group except as to the member that accrued them.

(a) **Losses Included.** This includes deductions or losses
accrued and deducted in a SRLY and carried over as an NOL or a capital loss carryover to a
consolidated year; and as to loss assets (i.e., with a value less than basis), the BID rule applies
only if the asset was acquired by the member within 10 years before the consolidated return year.

(b) **Profitable Subsidiary Acquired.** An affiliated group with
BIDs may acquire a profitable subsidiary and offset the subsidiary’s income with the BIDs of the
group.

(c) **Exception.** The BID limitation does not apply to a
corporation if when it joined the group its aggregate adjusted basis for all assets (except cash,
and except securities the fair market value of which is not less than 95% of basis, or which have
been held 2 years or which are stock representing 50% of the fair market value of a corporation
owned by new member or transferor) did not exceed the aggregate fair market value of all such
assets by more than 15%.

H. **Miscellaneous Limitations.** (See Bitker & Eustice, Federal Income

(1) **Some General Problems.** A transaction may fail to qualify as a
“reorganization” if it lacks business purpose. In extreme cases, the corporate entity itself may be
disregarded if it lacks economic reality. The no assignment of income doctrine may apply. IRC
§ 482 may be used to reallocate (but not disallow) income, deductions, credits, and other
allowances to clearly reflect income. A corporation may become so dormant during the process
of liquidation that it may be deemed nonexistent and de facto dissolved so that its tax losses
cannot later be revived even if the state law corporate shell continues to exist.

(2) **Lisbon Shops.** The continuity of business enterprise doctrine of
*Lisbon Shops v. Koehler*, 353 U.S. 382 (1957) may still have some validity despite statutory
treatment of the problem. Under this doctrine which arose under the 1939 Internal Revenue
Code) a reorganized corporation would carryover losses only to extent that postreorganization
income is from the same business enterprise; dropping the loss business could be fatal to the
entire carryover derived from that business. Strong authority exists against the continued vitality
of *Lisbon Shops*, despite IRS views to the contrary as contained in T.I.R. 773, October 10, 1965. See
Bitker & Eustice, ¶ 14.46.

7. **Special Concerns of Pass-through Entities.**

A. **S-Corporations.** S-corporations are domestic corporations with a valid S-
election in place under IRC § 1361. In order to have a valid election, certain conditions must be
met, including (but not limited to) (i) no more than 75 (100 shareholders after 2004)
shareholders, (ii) all shareholders are individuals (other than nonresident aliens or, in most cases,
their spouses), decedents’ estates, bankruptcy estates, certain trusts, or charities, or the
corporation’s stock may be 100% owned by another S-corporation, and (iii) there is only one class of stock. IRC § 1361(b). If the corporation has a valid S-corp election in place, then with some exceptions, income is not taxed at the corporate level, but income, loss, deductions, and credits pass through to its shareholders. The pass-through feature of S-corporations makes them different from other corporations (called “C-corps”) without the S-corp election. Thus, in an acquisition, the special treatment of the S-corp shareholders needs to be considered.

(1) Sale of Stock for Cash. The gain of S-corp shareholders on the sale of their stock for cash will be the difference between the amount realized for their stock and their adjusted basis in their stock. IRC § 1001(a).

(a) Redemption. However, a loss on the stock might not be deductible on a stock redemption (IRC § 1368(b); see Eustice and Kunz Federal Income Taxation of S Corporations Fourth ed. at ¶ 13.08[4]. The distributions from the corporation in redemption are treated differently from normal distributions, and, thus, who gets which type of distribution could be a matter for agreement. The seller would want to avoid regular distributions, which could carry out with them earnings and profits for dividend treatment. But where the corporation has no earnings and profits, this won’t make a difference.

(b) Basis of Stock. The basis will have been adjusted up and down over the years reflecting income and loss passing through the corporation and certain tax-free distributions. IRC § 1367. Also, the income or loss of the corporation in the year of sale will likely affect the basis of the stock sold so that the shareholders as sellers generally would not know the exact basis for their stock until after the end of the corporation’s taxable year. If a party takes a position inconsistent with prior tax reporting, the adjusted basis element would allow the Service (or the seller) to adjust certain errors that may have been made in prior S-corporation years. The seller may want to consider asking the buyer for an agreement that the buyer and the corporation will maintain consistency with prior tax reporting. This should last for a minimum of three years after the seller files the tax return with respect to gain on the sale; perhaps the chance that a return extension will be needed should be taken into account in establishing the time period.

(c) Book Closing. Income and loss generally pass through to shareholders on a per-share, per-day basis. IRC § 1377(a)(1). Where there is a 50% change of ownership during the year the S-election terminates, then the normal per-share, per-day at-the-end-of-the-year rule does not apply. IRC § 1362(e)(6)(D). Also, however, where a stockholder’s stock interest terminates during the year or the sale terminates the S-election, the corporation may close its books with appropriate consents or (in the case of a terminated S-election) the books may be closed automatically. IRC §§ 1362(e), 1377(a)(2). There are three book closing events which are applied in priority order so there is no overlap:

(i) the S-election is terminated (for example, by a sale to a nonqualifying person); this creates a new tax year;

(ii) a complete termination of a shareholder’s interest; the book closing is elective (IRC § 1377(a)(2)) with the consent of all affected shareholders (i.e.,
the terminating shareholder and all to whom such shareholder transferred shares during the taxable year) and will be hypothetical as to the affected shareholders rather than actually creating a new return filing period, etc.; and

(iii) a shareholder disposes of 20% or more of the outstanding stock during any 30-day period of the corporation’s tax year, the corporation redeems 20% of its stock, or corporation issues to new shareholders shares equal to 25% of the prior shares outstanding; the book closing is elective, and this election allows separate treatment for the selling shareholders regarding income and other attribute allocations but does not create a new filing period. Regs. §1.1368-1(g)(2)(i).

(d) Planning for Book Closing. The book closing rules may provide a planning opportunity for the buyer and seller who can calculate the effect of closing the books and compare this to the expected effects of not closing the books. For example, if the books were not closed in a situation where no income would pass to the seller and, say, $40 would pass to the buyer, but where if the books were closed $20 would pass to the seller and $20 to the buyer, then it may be better overall to close the books and for the seller to receive an allocation of income. Such a situation may arise when there is a sale at midyear where the business results for the first part of the year were to break-even or incur a loss, and where the business results in the last part of the year more than make up for the poor first part of the year. The reason for this is that since the seller will be recognizing capital gain anyhow, the cost of the additional ordinary income to the seller is only the difference between the rates for capital gain and ordinary income, but the seller will have a $20 basis increase (the allocated income is not distributed) in his stock, reducing his gain on the sale. The buyer will save current ordinary income tax on the amount of income allocated to the seller. If these were the economics, it may be possible to structure a transaction better for both the buyer and the seller and not so good for the U.S. Treasury.

(e) Capital Gain. The gain of the shareholders would be taxed at capital gain rates, assuming a long-term investment in the stock.


(i) Whether the S-election will continue through the end of the corporation’s tax year. A retroactive revocation could lead to a nasty surprise. The S-corp revocation would only be an issue if it occurred on or before the 15th day of the third month of the corporation’s taxable year and, thus, depending on the corporation’s tax year, may or may not create a risk.

(ii) The effective date of the sale.

(iii) Whether the corporation will attempt to change its accounting methods, which it could do retroactively with the consent of the Service even to the detriment of the selling shareholder.
(iv) Whether an election to close the corporation’s books will be made. If income flowed through to the seller, the seller’s stock basis will increase and its favorably-taxed capital gain will consequently decrease.

(v) If the S-election will end (e.g., too many or wrong kind of shareholders will exist) whether an election under IRC §1362(e)(3) to allocate income and deductions between a short S-election year and a short C-corp year will be made.

(g) **Tax Indemnity.** Sometimes a buyer will agree to a tax indemnity provision and not close the corporate books. This may help with solving the foregoing problems. However, it may be a good idea for the tax indemnity from the buyer to cover not only the income tax on the corporate income itself, but also the additional tax from reduction of capital gain treatment on the stock, and the tax on receipt of the indemnity payment itself.

(2) **Sale of Stock for Stock.** Assuming a taxable sale (i.e., not a tax-deferred reorganization), the sellers would recognize gain or loss on the sale of their stock based on the value of the stock received in the same way as if a cash sale were involved. (The buyer, as well, may recognize gain on the stock used to pay the purchase price to the seller unless the buyer is a corporation issuing its own shares or some other exception applies.)

(3) **Sale of Assets for Cash.** The corporation will recognize gain or loss on the sale of its assets (or on the distribution to shareholders of appreciated assets).

(a) The income passes through to the shareholders; generally, this will be mostly capital in nature but may include ordinary income, too.

(b) The shareholders also receive an increase in the basis of their stock which will then reduce the amount of gain recognized by them on a liquidating distribution of cash to them. However, if the liquidating corporation makes distributions over more than one tax year of its shareholders problems may occur and such a situation should be reviewed carefully.

(c) Shareholder income on a liquidation distribution will generally be capital gain in character and measured by the difference between the shareholders’ adjusted basis and the amount received.

(i) Thus, there is generally only a single level of tax on such a transaction, a result much more favorable than a liquidation by a C-corporation.

(ii) If the corporation has accumulated earnings and profits or has made its S-election less than ten years earlier and had appreciated assets at that time, it is possible that a double level tax and dividend treatment could result. If the S-election has been in effect from the commencement of corporate operations, this would not be a problem.
(4) **Installment Reporting.** If the sale of assets by the corporation involves receiving an installment obligation, when the note is distributed to the shareholders, if certain conditions are met, the benefit of installment reporting of the corporation’s gain which is passed through to the shareholders will not be lost.

(a) **Conditions.** The conditions which allow retaining installment reporting are: The corporation must distribute the obligation in complete liquidation, the corporation must adopt a plan of liquidation and liquidate within a 12-month period, the installment obligation must result from a sale made within this 12-month period, if inventory is involved it must be sold in a bulk sale, and if depreciable property is involved, the buyer and shareholder must not be related. IRC §§ 453(h) and 453B(h).

(b) **Conditions Met.** If these conditions are met, corporate gain will not be recognized at the corporate level and thus will not pass through to the shareholders, will not cause shareholder level taxes, and will not increase the shareholders’ basis in their stock. The result is a greater deferral benefit from installment reporting on receipt of the installment note because income will be recognized as the payments on the note are received.

(i) Tax on passive income under IRC § 1375, and tax on built-in gains under IRC §1374 in the applicable 10 year period will, however, still be recognized at the corporate level.

(ii) If the stockholder receives substantial assets as well as the note and has a substantial basis in his stock, it may be best to distribute the other assets separately before the note in order to avoid problems with basis allocation that could allocate stock basis to the note and make taxes worse than if the corporation had not liquidated.

(c) **Conditions not Met.** If the conditions are not met, the corporation’s income passes through to the shareholders on the recognition of the income, who pay tax on it and receive an increase in the basis of their stock. Any further gain to the shareholders (with respect to their stock) on distribution of the note to them can be reported on the installment basis; the result is, basically, the loss of installment reporting on the corporation’s gain.

(d) **No Liquidation.** If the corporation sells assets for an installment note and does not liquidate, the shareholders will have the benefit of the installment reporting through the pass through of income to them as received by the corporation. The corporation can normally distribute cash in the amount of the gain without triggering tax with respect to the shareholders’ stock. This may be an alternative where the corporation cannot meet the conditions described above. For example, it could be an alternative to liquidation. However, for this to work there must be no termination of the S-election under IRC § 1362(d)(3), no tax on passive income under IRC § 1375, and no tax on built-in gains under IRC §1374 in the applicable 10 year period (consider a lease with and option to purchase or wait to sell these assets). Thus, there may be problems from the corporation’s receipt of excessive amounts of passive income which may trigger taxation and termination of the S-election or from tax on built in gains if the corporation has ever been a C-corporation.
(5) **Sale of Assets for Stock.** In a taxable sale (not a tax-deferred reorganization), the results are the same as with a cash sale, with the gain to the corporation determined by the value of the stock received.

(6) **Merger or Reorganization - Stock Transaction - Generally.** Mergers or stock-for-stock or stock-for-asset reorganizations under IRC § 368 may involve S-corporations and result in tax deferral. The specific statutory requirements of the applicable reorganization provision must be met and the usual general reorganization requirements of business purpose, continuity of proprietary interest, a plan of reorganization, and continuity of business enterprise must also be met. If the conditions are met, there will be no gain or loss recognized at the corporate or shareholder level (absent the receipt of cash or other “boot” consideration). The shares received by the transferring shareholders will generally have a basis the same as their basis in the shares of the acquired Target corporation.

(a) The S-election may continue if the surviving corporation has an S-election and continues to qualify to maintain it (i.e., the transaction does not create a second class of stock, result in a disqualified shareholder, exceed the limit on the number of shareholders, etc.). See Rev. Ruls. 69-566, 1969-2 CB 165 and 79-52, 1979-1 CB 283.

(b) The income or loss of the nonsurviving acquired S-corporation for the year should pass through to its shareholders as of the date of the reorganization and the taxable year of the acquired corporation terminates. Income may thus be accelerated but will not be shifted.

(c) An acquiring or surviving S-corporation may have adjustments that could result in some income shifting, however. The allocated income or loss under IRC § 1366 is for the entire taxable year. Thus income or loss before or after the transaction could shift. With appropriate consents of all persons owning stock in the year, the tax year of the corporation can be terminated under IRC § 1377(a)(2) if the interest of a shareholder in the corporation terminates.

(d) Where a corporation with the S-election is acquired, the effect of a merger or reorganization on suspended shareholder losses under IRC § 1366(d)(2) which normally allows a corporate loss in excess of a shareholder’s basis in the stock of the corporation to be carried forward indefinitely, is not always clear.

(i) Will the one year posttermination period under IRC § 1377(b) begin so the loss may be used? If the assets of the S-corp are acquired by a C-corp where IRC § 381(a)(2) (relating to the carryover of tax attributes applies), then a posttermination period will begin the day after the last day the S-corp was in existence. Regs. § 1.1377-2(b). This is the answer then for an A-Reorg and for a C-Reorg. Also, if S-corp status ends in an acquisition which is a B-Reorg the posttermination period will begin. IRC § 1377(b). The shareholder may want to build basis by contributing assets to the S-corp in order to be able to take advantage of the deductions available at the end of the posttermination period because any deduction allowed is limited by the stock basis in the acquired corporation.
(ii) Is it possible to continue the suspended loss carry forward if the acquirer is an S-corporation? The AAA (accumulated adjustments account) carries over (even if negative) when the acquirer is another S-corp (where IRC § 381(a)(2) applies), but no posttermination period commences. Regs. §§ 1.1368-2(d)(2), 1.1377-2(b). Will there be an analogous treatment to allow the carryover of the suspended losses where they cannot be used at the end of a posttermination period?

(7) Merger or Reorganization - Effect of Cash. Any cash or other distributions just before, during, or just after a merger, stock-for-stock, or stock-for-asset transaction will require analysis under the particular governing code sections for each form of transaction because the results will not be the same. Three time periods are important: pretransaction, pursuant to the transaction, and posttransaction.

(a) Merger. In an A-Reorg, a statutory merger:

(i) If the acquired Target corporation distributed cash pursuant to the merger, the cash may be taxed in the shareholders’ hands by being allocated to gain first and to basis last (the usual reorganization rule) or to basis first and gain last (the usual S-corp rule); the matter is not clear.

(ii) Too much cash will disqualify the reorganization and make it a taxable sale.

(iii) Premerger distributions should be under the S-corp rules.

(iv) Postmerger distributions by an S-corp acquirer should generally be treated as S-corp distributions including out of the accumulated adjustments account of the acquired corporation. The AAA account is the account holding income previously taxed to shareholders and retained by the corporation where the corporation has been a C-corp at some time.

(v) Postmerger distributions by a nonS-corp acquirer cannot have the S-corporation effect and may be taxable dividends.

(b) Stock-for-Stock Reorganization. In a stock-for-stock transaction:

(i) Prereorganization distributions should not disqualify the transaction and should receive the usual S-corp treatment.

(ii) No cash may be distributed pursuant to the reorganization since it must be solely for voting stock.

(iii) Post reorganization distributions may obtain tax-free S-corp treatment for at least a year, even where the acquirer is not itself an S-corp.
(c) **Stock-for-Asset Reorganization.** In a stock-for-asset transaction:

(i) A prereorganization distribution by the acquired corporation two months before the transaction should not be treated as boot in the reorganization and should receive S-corp treatment.

(ii) Distributions treated as boot distributions pursuant to the reorganization may or may not receive S-corp treatment; the rules are unclear.

(iii) Too much cash will disqualify the reorganization and make it a taxable sale.

(iv) An acquired S-corp cannot make any postreorganization distributions because any remaining assets will be treated as being distributed in the reorganization (which, if too much, may disqualify the transaction which must involve the acquisition of substantially all the assets of the acquired corporation).

(v) If the acquiring corporation is itself an S-corp, then tax-free S-corp distributions may be possible out of the acquired corporation’s accumulated adjustments account (*i.e.*, the AAA account).

(8) **Qualified Subchapter S Subsidiaries.** Since 1996, S-corporations have been able to own subsidiaries and have been able under certain conditions to elect to treat 100%-owned subsidiaries as if they were divisions. The election can be made effective by the parent any time during the tax year, as shown on the election form (but may not be effective more than two months, or 15 days prior to filing, or 12 months after filing). Regs. §§ 1.1361-3(a)(3) and (4). These S-corporation subsidiaries would, under such an election, generally be disregarded entities for income and other (*e.g.*, estate, gift, payroll) tax purposes but not be disregarded for nontax purposes. (See Regs. § 1.1361-4(a)(4)). These disregarded S-corporation subsidiaries are referred to as Q-Subs or sometimes as QSSSs.

(a) **Significance.** A Q-Sub election may be useful in a business acquisition and creates some additional issues to be considered. For example:

(i) Businesses with different risks can be segregated into different corporations without the need to use a brother-sister group; now parent-subsidiary groups are available for S-corporations. This can be quite useful in an acquisition. (Under prior law, a corporation (whether or not an S-corporation) was not eligible to be a shareholder of an S-corporation.

(ii) An S-corporation can acquire 80% or more of the stock of another target corporation and need not liquidate the target in order to maintain the acquiree’s S-election. (Under prior law, generally a corporation could not both maintain the S-election and own 80% or more in vote or value of another corporation.) One result of this is that
an S-corporation may now hold an interest in a consolidated group (although it won’t be a member of the consolidated group for tax reporting).

(iii) Under state law, an S-corporation target acquired by another S-corporation need not be liquidated to maintain the target’s tax pass-through benefits.

(iv) The Q-Sub election will cause a deemed liquidation of the subsidiary. Thus, an S-corporation acquiring stock and contemplating the Q-Sub election, or a C-corp making such an acquisition and contemplating the S-election for itself and the Q-Sub election for the target, will both want to consider the effects of this deemed liquidation. IRC § 1361(b)(3).

(b) Eligibility for Q-Sub Election. A Q-Sub is defined (at IRC § 1361(b)(3)(B)) as a corporation which:

(i) is domestic and not in one of the ineligible classes (financial institution using reserve for bad debt, insurance company, has § 936 election for Puerto Rico and possessions, domestic international sales corporation ("DISC") or former DISC);

(ii) is owned or treated as owned 100% by a parent corporation which has made the S-election; the Q-Sub need not be an S-corporation and may have more than one class of stock, so long as all the stock is owned, or treated as owned, by the parent; and

(iii) is subject to the Q-Sub election made by its parent.

(iv) Where a Q-Sub election has terminated, the subsidiary cannot be an S-corporation or a Q-Sub again for five years. IRC § 1361(b)(3)(D).

(v) Where the qualification requirements cease to continue, the subsidiary is treated as acquiring its assets and assuming its liabilities in exchange for its stock. IRC § 1361(b)(3)(c).

(c) Possible Q-Sub Families. Since the parent only needs to be treated as owning 100% of the Q-Sub, so long as no C-corporation intervenes in the chain, family structures can be constructed in a number of ways, using Q-Sub S-corporations and single-member limited liability companies. For example (Regs. § 1.1361-2(d), examples (1), (2), and (3)):

(i) X an S-corp

X owns: Y an S-corp Q-Sub 100%
Y owns: Z a corporation—may be a Q-Sub of X

(ii) X an S-corp

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X owns: Y an LLC 100%
Y owns: Z a corporation—may be a Q-Sub of X

(iii) X an S-corp
X owns: Y an S-corp Q-Sub 100%
Y owns: Z a corporation 50%
Z a corporation 50%; Z may be a Q-Sub of X

(d) The Q-Sub Election in Stock Acquisitions. If a Q-Sub election is desired in connection with the acquisition of another corporation, when the election and its resulting deemed liquidation becomes effective is an issue.

(i) Acquisition Rules. Where an acquisition is involved, the timing of the liquidation depends on whether there is also a Section 338 election.

A) No Section 338 Election. A special rule applies to IRC § 338 elections; let’s first look at the general rule. Although one might expect that on the day of the acquisition, the selling shareholders would be treated as the owners of the target (see e.g., Regs. § 1.381(a)-1(a) (tax attributes transfer day after tax-free reorganization), Regs. § 1.1377-1(a)(2)(ii) (seller reports income for day of sale on sale of stock between S-corporation shareholders), Regs. § 1.1502-76(b)(1)(ii) (target becomes member of acquiring consolidated group on day after the acquisition), nevertheless, Regs. § 1.1361-4(a)(5) Ex. (2) contemplates that the Q-Sub election could be made effective as of the day of the transfer, so that the target corporation’s deemed liquidation and the termination of any S-election of the target corporation would occur on the day of the acquisition. Thus, according to the example in the regulation, the target “is not treated as a C-corporation for any period solely because of the transfer” to the acquiring S-corporation which would, without the Q-Sub election being effective, otherwise be an ineligible S-corporation shareholder triggering C-corporation status for the target subsidiary and adverse built-in gains, LIFO recapture, and passive investment tax results for a target S-corporation.

[1] Acquisition of a Non-S-Corporation Target. Where the target in an acquisition is not an S-corporation, the deemed liquidation occurs on the day of the transaction (Regs. § 1.1361-4(b)(3)(i)). The liquidation occurs immediately after the time at which the S-corporation first owns 100% of the stock where the acquirer does not own 100% of the subsidiary’s stock on the day before the Q-Sub election is effective).

[2] Acquisition of an S-Corporation Target. If the target is itself an S-corporation, the liquidation is deemed to have occurred at the beginning of the day the termination of its S-election is effective. Thus, if the acquirer makes an S-election for itself and a Q-Sub election for an S-corporation target both effective as of the day of the acquisition, the target will liquidate into the acquirer at the beginning of the day and there is no gap period during which the target could be a C-corporation between the termination of the target’s S-election (by reason of the Q-Sub election) and the deemed liquidation. Regs. §
1.1361-4(b)(3)(ii). This rule prevents the adverse tax consequences which could arise if the target S-corporation were to be treated as a C-corporation. In such an acquisition of an S-corporation, its suspended losses are carried over. Regs § 1.1361-4(c).

B) Section 338 Election. The result is different if an election under IRC § 338 is made by an S-corporation acquiree for the target, then the Q-Sub election will not be effective before the day after the acquisition date. Regs. § 1.1361-4(b)(3). Thus, if an IRC § 338(h)(10) election is made, the earliest possible Q-Sub effective date would be the day after the transaction. This is consistent with the general rules for IRC § 338 elections. See e.g., Regs. § 1.338-1(e)(1) (target is part of selling group on the day of the acquisition for purposes of allocating gain).

(ii) Nonacquisition Rule. The rules described above for acquisitions need to be understood against the background of the more general rule. Where the special acquisition rules don’t apply, the liquidation is deemed to occur at the close of the day before the Q-Sub election is effective. Thus, where a C-corporation parent makes an S-corporation election for itself and a Q-Sub election for an existing subsidiary, the liquidation occurs while the parent is still a C-corporation, immediately before the S-election is effective (which is a condition to making a Q-Sub election). Regs § 1.1361-4(b)(1). The acquisition rules are exceptions to this rule.

(e) Effect of the Deemed Liquidation. The deemed liquidation may or may not be a tax-free liquidation under IRC §§ 332 and 337, depending on the facts and circumstances and the application of general principles of tax law, including the step transaction doctrine. Regs. § 1.1361-4(a)(2). (There was a transition period which ended January 1, 2001, during which the step transaction doctrine was not applied to certain transactions among related corporations allowing them to be tax free. Regs. § 1.1361-4(a)(5).)

(i) Taxable. Under this rule, the following are examples of transactions which will be taxable:

A) A Q-Sub election made for an existing insolvent subsidiary will be taxable because the requirements of IRC § 332 for a tax-free liquidation will not be met. Where liabilities exceed assets, the subsidiary cannot distribute property in exchange for its stock.

B) A Q-Sub election made for an existing solvent subsidiary which owes money to its parent may be tax free for the subsidiary (IRC § 337), but not for the parent because it could recognize income on the receipt of property in satisfaction of the debt. For example, there could be a difference between the parent’s basis and the amount received for the debt. See Regs. § 1.332-7; Rev. Rul. 72-464, 1972-2 C.B. 214.

C) The contribution to a separate S-corporation of all the stock of a corporation by a shareholder of the separate S-corporation, followed by a Q-Sub election with respect to the contributed subsidiary of the S-corporation parent may (if other requirements are met) be treated as a D-Reorganization (under IRC § 368(a)(1)(D)) and the
liabilities of the contributed subsidiary will, in such event, be deemed assumed by the parent. If the deemed assumed liabilities exceed the basis of the subsidiary’s assets, then under IRC § 357(c), the assets will be treated as sold and gain or loss (capital or ordinary as the case may be) will be recognized. Regs. § 1.1361-4(a)(2)(ii) Example (3).

(ii) **Nontaxable.** Examples of transactions which will not be taxable include:

A) A corporation acquires for cash and short-term notes all the stock of a solvent corporation from unrelated shareholders, and as part of the same transaction, makes both the S-corporation election (for the acquirer) and the Q-Sub election (for the target). The sale qualifies under IRC § 338(d)(3), and the liquidation will be treated as a separate step from the stock acquisition and may be tax free under IRC §§ 332 and 337. Regs. § 1.1361-4(a)(2)(ii) Example (1). This may be quite useful in an acquisition.

B) If, instead of cash and notes in the prior example, 10% of the stock of the acquiring corporation were used to acquire the subsidiary, the transaction will be treated, under the step transaction doctrine, as a C-Reorganization (under IRC § 368(a)(1)(c)) if the other reorganization requirements are met. The transaction should thus be tax free. If not qualified as a C-Reorganization, the transaction would, under IRC § 338, be a taxable acquisition of the target (gain or loss recognized to selling shareholders), followed by a tax-free Q-Sub liquidation.

(f) **Reorganizations with Disregarded Q-Sub.** Subsidiaries are very useful in tax-free acquisitions using the reorganization provisions (IRC § 368 and related code provisions). Statutory mergers (A-Reorganizations under IRC § 368(a)(1)(A)) or forward triangular mergers (IRC § 368(a)(2)(D)) are the only tax-free reorganizations allowing up to 50% nonstock consideration. Acquirers like to insulate the risks of acquired businesses in subsidiaries. Thus, it may make business sense to use a Q-Sub in a transaction. However, where the Q-Sub is ignored for tax purposes, can there be a merger into a subsidiary to qualify for an A-Reorganization at the subsidiary level or for a triangular merger? Also, if the transaction does not involve a state law merger of the parent, will the transaction be able to qualify as an A-Reorganization at the parent level, either where the actual merger party, the subsidiary, is disregarded and treated as part of the parent for tax purposes only, not state law purposes? The matter is unclear. See, however, Regs. § 1.1361-5(b)(3), Example (4) (Q-Sub may be distributed under IRC §§ 355 as part of a D-Reorganization and is thus not disregarded for this purpose; see also PLRs 9512020, 9411035, and 8903074 (for how Service has treated REITs in analogous situation)). See Regs. § 1.368-2(b)(1).

(i) The requirements for an A Reorg include that simultaneously (A) the assets and liabilities of each member of the combining unit become those of one or more members of the transferee combining unit and the combining entity of the transferor combining unit ceases separate existence.

(ii) X an S-corp (with or without other assets)
X owns: Y a Q-Sub
Y merges with Z a corporation
This transaction does not qualify because X continues in existence and Y is not a continuing entity.

(iii) P, a corporation
P owns: A, a disregarded entity (Q-Sub or single-member LLC)
T merges into A with P stock as consideration
This transaction may work as an A-Reorg.

(iv) P, an S-corp
P owns: A, a Q-Sub
X, an S-corp
X owns: Y, a Q-Sub
X merges into A
This transaction probably qualifies as an A-Reorg (but would not if A was an LLC)

B. **Limited Liability Companies and Partnerships.** Limited liability companies taxed as partnerships and partnerships themselves are taxed under a significantly different regime than corporations, even those with the S-election. Thus the discussion of reorganizations and similar topics of interest in corporate acquisitions do not apply. When partnerships and partners are referred to in the following sections, those references include limited liability companies taxable as partnerships and their members.

(1) **Partnership Sale of Business Assets.** If a partnership sells to nonpartners its business assets as a going business, the “sale of a going business doctrine” may treat the sale as being a transfer of partnership interests rather than as a sale of assets, even where the partnership may continue, not all its assets are transferred and not all its liabilities are assumed (at least where the remaining assets are not essential). See Baran v. Com’r, 334 F.2d 58 (5th Cir. 1964), Kaiser v. Glenn, 216 F.2d 551 (6th Cir. 1954) (per curium), Dahlen v. Com’r, 24 T.C. 159 (1955) (acq.). See McKee, Nelson, Whitmire, Federal Taxation of Partnerships and Partners, Fourth Edition, ¶16.03[3] (2007), which describes the “questionable ancestry” of the doctrine and the effects described below. The doctrine does not apply to asset sales by inactive partnerships. Baker Commodities, Inc. v. Com’r, 48 T.C. 374 (1967), aff’d, 415 F.2d 579 (9th Cir. 1969) cert. denied, 397 U.S. 988 (1970).

(a) **Effect on Partners.**

(i) Partners may lose ordinary losses on particular assets where the business is treated as a unitary asset and the assets are not disaggregated, for example, ordinary losses on assets subject to IRC § 1231 (certain depreciable assets used in a trade or business and certain timber, ore, and livestock).
(ii) If a partner’s basis in the partnership interest differs from the partner’s share of basis in partnership assets, the timing and character (but not amount) of gain or loss to the partner may be affected.

(iii) If the partnership is incorporated, there is a difference in treatment if assets or partnership interests are deemed to be the contributions to the corporation. However, the Service has not been consistent where incorporations are concerned. See Rev. Rul. 84-111, 1984-2 C.B. 88 (form of transaction as asset or interest contribution may be chosen by the parties and have corresponding tax effects); see also Rev. Rul. 72-172, 1972-1 C.B. 265 (sale of interests treated as contribution of assets).

(iv) Selling partners may benefit if the transaction is treated as a transfer of partnership interests where the partnership owns ordinary income-producing assets, so long as IRC § 751(a) (the “hot asset” rule relating to accounts receivable and inventory) is not triggered. Inventory that is depreciated” under IRC § 751(d)(1) could be such an asset producing ordinary loss.

(v) Selling partners would, on the other hand, tend to benefit if the transaction is treated as a sale of assets where the partnership has loss-producing assets that would not trigger IRC § 751(a) on the sale of partnership interests. Inventory that is depreciated and assets subject to IRC § 1231 could be such assets.

(vi) Provisions dealing with transfers among related persons, such as IRC §§ 267(a)(1), 707(b), and 1239 may become effective.

(vii) There may be differences between holding periods of partnership assets and of the partner’s interests which could affect capital gain treatment.

(b) Effect on Purchaser. The sale of a going business doctrine does not have the same effect on the purchaser of a business who is treated as receiving assets, not partnership interests, whether the form of the transaction is an asset purchase or a purchase of interests because the purchase of all interests terminates the partnership. See Edwin E. McClauslen, 45 T.C. 588 (1966), PLR 8329037 (April 19, 1983), and Rev. Rul. 99-6, 1999-5 IRB 6 (situation 1).

(c) Assignment of Income and Collapsible Partnerships. The assignment of income doctrine could be applied to the disposition of partnership interests where the effect is an otherwise not allowable transfer of the right to receive income in the future. See Tennyson v. U.S., 76-1 USTC ¶ 9264 (W.D. Ark. 1976), Rev. Rul. 60-352, 1960-2 C.B. 208. Also, if the sale of a partnership interest occurs when the partnership purpose has been fulfilled, the sale of a partnership interest could be an abusive attempt to turn ordinary income into capital gain. See Haggard v. Wood, 298 F.2d 24 (9th Cir. 1961) (sale of partnership interests treated as, in effect, a distribution of the completed cotton crop) and Trousdale v. Com’r, 219 F.2d 563 (9th Cir. 1955) (sale of partnership interest when construction project completed and no further business conducted).
(2) Sale of a Partnership Interest - Generally. In an acquisition of a partnership business, some or all the partnership interests of the partners may be acquired. The sale or exchange of a partnership interest results in capital gain except the amounts attributable to the hot assets of accounts receivable and appreciated inventory will be treated as ordinary income, and investment tax credit may be recaptured. IRC §§ 741, 751(a). As described below, if sufficient interests (50% or more) are transferred, the partnership may be terminated for tax purposes.

(a) **Buyer.** The buyer may be able to exclude income later received from the hot assets if an election is made to adjust the basis of partnership property.

(b) **Seller.** The selling partner must take into account all profits and losses to the time of sale and, as to the selling partner only, the partnership tax year ends.

(3) Installment Reporting. Installment reporting (and open transaction treatment to the extent it may still be available) may apply to sales by partnerships of assets or by partners of partnership interests.

(a) **Partnership Interests.** If partnership interests are being sold, they are generally treated as an interest in an entity and not as proportionate interests in underlying assets pursuant to IRC § 741. However, for hot assets (accounts receivable and inventory) under IRC § 751, the underlying assets are treated as fragmented. Rev. Rul. 89-108, 1989-2 C.B. 100. The Service has authority to issue regulations in this area, however. IRC § 453A(e)(2). Thus, it could require fragmentation by regulation. Also, abusive transactions may be subject to substance over form doctrines and the general anti-abuse rules promulgated in the Regulations. See Regs. § 1.701-2.

(b) **Partnership Assets.** If partnership assets are sold, even though for other purposes, this transaction may, under the “sale of a going business” doctrine, be treated as a sale of partnership interests, it is possible the installment treatment of the transaction could be on a fragmented asset-by-asset basis under the general rule of Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) which applies IRC § 453 on an item-by-item basis. The matter is not clear.

(4) Mergers. Regulations (effective for transactions after January 3, 2001; may be elected for transactions after January 10, 2000), have created a base level for the analysis of mergers or consolidations between partnerships. These regulations amend regulations under IRC §§ 708, 743, and 752.

(a) **General Rules.** As has long been the case, a merger of two or more partnerships is treated as the continuation of the one from which came continuing partners who own more than 50% in the capital and profits of the resulting partnership. IRC § 708(b)(2)(A). If necessary to determine the continuing partnership, the net asset values of the contributed assets to the resulting partnership is compared among the partnerships which merged with the largest being treated as continuing. The other partnerships are deemed terminated. The terminated partnerships’ tax years close under IRC § 706(c). Regs. § 1.708-1(b)(2)(i). Which
partnership survives under state law is not relevant. The terms “merger” or “consolidation” are not defined by regulation and so do not have a technical meaning as words of art.

(b) **Forms of Merger.** There are now only two remaining forms of partnership mergers, the “assets-up form” (Regs. § 1.708-1(c)(3)(ii)) and the “assets-over” form (Regs. § 1.708-1(c)(3)(i)). If the transaction is anything other than assets-up in form, it is treated as an assets-over merger. Between the two remaining forms, the form selected by the parties will be honored.

(i) **Assets-Up.** The assets-up form operates like this:

terminating partnership distributes assets to partners in liquidation (actual title must change)

partners exchange the assets immediately for partnership interests in resulting partnership.

(ii) **Assets-Over.** Under the regulations, a true assets-over transaction, an interests-over transaction, a state law merger without other form (e.g., under a limited liability company statute), or any other form, is treated as an assets-over transaction. This is consistent with the long-held position of the Service. See Rev. Rul. 68-289, 1968-1 C.B. 314; Rev. Rul. 77-458, 1977-2 C.B. 220; Rev. Rul. 90-17, 1990-1 C.B. 119. The true assets-over transaction operates like this:

terminating partnership transfers its assets to the resulting partnership in exchange for partnership interests

terminating partnership distributes to its partners resulting partnership interests in liquidation of their interests in the terminating partnership.

(iii) **Interests Over.** The interests-over form, which will be treated as an assets-over form, operates this way:

partners of terminating partnership contribute the partnership interests to resulting partnership in exchange for interests in it

terminating partnership is liquidated into the resulting partnership.

(c) **Tax and Other Effects.** The tax effect of each step of a transaction needs to be analyzed for each participant in that step.

(i) **Assets-Up.** In the assets-up form, where titles to assets are transferred to the partners and then contributed to the resulting partnership, some of the significant results are:

A) The basis of the resulting partnership in the assets contributed to it is a carryover basis (IRC § 723) determined (i) the basis of each partner in
those assets (see IRC § 732) determined partner by partner after the liquidation, (ii) adjusted on
contribution to the resulting partnership if needed under IRC § 723 (personal use property
contributed to a partnership produces a basis in the hands of the partnership equal to the lesser of
its value or its basis in the hands of the contributing partner). The basis in the assets in the hands
of the resulting partnership may be higher or lower than it was in the hands of the terminating
partnership if the partner’s outside basis in their partnership interests is not in the aggregate equal
to the aggregate inside basis of the terminating partnership in its assets.

B) The partner’s basis in his or her partnership
interest in the resulting partnership will be the basis of the property contributed. IRC § 722.

C) There could be recognition of gain under
IRC §§ 704(c)(1)(B) and 737 for a seven-year period after contribution. (In the case of
distributions of contributed property other than to the contributing partner within such seven
years’ gain or loss recognized at time of distribution under IRC § 704. A partner contributing
appreciated property to a partnership recognizes precontribution gain on the distribution within
seven years of other property to such partner and IRC § 737. The parties may desire the other
form of merger in order to avoid these rules.

D) Taking title may create liability exposure for
the partners. This can be dealt with by the partners’ first each forming a one-member LLC and
contributing their partnership interest to it. The LLC will be a disregarded entity for tax
purposes but will provide some state law liability protection.

E) See general distribution rules below for
effects of cash and noncash distributions.

(ii) Assets-Over. In the assets-over form, or in a
transaction treated as an assets-over form of transaction, some significant results are:

A) Gain recognition under the seven-year taint
rules may be avoided because there are exceptions to the application of IRC §§ 704(c)(1)(B) and
737 to assets-over transactions. Regs. §§ 1.704-4(c)(4) and 1.737-2(b). But see Rev. Rul. 2004-
43, 2004-18 I.R.B. 842 (Incremental built-in gain “created” on contribution to the continuing
partnership may be recognized by a partner of the terminating partnership within seven years
after the merger even if the property was contributed to the terminating partnership more than
seven years before the distribution. The ruling was revoked but its principles will be used in
regulations under Code Sec. 704(c)(1)(B) and Code Sec. 737 implementing the principles of
Rev. Rul. 2004-43; Notice 2005-15, 2005-7 IRB., The regulations will be effective for
distributions occurring after Jan. 19, 2005.)

B) In the assets-over form, the terminating
partnership is at least momentarily treated as a partner of the resulting partnership. An
assumption or reallocation of debt is, under generally-applicable rules, treated as a cash
distribution to the partner whose debt is assumed or reallocated to another. IRC § 752(b). This
deemed cash distribution could cause gain recognition where the debt relief deemed distribution
exceeds its tax basis in its partnership interest in the resulting partnership. This gain is then passed through to the partners of the terminating partnership under IRC 704(b). However, the regulations would net the liabilities shifted so that the taking on of a share of liabilities of the resulting partnership is netted against the relief of liabilities of the terminating partnership. Regs. § 1.752-1(f).

C) There are some special rules designed to correct some inequities which could result where a partner of the terminating partnership is being bought out as part of the merger transaction.

[1] If the terminating partnership has a partner who will be bought out as part of the transaction but the terminating partnership does not have the liquidity to accomplish the purchase and so receives a cash distribution from the resulting partnership to do the buy-out, then there could be a disguised sale under IRC § 707(a)(2)(B). Generally, a contribution of property followed (sufficiently closely in time) by a receipt of cash is the sale of the property. However, for the assets-over form of transaction, there is a special exception to this general rule. Regs. § 1.752-1(f). Where the merger documents specify that the resulting partnership is buying out the partner’s interest in the terminating partnership, and sets a price, then this transaction will be respected as a sale of the partner’s interest to the resulting partnership. The transaction would thus not be recharacterized as a sale of the assets of the terminating partnership and thus will prevent gain from being recognized to all the partners of the terminating partnership. This will be true even if the funds are actually paid through the terminating partnership.

[2] However, this will also cause the resulting partnership and those who were its partners just before the merger to succeed to the capital account and to the built in gain (under 704(c)) of the bought-out partner. This means that if the bought-out partner had contributed to the terminating partnership property with built-in gain (value exceeds basis), the gain on the sale of that property will first be specially allocated to the preexisting partners of the resulting partnership under IRC § 704(c). But there is also a special exception to help here, too. If the resulting partnership has an IRC § 754 basis adjustment election in place for the year of the merger, then the basis adjustment (under IRC § 743(b)) to the partnership’s assets from the buy-out of the partner will also be specially allocated to such preexisting partners of the resulting partnership and thus reduce the built-in gain problem. Regs. § 1.743-1(h)(1).

D) Distribution by the terminating partnership of the resulting partnership interests in complete liquidation of the terminating partner’s interests in the terminating partnership creates a basis in the resulting partnership interests received equal to the basis of the partner in the terminating partnership interest, less any money distributed in the same transaction.

E) The basis of the resulting partnership in the assets contributed to it is a carry-over basis, as in the Assets-Up transaction.
F) See distribution rules below for effect of cash and noncash distributions.

(5) **Partnership Divisions.** In acquisitions, a partnership may be divided. In such an event, where a partnership splits into two or more partnerships, the resulting partnerships will be considered continuations of the dividing partnership, except for any resulting partnerships which have members who held 50% or less in capital or profits of the divided partnership. IRC § 708(b)(2)(B). Continuing partnerships are subject to the elections made by the dividing partnership.

(a) The noncontinuing parts are treated as separate new partnerships, and if no part meets the more-than-50% test, then the dividing partnership is treated as terminated. Regs. § 1.708-1(b)(2)(ii). The partners of the noncontinuing part are treated as if their partnership interests had been liquidated.

(b) As with partnership mergers, partnership divisions are treated as occurring in two forms—the assets-up form if this applies and the assets-over form for all other transactions. Regs. § 1.708-1(d)(3). For purposes of these rules, a resulting partnership treated as a continuing partnership may be treated as distributing assets to its members to contribute to recipient partnerships (assets-up form) or as distributing assets to recipient partnerships in exchange for partnership interests then distributing such partnership interests to its members (assets-over form). Each step needs to be evaluated for its effect on each participant, but we will not be dealing with this further.

(6) **Distributions - General Rules.** Distributions can be made during the life of the partnership or upon liquidation, for example after an acquisition of the operating assets of the partnership.

(a) **Gain on Cash Distributions.** Partners usually recognize gain on distributions only to the extent the cash distributed exceeds the basis of the partner’s partnership interest. IRC § 731(a)(1). Subject to special rules relating to hot assets, there is generally no gain recognized on the distribution of assets other than cash. Thus, if it is desired to postpone the gain, assets other than cash should be the only assets distributed. The gain is treated as relating to the sale or exchange of the partnership interest. No loss is recognized, except in some cases of liquidating distributions, because the transaction will not be deemed to be closed. (If a loss is desired to be recognized, some or all of the partnership interest should be sold.)

(b) **Ongoing Basis Adjustments.** A partner’s basis in his partnership interest is regularly adjusted by being increased by his share of taxable income and decreased by losses and distributions. IRC § 705. Losses cannot be used in excess of the partner’s basis in his partnership interest. The partnership interest’s basis is also adjusted to reflect the partner’s use of the investment tax credit. IRC § 48(q)(6). Distributions in excess of the basis of the partnership interest are generally treated as gain from the sale or exchange of the partnership interest. IRC § 731(a); but see IRC § 736 on payments to retiring partner or deceased partner’s successor, and IRC § 751 on unrealized receivables and inventory.
(c) **Basis Adjustment from Distribution.** The partner’s basis in his partnership interest is adjusted by decreasing it in the amount of cash and the basis of partnership property distributed to the partner. IRC § 733. If a partner receives partnership property the partner’s basis in that property is the same as was the partnership’s, but not above the partner’s own basis in the partnership interest just prior to the distribution. IRC § 732(a). Special rules apply to distributions of certain “hot” assets, such as unrealized accounts receivable and inventory, which may make the gain on resale of these items ordinary. IRC §§ 735(a) and (b), 751.

(d) **Hot Assets.** Items known as “hot assets” get some special treatment designed to prevent transforming what should be ordinary income into capital gain. Hot assets include inventory (meaning any inventory for some purposes such as a sale of partner’s interest, but substantially appreciated inventory for other purposes, such as a distribution) and unrealized accounts receivable. Unrealized receivables include typical trade receivables for goods or services but, as defined in IRC § 751(c), also include a laundry list of items with special tax treatment, such as depreciation recapture and market discount. These recapture-type items are thus treated as if they were a form of property.

(i) **Hot Asset Distribution.** Special rules apply to distributions of hot assets, which may make the gain on resale of these items ordinary. IRC §§ 735(a) and (b), 751. Unrealized accounts will create ordinary gain or loss without a time limit on disposition, and inventory items (whether or not substantially appreciated) disposed of within five years of the distribution will create ordinary gain or loss, even though the property may have ceased to be inventory in the hands of the distributee partner.

(ii) **Nonhot Asset Effect.** Further, if an uneven distribution of hot assets diminishes the partner’s interest in nonhot assets, or vice versa, if such a distribution of nonhot assets diminishes the partner’s interest in hot assets, there will be, in essence, a deemed sale or exchange of the one class of assets for the other, and the partner or the partnership (or both) may recognize gain or loss, which will be ordinary with respect to the hot assets, and capital with respect to the nonhot assets. IRC § 751(b). Substantially appreciated inventory is a hot asset for this purpose. Cash is a nonhot asset, and a cash distribution could trigger IRC § 751(b) “sale” treatment where, for example, it diminishes the interest of the partner in unrealized receivables.

A) There is an exception for the return to a partner of a particular property contributed. IRC § 751(b)(2)(A).

B) We will deal further below with liquidations of a partner’s interest and IRC § 736, but it should be noted now that hot assets will have an effect in a great many situations there, as well as in the case of nonliquidating distributions. Payments to liquidate the interest of a retiring or deceased partner fit into one of two categories under IRC § 736. Payments under IRC § 736(a) (as a distributive share of income or as a guaranteed payment) are not subject to the IRC § 751(b) deemed sale treatment. IRC § 751(b)(2)(B). On the other hand, payments under IRC § 736(b) (relating to the interest of the partner in partnership property) are generally subject to the IRC § 751(b) treatment where
unrealized receivables or substantially appreciated inventory is involved. However, there is a further exception for the share of normal trade unrealized receivables of a retiring or deceased general partner of a service partnership (i.e., where capital is not a material income producing factor); payments with respect to such receivables are excluded from IRC § 736(b) and thus are covered by IRC § 736(a) and the exception to IRC § 751(b) deemed sale treatment. But there is an exception to the exception such that recapture-type items treated as unrealized receivables under IRC § 751(c) remain subject to IRC § 751(b) treatment, even where the normal receivables of a service general partner do not.

C) Certain reorganizations or realignments with a business purpose and without tax avoidance motive may be able to avoid IRC § 751(b) treatment. See PLR 8619015, PLR 8514035, and PLR 8838063 as supplemented by PLR 8851005.

D) Also, IRC § 751(b) treatment “does not apply to current drawings or to advances against the partner’s distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital.” Regs § 1.751-1(b)(1)(ii).

E) Inventory will be substantially appreciated inventory, decided on an all or none basis, if its value exceeds 120% of its adjusted basis. IRC § 751(b)(3). In order to avoid manipulations from the acquisition of additional, nonappreciated inventory, inventory is excluded from use in applying this rule if the principal purpose for acquiring the inventory was to avoid the special rules on substantially appreciated inventory. IRC § 751(d)(1)(B).

F) Remember that unrealized receivables include numerous recapture-type items. IRC § 751(c).

(f) Liquidating Losses. Liquidating distributions may result in loss. If only cash or hot assets are distributed in liquidation of a partner’s interest, loss will be recognized if the amount of cash received and the partnership’s basis in the hot assets is less than the basis of the partner’s partnership interest. Loss recognition will be postponed if any other asset, even with little value, is distributed. Regs. § 1.731-1(a)(2). The basis of property other than cash distributed in liquidation will be the partner’s basis in his partnership interest immediately before the distribution, reduced by any cash received as part of the liquidating distribution. IRC § 732(b).

(g) Reduction of Liabilities. A reduction in the partner’s share of partnership liabilities will be treated as a deemed distribution of cash (IRC § 752(b)) which may cause a gain to be recognized if the deemed distribution exceeds the partner’s basis in his partnership interest. IRC § 731(a).

(h) Partnership Gain or Loss. The partnership itself does not generally recognize gain or loss on a distribution of cash or property to a partner. IRC § 731(b). There are exceptions for payments to retiring or deceased partners in liquidation of their interests.
where the partnership continues (IRC § 736) and for uneven distributions of hot assets (IRC § 751(b)).

(i) **Seven-year Taint.** Built-in gains or losses may be recognized if property has been contributed to the partnership within seven years.

(i) If appreciated or depreciated property has been so contributed, then as of the distribution of it to any other partner, the contributing partner will recognize gain (or loss) in the amount of the built-in gain (or loss) which existed at the time of contribution determined as if the property had been sold at the date of distribution. IRC § 704(c)(1)(B). (There may be an exception where like kind exchange property is distributed to the contributing partner (see IRC § 704(c)(2)).)

(ii) Further, in the case of a distribution of some other property to a partner who contributed appreciated property in the previous seven years, the contributing partner will recognize gain equal to (i) the net built-in gain at the time of contribution, or (ii) if less, the excess of the value of the distributed property over the basis of the partner’s partnership interest, reduced, but not below zero, by money received in the distribution. IRC § 737(a).

(iii) There is an exception, however, for the return to the distributee partner of the property earlier contributed. IRC §§ 737(d) and 704(c)(1)(B).

(7) **Liquidation of a Partnership Interest on Death or Retirement.** A partnership interest may be completely disposed of on death or retirement by liquidating the entire partnership (treated as distributions; see IRC §§ 731, 732, and 751 and the discussion above), by selling the partnership interest to another person (an existing partner or a third party) (see IRC §§ 741 and 751 and the discussion below), or by liquidating the interest of the deceased or retiring partner by the continuing partnership (see IRC § 736). Let’s look at such liquidations of partnership interests.

Payments in liquidation of a partner’s interest under IRC § 736 come in two varieties, those made in exchange for the partner’s interest in partnership property which are thus capital in nature (IRC § 736(b)), and those for something else, which are treated as ordinary in nature (IRC § 736(a)). The payments in exchange for partnership property generally result in capital gain or loss to the receiving partner and provide no deduction to the partnership. Other payments (IRC § 736(a)) are either a share of income or are guaranteed payments under IRC § 707, depending on whether the amount of the payment is determined by reference to partnership income or not; these payments result in ordinary income to the receiving partner and reduce the income of the remaining partners. To the extent a payment under IRC § 736(a) is treated as a guaranteed payment (rather than a distributive share of income), it is deductible by the partnership. (IRC § 707(c) capitalization does not apply to IRC § 736(a)(2) payments. Regs §§ 1.736-1(a)(4) and 1.717-1(c).) Guaranteed payments do not affect capital accounts. Regs. § 1.704-1(b)(2)(iv)(o). In allocating payments between those covered by IRC § 736(b) (capital in nature) and those covered by IRC § 736(a) (ordinary in nature), two types of partnership get two different treatments with respect to unrealized receivables and good will.
(a) **General Partners in Service Partnerships.** Partnerships where capital is not a material income producing factor, generally service partnerships such as law and accounting firms, physicians, architects, etc., do not treat payments to a general partner with respect to unrealized normal trade receivables as being in exchange for the partner’s interest in partnership property, and the same holds true for good will unless the partnership agreement provides for a payment for goodwill. IRC § 736(b) and (c). Thus, these items will generally result in ordinary income to the retiring or deceased partner and reduce income for the remaining partners. Although not clear, it may be that limited liability company member managers, or all members where none are managers, should be treated as general partners for this purpose. See Rev. Proc. 95-10, 1995-1 C.B. 501 (treating member managers as general partners for other purpose).

(b) **Other Partnerships.** Other partnerships and partners who are not general partners, on the other hand, will treat payments in exchange for unrealized receivables and good will as being in exchange for partnership property. This results in ordinary gain or loss as to the receivables and capital gain or loss as to the good will. If the partnership makes a basis step-up election under IRC § 754, the basis of the retiring partner’s share of good will, will be stepped up in the hands of the partnership and the partnership will obtain an amortization deduction for the intangible asset under IRC § 197 (see House Ways and Means Committee Rept. p. 775, on Act § 13261).

(c) **Hot Assets.** As discussed above, a distribution which results in the reduction of a share of hot assets or of nonhot assets can trigger gain or loss to the partner, the partnership, or both under IRC § 751(b). For a number of purposes, other than IRC § 736 liquidation payments, “unrealized receivables” includes a variety of recapture and other ordinary income-generating items. IRC § 751(c). However, since such recapture items are not unrealized receivables for purposes of IRC § 736 pursuant to the IRC § 751(c) definition, the exception in IRC § 736(b)(2) for the unrealized receivables of general partners in a service partnership (where capital is not a material income-producing factor) will not apply, and thus IRC § 751(b) deemed sale treatment will apply to distributions in exchange for potential recapture-type items, such as IRC § 1245 depreciation recapture or market discount, even if IRC § 751(b) does not apply to the ordinary service trade receivables of the service general partnership.

(d) **Typical Results.** The result of a cash payment with respect to the share of receivables of a retiring or deceased partner who is not a general partner or of any partner in a capital intensive partnership is often (i) ordinary income to the partner, thus accelerating income to the partner (who is treated as having sold his share of the receivables), (ii) no timing benefit for the partnership which will, however, obtain an increase in basis for its receivables (it just paid for an additional share of them), and (iii) no gain or loss to the partnership with respect to the exchange of cash for the receivables (although cash is a nonhot asset, it can’t be sold to trigger gain or loss). If, however, the interest of the partnership in some other asset decreases, that other asset could be deemed sold to that extent, triggering gain or loss to the partnership. Thus, it is important to review what happens with respect to each class of asset as to each side of the transaction.
(e) **Installment Liquidations.** Even if no longer a state law partner or member, until all liquidation payments are made, the withdrawing member remains a tax partner.Regs. § 1.736-1(b)(5) and (6). Where installment liquidation payments are made, each installment is allocated between IRC § 736(a) and IRC § 736(b) amounts. Losses are not recognized until the end. Generally, fixed payments are allocated ratably and contingent payments are allocated first to IRC § 736(b). Regs. § 1.736-1(b)(5)(i). The partners may agree to a different timing and allocation so long as the amounts allocated to the IRC § 736(b) portion equal the value of the partner’s share of partnership property. Regs § 1.736-1(b)(6). This could accelerate the leaving partner’s ordinary income and the partnership’s deduction for IRC § 736(a) amounts, and could delay an IRC § 754 basis adjustment for partnership property since it won’t apply until gain is recognized by the leaving partner. Rev. Rul. 93-13, 1993-1 C.B. 126.

(i) If payments for goodwill are specified in the partnership agreement pursuant to IRC § 736(b)(2)(B), then each installment payment creates a new goodwill asset amortizable by the partnership over 15 years. Reg. § 1.734-1(e)(1), Rev. Rul. 93-13. The time value of such a serial amortization sequence will generally be less than an up-front payment with immediate amortization.

(ii) Payments to a retired partner under IRC § 736(a) (ordinary income) are taxed on the return for the year for which the payments are made, rather than the year of receipt (possibly accelerating the tax). Reg. § 1.736-1(a)(5). Installment reporting rules generally do not apply to IRC § 736 redemption payments since they are taxed under IRC § 731 (except, of course, hot assets under IRC § 751(b)). See Reg. § 1.736-1(b)(6). Thus, basis is recovered first, often producing a tax deferral greater than that available under the installment reporting rules, a deferral benefit not available for corporations, whether a C or S corporation.

(iii) An installment liquidation of a member’s interest also appears to eliminate interest on deferred taxes under IRC § 453A if it would apply (generally, all installment obligations held by the taxpayer exceed $5 Million), and arguably may also prevent the deemed interest rules (IRC §§ 483, 1272, and 7872) from applying because any interest-like component of the payment is a guaranteed payment for the use of capital under IRC § 707(c) and should not be treated like real interest. See IRC § 736(a)(2), which treats payments not determined by profits as guaranteed payments.

(8) **Sale or Distribution Elective Basis Adjustment.** If the acquisition does not terminate the partnership, an elective basis adjustment under IRC § 754 should be considered upon a distribution by the partnership (e.g., of the consideration received) or upon the sale of the partnership interests. Unless the partnership makes an election under IRC § 754, the basis of partnership property is not adjusted due to a sale of a partnership interest, the death of a partner resulting in a step-up of the partner’s basis in his or her partnership interest, or the (nonpro rata) distribution of partnership property, even though the basis of the partner’s partnership interest will be adjusted in such events. With the IRC § 754 election, however, the differences that arise between the partner’s basis in his or her partnership interest (outside basis) on the one hand, and the partner’s share of the partnership’s basis in its properties (inside basis) on the other hand, can be mitigated.
(a) **Distributions.** In cases of distributions, the IRC § 754 election is designed to allow the partnership to adjust under IRC § 734 the basis of its property distributed to a partner to the basis of the partner’s interest in his or her partnership interest and to reflect in the basis of assets retained by the partnership any gain or loss recognized by the distributee partner. This helps alleviate the differences that develop overtime between the partnership’s basis in its assets and the basis of the partner’s interest in the partnership. Basis can be lost in a current distribution to a partner because the basis of the property received by the partner will generally be the partnership’s basis but it cannot be greater than the partner’s basis in the partnership interest affected (less any money distributed). Generally, if on distribution a distributed asset can be said to lose basis, the other assets that remain with the partnership will gain basis, and if a distributed asset can be said to gain basis, the other assets of the partnership will be reduced.

(i) The adjustments to the remaining property of the partnership work this way:

A) Basis goes up by the gain recognized by the partner receiving the distribution and by the amount of any basis decrease (lost basis) on the distributed asset.

B) Basis goes down by the loss recognized by the partner receiving the distribution, and by the amount of any basis increase (gained basis) on the distributed asset.

(ii) Another way to look at this situation is that the remaining partners are in effect using the distributed asset to buy the share of the distributee partner in the remaining assets and the remaining assets should be adjusted accordingly to reflect this cost.

A) In a cash distribution the partnership will generally increase its basis in remaining assets because the other partners essentially paid cash for an additional share of them.

B) In an asset distribution where the distributee takes a basis in the distributed assets higher than the partnership’s basis in them, the partnership will decrease its basis in its remaining assets because the other partners have essentially exchanged an interest in low basis assets for the distributee’s share of high basis assets.

C) In an asset distribution where the distributee takes a basis in the distributed assets lower than the partnership’s basis in them, the partnership will increase its basis in its remaining assets because the other partners have essentially exchanged an interest in high basis assets for the distributee’s share of low basis assets.

(b) **Transfer of Partnership Interest.** Where a partner sells a partnership interest, or where the partner dies and his or her estate receives a step up in basis with respect to his or her interest, the IRC § 754 election allows the partnership to adjust under
IRC § 743 the basis of the partnership’s property and to adjust the income allocated to the new partners to reflect the price paid on the stepped up basis. The adjustment will affect the basis in the partnership property with respect to the new partner but not the other partners.

(i) Purchase. Thus, with the IRC § 754 election, a new partner who pays full value to a selling partner for a partnership interest where the partnership assets have increased in value over the inside basis, should not have to bear a share of the tax on a later sale of the asset of the partnership at the value used in setting the price for the new partner’s partnership interest where the selling partner has paid the tax on the inherent gain.

(ii) Death. Also, on the death of a partner where the basis of the partner’s interest is stepped up to fair market value, the inherent gain should disappear and not be borne by the partner’s heirs on later sale of the assets by the partnership.

(c) Allocation of the Adjustment. There are complex rules for allocating the basis adjustment among the partnership’s remaining assets. IRC § 755. Generally, the adjustment is allocated first among classes of assets (to capital assets: e.g., capital and depreciable assets (IRC § 1231(b)), and to everything else termed ordinary income property: e.g., accounts receivable, inventory) proportionate to the appreciation in the class compared to other classes, and then among the assets of the classes being adjusted proportionate to the appreciation in the asset compared to the other assets in the class. Generally, allocations are based on the amounts of income, gain, or loss (including remedial allocations under Regs. § 1.704-3(d)) that would be allocated to the transferee-partner with respect to each asset if all assets were sold at fair market value in a taxable transaction. Regs. §§ 1.755-1(b)(2) through 1.755-1(b)(4). There are further special and complex rules dealing with allocating basis to intangible assets, particularly good will and going concern value. IRC § 1060(d). McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners (Thomson Reuters/WG&L, 4th ed. 2007) (generally see chapters 24 and 25; for good will, see ¶ 24.04[3]).

(d) Making the IRC § 754 Election. Generally, the IRC § 754 election is made with the partnership tax return for the year in which a transaction that could benefit by the election occurs, unless the election is already in place. Once made, the election continues until revoked with the consent of the Service. Regs. § 1.754-1(c).

(i) Process of Electing. The election under IRC § 754 is to be made with a timely-filed return for the taxable year during which a distribution or transfer (including by death) occurs. Reg. § 1.754-1(b)(1). This can well be before the estate tax return of a decedent is due. In such a situation, the election might not have been timely made. However, in any situation of a late filing of the election (at death or otherwise), there are two possible sources of relief, a 12-month automatic extension of time within which to make the election, or a discretionary allowance of an extension of time to do so.

A) The 12-month automatic extension is provided by Reg. § 301.9100-2. It requires corrective action consisting of filing, at the address where the original election should have been filed if made timely, an amended or original return for the appropriate period with the election attached (including having the election signed by any
authorized partner under Reg. § 1.754-1(b)), stating at the top of the return or the election “Filed Pursuant to § 301.9100-2,” and acting consistently by the taxpayers affected by the election in the filing of their returns (or amendments) and in otherwise acting consistently with the requirements for making the election.

B) The discretionary extension may apply where the automatic extension does not and will generally be granted if the requirements of Reg. § 301-9100-2 are met, the taxpayer acts reasonably and in good faith (e.g., the action is before the failure is noticed by the Service, and the action is not taken with 20/20 hindsight to retroactively obtain a benefit after events have transpired), and granting the extension is not prejudicial to the interests of the government. See Reg. § 301.9100-3.

(ii) Not Making the Election. What is the difference if an election is not made? There will be some difference in the timing and character of income. If an increase adjustment would otherwise be made, the remaining partners will recognize more current income and, with a higher basis in their partnership interests, will recognize less capital gain at the liquidation of the partnership. If a decrease adjustment would otherwise be made, the remaining partners will recognize less current income (due to smaller gains and greater depreciation deductions) and with a lower basis in their partnership interests, will recognize more capital gain on liquidation of the partnership. Distortions between inside and outside basis become permanent on the death of a partner where his or her partnership interest gets the step up basis at death and the election is not made.

(e) Transferee Partner Election. A special basis election may be possible for a partner to make where the partner buys or inherits the partnership interest from another partner when no IRC § 754 election was in place, and within two years receives a property (not money) distribution. In this case the partner can elect to have the property’s basis treated as if it had been adjusted under IRC § 743(b) and IRC § 754 at the time the partnership interest was obtained. IRC § 732(d).

(9) Termination. The termination of a partnership for tax purposes may occur without a state law termination. If the entire (or most of the) business of the partnership or all (or half or more of) the interests of the partners in the partnership are acquired (through purchase or combining partnerships) by an outside party, a termination could well occur.

(a) Requirements to Termination. All that is required is that:

(i) partnership operations cease to be carried on by any partners,

(ii) 50% or more of the total interest in partnership capital and profits is sold or exchanged within a 12 month period, (IRC § 708(b)), or

(iii) in some circumstances, the merger or consolidation of two or more partnerships (the resulting partnership is deemed a continuation of the prior...
partnership whose partners own 50% or more of the capital and profits interest in the resulting partnership) or the division of one partnership into two or more (the resulting partnerships in which partners continue to hold 50% or more in the capital or profits will be deemed to be continuations of the prior partnership) (IRC § 708(b)(2)).

(b) Inadvertent Terminations. These rules can lead to inadvertent partnership terminations, and in some such circumstances to adverse tax results to the partners. For example, if the holder of a 50% capital and profits interest incorporates a wholly owned corporation and contributes the partnership interest to the corporation, this will cause a termination of the partnership for tax purposes.

(i) Some transactions changing 50% of the partnership’s interests will not create a termination of the partnership: a contribution for a more than 50% interest (assuming no disguised sale), a redemption of a more than 50% partner, or a gift bequest or charitable contribution of more than a 50% interest. See Regs. §§ 1.708-1(b)(1)(ii), 1.708-1(b)(2).

(ii) Some transactions which will trigger a termination under the 50% interest rule include: contribution of a partnership interest to a corporation or partnership (Regs. § 1.708-1(b)(2)), distribution of a partnership interest by a corporation or partnership (IRC § 761(e), FSA 2002 19008), or a transfer of economic rights where the transferee does not become a partner (see Evans v. Com’r, 54 T.C. 40 (1970) aff’d, 447 F.2d 547 (7th Cir. 1971) (transfer to corporation without required consent of other partner). There are no ownership attribution rules under IRC § 708 to prevent such results (see FSA 200132009).

(c) Effects of Termination. Upon a termination the partnership’s tax year closes (requiring a separate final tax return) and, if the partnership continues under state law, a deemed contribution of partnership property to the “new” partnership will occur for interests in the “new” partnership, followed by a deemed distribution of the interests in the “new” partnership to the partners in liquidation of the “old” partnership. IRC § 706(c); Regs. § 1.708-1(b)(1)(iv). See TD 8717, 1997-1 CB 125.

(i) Favorable tax elections may be lost.

(ii) No gain or loss should be recognized on the termination. See Regs. § 1.731-2(g)(2) (distribution of partnership interests not treated as money or securities) and IRC § 731.

(iii) The rules on property contributions (IRC § 704(c)) will apply to the deemed contribution, including as to holding period and character of the assets. Regs. § 1.708-1(b)(1)(iv).

(iv) For depreciation, property deemed contributed to the “new” partnership will continue to be subject to the antichurning rules of IRC § 168(f)(5); also the rules of IRC § 168(e)(4)(e) and § 381(c)(6) (“step-in-the-shoes” rule) should apply for the new partnership to inherit the depreciation position of the “old” partnership.
(v) The basis of partnership property will not automatically increase or decrease. IRC § 723 carryover basis applies.

(vi) Investment credit will not be recaptured.

(vii) Suspended losses under IRC § 704(d) should carry over.

(viii) The capital accounts of the partners will not be affected. Regs. § 1.704-1(b)(2)(iv)(1).

(ix) No new built-in gain property is created; rather, property is treated as IRC § 704(c) property only to the extent that it was so treated in the hands of the terminated (“old”) partnership immediately prior to termination. Section 737 (gain to a contributing partner on distribution within seven years of other property to that partner) will not apply to the deemed distribution of interests in the “new” partnership, and a distribution of property will be subject to the IRC § 737 recognition of seven-year taint precontribution gain only to the same extent that a distribution from the “old” partnership would have been subject to IRC § 737.

(x) The distribution of the “new” partnership interest is generally not a sale or exchange, but for basis adjustment under IRC § 743 it will be, so an IRC § 754 election can be filed with the “new” partnership’s first return. Regs. § 1.708-1(b)(1)(v).