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CHANGING FROM ONE FORM OF ENTITY TO ANOTHER:
TAX CONSEQUENCES AND PITFALLS

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I. INTRODUCTION

Over the last decade, nearly all states have enacted statutes that allow business entities to convert from one type of entity to another type of entity by merely filing a form (such as articles of conversion) with the state (state law formless conversion statutes). Additionally, during this same time, many states have also enacted statutes allowing one type of business entity to merge into a different type of business entity, such as the merger of a corporation into an LLC (state law cross-entity merger statutes). The effect of such statutes is that title to the assets of the entities is automatically owned by the converted or surviving entity, and correspondingly liabilities are automatically owned by the converted or surviving entity.

Additionally, since the issuance of the “check-the-box” regulations in 1997, eligible entities have been able to select their classification for federal income tax purposes.

These state law formless conversion statutes, cross-entity merger statutes and the check-the-box regulations can have significant non-tax and state tax law advantages, including:

1. the possible avoidance of non-transferability, acceleration and similar clauses contained in various contracts;

2. avoiding application of transfer fees, sales taxes, documentary stamp taxes, etc.; and

3. simplicity.

However, the ease of converting an entity from one type of entity to another type under state law formless conversion statutes, state law cross-entity merger statutes and the check-the-box regulations can present significant tax pitfalls and a trap for the unwary as a result of the federal tax consequences resulting from changing the tax classification of the entity for federal income tax purposes.

This outline will examine the tax consequences of changing from one form of entity to another form of entity under the various methods available, including conversions of sole proprietorships into corporations, the incorporation of a partnership, the conversion of a corporation into a sole proprietorship or a single-member LLC that is a disregarded entity, the conversion of a corporation into a partnership, the conversion of a disregarded entity into a partnership, the conversion of a partnership into a disregarded entity and the conversion of a C corporation into an S corporation. In addition to highlighting the tax consequences of each of these transactions, the pitfalls associated with such transactions will also be discussed.
II. CHECK-THE-BOX REGULATIONS

A. **In General.** The check-the-box ("CTB") regulations provide that an “eligible entity” having two or more members is permitted to elect to be classified as an “association” taxable as a corporation, or, alternatively, report its tax items as a partnership. Treas. Reg. § 301.7701-3(a). The default rule, i.e., non-election, is that of a partnership for federal income tax purposes.

B. **Single Member “Eligible Entity”**. Where an eligible entity has only a single owner or member, it may elect to be classified as an association taxable as a corporation or be disregarded as an entity (a so-called “disregarded entity” or “DE”) for federal tax purposes. Treas. Reg. § 301.7701-3(b)(1). Under the default rule, a single member eligible entity will be treated as a DE.

C. **Multiple Member Entities.** Unless a “per se” corporation, including a foreign “per se” corporation under the CTB regulations, a multiple member entity may be classified as a partnership unless it elects to file a reverse election to be treated as a corporation. Under the default rule, a multi-member entity will be treated as a partnership under Subchapter K unless it files an election to be classified as an “association” taxable as a corporation.

D. **Foreign Entities.** Certain foreign corporations or entities are required by specific list under the regulations to be treated as “per se” corporations. Treas. Reg. § 301.7701-2(b)(8)(i). However, for foreign entities which fall outside the scope of the “per se” rule, the CTB regulations provide default rules for entity classification. Unless an entity elects otherwise, (1) a multi-member foreign entity will be classified as an association if all members have limited liability, or a partnership if one or more members does not have limited liability, and (2) a single-member entity will be classified as an association if the member has limited liability, or as a disregarded entity if the member does not. Treas. Reg. § 301.7701-3(b)(2).

E. **Special Rules for Banks.** A domestic or foreign bank cannot treat a wholly owned nonbank entity as a DE for purposes of applying the special provisions in the Code applicable to banks. Treas. Reg. § 301.7701-2(c)(2)(ii).

F. **Validity of the CTB Regulations.**

1. **McNamee v. Comm’r.** In McNamee v. Comm’r, 488 F.3d 100 (2d Cir. 2007), the Second Circuit Court of Appeals upheld the validity of the CTB regulations and affirmed a collection due process ("CDP") determination that an individual owner was personally liable for unpaid payroll taxes of an accounting firm/single member LLC that had not elected to be treated as a corporation. The CTB regulations were found to be a reasonable interpretation of somewhat ambiguous language contained in section 7701 and provided a reasonable approach in allowing a single member eligible entity to elect between an association or DE. The fact that the IRS had
proposed regulation changes that would definitively treat the entity as compared to the single member owner as the employer for payroll tax purposes was irrelevant and didn’t change the reasonableness of existing regulations since the changes were only proposed.

2. **Littriello v. United States**, 484 F.3d 372 (6th Cir. 2007), *cert. denied*, 28 S. Ct. 1290 (Feb. 19, 2008). A district court decision upholding the validity of the “check-the-box” regulations, and the sole owner-sole member’s personal liability, as sole proprietor for employment taxes of LLCs that had not elected to be treated as a corporation, was affirmed by the Sixth Circuit Court of Appeals. The court found the regulations to be a reasonable interpretation of what was ambiguity in Section 7701 as applied to hybrid entities; so, taxpayer’s failure to elect corporation treatment for LLCs clearly resulted under regulations in LLCs being disregarded and deemed sole proprietorships for tax purposes. The taxpayer’s argument that the statute was clear, and that it was the regulations that brought in ambiguity, was illogical and contrary to established Supreme Court law. This ambiguity was exacerbated by the different state law treatments of single member entities. Similarly, the argument that the IRS was required to recognize an LLCs’ separate existence as a matter of state law was flawed and based on distinguishable case precedent. Additionally, the taxpayer’s attempt to apply proposed amendments, providing that single-owner eligible entities be treated as separate entities for employment tax purposes, was rejected. The court found the regulations were a reasonable interpretation of what was an ambiguity under Section 7701 because Sections 7701(a)(2) and 7701(a)(3) fail to make a clear distinction between an “association” treated as a corporation and a “group, pool or joint venture,” which is treated as a partnership. The taxpayer’s failure to elect corporation treatment for LLCs resulted in DE status and treatment as sole proprietorships for tax purposes.

3. **Eligible Entities.** An eligible entity is an entity which is neither a trust under Treas. Reg. § 301.7701-4, nor a “corporation” under Treas. Reg. § 301.7701-2(b). See Treas. Reg. §§ 301.7701-2(a), 301.7701-3(a).

a. **Per Se Corporation.** A corporation as defined in Treas. Reg. § 301.7701-2(b) is always classified as a corporation for federal tax purposes. A corporation includes (i) a business entity organized under federal or state law that describes the entity as a body corporate, joint stock company or joint stock association; (ii) an insurance company or state chartered bank (Treas. Reg. §§ 301.7701-2(b)(4), 301.7701-2(b)(5)); (iii) a business entity wholly owned by a state or political subdivision thereof or a foreign government (Treas. Reg. § 301.7701-2(b)(6)); (iv) a business entity taxable as a corporation (see Treas. Reg. ...
§ 301.7701-2(b)(7)); and (v) a foreign entity required to be treated as a corporation under Treas. Reg. § 301.7701-2(b)(8).

b. **Dual-Chartered Entities.** The regulations provide that if the entity would be treated as a corporation as a result of its formation in any of the jurisdictions in which it is organized, then it is treated for federal tax purposes as a corporation even though its organization in the other jurisdictions would not have caused it to be treated as a corporation. Treas. Reg. § 301.7701-2. A dual chartered entity will be treated as domestic if organized as any form of entity in the U.S. regardless of how it is organized in any foreign country. Treas. Reg. § 301.7701-5. For grandfather provisions in the regulations, see Treas. Reg. § 301.7701-2(e)(3)(ii). Also see Treas. Reg. § 301.7701-2(b)(9), Example (1).

(1) **Facts.** X is an entity with a single owner organized under the laws of Country A as an entity that is listed in paragraph (b)(8)(i) of this section. Under the rules of this section, such an entity is a corporation for Federal tax purposes and under Treas. Reg. § 301.7701-3(a) is unable to elect its classification. Several years after its formation, X files a certificate of domestication in State B as a limited liability company (LLC). Under the laws of State B, X is considered to be created or organized upon the filing of the certificate of domestication and is therefore subject to the laws of State B. Under the rules of this section and Treas. Reg. § 301.7701-3, an LLC with a single owner organized only in State B is disregarded as an entity separate from its owner for Federal tax purposes (absent an election to be treated as an association). Neither Country A nor State B law requires X to terminate its charter in Country A as a result of the domestication, and in fact X does not terminate its Country A charter. Consequently, X is now organized in more than one jurisdiction.

(2) **Result.** X remains organized under the laws of Country A as an entity that is listed in paragraph (b)(8)(i) of this section, and as such, it is an entity that is treated as a corporation under the rules of this section. Therefore, X is a corporation for Federal tax purposes because the rules of this section would treat X as a corporation with reference to one of the jurisdictions in which it is created or organized. Because X is organized in Country A in a manner that does not meet the definition of an eligible entity in Treas. Reg. § 301.7701-3(a), it is unable to elect its classification.
c. Special Rule for Cross Border Subsidiaries. A domestic corporation may elect to have a wholly owned Canadian or Mexican subsidiary treated as a domestic corporation for all U.S. income tax purposes if the subsidiary is organized and “maintained solely for the purpose of complying with the laws of [Canada or Mexico] as to the title and operation of property.” Section 1504(d). See Notice 2000-7, 2000-4 IRB 419 (effect of repeal of certain Canadian banking legislation on section 1504(d) elections).

G. Entity Classification Election. An “eligible entity” is required to make an entity classification election by filing Form 8832, Entity Classification Election. Treas. Reg. § 301.7701-3(c)(1)(ii).

H. Effective Date. The election will be effective on the date specified by the entity on Form 8832, or on the date filed if no date is specified on the election form. Treas. Reg. § 301.7701-3(c)(1)(iii). The specified effective date cannot be more than 75 days prior to or 12 months after the date on which the election was filed. Treas. Reg. § 301.7701-3(c)(1)(iii).

I. Extensions of Time to File an Election. Under Treas. Reg. § 301.9100, the IRS has authority to grant an extension of time to make an election. Typically, an entity must apply for a waiver for a late election by making a private letter ruling request (for which a user fee must be paid) to the IRS. In response to the deluge of letter rulings requesting approval for late elections, the IRS issued Rev. Proc. 2002-15, 2002-1 C.B. 490. This revenue procedure provided a simplified method for newly formed entities to request relief for the late filing of their initial classification election by permitting an initial “election out” of the default classification rules in Treas. Reg. §§ 301.7701-3(b)(1) and 301.7701-3(b)(2) to be made by filing Form 8832 within six months and 75 days of the entity’s formation. An entity is eligible for relief if three conditions are met: (1) the entity failed to obtain its desired classification as of the date of its formation because Form 8832 was not timely filed; (2) the due date for the entity’s initial tax return has not passed; and (3) the entity had “reasonable cause” for its failure to make a timely election.

1. Extended Time to File. Subsequently, the IRS has extended the time for requesting relief from the six months (and 75 days) permitted under Rev. Proc. 2002-15, to the unextended due date of the entity’s federal tax return for the year of the entity’s formation in Rev. Proc. 2002-59, 2002-2 C.B. 615. More recently, in Rev. Proc. 2009-41, 2009-39 I.R.B. 439, the IRS extended late entity classification relief to both initial classification elections and changes in classification elections along with extending the time for filing late entity classification elections to within 3 years and 75 days of the requested effective date of the eligible entity’s classification. Additionally, Rev. Proc. 2009-41 provides guidance for those eligible entities that do not qualify for relief under this revenue procedure and that
are required to request a letter ruling in order to request relief for a late entity classification election.

2. **S Corporations.** The IRS has provided a safety net of relief for untimely filed S corporation elections in a variety of situations. With respect to entity classification elections, if an entity files an S corporation election but fails to file Form 8832, the entity will be deemed to have filed an election to be treated as a corporation under Treas. Reg. § 301.7701-3(c)(1)(v)(C).

In addition, if an entity fails to timely file an S corporation election (see generally Section 1362(b)(1)), the IRS has provided a simplified, special procedure to request relief for the late filing of both elections. See Rev. Proc. 2004-48, 2004-2 C.B. 172; and Rev. Proc. 2007-62, 2007-41 I.R.B. 786 (supplementing Rev. Proc. 2004-48 and providing an additional simplified method for certain eligible entities to request relief for late S corporation elections and late entity classification elections).

**J. Waiting Period.** Under the check-the-box regulations, an eligible entity that elects to change its classification cannot elect to change its classification again during the 60 months succeeding the effective date of the prior election (the “60-month waiting period”). Treas. Reg. § 301.7701-3(c)(1)(iv). The 60-month waiting period, however, does not apply to an eligible entity that elects out of its default classification effective from its inception. See Treas. Reg. § 301.7701-3(c)(1)(iv).

1. **Rescission of Election.** Additionally, an entity may rescind an entity classification election without triggering the 60-month waiting period provided such a rescission occurs before the end of the same taxable year as the initial conversion. See PLR 200952036 (Dec. 24, 2009) (permitting a C corporation, which was previously a limited partnership, to rescind incorporation, convert into an LLC, and maintain partnership treatment for federal income tax purposes at all times during the tax year in question); PLR 200843001 (July 2, 2008) (permitting rescission of the sale of a portion of a foreign DE’s ownership interests to avoid triggering an automatic classification change to a partnership); PLR 200613027 (Dec. 16, 2005) (permitting rescission of the conversion of an LLC taxable as a partnership to a C corporation in anticipation of a failed initial public offering).

2. **IRS Reconsidering Availability of Rescissions.** In Rev. Proc. 2012-3, 2012-1 I.R.B. 113, the IRS added as a no rule area, whether a completed transaction can be rescinded for federal income tax purposes. This issue is identified as an area under study in which rulings will not be issued until the IRS resolves the issue through publication of a revenue ruling, a revenue procedure, regulations or other guidance.
III. CHANGE OF A SOLE PROPRIETORSHIP OR DISREGARDED ENTITY INTO AN ASSOCIATION TAXABLE AS A CORPORATION

A. In General. One of the simplest types of changes in entity status is the incorporation of a sole proprietorship. This may be achieved by actual incorporation of a sole partnership, the filing of a Form 8832, Entity Classification Election, for a disregarded entity (such as a single-member LLC) to be treated as an association taxable as a corporation, the conversion of a single-member LLC treated as a DE into a corporation under the applicable state law formless conversion statute, or the merger of a single-member LLC treated as a DE into a corporation under the applicable state law cross-entity merger statute. Whether achieved by actual incorporation of the sole proprietorship, filing an election under Section 8832 for a single member LLC to be taxed as an association, the conversion of a single-member LLC into a corporation under the applicable state law formless conversion statute or the merger of a single-member LLC treated as a DE into a corporation under the applicable state law cross-entity merger statute, the tax consequences to the individual and the corporation should be the same.

B. Tax Consequences to the Individual Owner of the Sole Proprietorship or Disregarded Entity.

1. Recognition of Gain or Loss. Under the general rule of Section 351(a), no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.

   a. The general non-recognition rules of Section 351 will not apply if the new corporation constitutes an “investment company” under Section 351(e).

   b. A corporation may be classified as an “investment company” if more than 80% of its assets are held for investment and constitutes stock, securities, money, etc. Sections 351(e)(1)(A) and (B), and Treas. Reg. §§ 1.351-1(c)(1)(ii), (iii) and (iv).

   c. Even if the 80% test is met, the company will not be classified as an “investment company” unless it results in “diversification.” Diversification does not occur if each of the transferors conveys identical assets to the newly organized corporation. Additionally, diversification does not occur if not more than 25% of the portfolio of stock and securities conveyed by each transferor constitutes stock and securities of any one issuer, and not more than 50% of such portfolio is in the stock and/or securities of five or fewer issuers. Section 368(a)(2)(F)(i) and Treas. Reg. §§ 1.351-1(c)(1)(ii)(5), (6) and (7).
2. **Receipt of Boot.** If any cash or “other property” is received in connection with an incorporation, the transaction will not be disqualified from non-recognition treatment under Section 351(a), however, gain (the excess, if any, of the fair market value of the stock and other consideration received over the basis of the transferred assets) realized in the transaction will be recognized to the extent of any such cash or “other property” (i.e., “boot”) received. Specifically, Section 351(b) provides that if Section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under Section 351(a), other property or money, then gain to such recipient will be recognized but not in excess of the amount of money received, plus the fair market value of such other property received. Section 351(b)(2) provides that if a transferor receives boot, no loss may be recognized by the recipient.

   a. Rev. Rul. 68-55, 1968-1, C.B. 140, provides that in determining gain recognized under Section 351(b)(1), where several assets are transferred, each asset must be considered transferred separately in exchange for a portion of each category of consideration received. Each category of consideration received by the transferor is separately allocated to the transferred assets in proportion to their relative fair market values.

   b. If a loss is realized with respect to any particular asset, it will not be recognized under Section 351(b)(2).

3. **Property Requirement.** Section 351(d) provides that for purposes of Section 351, stock issued for: (1) services, (2) indebtedness of the transferee corporation which is not evidenced by a security; or (3) interest on indebtedness of the transferee corporation which is accrued on or after the beginning of the transferor’s holding period for the debt, is not considered as issued in return for property. Under such circumstances, ordinary income could be realized to the extent that any stock received in the transaction is not attributable to the contribution of “property.”

4. **Liabilities.**

   a. **General Rules.** Under the general rule of Section 357(a), if the taxpayer receives property which is permitted to be received under Section 351 without the recognition of gain if it were the sole consideration, and as part of the consideration, another party to the exchange assumes the liability of the taxpayer, then such assumption will not result in the recognition of gain except as provided below.

   b. **Liabilities in Excess of Basis.** Under Section 357(c), to the extent that the aggregate amount of liabilities assumed by the corporation
(or assets to which the assets received by the corporation in the transaction are subject) exceeds the adjusted basis of the assets transferred to the corporation, gain is recognized.

c. **“Nasty Purpose Liabilities.”** Under Section 357(b), if, taking into consideration the nature of the liability and the circumstances in light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption of the liability was to avoid federal income tax on the exchange, or was not a bona fide business purpose, then such assumption (in the total amount of the liability assumed pursuant to the exchange) will, for purposes of Section 351, be considered as money received by the taxpayer on the exchange.

5. **Control.** Another requirement that must be met for the nonrecognition rules of Section 351 to apply is that the transferors of the property to the corporation must be in “control” after the transaction. Section 368(c) defines the term “control” to mean the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. An example of where this test would not be met is where even though the sole proprietor or individual owner of the disregarded entity receives the requisite ownership “immediately after the exchange,” there is a plan to transfer stock to non-transferors as part of the same transaction. Three tests are primarily used to determine whether the transferors have control of the corporation “immediately after the exchange”:

a. **Binding Commitment Test.** The binding commitment test is relatively straightforward. If, at the time the parties commence the first transaction, they are under a binding commitment to undertake the subsequent transactions, then all transactions will be integrated into one transaction.

b. **Mutual Interdependence Test.** This test has been articulated as being the question of whether “the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.”

c. **End Results Test.** Under the end results test, the IRS looks to whether the parties intended in the beginning to achieve a particular result, and whether the separate steps were merely entered into as a means of achieving that result.

6. **Basis for Stock.** Under Section 358(a)(1), in the case of an exchange to which Section 351 applies, the basis of the stock received by the transferor is the same as the basis of the property exchanged: (a) decreased by the
fair market value of any other property and money received by the taxpayer; (b) decreased by the amount of loss to the taxpayer which was recognized on the exchange; and (c) increased by the amount of gain to the taxpayer which was recognized on such exchange (a “substituted basis”).

7. **Holding Period for Stock.** The holding period for the stock received in the exchange will receive “tacking” of the holding period of any assets transferred to the corporation, provided, however, ordinary income assets (assets other than a capital asset as defined in Section 1221 or property described in Section 1231) are not entitled to tacking and the holding period for the stock begins on the date following the date of the exchange. Section 1223(1).

C. **Tax Consequences to the Corporation.**

1. **Nonrecognition of Gain or Loss.** Under Section 1032(a), no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation.

2. **Basis of Property Contributed to Corporation.** Under Section 362(a)(1), the basis of property contributed to a corporation in a transaction to which Section 351 applies is equal to the basis of the assets in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer (a “carryover” or “transferred” basis).

3. **Holding Period of Property Contributed to Corporation.** Since the assets will have a “carryover” or “transferred” basis to the transferee corporation, Section 1223(2) allows the transferee corporation to tack on the transferor’s holding period for the contributed assets.

D. **Other Considerations.**

1. **Employer Identification Number.** In the case of the incorporation of a sole proprietorship, a new employer identification number will need to be obtained for the corporation. In the case of an election by a disregarded entity such as a single-member LLC to be treated as an association taxable as a corporation, the conversion of a disregarded entity into a corporation under the applicable state law formless conversion statute, or the merger of a disregarded entity into a corporation under the applicable state law cross-entity merger statute, if the disregarded entity had an employer identification number prior to the transaction, then the corporation would use that number; otherwise, the corporation must obtain a new employer identification number.

2. **S Election.** Regardless of whether the transaction involves the incorporation of a sole proprietorship, the election by a disregarded entity under the check-the-box regulations to be treated as an association taxable
as a corporation, the conversion of a disregarded entity such as a single-member LLC under the applicable state law formless conversion statute, or the merger of a disregarded entity into a corporation under the applicable state law cross-entity merger statute, if the corporation desires to be taxed as an S corporation, an S election will need to be filed for the corporation within two months and fifteen days of the incorporation, election to be treated as a corporation, conversion or merger, as the case may be. Sections 1362(a) and (b).

IV. CHANGING A PARTNERSHIP INTO A CORPORATION

A. Incorporation of a Partnership. In Rev. Rul. 84-111, 1984-2 C.B. 88, the IRS permitted taxpayers to choose their tax treatment in partnership incorporation transactions by structuring the transaction in one of three ways. Each of the three methods treats the incorporation as a two-step process.

B. “Assets Over” Transaction. The first method set forth in Rev. Rul. 84-111, is the so-called “assets over” or “partnership asset transfer” approach. Under this approach, the partnership first transfers its assets to the newly organized corporation in exchange for the stock and the assumption by the corporation of the liabilities of the partnership, and in the second step the partnership liquidates by distributing the corporate stock received in the incorporation transaction to the partners in accordance with their partnership interests.

1. Tax Consequences to Partnership on First Step of Transaction: Transfer of Assets by the Partnership to the Corporation.

a. Under Section 351, generally no gain or loss will be recognized by the partnership on the transfer of all of its assets to the corporation for the corporation’s stock and the assumption by the corporation of the partnership’s liabilities.

b. Under Section 358(a), the basis to the partnership of the stock received from the corporation is the same as the basis to the partnership of the assets transferred to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as the payment of money to the partnership under Section 358(d). Additionally, the assumption by the corporation of the partnership’s liabilities decreases each partner’s share of the partnership liabilities, and as such, decreases the basis of each partner’s partnership interest under Sections 752 and 733.

c. Under Section 1223(1) of the Code, the partnership’s holding period for the stock received in the exchange includes its holding period in the capital assets and Section 1231 assets transferred to the corporation (to the extent that the stock is received in exchange for such assets). To the extent that stock was received in exchange
for non-capital/non-1231 assets, the partnership’s holding period for such stock begins on the date following the date of the exchange. See Rev. Rul. 70-598, 1970-2 C.B. 168.

2. **Tax Consequences to Corporation on First Step of Transaction**

   a. Under Section 1032, the corporation recognizes no gain or loss on the issuance of its stock to the partnership in exchange for the partnership’s assets.

   b. Under Section 362(a), the corporation’s basis in the assets received from the partnership generally equals their basis to the partnership immediately before the transfer (i.e., a carryover basis). If the partnership had a lower basis in its assets than the partners have in their partnership interests, this could result in the corporation receiving a lower basis than it would have had if the partners transferred their partnership interests to the corporation in an “interests over” transaction discussed below. However, the corporation should receive the benefit of any prior step-ups in basis attributable to a sale, exchange or distribution transaction to which a Section 754 election previously applied.

   c. Because the corporation will generally receive a carryover basis in the assets of the partnership, the corporation will continue to depreciate such carryover basis in the same manner as the assets were previously being depreciated by the partnership. However, any increase of basis resulting from the various gain recognition rules discussed above would be subject to the depreciation period, method and convention applicable to a newly acquired asset.

   d. Under Section 1223(2), the corporation’s holding period in the assets transferred to it will include the partnership’s holding period in such assets.

3. **Tax Consequences to Partners on Second Step of Transaction: Distribution of Stock in Liquidation of Partnership**

   a. Under Section 731(a), no gain or loss will be recognized by the partners upon the distribution of the stock of the corporation to the partners in complete liquidation of the partnership.

   b. Under Section 732(b), the adjusted bases of the former partners in their stock of the new corporation will be the same as the adjusted bases in their interests in the partnership (as increased by any gain resulting from the transfer of the partnership’s assets to the corporation, and decreased by any liabilities transferred to the corporation, in the first step of the transaction).
c. As discussed in IV.B.1.c. above, the parties will receive a tacking of holding period for the stock received to the extent the stock was received in exchange for capital or Section 1231 assets.

4. **Tax Consequences to Partnership on Second Step of Transaction.**
   a. Under Section 731(b), the partnership will recognize no gain or loss on the distribution of the stock of the corporation to the partners in complete liquidation of the partnership.
   
b. Under Section 708(b)(1)(A), the partnership will be terminated.

5. **Other Tax Consequences.**
   a. Rev. Rul. 84-111 also provides that the momentary ownership by the partnership of the corporation’s stock should not violate the control requirement of Section 368(c) of the Code.
   
b. Additionally, the momentary ownership of the corporation’s stock by the partnership will not preclude it from qualifying as an S corporation so that it will not be subject to the built-in-gain tax. See Section 1374(c)(1). Also see PLR 8926016 (March 29, 1989); PLR 9421022 (Feb. 24, 1994); PLR 9422055 (March 10, 1994); and Rev. Rul. 72-320, 1972-1 C.B. 270.
   
c. Finally, stock received in an “assets over” partnership incorporation may not satisfy the original issuance requirement in order to qualify for Section 1244 loss treatment, whereas stock received under the “assets up” and “interests over” methods, which will be discussed below, may qualify for Section 1244 loss treatment.

C. **“Assets Up” Approach.** Under this approach, the partnership first liquidates by distributing its assets, subject to its liabilities, to its partners. The second step is the transfer by the partners of assets received from the partnership to the transferee corporation in exchange for the stock of the corporation.

1. **Tax Consequences to Partners on First Step of Transaction: Liquidation of the Partnership.**
   a. Under Section 731(a), in general no gain or loss will be recognized by the partners upon their complete liquidation of the partnership, with certain exceptions. Under Sections 731(a)(1) and (c), gain is recognized to the extent that a partner’s share of cash, and with certain exceptions, marketable securities, distributed to him exceeds his adjusted basis in the partnership. Additionally, a partner may be required to recognize gain on the liquidation if he contributed appreciated property to the partnership within the last 7
years under Sections 704(c)(1)(D) and 737. However, these provisions do not apply to the extent the partner receives back the same property he originally contributed, or receives only a portion of that property and no other property. Sections 704(c)(1)(B), 737(d), 751(b)(2)(A), and Treas. Reg. § 1.704-4(c)(2). The gain recapture rules only apply to “assets up” transactions. Treas. Reg. §§ 1.704-4(c)(4) and 1.737-2(c).

b. Under Section 732(b), the basis of the partners in the assets deemed distributed in liquidation of the partnership will be based upon the partners’ adjusted basis in their partnership interests, rather than the partnership’s prior basis in the assets themselves. Consequently, the “assets up” approach may produce a different result than the “assets over” approach. Each partner’s basis in his partnership interest will then be allocated separately among the assets distributed by the partnership (and subsequently contributed to the corporation by the partners) in the following manner:

(1) Each partner’s basis in his partnership interest is allocated first to Section 751 property to the extent of the partnership’s basis in the assets. To the extent the new partner receives more or less than his proportionate share of Section 751 property, there is a deemed sale.

(2) Any remaining basis of the partner in his partnership interest is allocated among the partnership’s non-Section 751 property. If there is excess partner interest basis left over after the allocation to Section 751 property and there is no non-Section 751 property, the partner may be able to recognize a capital loss. See Section 731(a)(2) and Treas. Reg. § 1.732-1(c)(3).

(3) Any differences between the partner’s aggregate basis in his partnership interest and the partnership’s aggregate asset basis to which that partner’s partnership interest basis is allocated is used first to reduce the disparities between the fair market value and the adjusted basis of the individual assets.

(4) Any excess remaining basis is allocated among all of the partnership’s non-Section 751 property in proportion to fair market value. If there is a deficiency in partner interest basis at either the Section 751 property allocation step or the non-Section 751 property step, the deficiency is allocated in proportion to the partnership’s basis in the relevant category of assets.
c. Under Section 735(b), the partners’ holding periods for the assets distributed to them by the partnership generally includes the partnership’s holding period in such assets.

2. **Tax Consequences to Partnership on First Step of transaction.**

   a. On the liquidating distribution of all of the partnership’s assets to its partners, the partnership terminates under Section 708(b)(1)(A)

   b. Under Section 731(b), the partnership recognizes no gain or loss on the liquidating distribution of its assets to its partners.

3. **Tax Consequences to Partners on Second Step of Transaction: Transfer of Assets to the Corporation in Exchange for Stock.**

   a. Under Section 351, no gain or loss is recognized by the partnership’s former partners on the issuance by the corporation of its stock for the assets and liabilities of the partnership received by the partnership’s partners in liquidation of the partnership.

   b. Under Section 358(a)(1), the basis to the former partners of the stock received from the corporation is the same as the Section 732(b) basis to the former partners in the assets received in liquidation of the partnership (and transferred to the corporation), reduced by the liabilities assumed by the corporation, which assumption is treated as the payment of money to the partners under Section 358(d).

   c. Under Section 1223(1), the partners’ holding periods for the stock received in the exchange includes the partners’ holding periods in the capital assets and Section 1231 assets transferred to the corporation (to the extent that the stock was received in exchange for such assets). However, to the extent that the stock received was in exchange for non-capital and non-1231 assets, the holding period of the stock begins on the date following the date of the exchange.

4. **Tax Consequences to Corporation on Second Step of Transaction.**

   a. Under Section 1032, the corporation recognizes no gain or loss upon the issuance of its stock in exchange for the assets contributed to the corporation by the former partners of the partnership which they received in liquidation of the partnership.

   b. Under Section 362(a), the corporation’s basis in the assets received from the former partners of the partnership equals the basis of the former partners as determined under Section 732(b) and allocated
among the assets under Section 732(c) immediately before the transfer to the corporation.

c. Under Section 1223(2), the corporation’s holding period of the assets received from the former partners of the partnership generally includes the partners’ holding periods in such assets.

d. Again, to the extent the corporation receives a carryover basis in the assets of the partnership, the corporation will continue to depreciate such carryover basis in the same manner as the assets were previously being depreciated by the partnership. However, any increase of basis resulting from the various deemed recognition rules would be subject to a new depreciation period, method and convention applicable to a newly acquired asset.

D. **“Interests Over” Approach**. Under the third approach set forth in Rev. Rul. 84-111, the partners first transfer their partnership interests to the transferee corporation in exchange for the corporation’s stock, and in the second step the partnership automatically dissolves because it has only one partner.

1. **Tax Consequences to Partners on First Step of Transaction: Transfer of Partnership Interests to Corporation in Exchange for Stock**.

   a. Under Section 351, generally no gain or loss should be recognized by the partners on the transfer of their partnership interests to the corporation in exchange for the corporation’s stock.

   b. Under Section 358(a), the adjusted basis of the partners in the stock of the corporation should be equal to the basis in their partnership interests, reduced by any liabilities assumed.

   c. Under Section 1223(1), the holding periods of the partners for the stock received from the corporation will include the respective holdings periods in their partnership interests, except that stock received for Section 751 assets that are not capital/1231 assets will have a new holding period.

2. **Tax Consequences to Corporation on First Step of Transaction**.

   a. Under Section 1032, the corporation will recognize no gain or loss on the issuance of its stock to the partners in exchange for their partnership interests.

   b. Under Section 362(a), the corporation’s basis in the partnership interests received from the former partners of the partnership should be equal to the former partners’ basis in their partnership interests.
c. Under Section 1223(2), the corporation’s holding period in the partnership interests received from the former partners of the partnership should generally include the partners’ holding periods for their partnership interests.

3. **Tax Consequences to Partnership on Second Step of Transaction:**
   **Liquidation of the Partnership.**

   a. Under Section 708(b)(1)(A), the partnership will terminate since it only has one partner.

   b. Under Section 731(b), the partnership will recognize no gain or loss on the distribution of its assets in liquidation to the corporation.

4. **Tax Consequences to Corporation on Second Step of Transaction.**

   a. Under Section 732(b), the corporation’s adjusted basis in the assets it receives in the deemed liquidation of the partnership should be equal to the corporation’s basis in the partnership interests, which in turn is equal to the partners’ adjusted basis in their partnership interests. However, the basis allocation rules under Section 732(c) may produce different results in the “interests over” method than in the “assets up” method, because there is only one partner upon dissolution of the partnership.

   b. Under Section 1223(2), the corporation’s holding period in the assets includes the partnership’s holding period in the assets.

   c. The corporation should continue to use the partnership’s depreciation method, etc. on the carryover basis of any transferred assets, and the corporation’s holding periods for such assets should be the same as the partnership’s historical holding periods. However, as discussed above, any increase in basis would have to be recovered under a new depreciation method and period, and a new holding period would begin for such assets.

E. **Incorporation of Partnership Under the Check-the-Box Regulations.** Under Treas. Reg. § 301.7701-3(g)(1)(i), elections from partnership to corporation status under the check-the-box regulations are treated as made under the “assets over” approach.

F. **Conversion of a Partnership to a Corporation Under Applicable State Law Formless Conversion Statute.** Rev. Rul. 2004-59, 2004-1 C.B. 1050, provides that when a partnership is converted to a corporation under the applicable state law formless conversion statute, the “assets over” approach applies.
G. **Merger of Partnership into a Corporation Under Applicable State Law Cross-Entity Merger Statute.** Presumably, the merger of a partnership into a corporation under the applicable state law cross-entity merger statute will also be treated as made under the “assets over” approach. See PLR 9409035 (Dec. 7, 1993).

V. **CHANGING A CORPORATION INTO A SOLE PROPRIETORSHIP OR A DISREGARDED ENTITY (SINGLE-MEMBER LIMITED LIABILITY COMPANY)**

A. **In General.** As opposed to an “incorporation” transaction such as the incorporation or conversion of a sole proprietorship or partnership into a corporation, the changing of a corporation or association taxed as a corporation into a sole proprietorship (or a partnership as will be discussed below), constitutes a “de-incorporation” transaction, which will result in a taxable liquidation of the corporation. One of the simplest types of de-incorporation transactions, is the changing of a corporation into a sole proprietorship or single-member LLC treated as a disregarded entity for tax purposes.

1. As with the incorporation transactions discussed above, the change in entity status can be achieved by the actual liquidation of the corporation or an LLC which elected to be treated as an association taxable as a corporation, the conversion of a corporation into a single-member LLC (which does not elect to be treated as an association taxable as a corporation) under the applicable state law formless conversion statute, the merger of the existing corporation into a single-member LLC (which does not elect to be treated as an association taxable as a corporation) under the applicable state law merger statute, or for an eligible entity such as an LLC which has previously elected to be treated as an association taxable as a corporation, the filing of a Form 8832, Entity Classification Election, to change the status of the entity from an association taxable as a corporation to a disregarded entity.

2. Whether achieved by a simple liquidation of the corporation to the sole shareholder who will operate the business as a sole proprietorship or form a new single-member LLC to operate the business, the conversion of a corporation into a single-member LLC under the applicable state law formless conversion statute for which an election is not made to treat the single-member LLC as an association taxable as a corporation, the merger of a corporation into a single-member LLC under the applicable state law merger statute where no election is made to treat the single-member LLC as an association taxable as a corporation, or the filing of a Form 8832 election for a change in classification of an eligible entity such as a single-member LLC which previously elected to be treated as an association taxable as a corporation to be treated as a disregarded entity, the tax consequences to the corporation and the shareholder should be the same.
B. Tax Consequences to the Corporation.

1. Recognition of Gain or Loss. Under the general rule of Section 336, the corporation will be treated as distributing all of its assets and liabilities to its sole shareholder in complete liquidation of the corporation. Specifically, Section 336(a) provides that the corporation will be treated as if its property were sold to the distributee at its fair market value.

2. Treatment of C Corporation Versus S corporation. Any gain or loss realized under Section 336 will be recognized at the corporate level if the corporation is taxed as a C corporation, but generally will not be subject to taxation at the corporate level if the corporation is an S corporation. Rather, such gain or loss will be passed through to the shareholders of the S corporation under Section 1366, and in turn increase their bases in the S corporation under Section 1367. However, if the S corporation is subject to the built-in gain tax imposed under Section 1374, the deemed sale of the property could trigger built-in gain tax at the corporate level.

3. Beware of Section 1239. Because Section 336(a) provides that the property is treated as sold to the distributee at its fair market value, any gain attributable to depreciable property distributed to a shareholder owning more than 50% of the stock of the corporation may be subject to ordinary income, rather than capital/Section 1231 gain. Although this may not be important in the C corporation context since C corporations do not enjoy special capital gain rates, Section 1239 can have a significant impact on S corporations since the gain would flow through to the shareholders as ordinary income rather than as capital gain, and could cause a mismatching of ordinary income against capital loss. This poses a significant trap for the unwary.

4. Deductibility of Loss on Liquidation. The corporation, whether a C or S corporation, will be allowed to deduct any losses on the deemed sale (to the extent the adjusted tax basis to the corporation of its assets exceeds the fair market value of such assets at the time of the distribution), with the following exceptions:

   a. Under Section 336(d)(1), no loss will be allowed on distributions to a more than 50% shareholder, unless the distribution is pro rata and the property was not acquired in a tax-free contribution transaction during the preceding 5-year period.

   b. Under Section 336(d)(2), the IRS could disallow a loss on previously contributed property if “a” principal purpose of the contribution of that property was to recognize loss in connection with the liquidation.
C. **Tax Consequences to the Shareholder.**

1. **Recognition of Gain or Loss.** In addition to corporate-level gain or loss, under Section 331(a), the shareholder will recognize gain or loss to the extent the fair market value of the assets distributed to the shareholder exceeds such shareholder’s basis in the stock of the corporation or loss to the extent the shareholder’s adjusted tax basis in the stock of the corporation exceeds the fair market value of the property distributed to the shareholder. Any shareholder-level gain will constitute capital gain or loss if the shareholder has held his stock for more than one year. Section 1222.

2. **C Corporations Versus S Corporations.** Although both C corporation and S corporation shareholders will recognize gain or loss at the shareholder level, there should generally only be one level of tax in the event the corporation is an S corporation because any gain recognized at the corporate level under Section 336 will pass through to the shareholder under Section 1366(a) and increase such shareholder’s basis in his stock under Section 1367(a). Note, however, if ordinary income is triggered at the corporate level, by reason of gain from inventory, depreciation recapture or the application of Section 1239, as discussed above, any capital loss recognized at the shareholder level may not offset the ordinary income passed through to the shareholder under Section 1366. Under Section 1211(b), in the case of a taxpayer other than a corporation, losses from the sale or exchange of capital assets are allowed only to the extent of the taxpayer’s capital gains plus up to $3,000 of ordinary income per year.

3. **Qualified Subchapter S Trusts.** Another possible mismatching of gain and loss could occur in the case of the sale of S corporation stock by a qualified subchapter S trust (QSST), if the gain passing through from the S corporation is taxable to the current income beneficiary, whereas the loss on liquidation is taxable to the trust itself. However, the IRS has made it clear that both the loss and the corresponding gain in such situations should be reported by the QSST. See PLR 9721020 (Feb. 20, 1997), which provides that if an S corporation liquidates, the trust should report both (a) the Section 331 gain or loss on the stock; and (b) the Section 336 gain or loss that passes through from the corporation.

VI. **CHANGING A CORPORATION INTO A PARTNERSHIP**

A. **In General.** As discussed above, whether achieved through an actual liquidation of the corporation and transfer of the assets of the liquidated corporation to a newly formed partnership or LLC taxed as a partnership, the conversion of a corporation to a partnership or LLC taxed as a partnership under the applicable state law formless conversion statute, the merger of a corporation into an LLC taxed as a partnership under the applicable state law merger statute, or the filing
of a Form 8832 changing the classification of an eligible entity taxed as an association to an entity taxed as a partnership, such de-incorporation transactions will be treated as a liquidation of the corporation on which gain or loss is recognized at the corporate level under Section 336 and at the shareholder level under Section 331. Unlike the change of a corporation wholly owned by a single shareholder into a single-member LLC or sole proprietorship, however, the change of a corporation with multiple shareholders into an entity taxed as a partnership will involve a second step involving the formation of the new partnership. Although there is no corollary to Rev. Rul. 84-111 in the de-incorporation context (as opposed to the incorporation context), the form selected by the taxpayers should be respected by the IRS for tax purposes. In other words, taxpayers may be free to choose among the three alternative approaches -- assets up, assets over, and interests over -- available in partnership incorporation transactions in connection with de-incorporation transactions.

B. “Assets Up” Approach for De-Incorporation Transactions. In the absence of specifically structuring the transaction otherwise, most practitioners would agree that the “assets up” approach would most likely be applied to the changing of an entity from corporation status to partnership status. Under this approach, the corporation will be treated as first liquidating by distributing all of its assets, subject to its liabilities, to its shareholders. The second step would be the transfer of the assets received by the shareholders from the corporation to the transferee partnership (or LLC taxed as a partnership) in exchange for partnership interests. The “assets up” approach would seem the most straightforward and intuitive approach for the change in entity status of a corporation into a partnership. In PLR 9701032 (Oct. 3, 1996) and PLR 7802043 (Oct. 17, 1977), the IRS applied the “assets up” approach in situations where the transactions were actually structured as “assets up” transactions. Additionally, PLR 8837068 (June 22, 1988), the IRS applied the “assets up” approach where the transaction was actually structured as an “assets over” transaction.

1. Tax Consequences to Corporation on First Step of Transaction: Distribution of Assets to Shareholders in Liquidation of Corporation.

a. Under the general rule of Section 336(a), gain or loss will be recognized to the liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distribute at its fair market value.

b. In the case of a C corporation, the gain or loss will be recognized at the corporate level, and in the case of an S corporation, the gain or loss will generally flow through to the shareholders under Section 1366(a), unless the corporation is subject to the built-in gain tax imposed under Section 1374.

c. As discussed above, because Section 336(a) provides that the property is treated as sold to the distribute at its fair market value,
any gain attributable to depreciable property distributed to a shareholder owning more than 50% of the stock of the corporation may be characterized as ordinary income, rather than capital/Section 1231 gain, pursuant to Section 1239.

d. Losses will generally be allowed to the extent the corporation’s tax basis in the property exceeds it fair market value, provided, however, that under Section 336(d)(1), no loss is allowed on distributions to a more than 50% shareholder, unless the distribution is pro rata and the property was not acquired in a tax-free contribution transaction during the preceding 5-year period, and under Section 336(d)(2), no loss is allowed on previously contributed property if “a” principal purpose of the contribution of such property was to recognize loss in connection with the liquidation.

2. **Tax Consequences to Shareholders on First Step of Transaction.**

   a. Also, as discussed above, in addition to the gain or loss recognized at the corporate level, the deemed or actual liquidation will be taxable to the shareholders under Section 331(a), regardless of whether the corporation is a C or S corporation. Gain or loss at the shareholder level will again be capital gain or loss provided that the stock has been held for more than one year. Additionally, as discussed above, for S corporations, unlike C corporations, there should generally be only one level of tax because gain recognized at the corporate level will pass through to the shareholders under Section 1366(a) and increase basis at the shareholder level under Section 1367(a). Again, however, ordinary income could be triggered at the corporate level from depreciation recapture, inventory or the application of Section 1239, which would result in not being able to offset capital losses at the shareholder level against the ordinary income at the corporate level passed through to the shareholders under Section 1366(a).

   b. Under Section 334(a), the shareholders will receive a fair market value basis in the assets received in liquidation of the corporation.

3. **Tax Consequences to Partners on Second Step of Transaction: Contribution of Assets Received in Liquidation of Corporation by Former Shareholders to Partnership.**

   a. Under the second step of the “assets up” approach, the shareholders will be treated as having contributed their assets received in liquidation of the corporation to the partnership. In general, no gain or loss should be recognized on the contribution of the assets received in liquidation to the partnership because the
assets being contributed will have a full fair market value basis under Section 334(a), and Section 721(a) generally provides that no gain or loss is recognized to the partners upon a contribution of property to the partnership. Possible exceptions to the partners not recognizing gain or loss could include:

(1) the “investment company” rules under Section 721(b), or

(2) gain recognized as the result of a constructive distribution under Section 752(b) where a partner has a net reduction in liabilities as part of the partnership formation transaction in excess of his adjusted basis in the assets contributed to the partnership.

b. Each partner’s basis in his partnership interest should be equal to the adjusted basis of the assets contributed (which will be their fair market value under Section 334(a)), and a new holding period for the partnership interests would start on such date under Section 1223(1).

4. Tax Consequences to Partnership on Second Step of Transaction

a. The partnership will generally recognize no gain or loss on its receipt of the assets received by the shareholders in liquidation of the corporation to the partnership under Section 721(a).

b. Additionally, the partnership should receive a carryover basis in the contributed assets (equal to their fair market value).

c. The holding period for the contributed assets will begin on the date of receipt by the partnership of such assets from the partners under Section 1223(2).

C. “Assets Over” Approach for De-Incorporation Transaction. Under this approach, the corporation first will be treated as transferring its assets, subject to its liabilities, to a newly organized partnership in exchange for partnership interests, and in the second step of the transaction, the corporation would liquidate by distributing the partnership interests to its shareholders, which would result in the individual shareholders becoming the partners of the partnership. Because the newly-formed partnership would be momentarily wholly-owned by the corporation before the distribution of the partnership interests in liquidation of the corporation, a question arises as to whether a separate partnership entity actually exists, rather than a disregarded entity. Consequently, the application of the “assets over” approach on a de-incorporation transaction is conceptually problematic. As a result of this issue, some practitioners seeking “assets over” treatment in the context of a de-incorporation transaction form a bona fide partnership with one or more outside partners as part of the first step of the “assets
over” approach. See PLR 200214016 (Dec. 21, 2001); PLR 9701029 (Oct. 2, 1996); and PLR 9543017 (July 26, 1995).

1. **Tax Consequences to Corporation on First Step of Transaction: Transfer of Assets to the Partnership in Exchange for Partnership Interests.**
   a. On the transfer of the corporation’s assets to the partnership, no gain or loss would be recognized by the corporation under Section 721(a) if the entity is treated as a partnership. Alternatively, no gain or loss should be recognized if the entity is treated as a disregarded entity since no taxable transaction occurs upon the transfer by the corporation of its assets to a disregarded entity.
   b. Under Section 722, the corporation should receive a basis in the partnership interests equal to the corporation’s basis in the assets it contributed to the partnership.
   c. Under Section 1223(1), the corporation should be able to “tack” the holding period of the contributed assets to its holding period for the partnership interest to the extent the partnership interests were received in exchange for capital/Section 1231 assets.

2. **Tax Consequences to Partnership on First Step of Transaction.**
   a. In general, the partnership will not recognize gain or loss on the contribution of the assets by the corporation to the partnership.
   b. Although certainly not as clear as the “assets up” approach discussed above, under the “assets over” approach, the new partnership may **not** receive a stepped-up basis in its initial assets under Section 723. To the extent the assets contributed by the corporation to the partnership receive a carryover basis, the new partnership should be able to continue to depreciate the old basis in the same manner as the predecessor corporation and the partnership should also receive tacking of the corporation’s holding period with respect to any assets having a carryover basis pursuant to Section 1223(2).

3. **Tax Consequences to Corporation on Second Step of Transaction: Distribution of Partnership Interests in Liquidation of Corporation.**
   a. The second step in the “assets over” approach would be a fully taxable liquidation of the corporation under Section 336(a) by distribution of the new partnership interests received by the corporation to the shareholders of the corporation in liquidation of the corporation.
b. Because partnership interests rather than assets are being distributed in the deemed liquidation, the gain should be capital except to the extent attributable to Section 751 assets. Similarly, depreciation recapture might be avoided and Section 1239 ordinary income treatment might be avoided since partnership interests are non-depreciable as opposed to the distribution of depreciable assets.

4. **Tax Consequences to Shareholders on Second Step of Transaction.**

a. Under Section 331(a), the shareholders will be subject to taxation to the extent the fair market value of the partnership interests exceeds their basis in the stock of the corporation.

b. Under Section 334(a), the former shareholders of the corporation would receive a fair market value basis in the partnership interests received in liquidation of the corporation. The shareholders may be able to make a Section 754 election to trigger an upward basis adjustment of the assets inside the partnership on the taxable corporate liquidation. See PLR 9701029 (Oct. 2, 1996); and PLR 9543017 (July 26, 1995). This would address the concerns discussed in VI.C.2.b. above regarding the partnership not receiving a stepped-up basis in the assets.

D. **“Interests Over” Approach.** Under the third approach, the shareholders would actually transfer their stock to the transferee partnership in exchange for partnership interests, and the corporation would then be liquidated into the partnership.

1. **Tax Consequences to Shareholders on First Step of Transaction: Contribution of Stock to Partnership in Exchange for Partnership Interests.**

a. Under this approach, no gain or loss should be recognized by the shareholders on the transfer of their stock to the partnership in exchange for partnership interests under Section 721(a).

b. Under Section 722, the shareholders should receive a substituted basis in their partnership interests equal to the basis they had in their stock of the corporation and should receive a tacking of the holding periods for such partnership interests under Section 1223(1).

c. A major pitfall of the “interests over” approach is that if the corporation is an S corporation, the momentary ownership of the corporation’s stock by the partnership in the first step of the transaction may terminate the corporation’s S corporation election. This in turn will result in double taxation as a result of the inability
to pass through any gain recognized by the corporation on the second step of the transaction to its shareholders under Section 1366, and in turn, increasing their basis under Section 1367.

2. **Tax Consequences to Partnership on First Step of Transaction.**

   a. Under Section 721(a), no gain or loss should be recognized by the partnership on the contribution of the stock to the partnership by the shareholders of the corporation in exchange for partnership interests.

   b. Under Section 723, the partnership’s basis in the stock of the corporation should be the adjusted basis of the stock to the shareholders at the time of the contribution (a “substituted” or “transferred” basis).

   c. Under Section 1221(2), the partnership should be able to “tack” the holding period for which the shareholders held the stock of the corporation to its holding period for the stock.

3. **Tax Consequences to Corporation on Second Step of Transaction: Liquidation of Corporation by Distribution of Assets to the Partnership.**

   a. The corporation would recognize gain or loss under Section 336(a) on the second step of the “interests over” approach as its assets will be treated as distributed to the partnership in liquidation of the corporation.

   b. If the corporation was an S corporation, and the momentary ownership of the corporation’s stock by the partnership terminates the corporation’s S status as discussed above, the liquidation would result in double taxation on the liquidation the same as if the corporation were a C corporation.

4. **Tax Consequences to Partnership on Second Step of Transaction.**

   a. Under Section 331(a), the partnership will recognize gain or loss to the extent the fair market value of the assets received by it in liquidation of the corporation exceeds the partnership’s basis in the stock of the corporation.

   b. Under Section 334(a), the partnership will have a fair market value basis in the assets it receives in liquidation of the corporation.

   c. Finally, if the shareholders’ respective adjusted bases in their stock of the corporation differ, Section 704(c) should apply to allocate
the gain on the liquidation in proportion to the appreciation in their respective stock holdings.

E. **Check-the-Box Regulations.** If an eligible entity has elected to be treated as an association taxed as a corporation, and makes an election on Form 8832 to change its classification to that of a partnership, Treas. Reg. §§ 301.7701-3(g)(1)(ii) and (iii) *expressly provide that the “assets up” treatment will apply.*

F. **State Law Formless Conversion Statute.** Unlike Rev. Rul. 2004-59, which specifies the treatment of the conversion of a partnership into a corporation under the applicable state law conversion statute, there is no clear guidance on how a liquidation should be treated when it is effectuated through the conversion of a corporation into a partnership or LLC taxed as a partnership under the applicable state law formless conversion statute. However, a number of private letter rulings have applied “assets up” treatment in such cases. See, e.g., PLR 200129029 (April 20, 2001) (“assets up” approach applied to conversion of a subsidiary corporation into a limited liability company); and PLR 9401014 (Oct. 7, 1993) (“assets up” approach applied on apparent conversion of foreign subsidiary into foreign partnership).

G. **Cross-Entity Merger Statute.** There is no clear guidance on how the deemed liquidation should occur when a corporation is merged into a limited liability company taxed as a partnership under an applicable state law cross-entity merger statute. However, a number of private letter rulings have used the “assets over” approach where a corporation has been merged into an LLC taxed as a partnership pursuant to applicable state law cross-entity merger statutes. See, e.g., PLR 200628008 (March 28, 2006) (merger of two S corporations into a limited liability company utilizes “assets over” approach); PLR 200606009 (Oct. 17, 2005) (merger of a corporation into a limited liability company electing to be treated as a partnership utilizes “assets over” approach); PLR 200333020 (May 6, 2003) (merger of corporate subsidiaries into partnerships utilizes “assets over” approach); PLR 200310026 (August 27, 2002) (merger of parent corporation into subsidiary partnership utilizes “assets over” approach); PLR 200214016 (Dec. 21, 2001) (merger of a corporation owned by two higher tiered corporations into a limited liability company utilizes “assets over” approach); PLR 9701029 (Oct. 2, 1996) (merger of a C corporation into a limited liability company with a Section 754 election utilizes “assets over” approach); PLR 9543017 (July 26, 1995) (merger of S corporation into limited liability company with a Section 754 election utilizes “assets over” approach); PLR 9409016 (Nov. 30, 1993), 9409014 (Nov. 29, 1993), and 9404021 (Nov. 1, 1993) (merger of corporate subsidiary into subsidiary partnership utilizes “assets over” approach).

VII. **CONVERSIONS OF A DISREGARDED ENTITY INTO A PARTNERSHIP AND A PARTNERSHIP INTO A DISREGARDED ENTITY**

A. **In General.** The acquisition of a disregarded entity by a single buyer is treated for federal income tax purposes as the sale of assets by the owner of the
disregarded entity which neither elected or converted to association status. The check-the-box regulations do not address a change in tax status caused by a change in number of members, but this subject has been addressed by the IRS in two well-known rulings: Rev. Rul. 99-5, 1999-1 C.B. 434 (increase in number of owners of disregarded entity from one to two or more), and Rev. Rul. 99-6, 1999-1 C.B. 432 (sale of membership interest in a partnership to a single purchaser resulting in the conversion to a disregarded entity).

B. Conversion of a Disregarded Entity into a Partnership: Increase From One Member to Two (or More) Members. In Rev. Rul. 99-5, supra, two scenarios involving the conversion of a disregarded entity into a partnership are discussed. In both cases, A owns 100% of the interests in an LLC valued at $10,000 and B purchases a 50% interest from A.

1. In situation one, B acquires the interest from A for $5,000. The transaction is treated as a sale of one-half of each asset to B, followed by a contribution of all of the assets by A and B to a new partnership. A recognizes gain or loss on the sale of each asset held by the LLC.

2. In situation two, B acquires a new 50% interest in the LLC from the LLC for $10,000 and the proceeds of the sale are retained in the business of the LLC. The transaction is treated as a transfer of all of the assets by A to a new partnership for an interest in the partnership, and a transfer of cash by B to the new partnership. No gain or loss, in general, is recognized by either party under Section 721.

3. What if A transfers an interest in the LLC to B, but A contributes the cash to the business, so that their interests were 2/3 to A and 1/3 to B? Would the form of the transaction be followed, resulting in gain to A on an asset sale to B, or would the transaction be treated as a subscription by B to a 1/3 interest in the resulting partnership, resulting in nontaxable Section 721 treatment to A? See Monte A. Jackel, “New Rulings Address One-to-Two and Two-to-One Entity Conversions”, 82 Tax Notes 1167 (Feb. 22, 1999).

4. What if B purchases his interest directly from the LLC but cash is distributed to A? Presumably the disguised sales rules under Section 707(a)(2)(B) would apply. This result could also occur if A caused new liabilities to be assumed by the new entity.

5. Other Consequences. Each version will have a varying outcome with respect to: (i) basis; (ii) holding period; (iii) Section 704(c) attributes and possibly with respect to Section 197.

C. Conversion of a Partnership into A Disregarded Entity: Purchase of All of the Interests in an LLC Taxable as a Partnership by One Buyer.
1. In Rev. Rul. 99-6, the IRS addressed the purchase of all of the interests in an LLC taxed as a partnership by a single purchaser, resulting in a conversion to an single-member LLC.

2. In situation one, A and B are each equal 50% owners of an LLC. B purchases A’s interest in the LLC for 10X and continues to operate the business as a single member LLC. The ruling concludes that: (i) the partnership terminates under Section 708(b)(1)(A); (ii) A, under Section 741, is treated as selling his partnership interest to B; and (iii) B, however, is treated as if the LLC first made a liquidating distribution of all of its assets to A and B and then B acquired the assets deemed distributed to A for full monetary consideration paid. B would therefore have a carryover basis in 1/2 of the assets (his pre-purchase share and tacking of holding period for his interest) and a fair market value purchase price basis in 1/2 of the assets deemed purchased from A with a new holding period.

3. In situation two, C and D are equal partners in CD, an LLC. C and D sell their entire interests in CD to E, an unrelated person, for $10X each. The business is continued by the LLC, which is owned solely by E. The IRS concluded: (i) the CD partnership terminates under Section 708(b)(1)(A); (ii) C and D must report gain or loss under Section 741; (iii) the CD partnership is deemed to make a liquidating distribution of its assets to C and D; and (iv) immediately thereafter, E is deemed to acquire, by purchase, all of the former partnership’s assets. E has a cost basis of $20X in the assets and a new holding period. Compare Rev. Rul. 84-111, 1984-2 C.B. 88 (Situation 3), which determines the tax consequences to a corporate transferee of all interests in a partnership in a manner consistent with McCauslen v. Comm’r, 45 T.C. 588 (1966), and holds that the transferee’s basis in the assets received equals the basis of the partnership interests, allocated among the assets in accordance with Section 732(c).

VIII. CONVERSION OF A C CORPORATION INTO AN S CORPORATION

A. The Built-In Gain Tax Hurdle and Other Pitfalls of Conversion. Although a corporation which converts from C corporation to S corporation status may enjoy considerable tax and other benefits attributable to its S status, the conversion process is fraught with potential pitfalls. These include the potential imposition of the excess passive investment income tax under Section 1375 and the possible termination of the corporation’s S election under Section 1362(d), the imposition of the LIFO recapture tax under Section 1363(d), the potential application of the distribution rules applicable to S corporations having subchapter C earnings and profits under Section 1368(c), the loss of net operating loss carryovers under Section 1371(b) and the imposition of the built-in gain tax under Section 1374. Generally, the greatest exposure facing a corporation upon conversion to S corporation status is the imposition of the built-in gain tax under Section 1374. This problem will be especially acute with respect to the corporation that reports its income under the cash method of accounting. A brief discussion of the
mechanics of the built-in gain tax will ensue and will be followed by an examination of the special problems facing the cash-basis corporation converting to S corporation status.

B. General Built-In Gain Tax Rules.

1. Section 1374 imposes a corporate-level tax on the built-in gain of S corporations that were previously C corporations. Section 1374 as originally enacted applies to built-in gain recognized by a corporation during the 10-year period following such corporation’s conversion to S status. Section 1374(d)(7). Treas. Reg. § 1.1374-1(d) provides that the recognition period is the ten-calendar year period, and not the ten-tax year period, beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets under Section 1374(d)(8) in a carryover basis transaction. The tax rate is presently 35% (the highest rate of tax imposed under Section 11(b)) of the S corporation’s “net recognized built-in gain.” Section 1374(b)(1).

2. On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010, H.R. 5297. Section 2014 of the Act amends Section 1374 to provide for the reduction of the recognition period during which corporations that converted from C corporation status to S corporation status are subject to the built-in gain tax from 10 years to 5 years for taxable years beginning in 2011. Specifically, the text of the amendment is very similar to the temporary reduction from 10 years to 7 years made by the American Recovery and Reinvestment Act of 2009. Pub. L. No. 111-5, 123 Stat. 115 (2/17/2009) The text of the amendment reads as follows:

(b) Special Rules for 2009, 2010 and 2011. - No tax shall be imposed on the net recognized built-in gain of an S corporation - (i) in the case of any taxable year beginning in 2009 or 2010, if the 7th taxable year in the recognition period preceded such taxable year, or (ii) in the case of any taxable year beginning in 2011, if the 5th year in the recognition period preceded such taxable year.

3. The amendment is applicable to taxable years beginning after December 31, 2010, and generally raises the same questions as were raised in connection with the reduction from 10 years to 7 years for taxable years beginning in 2009 and 2010. For a discussion of these issues, see Looney and Levitt, “Reasonable Compensation and The Built-In Gains Tax,” 68 NYU Fed. Tax. Inst., ¶15.05[1][a], [b], [c] and [d] (2010). However, it should be noted that the proposed amendment specifically uses the term “taxable year” in connection with the recognition period for taxable years beginning in 2009 and 2010, but only uses the term “5th year” (not taxable
year) in connection with the recognition period for a taxable year beginning in 2011. This appears to resolve any ambiguity created by the previous amendment and clarifies that for dispositions in 2009 and 2010, 7 tax years (including short tax years) need to have transpired prior to the year of disposition for the built-in gain tax not to apply to such dispositions, and that for dispositions in 2011, 5 calendar years need to have transpired prior to the year of disposition for the built-in gain tax not to apply to such dispositions.\(^1\)

C. **NUBIG Limitation.**

1. Section 1374(c)(2) provides that the net recognized built-in gain taken into account under Section 1374 for any tax year may not exceed the NUBIG of all the corporation’s assets less the built-in gain recognized by the corporation in prior years during the recognition period. Section 1374(d)(1) provides that NUBIG is the amount by which the fair market value of all the corporation’s assets as of the beginning of its first tax year as an S corporation exceeds the corporation’s aggregate adjusted tax bases in such assets at such time. Treas. Reg. \(\S\) 1.1374-3(a) provides a more expansive definition of NUBIG as the total of the following amounts:
   a. The amount that would be the amount realized if on the first day of the recognition period the corporation sold all of its assets at fair market value to an unrelated party which assumed all of its liabilities; decreased by
   b. Any liability of the corporation that would be included in the amount realized but only if the corporation would be allowed a deduction on payment of such liability; decreased by
   c. The aggregate adjusted bases of the corporation’s assets on the first day of the recognition period; increased or decreased by
   d. The corporation’s Section 481 adjustments on the first day of the recognition period; and increased by
   e. Any recognized built-in loss that would not be allowed under Section 382, 383 or 384.

\(^1\) The differences between the express statutory language and the Committee Reports accompanying the 2009 Act raised the issue of whether Congress actually intended to use tax years rather than calendar years in measuring the 7-year recognition period. In fact, Section 2(h) of the Tax Technical Corrections Act of 2009, H.R. 4169, 111 Congress, 1st Session, which was introduced on December 2, 2009, but which did not pass, would have changed the phrase “7th taxable year” to “7th year” in Section 1374(d)(7)(B) retroactively for tax years beginning after 2008. With the passage of the Small Business Jobs Act of 2010, it appears that Congress has conceded that tax years will apply to the special 7-year rule applicable to dispositions in 2009 and 2010 but that calendar years will be used for the special 5-year rule applicable to dispositions made in 2011.
2. Pursuant to the NUBIG limitation, the maximum amount of built-in gain subject to tax under Section 1374 is generally limited to the amount of pre-C to S conversion appreciation in the corporation’s assets and does not include any post-C to S conversion appreciation in such assets.

3. Section 1374(d)(5)(C) also provides that a corporation’s NUBIG is to be properly adjusted for amounts which would be treated as built-in gain under Section 1374(d)(5)(A) or as built-in losses under Section 1374(d)(5)(B). These built-in gain and loss items are included in the computation of NUBIG without regard to when or whether such items are actually recognized during the recognition period.

D. **Taxable-Income Limitation.**

1. In addition to the limitation placed on the aggregate amount of net built-in gain that may be recognized by an S corporation under the NUBIG limitation, the taxable-income limitation limits the amount of net built-in gain recognized by an S corporation on an annual basis. Because a corporation’s taxable income may serve as the base for the built-in gain tax, the maximum amount of net built-in gain (built-in gain less built-in losses) that must be recognized by an S corporation in a particular tax year within the BIG Period is limited to the amount of the corporation’s taxable income for such year (the taxable-income limitation). Section 1374(d)(2)(A)(ii) and Treas. Reg. § 1.1374-2(a)(2).

2. Any recognized built-in gain that is not subject to the built-in gain tax because of the taxable income limitation must be carried forward and is subject to the built-in gain tax in the S corporation’s succeeding tax years to the extent that it subsequently has other taxable income (that is not already subject to the built-in gain tax) for any tax year within the BIG Period. Section 1374(d)(2)(B), as amended by Section 1006(f)(5) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, 102 Stat. 3342 (1988). This modification reduced potential manipulation of timing post-conversion losses to avoid the built-in gain tax on the corporation’s NUBIG, and applies only to corporations filing S elections on or after March 31, 1988.

E. **Built-In Income and Built-In Deduction Items.**

1. Under Section 1374(d)(3), an S corporation’s recognized built-in gain includes gain recognized from the “disposition” of any asset. The legislative history of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) clarified that the “disposition of any asset” includes not only sales and exchanges, but also other income recognition events that effectively dispose of, or relinquish, the taxpayer’s right to receive income. H. R. Rep. No. 795, 100th Cong., 2d Sess. 63 (1988). See also Ann. 86-128, 1986-51 I.R.B. 5. Specifically, Section 1374(d)(5)(A)
provides that any item of income that is properly taken into account during the recognition period but which is “attributable” to periods prior to the date of the corporation’s conversion to S status will be treated as a recognized built-in gain for the tax year in which it is properly taken into account. This type of item is generally referred to as a “built-in income item.” Similarly, Section 1374(d)(5)(B) provides that any amount which is allowable as a deduction during the recognition period but which is “attributable” to a period prior to the date of the corporation’s conversion to S status will be treated as a recognized built-in loss for the tax year for which it is allowable. This type of item is generally referred to as a “built-in deduction item.” In determining whether an item constitutes a built-in income or built-in deduction item under Sections 1374(d)(5)(A) and 1374(d)(5)(B), the focus is therefore on whether such item is “attributable” to a period prior to the date of the corporation’s conversion to S status.

2. The IRS adopted an “accrual method rule” in determining whether an income item or a deduction item is attributable to a period prior to the date of the corporation’s conversion to S status. Specifically, Treas. Reg. § 1.1374-4(b)(1) provides that any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period by a taxpayer using the accrual method of accounting. The most common example of a built-in income item subject to the built-in gain tax is the collection of accounts receivable by a cash-basis taxpayer. Likewise, Treas. Reg. § 1.1374-4(b)(2) provides that any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period by a taxpayer using the accrual method of accounting. The most common example of a built-in deduction item is the payment of accounts payable by a cash-basis taxpayer. Consequently, the benchmark for whether an item constitutes a built-in income or built-in deduction item under Section 1374(d)(5), is whether such item would have been includable in income, or allowed as a deduction, prior to the corporation’s conversion to S status if the corporation had been an accrual basis taxpayer.

3. In determining whether an item would have been includable in income, or allowed as a deduction, prior to the corporation’s conversion to S status if the corporation had been an accrual basis taxpayer, the regulations generally provide that all rules applicable to an accrual basis taxpayer apply, specifically including Section 267(a)(2) (relating to the timing of deductions by an accrual basis payor with respect to a cash basis payee that is a related party), and Section 404(a)(5) (relating to the timing of deductions for deferred compensation).
4. Section 267(a)(2) generally prohibits an accrual basis taxpayer from deducting an item payable to a cash basis payee until the amount is includable in the cash basis payee’s income if the payor and payee are related within the meaning of Section 267(b).

5. Similarly, Section 404(a)(5) generally prohibits a corporation from taking a deduction for any amounts deferred under a non-qualified deferred compensation plan, until such amounts are includable in the employee’s gross income.

6. Many commentators objected to the IRS’s application of Sections 267(a)(2) and 404(a)(5) to preclude treatment of an item as a built-in deduction under Section 1374(d)(5)(B). Specifically, H. R. Rep. No. 100-795, 100th Cong., 2d Sess. 63-64, which accompanied TAMRA, provides the following:

“As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gain from the receivables, there would be no amount subject to the built-in gain tax.”

7. In determining whether an item would be deductible by an accrual basis taxpayer for purposes of the built-in gain tax, however, the regulations modify the rules generally applicable to accrual basis taxpayers in three respects. First, Treas. Reg. § 1.1374-4(c)(1) provides that any amounts properly deducted in the recognition period under Section 267(a)(2), relating to payments to related parties, will be treated as recognized built-in loss to the extent that the following requirements are met:

a. All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

b. The amount is paid in the first two and one-half months of the recognition period or is paid to a related party owning (under the attribution rules of Section 267) less than 5% (by voting power and
value) of the corporation’s stock, both as of the beginning of the recognition period and when the amount is paid.

8. Additionally, Treas. Reg. § 1.1374-4(c)(2) provides that any amount properly deducted in the recognition period under Section 404(a)(5), relating to payments for deferred compensation, will be treated as recognized built-in loss to the extent that the following requirements are met:

a. All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

b. The amount is not paid to a related party to which Section 267(a)(2) applies.

9. The regulations also provide that in determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer, Section 461(h)(2)(C) (which provides that economic performance does not occur for tort liabilities or worker’s compensation liabilities until payment has been made), and Treas. Reg. § 1.461-4(g) (which provides that economic performance does not occur for liabilities arising out of breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts and taxes until payment is made), do not apply. Treas. Reg. § 1.1374-4(b)(2). Thus, to constitute a built-in deduction item within the meaning of Section 1374(d)(5)(B), only the all events test (and not the economic performance test) needs to be satisfied with respect to the liabilities referred to in Section 461(h)(2)(C) and Treas. Reg. § 1.461-4(g).

10. Treas. Reg. §§ 1.446-1(c)(1)(ii) and 1.451-1(a), provide that accrual method taxpayers recognize income for the tax year in which the following two requirements are met:

a. All of the events have occurred that fix the right to receive such income; and

b. The amount thereof can be determined with reasonable accuracy.

11. Similarly, Treas. Reg. §§ 1.446-1(c)(1)(ii) and 1.461-1(a)(2) provide that under the accrual method of accounting, deductions are allowable for the tax year in which:

a. All of the events have occurred that establish the fact of the liability giving rise to such deduction; and

b. The amount thereof can be determined with reasonable accuracy.
12. Under Section 461(h)(1), the “all events” test is not considered to be met any earlier than when economic performance with respect to such item occurs. In circumstances involving services or property provided to a taxpayer, economic performance is deemed to occur under Section 461(h)(2)(A) when the person provides such services or provides such property to the taxpayer. In circumstances where the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance is deemed to occur under Section 461(h)(2)(B) as the taxpayer provides such property or services.

F. Effect of Classification of Item as Built-in Income or Built-In Deduction Item.

1. An item that is classified as a built-in income item will be treated as a recognized built-in gain when taken into account by the S corporation during the BIG Period, and thus, potentially be subject to the built-in gain tax imposed under Section 1374. Section 1374(d)(5)(A). Under Section 1374(d)(5)(C), a built-in income item also has the effect of increasing the corporation’s NUBIG. Likewise, an item that is classified as a built-in deduction item will be treated as a recognized built-in loss when allowed as a deduction to the S corporation during the recognition period, and thus, will be available to offset any built-in gain recognized by the S corporation during such tax year. Section 1374(d)(5)(B). A built-in deduction item also has the effect of decreasing the corporation’s NUBIG under Section 1374(d)(5)(C).

2. Even if an item does not constitute a built-in loss item within the meaning of Section 1374(d)(5)(B), it still may potentially affect a corporation’s NUBIG. For example, an accrued bonus payable to a C corporation’s sole shareholder-employee that is not paid by the corporation within the first two and one-half months following the date of its conversion to S status would not constitute a built-in deduction item under 1374(d)(5)(B) since, under both Sections 267(a)(2) and 404(a)(5), such amount would not have been deductible by the corporation prior to the date of its conversion if it were an accrual basis taxpayer. The accrued bonus would, however, still serve to reduce the corporation’s NUBIG limitation since Treas. Reg. § 1.1374-3(a)(2) provides that NUBIG is decreased by the amount of any liability of the corporation to the extent the corporation would be allowed a deduction on payment of such liability. In other words, the accrual method rule does not apply in determining whether a liability decreases a corporation’s NUBIG.

3. Example 1. Assume a cash-basis corporation owns two buildings (Building “A” and “Building “B”), each of which has a built-in gain (excess of fair market value over basis as of the date of conversion to S status) of $100. Additionally, assume that prior to the corporation’s conversion to S status, the corporation accrued a bonus to its sole
shareholder-employee of $50. In its initial S year, the corporation sells Building “A” generating a recognized built-in gain of $100, pays the $50 accrued bonus to its shareholder-employee following the first two and one-half months of such year, and has other taxable income of $100.

4. Because the accrued bonus was not paid within the first two and one-half months following the corporation’s conversion to S status, the accrued bonus will not constitute a recognized built-in deduction item under Section 1374(d)(5)(B). As such, the corporation’s pre-limitation amount (the amount which would be its taxable income if only recognized built-in gain and recognized built-in losses were taken into account) will be $100. If the accrued bonus had been treated as a built-in deduction item, however, the corporation’s pre-limitation amount would only have been $50 ($100 recognized built-in gain on the sale of Building “A” less $50 recognized built-in loss on payment of the bonus). The accrued bonus will, however, decrease the corporation’s NUBIG to $150 ($100 built-in gain on Building “A” plus $100 built-in gain on Building “B” less $50 liability for accrued bonus). Thus, if Building “B” is sold during the BIG Period and results in a recognized built-in gain of the full $100, only $50 will be subject to the built-in gain tax under Section 1374, and the only adverse consequence of the accrued bonus not being treated as a built-in deduction item would be the acceleration of the corporation’s built-in gain ($100 gain recognized on the disposition of Building “A” rather than $50). This example demonstrates that the effect of an item not being classified as a built-in deduction under Section 1374(d)(5)(B), but which nevertheless reduces NUBIG, will be greatest where the corporation has several assets with built-in gain, only some of which are sold during the BIG Period. In such case, the corporation will pay more built-in gain tax than it otherwise would have paid if the item had been treated as a built-in deduction item and had been available to offset the recognized built-in gain of other assets. If all of the built-in gain assets are sold during the BIG Period, the only effect of an item not being classified as a built-in deduction item will be the acceleration of the built-in gain tax applicable to the corporation’s assets. Finally, if none of the built-in gain assets are sold by the S corporation during the BIG Period, there will be no adverse effect from an item not being classified as a built-in deduction.

5. Although not as clear as in the case of a liability not qualifying as a built-in deduction item, an item that does not constitute a built-in income item because it would not have been recognized by the corporation prior to the date of its conversion to S status if the corporation had been on the accrual method of accounting, could possibly still increase the corporation’s NUBIG limitation if such item was treated as an asset of the corporation on the date of conversion and the item had an ascertainable fair market value in excess of the corporation’s basis in such item on the date of conversion. Possible examples of such items include an account receivable subject to a substantial doubt as to collectibility and a
contingent or potential claim against a third party. The collection of an item that does not constitute a built-in income item under Section 1374(d)(5)(A) would not trigger application of the built-in gain tax since the collection of such an item would not constitute a recognized built-in gain. Assuming that such an income item increased the corporation’s NUBIG limitation, however, the corporation’s overall exposure to the built-in gain tax might be increased to the extent the corporation has other built-in gain assets.

6. **Example 2.** Assume that a cash-basis corporation owns Building “A”, which has a built-in gain of $100, and Building “B”, which has a built-in loss of $100. Additionally, the corporation has an account receivable in the face amount of $100 with respect to which there is sufficient doubt as to its collectibility so as to preclude the corporation (had it been an accrual basis taxpayer) from including the receivable in its income prior to the date of its conversion to S status. Further assume that the IRS can somehow show that the account receivable had some value (assume $20) as of the date of the corporation’s conversion to S status, so that the corporation’s NUBIG is increased to $20. (If the receivable actually had an ascertainable fair market value of $20, then the receivable arguably might also constitute a built-in income item to the extent of $20. Bifurcating a single asset in this manner, however, seems inappropriate and not supported by Section 1374 (or the Section 1374 regulations)).

7. In the event the corporation collects the full $100 account receivable in its first tax year as an S corporation, such amount would not constitute a recognized built-in gain subject to the built-in gain tax under Section 1374 since the item did not constitute a built-in income item under Section 1374(d)(5)(A). If, however, the corporation subsequently sells Building “A” with a built-in gain of $100 during the BIG Period, the corporation would have a net recognized built-in gain of $20 (the Corporation’s NUBIG limitation) on which the built-in gain tax would be imposed. If, alternatively, the account receivable had no effect on the corporation’s NUBIG, the corporation would not have been subject to the built-in gain tax on the disposition of Building “A” since its NUBIG would have been zero. This example illustrates that an item which does not constitute a built-in income item under Section 1374(d)(5)(A), but which nevertheless increases a corporation’s NUBIG, will have its greatest impact if the corporation has other built-in gain assets that are disposed of during the recognition period that are not offset by corresponding dispositions of built-in loss assets during the same tax year.

G. **Section 481 Adjustments, Deemed DISC Distributions, COD Income and Income from Completed Contract Method of Accounting.**

1. Treas. Reg. § 1.1374-4(d)(1) provides that any Section 481(a) adjustment taken into account in the recognition period that prevents an omission or
duplication of income or deduction will be recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods beginning before the recognition period. Similarly, the regulations provide that any item of income properly taken into account during the recognition period under Section 995(b)(2) (relating to deemed distributions from a DISC) will be treated as recognized built-in gain if the item results from a DISC termination or a DISC disqualification occurring before the beginning of the recognition period.

2. Treas. Reg. § 1.1374-4(f) provides that any item of income or deduction properly taken into account during the first year of the recognition period as discharge of indebtedness income under Section 61(a)(12) or as a bad debt deduction under Section 166 will be treated as recognized built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period.

3. Any item of income properly taken into account during the recognition period under the completed contract method where the corporation began performance of the contract prior to the beginning of the recognition period will be treated as recognized built-in gain if the item would have been included in gross income prior to the beginning of the recognition period under the percentage of completion method. Additionally, any similar item of deduction is treated as recognized built-in loss if the item would have been allowed against gross income prior to the beginning of the recognition period under the percentage of completion method. Treas. Reg. § 1.1374-4(g).

H. Installment Sales.

1. Treas. Reg. § 1.1374-4(h)(1) provides that if a corporation sells an asset either before or during the recognition period and reports income from the sale under the installment method of accounting during or after the recognition period, a tax is imposed under Section 1374 on such income.

2. Treas. Reg. § 1.1374-4(h)(2) provides that if a corporation is subject to built-in gain tax under the installment rule, the taxable income limitation is equal to the amount by which the S corporation’s net recognized built-in gain would have been increased from the year of the sale to the earlier of the year the income is reported under the installment method or the last year of the recognition period, assuming all income from the sale had been reported in the year of the sale and all provisions of Section 1374 apply. In the event the corporation sells an asset prior to the beginning of the recognition period, the entire amount of income to be reported from the sale that was not reported prior to the recognition period is treated as having been reported in the first year of the recognition period.
3. Treas. Reg. § 1.1374-4(h)(3) provides that where the taxable income limitation applies, the excess of the amount reported under the installment method over the amount subject to tax under the taxable income limitation rule is treated as if it were reported in the succeeding tax years, but only for the succeeding tax years in the recognition period. Any carryover amounts reported in succeeding tax years will be reduced to the extent that the amount was not subject to tax because the S corporation had an excess of recognized built-in loss over recognized built-in gain in the tax year of the sale and succeeding tax years in the recognition period.

4. If income is reported under the installment method by an S corporation for a tax year after the recognition period and the income is subject to tax under the installment rule, in determining the built-in gain tax, the S corporation’s Section 1374 attributes may be used to the extent their use is otherwise allowed under the Code. The corporation’s loss recognized for a tax year after the recognition period that would have been recognized built-in loss if it had been recognized in the recognition period, however, may not be used in determining the built-in gain tax imposed under Section 1374.

I. Interests in Partnerships.

1. The IRS adopted a “look-through” approach with respect to an S corporation’s interest in a partnership. Consequently, an S corporation’s distributive share of a partnership’s items is treated as recognized built-in gain or loss to the same extent that the S corporation would have been treated as having recognized built-in gain or loss had the items originated in, and been taken into account by, the S corporation itself.

2. Specifically, Treas. Reg. § 1.1374-4(i)(1) provides that if an S corporation owns a partnership interest at the beginning of the recognition period or transfers property to a partnership in a transaction to which Section 1374(d)(6) applies during the recognition period (where the basis of the property received by the S corporation is determined in whole or in part by reference to the basis of the property transferred by the S corporation), the S corporation must determine the effect on its net recognized built-in gain from its distributive share of partnership items in a four-step process: (1) the S corporation applies the rules of Section 1374(d) to the S corporation’s distributive share of partnership items of income, gain, loss or deduction to determine the extent to which the partnership item would have been treated as a recognized built-in gain or loss if such partnership item had originated in, and been taken into account by, the S corporation (“partnership 1374 items”); (2) the S corporation determines its net recognized built-in gain without partnership 1374 items; (3) the S corporation determines its net recognized built-in gain with partnership 1374 items; and (4) if the amount of the S corporation’s net recognized built-in gain determined with partnership 1374 items exceeds the S corporation’s
net recognized built-in gain determined without partnership 1374 items, such excess is classified as the S corporation’s “Partnership RBIG”, and the S corporation’s net recognized built-in gain is equal to the sum of its recognized built-in gains determined without partnership 1374 items plus its Partnership RBIG. If the S corporation’s net recognized built-in gain determined without partnership 1374 items exceeds the S corporation’s net recognized built-in gain determined with partnership 1374 items, such excess is classified as the S corporation’s “Partnership RBIL”, and the S corporation’s net recognized built-in gain is equal to the difference between the amount of its net recognized built-in gain determined without partnership items less its Partnership RBIL.

3. Under Treas. Reg. § 1.1374-4(i)(2), however, an S corporation’s Partnership RBIG for any tax year may not exceed the excess (if any) of the S corporation’s “RBIG limitation” over its Partnership RBIG for prior tax years (unless the S corporation forms or avails itself of a partnership with a principal purpose of avoiding the built-in gain tax), and an S corporation’s Partnership RBIL for any tax year may not exceed the excess (if any) of the S corporation’s “RBIL limitation” over its Partnership RBIL for prior tax years. Under Treas. Reg. § 1.1374-4(i)(4), an S corporation’s “RBIG limitation” or “RBIL limitation” is an amount equal to: (1) the amount realized if on the first day of the recognition period the S corporation sold its partnership interest at fair market value to an unrelated party; decreased by (2) the corporation’s adjusted basis in the partnership interest; and increased or decreased by (3) the corporation’s allocable share of the partnership’s Section 481(a) adjustments. If the result is a positive amount, the S corporation has a RBIG limitation, and if the result is a negative amount, the S corporation has a RBIL limitation. Consequently, the total amount of built-in gain which may be recognized by an S corporation by application of the look-through rules is generally limited to the excess of the fair market value of the S corporation’s partnership interest on the first day of the recognition period over the S corporation’s adjusted basis in such partnership interest on the first day of the recognition period.

4. Additionally, under Treas. Reg. § 1.1374-4(i)(3), if an S corporation disposes of its partnership interest, the amount which may be treated as recognized built-in gain may not exceed the excess (if any) of the S corporation’s RBIG limitation over its partnership RBIG during the recognition period, and the amount which may be treated as recognized built-in loss may not exceed the excess (if any) of the S corporation’s RBIL limitation over its Partnership RBIL during the recognition period. In other words, if an S corporation disposes of its partnership interest, the amount treated as recognized built-in gain or loss on the disposition may not exceed the difference between the fair market value of the S corporation’s partnership interest and the S corporation’s adjusted basis in such partnership interest as of the first day of the recognition period, less
any amounts previously treated as recognized built-in gain or loss to the S corporation under the look-through rules.

5. Treas. Reg. § 1.1374-4(i)(5) provides that the look-through rules do not apply to a tax year in the recognition period if the S corporation’s partnership interest represents less than 10% of the partnership capital and profits at all times during the tax year and prior tax years in the recognition period, and the fair market value of the S corporation’s partnership interest as of the beginning of the recognition period is less than $100,000. If, however, the S corporation contributes any assets to the partnership during the recognition period and the S corporation held the assets as of the beginning of the recognition period, the fair market value of the S corporation’s partnership interest as of the beginning of the recognition period is determined as if the assets were contributed to the partnership before the beginning of the recognition period. The exception to the look-through rules for small partnership interests does not apply, however, if a corporation forms, or avails itself of, a partnership with a principal purpose of avoiding the tax imposed under Section 1374.

6. Treas. Reg. § 1.1374-4(i)(6) provides that for purposes of Section 1374 only, an S corporation’s Section 704(c) gain or loss amount with respect to any asset is not reduced during the recognition period except for amounts treated as recognized built-in gain or loss with respect to such asset under the regulations.

7. Treas. Reg. § 1.1374-4(i)(7) provides that if on the first day of the recognition period an S corporation holds an interest in a partnership which holds an asset and during the recognition period the partnership distributes such asset to the S corporation which thereafter disposes of such asset, the asset is treated as having been held by the S corporation on the first day of the recognition period and as having the same fair market value and adjusted basis in the hands of the S corporation as such asset had in the hands of the partnership on such day.

J. Inventory Items.

1. Inventory items are subject to the built-in gain tax to the extent the fair market value of such items exceeds the corporation’s basis in such assets as of the date of conversion to S status. Treas. Reg. § 1.1374-7(a) provides that for purposes of the built-in gain tax, the fair market value of the inventory of an S corporation on the first day of the recognition period is equal to the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all of the S corporation’s assets by a buyer that expects to continue to operate the S corporation’s business. The buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts, including: (1) the replacement cost of the inventory; (2) the expected retail selling price
of the inventory; (3) the seller’s incentive to demand a price for the inventory that would compensate for and provide a fair return for expenditures the seller incurred to obtain, prepare, carry, and dispose of the inventory before the sale of the business; and (4) the buyer’s incentive to pay a price for the inventory that would compensate for and provide a fair return for similar expenditures the buyer expects to incur after the sale of the business.

2. Treas. Reg. § 1.1374-7(b) provides that the inventory method used by an S corporation for tax purposes must be used to identify whether inventory disposed of during the recognition period is inventory it held on the first day of such period. Consequently, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a tax year during such period is less than the carrying value of its inventory on the first day of the recognition period. If a corporation changes its method of accounting (from the FIFO method to the LIFO method or from the LIFO method to the FIFO method) with a principal purpose of avoiding the tax imposed under Section 1374, however, such corporation must use its former inventory method to identify its dispositions of inventory.

K. After-Acquired Assets

1. Under Section 1374(d)(6), where an asset having a built-in gain or loss on the first day of S corporation status is exchanged for another asset in a transaction in which the new asset’s basis is determined in whole or in part by reference to the basis of the old asset (such as in a like-kind exchange under Section 1031), the new asset will be treated as being held on the first day of S status and as having the same built-in gain or loss as did the old asset. The new asset will therefore be subject to the built-in gain tax to the same extent as the old asset.

2. Furthermore, Section 1374(d)(8) and Treas. Reg. § 1.1374-8(a) provide that if an S corporation acquires any asset in a transaction in which the S corporation’s basis in the acquired asset is determined in whole or in part by reference to a C corporation’s basis in such asset, Section 1374 applies to the net recognized built-in gain attributable to the asset so acquired.

3. Treas. Reg. § 1.1374-8(b) provides that for purposes of applying the built-in gain tax under Section 1374(d)(8), a separate determination of tax is made with respect to the assets the S corporation acquires in one Section 1374(d)(8) transaction from the assets the S corporation acquires in another Section 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation. Thus, an S corporation’s Section 1374 attributes when it became an S corporation may only be used to reduce the built-in gain tax imposed on dispositions of assets the S corporation held at that time. Likewise, an S corporation’s Section 1374
attributes acquired in a Section 1374(d)(8) transaction may only be used to reduce the built-in gain tax imposed on dispositions of assets the S corporation acquired in such transaction.

4. Treas. Reg. § 1.1374-8(c) provides that an S corporation’s taxable income limitation for any tax year is allocated between or among each of the S corporation’s separate determinations of net recognized built-in gain for that year (determined without regard to the taxable income limitation) based on the ratio of each such net recognized built-in gain amount to the sum of all of the S corporation’s net recognized built-in gain amounts.

5. Consequently, every asset acquisition from a C corporation (or from an S corporation subject to the built-in gain tax) will be subject to a separate determination as to the amount of net unrealized built-in gain and net recognized built-in gain, as well as to a separate 10-year recognition period beginning with the date the S corporation acquires such assets from the C corporation (or from the S corporation subject to the built-in gain tax). This rule applies to all S corporations, regardless of when their S elections were made or whether such corporations have always been S corporations.

L. Anti-Stuffing Rule. Treas. Reg. § 1.1374-9 provides that if a corporation acquires an asset prior to or during the recognition period with “a principal purpose” of avoiding the tax imposed under Section 1374, the asset and any loss, deduction, loss carryforward, credit and credit carryforward attributable to such asset will be disregarded in determining the S corporation’s pre-limitation amount, taxable income limitation, NUBIG limitation, deductions against net recognized built-in gain and credits against the built-in gain tax. This rule is primarily aimed at preventing shareholders from contributing assets having built-in losses to the corporation immediately prior to electing S status in order to avoid the built-in gain tax.

M. Pre-Conversion Planning Opportunities.

1. Early Election. Once a corporation has made the decision to convert from C corporation status to S corporation status, it should make its S election as soon as possible since only pre-conversion asset appreciation, and not post-conversion asset appreciation, is subject to the built-in gain tax. Additionally, the sooner the election is made, the sooner the 10-year recognition period during which the built-in gain tax is in effect will lapse.

An “early” election is crucial not only for an existing C corporation converting to S corporation status, but also for a sole proprietorship, partnership or other unincorporated business which is incorporating. In such cases, it is essential that the unincorporated business file its S election effective for its first taxable year so that it can completely escape application of the built-in gain tax (except with respect to any assets which it may
subsequently acquire from C corporations). If the newly formed corporation fails to elect S corporation status for its first taxable year and later converts to S corporation status, such corporation will be fully subject to the built-in gain tax because of its C corporation history, even if it was a C corporation for only one taxable year. The failure of an unincorporated business to elect S corporation status for its first taxable year as a corporation is particularly detrimental because not only will pre-conversion corporate appreciation in its assets be subject to the built-in gain tax, but also any pre-incorporation appreciation in its assets will be subject to the built-in gain tax.

2. **Deferral of Disposition of Loss Assets.** Where a C corporation contemplating conversion to S corporation status has built-in loss assets which it intends to dispose of in the near future, such corporation should defer the disposition of such built-in loss assets until after it has converted to S corporation status in order to minimize the impact of the built-in gain tax. By not disposing of such built-in loss assets prior to converting to S corporation status, the built-in losses in these assets will reduce the overall net unrealized built-in gain limitation and will also (when disposed of by the corporation) offset recognized built-in gain and reduce the corporation’s taxable income. Since built-in deduction items (such as accounts payable of a cash basis corporation) are treated as built-in losses for the taxable year in which such amounts are deducted by the corporation, a C corporation contemplating conversion to S corporation status should also defer the deduction of such items until after its conversion to S corporation status.

3. **Pre-conversion Transfer of Loss Assets to Corporation.** Another pre-conversion technique which may be utilized in limited circumstances to reduce the effect of the built-in gain tax involves the pre-conversion transfer, under Section 351 or Section 118, of built-in loss assets to the converting corporation. However, this particular method of minimizing the built-in gain tax must be used with great caution, since the anti-stuffing rule set forth in Treas. Reg. § 1.1374-9 may apply to the contributed loss assets. A corporation may receive the benefit of built-in loss assets contributed to it prior to its conversion to S corporation status if such corporation can demonstrate a “clear and substantial relationship” between the contributed property and the corporation’s business. As such, the pre-conversion contribution of built-in loss assets to a corporation should be considered by the tax practitioner as one method of minimizing the built-in gain tax under appropriate circumstances.

4. **Accounts Receivable Planning Opportunities.**
   a. **General.** Because the accounts receivable of a cash-basis corporation are included in determining a corporation’s NUBIG, and the collection of such receivables is treated as a recognized
built-in gain under Section 1374, the cash-basis corporation, and particularly the cash-basis service corporation, is potentially subject to a substantial tax liability under Section 1374. Consequently, it is imperative that the cash-basis service corporation converting from C corporation status to S corporation status consider all available planning opportunities to minimize the impact of the built-in gain tax with respect to its accounts receivable.

b. Zeroing Out of Taxable Income. Since the base of the built-in gain tax is limited to a corporation’s taxable income, one method of avoiding the built-in gain tax would be to zero out the corporation’s taxable income for the entire 10-year built-in gain period. Such a strategy seems inadvisable in that it could very well subject the S corporation to the same unreasonable compensation arguments to which it would have been subject had it remained a C corporation. An S corporation would be susceptible to an unreasonable compensation argument in this context since the result of recharacterizing amounts paid as compensation to the shareholder-physicians as distributions would be to increase the corporation’s taxable income above zero, and thus, subject it to the built-in gain tax.

c. Bonus Accrual Method. Due to the pass-through nature of an S corporation, the collection of accounts receivable by a cash-basis corporation that has converted from C corporation status to S corporation status, absent proper planning, will result in a forced double taxation on such receivables. One common method of avoiding the built-in-gain tax on the accounts receivable of a cash basis taxpayer is to accrue bonuses (in an amount equal to its receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in its first tax year as an S corporation. Although there are a number of open issues with regard to this strategy, PLR 200925005 confirms that this strategy does work.

(1) In PLR 200925005, the IRS ruled that the payment of certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable of the corporation at the time of its conversion to S status would constitute built-in deduction items, specifically including the payment of compensation to shareholder-employees of the corporation within the first two and one-half months following the corporation’s conversion to S corporation status.

(2) Under the facts of the ruling, the taxpayer is a cash basis C
corporation with a calendar tax year. The corporation is a personal service corporation which is wholly-owned by a number of professionals. The corporation bills its clients for the services performed by the professionals and when invoices are paid, the corporation pays salaries and wages to the professionals. Additionally, the corporation has other employees, such as non-shareholder clerical staff and non-shareholder professionals to which it pays wages.

(3) The taxpayer will elect to be an S corporation and will have built-in gain from its outstanding accounts receivable. The taxpayer requested the letter ruling to determine whether certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable as of the date of the corporation’s conversion to S status will qualify as built-in losses under Section 1374, and specifically, whether the amounts paid to its shareholder-employees within the first two and one-half months of the recognition period under Section 1374 of salary and wage expenses that are related to the production of accounts receivable that are outstanding as of the effective date of the S election will constitute built-in deduction items under Section 1374(d)(5)(B).

(4) The post-conversion collection of accounts receivable of a cash-basis corporation, particularly the cash-basis service corporation, is potentially subject to a substantial tax liability for the built-in gain tax imposed under Section 1374. Due to the pass-through nature of an S corporation, the collection of accounts receivable by a cash-basis corporation that has converted from C corporation status to S corporation status, absent proper planning, will result in a forced double taxation on such receivables of approximately 57.75%. Consequently, it is imperative that the cash-basis service corporation converting from C corporation status to S corporation status consider all available planning opportunities to minimize the impact of the built-in gain tax with respect to its accounts receivable.

(5) Since built-in deduction items (such as accounts payable of cash-basis corporations) are taken into account in

\[ \text{Assuming } $100 \text{ of accounts receivable, the built-in gain tax would be } $35 \times 35\% = $35 \times 0.35, \text{ and the shareholder-level tax (assuming the maximum marginal individual tax rate of 35%) would be } $65 \times 35\% = $22.75. \text{ Thus, total taxes on the } $100 \text{ of accounts receivable would be } $57.75 \times (35\% + 22.75\%), \text{ resulting in an effective federal tax rate of } 57.75\%. \text{ In addition, state corporate income taxes may be imposed on the corporate level gain.} \]
determining NUBIG of an S corporation under Section 1374(d)(5)(C), and the payment of such amounts is treated as a recognized built-in loss that may be matched against built-in income items (such as a cash-basis corporation’s accounts receivable), a common method that has been employed by practitioners to avoid the built-in gain tax imposed on the accounts receivable of a cash basis service corporation is to accrue bonuses (in an amount equal to its collectible receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in its first tax year as an S corporation. Even though such accrued bonuses may or may not be characterized as built-in deduction items (depending on whether they are paid in the first two and one-half months following conversion), the effect of accruing such bonuses nevertheless may be either to eliminate the potential application of the built-in gain tax altogether by reducing the corporation’s NUBIG to zero, or alternatively, if the corporation has goodwill or other appreciated assets, to at least minimize recognition of any built-in gain by reducing the corporation’s NUBIG by the amount of such accrued bonuses. There are a number of open issues regarding the mechanics of accruing such bonuses. These open issues include:

(a) whether such bonuses should be paid within the first two and one-half months so as to constitute built-in deduction items that offset the built-in income items (receivables), or whether such bonuses may be paid at any time during the corporation’s first taxable year as an S corporation based on the position that the accrued bonuses reduce the corporation’s NUBIG to zero;

(b) if the corporation intends to pay such bonuses in cash within the first two and one-half months and funds must be borrowed to pay such bonuses, whether the corporation or the shareholder-employees should borrow such funds;

(c) whether such bonuses could be paid by simply having the corporation distribute the accounts receivable attributable to the accrued bonuses within the first two and one-half months following conversion to S corporation status (as opposed to paying such bonuses out in cash);
(d) whether the regular salaries of the shareholder-employees should be “suspended” in order to enable the corporation to pay such bonuses;

(e) assessment of the effect of such bonuses on any buy-out provision in the event a shareholder-employee’s employment is terminated after receipt of the bonus but prior to any loans funding such bonus being repaid;

(f) whether the employment agreements of the shareholder-employees should be amended to provide compensation for nonbillable services to support compensation paid in “C” years as well as accrual of the bonus;

(g) documentation of such accrued bonuses in the minutes of the board of directors as compensation for past services; and

(h) whether the corporation should continue zeroing out its taxable income for some period of time in order to support compensation amounts paid in prior “C” years as well as to provide a “back-up” for the bonus accrual strategy.

(6) Although PLR 200925005 certainly does not answer all of these open questions, it certainly makes it clear that the built-in gain tax on accounts receivable can be avoided by the converted corporation paying out compensation related to such accounts receivable to its shareholder-employees within the first two and one-half months of the corporation’s first tax year as an S corporation, which is the method that has been most commonly employed by practitioners in order to avoid imposition of the built-in gain tax on the accounts receivable of a cash basis service corporation.

(7) The IRS expressly concludes in the ruling that the taxpayer’s payments to its shareholder-employee of salary and wages relating to the production of accounts receivable on the effective date of the S election, if paid in the first two and one-half months of the recognition period, qualify as built-in loss items under Section 1374(d)(5)(B). Additionally, the IRS found that the taxpayer’s payments to its non-shareholder employees of salary and wages related to the production of outstanding accounts receivable on the
effective date of the S election, if paid at any time during the recognition period, will qualify as built-in loss items under Section 1374(d)(5)(B). Finally, the IRS concluded that the taxpayer’s payments of other unpaid payable expenses and accounts payable related to the production of the accounts receivable outstanding on the effective date of the S election, if paid at any time during the recognition period, would qualify as built-in loss items under Section 1374(d)(5)(B).

(8) It is interesting to note that PLR 200925005 did not specifically state that any type of special bonus had to be accrued prior to the last day of the corporation’s last tax year as a C corporation or require any written evidence of such accrual in the corporate minutes or other documentation. Rather, the IRS simply concluded that the payment of salary and wages to the shareholder-employees of the corporation which related to the production of the accounts receivable on the effective date of the S election would qualify as built-in loss items if paid in the first two and one-half months of the recognition period. To be certain, the author would recommend that such bonus be accrued prior to the last tax year as a C corporation and evidenced at least in the Board of Director minutes of the corporation.

d. Acceleration of Accounts Receivable. Alternatively, in order to avoid forced double taxation on its receivables, a service corporation converting from C to S corporation status may choose to accelerate its receivables income and recognize such income prior to conversion to S corporation status. In this manner, the corporation may be able to defer (possibly indefinitely) shareholder-level tax on its receivables until the earnings and profits generated by the collection of such receivables are distributed to the corporation’s shareholders. The recognition of receivables income by a corporation prior to its conversion to S corporation status will have the added benefit of decreasing its overall NUBIG. The pre-conversion recognition of receivables income may be achieved in at least three ways.

(1) First, the corporation may simply assign and sell its accounts receivable prior to its conversion to S corporation status to a third party.

(2) Second, the corporation may sell its accounts receivable to its shareholder-employees prior to its conversion to S corporation status. Additionally, in each of the first two
alternatives, the sale of the receivables could be combined with the payment of a bonus in an amount equal to the sales proceeds in order to avoid payment of a corporate level tax on the corporation’s sale of its receivables.

(3) Finally, the corporation could, in order to avoid a pre-conversion C corporation tax on the sale of its accounts receivable, simply “bonus” its accounts receivable to its shareholder-employees. The pre-conversion recognition of receivables income by a service corporation, when combined with the payment of a corresponding bonus to its shareholder-employees, should also limit any attempts by the IRS to recharacterize payments to the corporation’s shareholder-employees as dividend distributions under unreasonable compensation arguments to the corporation’s last tax year as a C corporation.

5. **Examples.** The examples set forth below examine tax planning alternatives available with respect to the accounts receivable of a cash-basis service corporation converting to S corporation status. Note that these examples all utilize the tax rates in effect under the Bush tax cuts through 2010. The results will be even more dramatic if the Bush tax cuts are not extended by legislative action for 2013 and subsequent years.

a. **Example 1. No Planning.** Doctors R Us, a professional corporation using the cash receipts and disbursements method of accounting, has taxable income (pre-salary and bonus to its four shareholder-employees) of $1,000,000. The corporation is planning to pay total salaries and bonuses to its four shareholder-employees of $1,000,000, resulting in taxable income to the corporation of zero. The corporation also has $200,000 of accounts receivable as of December 31, 2008, which will be collected and give rise to income in 2009. The corporation desires to elect S corporation status effective January 1, 2009. If the corporation takes no action to affirmatively plan for its receivables and has no other built-in gain or built-in loss items, it potentially will be subject to a tax of $70,000 under Section 1374 on the collection of the $200,000 of receivables in 2009 (35% of $200,000). The $200,000 of income recognized on the collection of the receivables, reduced under Section 1366(f)(2) by the $70,000 corporate level tax imposed under Section 1374, will pass through to, and be taken into account by, the individual shareholder-employees of the corporation under Section 1366 in 2009. Consequently, assuming a maximum marginal tax rate of 35% for individuals, the shareholder-employees will be subject to a tax of $45,500 (35% of $130,000). The aggregate tax paid by both the corporation and the individual shareholders of the corporation
on the $200,000 of receivables will therefore be $115,500 ($70,000 corporate level tax under Section 1374 plus $45,500 tax imposed on the individual shareholder-employees), resulting in an aggregate tax rate of approximately 57.75% (ignoring the phase out of itemized deductions and personal exemptions, employment taxes and any state and local taxes).

b. **Example 2. Accrual of Bonus.** Now assume that the corporation accrues an additional bonus to its four shareholder-employees in 2008 of $200,000, an amount equal to its receivables. Under Section 1374(d)(1), the corporation should avoid application of the built-in gain tax altogether because its NUBIG will be zero (even if the accrued bonus does not constitute a built-in deduction item under Section 1374(d)(5) because of the limitations of Section 267(a)(2) and/or Section 404(a)(5)). As such, when the receivables are collected by the corporation in 2009, they will be subject to a single level of tax at the shareholder level of $70,000 (35% of $200,000). If the accrued bonus is paid within the first two-and one-half (2-1/2) months of the corporation’s first taxable year as an S corporation, it will constitute a built-in deduction item that will offset the built-in income item dollar for dollar, again resulting in a single level of tax at the shareholder level of $70,000. This same result should also occur if the accounts receivable themselves (rather than cash) are bonused out to the shareholder-employees in 2009.

If, however, the accrual of the bonus in 2008 is somehow determined to be without substance (and assuming that the $200,000 paid to the shareholder-employees is treated as a distribution so that the taxable income of the corporation is not reduced to zero in 2009), the tax effect will be the same as in **Example 1** above where there was no tax planning: a corporate level tax will be imposed on the S corporation under Section 1374 in an amount equal to $70,000, and the balance of the $200,000 will pass through to the individual shareholders of the corporation and be taxed at 35%, resulting in a total tax of $115,500 and an aggregate effective tax rate of approximately 57.75%.

c. **Example 3. Sale of Receivables to Third Party.** Now assume that instead of accruing a bonus in 2008, the corporation sells the receivables to a third party (for their face value). Also assume that the corporation continues its policy of reducing its taxable income to zero except for the $200,000 recognized on the sale of its receivables. In this situation, the corporation (assuming that it is a qualified personal service corporation within the meaning of Section 448(d)(2) which is subject to the flat 35% tax rate), will be subject to a tax of $70,000 on the sale of its receivables to the third
party (35% of $200,000). In turn, the earnings and profits of the corporation will be increased by $130,000, the difference between the $200,000 received on the sale of the receivables and the $70,000 of taxes paid with respect to the sale of the receivables. The shareholder-employees will not, however, be taxed on the $130,000 of earnings and profits until such earnings and profits are distributed to them.

Although the corporate level tax of $70,000 is accelerated and recognized in 2008 rather than in 2009, any tax payable at the shareholder level may be deferred for a number of years and, in fact, may never be recognized by the shareholders if the distributions made by the corporation never exceed its accumulated adjustments account following its conversion to S corporation status.

d. **Example 4. Sale of Receivables to Third Party and Payment of Bonus.** Assume the same facts as in Example 3 except that in addition to selling the receivables to a third party, the corporation distributes the additional $200,000 collected on the sale of its receivables to its four shareholder-employees as an additional bonus, thus reducing the corporation’s taxable income to zero. The corporation will not be subject to the built-in gain tax imposed under Section 1374 since it will no longer own any receivables, and additionally will not be subject to any tax in 2008 since it will have no taxable income. The shareholders will be subject, however, to a tax of $70,000 in 2008, determined by multiplying the additional $200,000 bonus by the highest marginal individual income tax rate of 35%.

The sole difference between this example and the straight accrual of a bonus alternative found in Example 2 is that the tax of $70,000 is paid in 2008 in this case whereas the tax of $70,000 is paid in 2009 in the case of a bonus accrued in 2008. This method has an additional advantage of not exposing the corporation to an unreasonable compensation argument beyond its last tax year as a C corporation since it will not be subject to Section 1374, and as such, will have no reason to pay high amounts of compensation to its shareholder-employees in order to zero out its income.

In the event the IRS successfully recharacterizes the additional $200,000 bonus paid in 2008 as a dividend distribution under an unreasonable compensation argument, however, the corporation will be subject to a corporate level tax on the $200,000 collected in 2008 of $70,000 (35% of $200,000), and the individual shareholders will additionally be subject to a shareholder level tax (assuming sufficient earnings and profits) of either: (i) $30,000
(15% of $200,000), resulting in an aggregate tax liability of $100,000, or an effective aggregate (corporate and individual) tax rate on the collection of the receivables of 50%; or (ii) $19,500 (15% of $130,000), resulting in an aggregate tax liability of $89,500, or an effective aggregate (corporate and individual) tax rate on the collection of the receivables of 44.75%.

Obviously, the tax practitioner should be confident that the additional bonus will not be recharacterized as a dividend before advising use of this alternative because of the adverse tax consequences if unsuccessful.

e. **Example 5. Sale of Receivables to Shareholder-Employees.** Assume the same facts as in Example 4 except that the corporation sells the receivables to its shareholder-employees for $200,000. Assuming that the shareholder-employees have $200,000 to pay the corporation for the receivables (or will execute promissory notes to the corporation for the receivables), the corporation will recognize a corporate level tax of $70,000 in 2008.

As the shareholder-employees collect the receivables in 2009, they will recognize no gain since they will have a cost basis in the receivables under Section 1012 equal to $200,000. Again, until some future point in time when the earnings and profits of $130,000 ($200,000 of sales proceeds minus $70,000 of tax) is distributed to such shareholder-employees, any shareholder level tax will be deferred. This is the same result as achieved in Example 3, where the receivables were sold to a third party. Since it may be impossible for a corporation to find a third party willing to buy its receivables, it may be forced to sell the receivables to its shareholders if it desires to dispose of its receivables prior to its conversion to S corporation status.

f. **Example 6. Sale of Receivables to Shareholder-Employees and Payment of Bonus.** Assume the same facts as in Example 5 where the corporation sold the receivables to its shareholder-employees, but assume as in Example 4 that the corporation accrues an additional bonus of $200,000 to its shareholder-employees. In actuality, the only money that will change hands on the sale of the receivables will be withholding taxes since the shareholders will be receiving a bonus equal to the amount which they are paying for the receivables of the corporation (less applicable withholding taxes).

Just as in Example 4, if this strategy is successful, the receivables will be subject to a single level of tax at the shareholder level equal to $70,000 (35% of $200,000) in 2008. As the receivables are
collected by the shareholders in 2009, they will recognize no income since they will have a cost basis in the receivables under Section 1012 of $200,000. In the event that the additional bonus of $200,000 is recharacterized as a dividend distribution in the corporation’s last tax year as a C corporation under an unreasonable compensation argument, it will face a corporate level tax of either (i) $70,000 (35% of $200,000) and the shareholders will face an additional shareholder level tax of $30,000 (15% of $200,000), for a total tax of $100,000 and an effective aggregate tax rate of 50%; or (ii) $19,500 (15% of $130,000), resulting in an aggregate tax liability of $89,500, or an effective aggregate (corporate and individual) tax rate on the collection of the receivables of 44.75%. Once again, the tax practitioner should make the corporation aware of this risk and be confident that the additional bonus to be paid to the shareholder-employees will not be recharacterized as a dividend.

g.  **Example 7. Bonus of Receivables.** Assume the same facts as in **Example 6** except that the corporation simply distributes the $200,000 of receivables proportionately to the shareholder-employees generating the receivables as a bonus. Under the assignment of income doctrine, the corporation should recognize $200,000 of income on the distribution of its receivables to its shareholder-employees, but will receive a corresponding compensation deduction for the $200,000 bonus paid to them. The shareholders will therefore recognize $200,000 of income in 2008, and be subject to a tax of $70,000 (35% of $200,000).

Once again, the shareholder-employees will have a Section 1012 tax-cost basis in the receivables, and as such, will recognize no income in 2009 when they collect the receivables. In the event, however, that the additional bonus is deemed to be unreasonable compensation and recharacterized as a dividend distribution, the aggregate tax imposed upon the receivables will be the same as in **Examples 4 and 6**.

6.  **Summary of Accounts Receivable Planning Alternatives.**

a.  These examples demonstrate that the accrual of a bonus in an amount equal to the receivables of a cash-basis service corporation in its final C year, produces the lowest amount of tax and the greatest amount of deferral on the entire amount of tax due (provided the corporation has no other built-in gain items). Alternatively, the sale of the corporation’s receivables prior to its conversion to S corporation status will accelerate the corporate level tax due on the receivables, but may result in an indefinite deferral of the shareholder level tax on the earnings and profits
generated by the sale of the receivables. The sale of receivables in a cash-basis service corporation’s last C year with a corresponding bonus in the amount of its receivables or the bonus of its receivables will result in a single level of tax and a one year acceleration of income in comparison to the bonus accrual alternative. The alternatives involving the sale or bonus of the cash-basis service corporation’s receivables in its last C year also have the added benefit of limiting any unreasonable compensation arguments to its last year as a C corporation, rather than exposing the corporation to such an argument in years following its conversion to S corporation status when the corporation may be subject to the built-in gain tax imposed under Section 1374.

b. Consequently, the tax practitioner must analyze the specific facts and circumstances of each situation, including the total compensation package otherwise being paid to the shareholder-employees of the corporation in its last year as a C corporation, in order to determine the optimal planning alternative regarding the cash-basis service corporation’s receivables. In no event, however, should the cash-basis service corporation merely convert to S corporation status without engaging in any planning to minimize the built-in gain tax which will be imposed under Section 1374 on such corporation’s receivables.

7. **Appraisal of Assets.** Where a converting corporation can establish either that the particular asset disposed of was not held by the corporation as of the effective date of its conversion from C corporation status to S corporation status, or that such asset’s built-in gain as of the date of the corporation’s conversion from C corporation status to S corporation status was less than the gain recognized by the corporation on such disposition, the amount of the corporation’s recognized built-in gain will be reduced accordingly. The built-in gain tax is thus limited to the amount of the converting corporation’s pre-conversion appreciation in its assets, and as such, it is essential that the converting corporation have each of its assets identified and appraised as of the effective date of its conversion from C corporation status to S corporation status.

N. **Post Conversion Planning Opportunities.** In addition to the pre-conversion planning opportunities discussed above, there are a variety of techniques which may be used by the converting corporation to minimize or eliminate its built-in gain tax following its conversion from C corporation status to S corporation status. A number of these post-conversion planning opportunities are discussed below.

1. **Preservation of Pre-1987 and Pre-1989 Elections.** Because the excess capital gains tax imposed by Section 1374 prior to its amendment by TRA’86 is generally less burdensome than the built-in gain tax imposed
under Section 1374, in most cases it will be beneficial for those C corporations which filed S corporation elections prior to January 1, 1987, to retain and preserve such elections so as not to become subject to the built-in gain tax. Similarly, since the rules applicable to C corporations converting to S corporation status during the transitional period and which otherwise qualified for transitional rule relief are less burdensome than the rules imposed under the built-in gain tax, corporations which made transitional-period S elections should retain and preserve such elections so as not to become subject to the built-in gain tax.

2. **Preservation of Post-December 31, 1988 Elections.** Though corporations filing S corporation elections after December 31, 1988 are fully subject to the built-in gain tax, it will still be beneficial for such corporations to preserve such elections in order to avoid the application of a new 10-year recognition period which would result if such corporation’s S election terminates and the corporation subsequently files a new S election.

3. **Matching of Built-In Losses with Built-In Gains.** Under the amendments made to the built-in gain tax by TAMRA, an S corporation is allowed to use its recognized built-in losses to offset its built-in gains. Thus, a corporation may minimize the impact of the built-in gain tax by disposing of assets which have built-in losses during taxable years in which it has disposed of assets having built-in gains. Similarly, a cash basis corporation subject to the built-in gain tax should match built-in loss items (such as accounts payable) with built-in gain items (such as accounts receivable) recognized during the taxable year. Since corporations electing S corporation status after March 31, 1988 must carryforward any excess recognized built-in gains over built-in losses that are not subject to the built-in gain tax due to the taxable income limitation, it will be even more important for such corporations (as opposed to corporations making S elections prior to March 31, 1988 which are not subject to the carryforward rule) to reduce their recognized built-in gains by the recognition of built-in losses to an amount which is less than the taxable income of the corporation for the taxable year. In other words, if a corporation which made an S corporation election after March 31, 1988 can make the base of the built-in gain tax the excess of recognized built-in gains over recognized built-in losses rather than taxable income, such corporation will be able to avoid application of the new carryforward rule enacted by TAMRA.

4. **Reduction of Taxable Income.** Since the base of the built-in gain tax is the lesser of the taxable income of the corporation or the amount which would be its taxable income if only recognized built-in gains and recognized built-in losses were taken into account, the corporation may minimize or eliminate the imposition of the built-in gain tax for a given taxable year by reducing or eliminating its taxable income. However, as
discussed above, for corporations making S elections after March 31, 1988, to the extent that the taxable income of the corporation is less than the excess of the corporation’s recognized built-in gains over its recognized built-in losses, such excess will be carried forward and treated as built-in gain in the corporation’s succeeding taxable year. Nevertheless, if the corporation can eliminate (or greatly minimize) its taxable income during the entire 10-year recognition period (by means of the payment of compensation to its shareholders or by some other method), such corporation may be able to completely avoid imposition of the built-in gain tax. For corporations which made S elections prior to March 31, 1988, the reduction of taxable income is just as important as the matching of recognized built-in losses with recognized built-in gains since such corporations are not subject to the carryforward rule enacted by TAMRA.

5. **Net Operating Loss Carryforwards.** Under Section 1374(b)(2), the base of the built-in gain tax for a particular taxable year, whether it is the excess of recognized built-in gains over recognized built-in losses or the corporation’s taxable income, may be reduced by net operating loss carryforwards arising from years in which the corporation was a C corporation. Likewise, capital loss carryforwards from C years are allowed to reduce the base of the built-in gain tax. The tax computed under Section 1374 may also be reduced by business credit carryforwards from C years. Thus, the tax practitioner should be aware of, and actively plan for the utilization of, net operating loss carryforwards, capital loss carryforwards and business credit carryovers, from C years.

6. **Non-Recognition Transactions.** Another post-conversion method of minimizing the impact of the built-in gain tax is for the S corporation to dispose of its built-in gain assets in non-recognition transactions, such as in a Section 1031 like-kind exchange, a Section 1033 involuntary conversion, a Section 351 incorporation transaction or a Section 361 reorganization transaction, so as to defer recognition of the built-in gain inherent in its assets. Though the amendments made by TAMRA subject any asset received by an S corporation in a non-recognition transaction such as those discussed above to the built-in gain tax to the same extent as the asset which was disposed of, the non-recognition transaction itself will not trigger application of the built-in gain tax and may therefore be used as a deferral device.

7. **Deferral of Disposition of Assets.** A corporation, if possible, should simply avoid the disposition of assets having built-in gain during the 10-year recognition period. Alternatively, where such dispositions are unavoidable, disposition of assets having built-in losses should be matched with the disposition of built-in gain assets, as discussed above, to minimize the corporation’s built-in gain tax exposure.
IX. CHANGES IN FORM OF ENTITY NOT RESULTING IN CHANGE OF TAX STATUS OF ENTITY

A. **In General.** Unlike the various transactions discussed above, an entity may change its status for state law purposes but still be treated the same for federal tax purposes. Some examples of such transactions include reorganizations under Section 368(a)(1)(F) involving both C and S corporations, changes from one type of tax partnership to another type of tax partnership and mergers involving partnerships. Changes in form of entities treated as an “F” reorganization will be briefly discussed below. This outline will not discuss the issues attendant to the change from one type of tax partnership to another type of tax partnership and mergers involving only partnerships.

B. **F Reorganizations.** Under Section 368(a)(1)(F), a tax-free reorganization includes a mere change in identity, form, or place of organization of one corporation, however effected. The most common example of an F reorganization which results in a change in the form of state law entity but does not change the federal income tax status of the entity is the conversion of a state law corporation (whether taxed as a C or S corporation) pursuant to the applicable state law formless conversion statute into an LLC which elects under the check-the-box regulations to be treated as an association taxable as a corporation. Although the entity has changed its state law form from a corporation to an LLC, it will continue to be taxed as a corporation for federal income tax purposes, and as such, no tax consequences result from such conversion. An F reorganization may also occur where a corporation mergers under the applicable state law cross-entity merger statute into an LLC which elects to be treated as an association taxable as a corporation. In the case of S corporations, special attention must be paid to whether a new S election must be made and what employer identification number will be used for the new entity.

1. **Rul. 64-250.** Rev. Rul. 64-250, 1964-2 C.B. 333, provides that when an S corporation merges into a newly formed corporation in a transaction qualifying as a reorganization under Section 368(a)(1)(F) and the newly formed surviving corporation also meets the requirements of an S corporation, the reorganization does not terminate the S election, and as such, the S election remains in effect for the new corporation (without the new corporation being required to file a new S election).

2. **Rev. Rul. 73-526.** In Rev. Rul. 73-526, 1973-2 C.B. 404, the IRS concluded that where an S corporation merged into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation.

3. **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.** In Rev. Rul. 2008-18, the IRS ruled that in the two situations presented in the rulings, which both qualified as F
reorganizations within the meaning of Section 368(a)(1)(F), the S election of the existing corporations did not terminate (and were carried over to the newly formed corporations), but that the newly formed corporations would be required to obtain new employer identification numbers.

a. In situation 1 of the ruling, B, an individual, owned all of the stock of Y, an S corporation. In year 1, B forms Newco and contributes all of the Y stock to Newco, which meets the requirements for qualification as a small business corporation. Newco timely elects to treat Y as a qualified subchapter S subsidiary (QSub) effective immediately following the transaction. The ruling states that the transaction meets the requirements of an F reorganization under Section 368(a)(1)(F). In year 2, Newco sells 1% of the stock of Y to D, an unrelated party.

b. In situation 2, C, an individual, owns all of the stock of Z, an S corporation. In year 1, Z forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merges with and into Z, with Z surviving and C receiving solely Newco stock in exchange for his stock of Z. Consequently, C owns 100% of Newco, which in turn owns 100% of Z. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub effective immediately following the transaction. Again, the ruling expressly states that the transaction meets the requirements of an F reorganization.

c. Rev. Rul. 2008-18 provides, however, that since the publication of Rev. Rul. 73-526, the Code has been amended to provide the classification of certain wholly-owned subsidiaries of S corporations as QSubs and the regulations under Section 6109 have been amended to address the effect of QSub elections under Section 1361. Specifically, Treas. Reg. § 301.6109-1(i)(1) provides that any entity that has a federal employer identification number will retain that employer identification number if a QSub election is made for the entity under Treas. Reg. § 1.1361-3 or if a QSub election that was in effect for the entity terminates under Treas. Reg. § 1.1361-5. Additionally, Treas. Reg. § 301.6109-1(i)(2) provides that, except as otherwise provided in regulations or other published guidance, a QSub must use the parent S corporation’s employer identification number.

d. Additionally, for tax years beginning after December 31, 2004, Section 1361(b)(3)(E) was amended to provide that except to the extent provided by the IRS, QSubs are not disregarded for purposes of information returns. Further, QSubs are not disregarded for certain other purposes as provided in the regulations. For example, Treas. Reg. § 1.1361-4(a)(7) provides
that a QSub is treated as a separate corporation for purposes of employment tax and related employment requirements effective for wages paid on or after January 1, 2009. Because a QSub is treated as a separate corporation for certain federal tax purposes, the QSub must retain and use its employer identification number when it is treated as a separate corporation for federal tax purposes.

**e.** Because of these recent changes, the IRS concluded that it would not be appropriate for the acquiring corporation in a reorganization under Section 368(a)(1)(F) to use the employer identification number of the transferor corporation that becomes a QSub. Thus, in situation 1, although Y’s original S election will not terminate but will continue for Newco, Newco will be required to obtain a new employer identification number and Y will retain its employer identification number even though a QSub election is made for it and will be required to use its original employer identification number anytime Y is otherwise treated as a separate entity for federal tax purposes. Additionally, in year 2, when Newco sells 1% of the stock of Y to D, Y’s QSub election will terminate under Section 1361(b)(3)(C) and Y will be required to use its original employer identification number following the termination of its QSub election.

**f.** Likewise, in situation 2, Z’s original S election will not terminate as a result of the F reorganization but will continue for Newco, and as such, Newco will not be required to file a new S election. Again, however, Newco will be required to obtain a new employer identification number and Z must retain its employer identification number even though a QSub election is made for Z and must use its original employer identification number any time it is otherwise treated as a separate entity for federal tax purposes or if its QSub election terminates.

**g.** Rev. Rul. 2008-18 applies to F reorganizations occurring on or after January 1, 2009. For F reorganizations occurring on or after March 7, 2008 and before the effective date of the ruling, taxpayers may rely on Rev. Rul. 2008-18. The ruling acknowledges that the IRS is aware that prior to the effective date of the ruling, S corporations have undergone F reorganizations in a manner similar to those described in situations 1 and 2 in which the acquiring corporation continued to use the transferor corporation’s employer identification number consistent with Rev. Rul. 73-526. In those cases, the IRS provides that the acquiring corporation should continue to follow Rev. Rul. 73-526 and use the transferor corporation’s employer identification number and that after the F reorganization, the transferor QSub should use the parent’s employer identification number until such time as the QSub is
otherwise treated as a separate corporation for federal tax purposes or until such time as the QSub terminates. At such time, the QSub must obtain a new employer identification number. The IRS also states in the ruling that for an F reorganization occurring prior to January 1, 2009, it may be prudent for the acquiring corporation to make a protective S election.

h. Rev. Rul. 2008-18 is consistent with a number of prior rulings issued by the IRS to the extent that the newly formed corporation making a QSub election for the existing (transferor) corporation is not required to make a new S election. On the other hand, Rev. Rul. 2008-18 reverses the holdings in a number of prior rulings which provided that the newly formed corporation should use the employer identification number of the existing corporation (which becomes a QSub). See, e.g., PLRs 200701017 and 200725012. The ruling does state, however, that in situations not involving a QSub, such as the specific situation set forth in Rev. Rul. 73-526 involving the merger of one S corporation with and into another corporation that constitutes an F reorganization, the surviving corporation in those circumstances would use the employer identification of the transferor corporation.

4. **IRS Applies Rev. Rul. 2008-18 to F Reorganization Involving Qualified Subchapter S Subsidiary.** In EEC 200941019 (Oct. 9, 2009), the IRS issued email guidance to a taxpayer providing that the taxpayer could rely on Rev. Rul. 2008-18, 2008-13, IRB 674.

a. In the email advice, C owns all of the stock of Z, an S corporation with an existing employer identification number. In year 1, Z forms NewCo, which in turn forms MergeCo. Pursuant to a plan of reorganization, MergeCo merged with and into Z with Z surviving and C receiving solely NewCo stock in exchange for Z stock. NewCo meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub effective immediately following the transaction.

b. The email advice provides that the taxpayer may rely on the principles set forth in Rev. Rul. 2008-18, and consequently, Z’s original S election will not terminate but will continue for NewCo, but NewCo will be required to obtain a new employer identification number and Z will retain its existing employer identification number even though a QSub election is made for it. Additionally, the IRS provided in the email advice that Z would not file a final Form 1120S, but rather that NewCo would report all of Z’s and NewCo’s income on its Form 1120S.
5. **Merger of Parent S Corporation into QSub Constitutes an F Reorganization.** In PLR 201007043, the IRS ruled that an S corporation’s merger into its wholly owned qualified subchapter S subsidiary (QSub) constituted a tax-free reorganization under Section 368(a)(1)(F) without adversely affecting S corporation status.

   a. In the ruling, the S corporation and one of its two wholly owned QSubs desired to combine their assets and operations into a single corporation in order to take advantage of planned efficiencies and to reduce expenses and redundancies. Because certain legal agreements of the QSub prohibited the QSub from merging upstream into the S corporation, it was decided that the S corporation should merge downstream into the QSub.

   b. Citing Rev. Rul. 64-250, 1964-2 C.B. 333, the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSub following the merger. Additionally, citing Rev. Rul. 2004-85, 2004-2 C.B. 189, the IRS found that the status of the S corporation’s other QSub would not terminate as a result of the F reorganization.

   c. Interestingly, the ruling does not address whether the surviving entity should continue to use the federal identification number previously used by the S corporation or the federal identification number of the QSub into which it was merged. In Rev. Rul. 73-526, 1973-2 C.B. 404, the IRS ruled that where an S corporation merges into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation. However, more recently in Rev. Rul. 2008-18, 2008-1 C.B. 674, the IRS ruled that in the two situations presented in the ruling, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the newly formed corporations would be required to obtain new employer identification numbers and that the existing corporation which became a QSub would retain its same employer identification number.

6. **S Corporation Sale of Assets Structured as F Reorganization Upheld.** In PLR 201115016, the IRS ruled that the contribution of all of an S corporation’s stock to a new wholly owned corporation (NewCo) in exchange for all of NewCo’s shares, followed by NewCo’s making a QSub election, qualifies as an F Reorganization, that NewCo will be eligible to be treated as an S corporation and that such S election will be treated not as if it had terminated, but instead had remained in effect.

   a. This ruling allowed the owner of the S corporation to use this F reorganization structure to create a holding company subsidiary
QSub structure, retaining the portion of the S corporation’s assets the shareholder wanted to keep in the parent S corporation and dropping into the QSub the assets the shareholder desired to sell through a sale of the stock of the now QSub, which will be treated as an asset sale. In other words, in this ruling the IRS concluded that F Reorganization treatment applied in a transaction in which the operations of an S corporation were split up.

X. CONCLUSION

The recent advent of the check-the-box regulations, state law formless conversion statutes and state “cross-entity” merger statutes make it very easy for a taxpayer (and his advisor) to change from one form of tax entity to another form of tax entity. As discussed in this outline, however, the tax consequences of such conversions, and the manner in which such conversions are effectuated, must be analyzed by the tax practitioner in order to achieve the best tax results for the taxpayer and to avoid unintended adverse tax consequences.