¶ 13.06 Sale of Stock (Including Sections 336(e) and 338)

The shareholders of an S corporation may sell some or all of their stock in the corporation. This paragraph discusses the tax consequences of such sales, including those that bring about a change of control over the S corporation. The latter category of transactions often has similar economic effects to a sale by the S corporation of all of its assets, and the tax analysis in some respects reflects that similarity.

¶ 13.06[1] Amount of Seller's Gain or Loss

A seller's gain or loss from the sale of stock equals the amount realized for the stock less its adjusted basis. The adjusted basis reflects, among other things, the amount of income and loss that previously passed through from the S corporation to the selling shareholder, as well as the amount of certain tax-free distributions received from the S corporation. The sale of stock may allow either the Service or the taxpayer to correct prior errors in closed years if the other party has not computed basis in accordance with prior reporting.

If stock is sold during a corporation's taxable year, the income or loss passing through from the corporation in the year of sale affects the basis of the stock sold. Thus, the seller will not know the exact basis for the stock that is sold until sometime after the sale. The pass-through of income or loss for the year of the sale is discussed shortly.

As discussed earlier in this work, in the case of a sale by a QSST, the gain or loss on the stock disposition is recognized by the trust, and not by the beneficiary otherwise treated as the owner of the S corporation stock. The income or loss passing through on the stock for the period leading up to the sale is, however, reported by the income beneficiary of the trust.

¶ 13.06[2] Character of Seller's Gain or Loss

Gain on the sale of stock generally is treated as capital gain. However, ordinary income may result if the stock is not a capital asset, if the stock is Section 306 stock, if the corporation has deducted intangible drilling and development costs, or if Section 304 applies to the sale. In a rare case, Section 1248(e) might cause some of the gain of a shareholder to be ordinary income.

Absent an election to treat a stock sale as an asset sale, appreciation on the S corporation's assets that would trigger ordinary income or loss at the corporate level if sold do not result in ordinary income or loss to the shareholder on the sale of stock. This is in sharp contrast to the partnership "hot asset" rules, which treat a portion of the proceeds of a sale of a partnership interest as a sale of the partner's share of the partnership's ordinary income-producing and ordinary loss-producing assets. However, if the S corporation holds appreciated collectibles at the time that a shareholder sells stock held for more than one year, the shareholder is treated as recognizing the shareholder's share of the collectibles gain that the corporation would have recognized had it sold all its collectibles immediately before the stock transaction. As collectibles gain is taxed at a higher rate than other capital gain, the result is unfavorable to the shareholder. In some cases, the shareholder may recognize both a collectibles gain and a long-term capital loss on the sale or exchange of the stock. If the S corporation's collectibles have not appreciated as a group, the "look-through" rule does not apply.

A loss on the sale of stock is generally treated as a capital loss. Capital losses and gains are long-term if the shareholder has held the stock for more than one year. However, ordinary loss treatment may result if the stock is not a capital asset or if it is Section 1244 stock. The stock must meet the normal tests of Section 1244 because the corporation's status under subchapter S has no effect on Section 1244.

A taxpayer who has foreign tax credits may care whether the gain on the sale of S corporation stock has a foreign source or a U.S. source. Under certain conditions, a sale of stock may produce foreign source income.

A shareholder who sells stock may be subject to tax under Section 1411 on the resulting "net investment income." With proper planning, a shareholder who avoids a "passive activity" may be able to
avoid this tax.  


A seller of S corporation stock in a deferred-payment transaction generally is eligible to report gain on the installment method under Section 453. To the extent that the S corporation holds marketable securities, Section 453(k) appears to authorize the Service to issue regulations disallowing installment method treatment of the gain. No such regulations have been issued, however.

¶ 13.06[4] Termination of S Status

¶ 13.06[4][a] In General

A sale of stock may result in a termination of the issuing corporation's S status in either of two situations: (1) if the buyer is not a permitted shareholder or (2) if the sale results in more than 100 unrelated shareholders. A well drafted agreement among existing shareholders can ordinarily prevent such disqualifying sales.

If a stock sale triggers termination of the corporation's election under subchapter S, the termination takes effect on the day of the terminating event. Section 1362(e)(1) divides the corporation's taxable year into two short years. Subchapter S applies only to the first short year, which ends on the day before the day on which termination occurs. The other short year is governed only by subchapter C. Any income realized during the C short year is taxed on an annualized basis.

As discussed earlier in this work, the allocation is generally calculated by prorating the entire results for the full taxable year based on the numbers of days in the two short years. However, the corporation may elect to close its books on the date of the termination, and in some cases it is required to do so. The amount of pass-through income and deductions for the year of the sale, which can affect the amount of the shareholder's basis in the S corporation's stock, is discussed next.

¶ 13.06[4][b] Sale Making Former S Corporation Member of Consolidated Group

When a consolidated group acquires enough stock of an S corporation to make it a member of the consolidated group (i.e., at least 80 percent of the stock by vote and value) and does not elect to treat the transaction as an asset purchase under Section 338, the Code and regulations prescribe the following results:

1. The S election of the acquired corporation ends because that corporation ceases to be a "small business corporation."
2. The termination of S status is "effective" on the day of the stock sale.
3. The S corporation's taxable year ends for all purposes on the day before the stock sale.
4. The corporation becomes a member of the consolidated group at the beginning of the day on which the termination of S status is effective.
5. The corporation determines its items of income and deduction for the period included in the consolidated return based on its normal method of accounting (that is, it must close its books).
6. The due date for the return for the final short S year is not accelerated by the end of that year.

The Service adopted these regulations primarily to eliminate the burden of filing a one-day return for the day of the stock purchase. Without the regulations, the subchapter S and consolidated return rules would produce a one-day year in between the final S year and the first consolidated year.

¶ 13.06[5] Taxation of Corporate Income or Loss for Year of Sale
¶ 13.06[5][a] In General

A sale of an S corporation's stock has no direct effect on the amount of corporate income or loss. Moreover, such a sale does not prevent the corporation's tax items from passing through to the selling shareholder for the period preceding the sale of the stock. Items of corporate income and loss generally pass through to shareholders on a per-share, per-day basis under Section 1377(a)(1), with the seller being treated as the shareholder for the day of the sale. The pass-through in turn affects the basis of the stock being sold, under Section 1367.

Does the pass-through from the S corporation to the selling shareholder occur at the end of the S corporation's taxable year, or at the time the stock is sold? The pass-through occurs at the end of the corporation's taxable year; the selling shareholder does not report the pass-through items until that time, even though by then he or she no longer holds the sold shares. Moreover, as has been seen, the sale transaction does not end the corporation's taxable year so as to trigger the pass-through prematurely, even if it results in termination of the shareholder's entire stock interest or termination of the corporation's election under subchapter S.

However, in all cases, the basis adjustments resulting from such pass-through items are retroactive—they are effective immediately before the sale of the stock.

¶ 13.06[5][b] Allocation of Pass-Through Items

¶ 13.06[5][b][i] In general.

Allocating the corporation's income, deduction, and credit items to the periods before and after a stock sale is of keen interest to both the selling and buying shareholders. The two logical possibilities for performing the allocation are (1) to close the corporation's books and perform an exact calculation of the partial year's tax items at the time of the sale, or (2) to let the full year run its course and pro rate the year's results between the two portions of the year based on the number of days in each portion. The applicable rules often allow the former course, and sometimes require it.

¶ 13.06[5][b][ii] Mandatory closing of books.

As discussed in greater detail earlier in this work, the corporation must close its books for pass-through allocation purposes if, during the taxable year in which its status as an S corporation terminates, there is a sale or exchange of 50 percent or more of its stock. In such a case, the books must be closed as of the termination date, even if the stock sale that reaches the 50 percent threshold occurs on a different date. A mandatory closing of the books also applies to any item resulting from application of Section 338, discussed later in this chapter. When elected, Section 338 treats a sale of corporate stock as a sale of the issuing corporation's assets. The rule requiring mandatory closure of the books places all of the corporate gain or loss resulting from the deemed asset sale in either the period before the stock sale or the period following the stock sale. The gain or loss under Section 338 is not combined with the corporation's other results for the taxable year and then prorated.

¶ 13.06[5][b][iii] Optional closing of books.

A corporation is permitted to close its books for pass-through allocation purposes whenever its election to be an S corporation terminates, including by virtue of a stock sale to an ineligible shareholder. In the year of termination, the corporation can close its books with the consent of all persons who own stock during the S short year and on the first day of the C short year. Closing of the books is also allowed when a shareholder's entire stock interest is terminated, including by a sale. Closing of the books is also allowed when a shareholder disposes of 20 percent or more of the corporation's stock within a thirty-day

In situations in which closing of the books is not expressly required or permitted, proration appears to be required. Section 1377(a)(1) generally provides for a per-share, per-day allocation of pass-through items.

¶ 13.06[5][c] Dynamics of Buyer and Seller

¶ 13.06[5][c][i] Uncertainty of pass-through allocation for year of sale.

The shift of ownership resulting from a sale of the corporation's stock may have indirect effects on the corporation's income and loss. For example, the corporation may have sustained an operating loss for the portion of its taxable year ending with the date of the stock sale. The seller may expect to deduct a share of that loss. However, following the stock sale, the buyer may cause the corporation to earn profits for the balance of its taxable year (perhaps as a result of an infusion of new capital). Thus, the corporation may end its taxable year with an overall net profit and no loss pass-through available to the seller. Closing the books should prevent unanticipated changes in the selling shareholder's tax position, especially if the seller and buyer spell out in the stock sale contract the tax allocations underlying their basic agreement.

Example

A sells all the stock of X corporation to B in the middle of the corporation's year. B is an eligible shareholder of an S corporation, and the corporation's election under Subchapter S is not terminated or revoked. X has a $100 net operating loss for the portion of its taxable year ending with the date of A's stock sale to B, and a $200 net operating profit for the portion of its taxable year beginning the day after the sale. Without a closing of the books of X, A and B each has $50 of pass-through income for the S corporation's year (half of the corporation's $100 operating profit for the entire year). However, if an election under Section 1377(a)(2) to close X's books is made, A has $100 of pass-through loss, while B has $200 of pass-through income. A may be unwilling to wait until the end of X's taxable year to know the tax consequences of the year's pass-through and the stock sale, in which case A will desire that X close its books upon the sale. In order for the books to be closed, X, A, and B must all consent. Before deciding whether or not to close the books, however, the parties should consider the overall tax impact on the selling shareholder, in light of the fact that the pass-through of income increases stock basis, thereby decreasing the gain or increasing the loss recognized on the sale.

¶ 13.06[5][c][ii] Termination and revocation.

As has been seen, the termination rules of Sections 1362(d)(2) and 1362(e), along with the pass-through rules of Sections 1366 and 1377(a), must be considered carefully in the case of stock sales. A sale may trigger termination of the corporation's election under subchapter S by spoiling its eligibility as a "small business corporation." Another possibility that should be considered is revocation of the corporation's S status under Section 1362(d)(1), which has its own set of rules regarding the effective date of the corporation's loss of S status. Termination by revocation ordinarily takes effect for the corporation's next taxable year. However, if effected within the first two and one-half months of a taxable year, revocation can be effective for the entire current year. Moreover, the parties can specify that the revocation will take effect on a particular prospective date, on or after the date of the revocation.
If the revocation course is chosen, the split-year rules of Section 1362(e) apply. Under those rules, the corporation's year is divided into two short years, an "S short year" and a "C short year." Income and losses are allocated between the two short-year periods on a daily basis, unless the books of the corporation are closed under the rules just discussed. Any income realized during the C short year is taxed on an annualized basis.

Example

A owns all the stock of X. A sells 40 percent of the stock to B on July 2. X revokes its S election as of the date of the sale. A will be taxed on all of X's income (or will be entitled to all of X's losses) for X's S short year ending on the day before the date of the sale. X will report any income or losses allocable to its C short year. If taxable income results, X will be taxed on an annualized basis on that income.

If both A and B agree, X's books can be closed, with income or loss being traced to the two short years under Section 1362(e)(3), using normal accounting rules. If this election is made, income and loss items will be assigned to the two short periods according to the times realized or incurred, as reflected in X's records.

¶ 13.06[c][iii] Change of accounting methods.

Another potential source of uncertainty is the possibility that after the stock sale, the buyer may cause the corporation to change its method of accounting with the consent of the Service. The seller can be harmed by this change but may not have the power to stop it (except by agreement).

¶ 13.06[c][iv] Contract provisions.

As can be seen from this discussion, the buyer and the seller of S corporation stock have details to iron out in the stock sale agreement. To avoid later conflicts, the parties may wish to agree on the following matters:

1. If the corporation remains eligible to be an S corporation, whether the corporation's S status will continue through the end of its taxable year;
2. When the parties will treat the sale as being effective for tax purposes;
3. Whether the corporation will attempt to change its accounting methods;
4. If available, whether an election will be made under Section 1377(a)(2) to close the corporation's books;
5. If the corporation's S status will end, whether an election will be made under Section 1362(e)(3) to close the corporation's books for purposes of allocating income and deduction items between the S short year and the C short year; and
6. Whether the seller's consent will be required for the corporation to file an amended return for any S taxable year prior to the sale.

These factors will affect whether, and to what extent, the corporation's income or loss will be reported by the buyer, the seller, or the corporation. The parties can then set the appropriate price for the stock based on predictable tax results.

In some cases, a seller may wish to have a buyer pay a certain amount for the stock plus a specified percentage of whatever income passes through to the seller in the year of the sale, with the percentage reflecting the tax burden of the seller on the pass-through income. Setting the percentage at the highest marginal tax rate is often not appropriate because the pass-through of income increases the seller's stock basis and decreases the seller's taxable gain.

In some cases, corporate income that passes through to the selling shareholder under Section 1366 will be, in effect, taxed to the seller at a reduced rate. In such a case, the buyer and the seller should try to maximize the income that passes through to the seller.
Example

B owns all the stock of X, an S corporation that uses the calendar taxable year. B has a basis of $10 for the stock as of January 1, 2015.

During 2015, C, an individual, buys all the stock of X for $100. X continues to be an S corporation. Thus, B will have $90 of gain if no gain or loss passes through to B from X during 2015. B and C are both in the highest marginal federal tax brackets.

X is eligible to elect to close its books under Section 1377(a)(2), with the consent of B and C. The election need not be filed until the time X's 2015 tax return is filed. That return shows $40 of taxable income, all ordinary income, for 2015.

B and C should calculate the effects of closing the books, or not closing the books, on the amount of income that passes through to B. Further, B and C should consider having X make, or not make, any accounting adjustments or elections that may be available. Assume that no income will pass through to B, and that $40 of income will pass through to C, if the books are not closed. Assume further that B will have $20 of income and C will have $20 of income if the books are closed.

Closing the books will save C $7.92 of current federal income taxes (39.6 percent of the $20 of income shifted to B). The cost to B, however, will be only $3.92. The $20 of additional income that passes through to B will increase B's stock basis to $30 and reduce B's taxable gain on the sale to $70. The $20 basis increase reduces B's capital gain by $20, thus saving B $4 in tax (20 percent of the $20 gain reduction).

13.06[5][d] History (Prior Law)

Before the Subchapter S Revision Act of 1982, a sale could greatly affect which taxpayers bore the burden of corporate income or enjoyed the tax benefit of its loss pass-through. For example, if a corporation had undistributed taxable income, that income normally passed through to the persons who owned stock in the corporation on the last day of its taxable year. Consequently, the buyer ordinarily was taxed on the corporation's income for its entire taxable year. However, a sale of stock for the sole purpose of shifting taxable income to the buyer was sometimes not effective for this purpose. Because of the importance of stock ownership on the last day of the corporation's taxable year, the buyer and seller sometimes disagreed on the effective date of a sale for tax purposes.


In contrast to the partnership basis rules of Section 743(b), the purchase of an S corporation's stock neither enables nor requires the corporation to change the basis of its assets. Thus, gains and losses on later dispositions of those assets, and the amounts of depreciation or amortization deductions with respect to them, are unaffected by the stock transaction.

The buyer of a controlling interest in an S corporation can alter the basis of the corporation's assets, however, by liquidating the corporation or by making an election under Section 336(e) or Section 338. Both result in deemed sales of the corporation's assets for their fair market values, which in turn become the bases of the assets formerly held by the target S corporation.

13.06[7] Relationship to Stock Redemption or Distribution Under Section 1368

In a sale of stock, a seller receives cash or property from the buyer. In a stock redemption, the seller receives cash or property from the corporation. Frequently, gains from stock redemptions qualify for sale treatment. When a stock sale is proposed, an individual buyer should consider asking the seller to combine the stock sale with a stock redemption. A combined sale and redemption may be appropriate if
the corporation has excess cash or property, or if the stock sale is to be effected by way of an installment
sale to be reported on the installment method. An individual buyer may not be able to withdraw cash from
the corporation on favorable tax terms to pay off the purchase-money notes if the corporation has
accumulated earnings and profits from a C corporation history. Under the distribution rules of Section 1368, however, the benefits of an S corporation's accumulated adjustments account are generally transferable. Thus, the buyer may be able to obtain nondividend cash withdrawals under Section 1368 (provided that the corporation retains its S status). In so doing, however, the buyer may be relying on the corporation's computation of its accumulated adjustments account in prior years.

Alternatively, if the corporation has excess cash, the prospective seller may withdraw cash prior to
the sale in the form of regular distributions. If Section 1368(b) applies, the seller may be able to receive
such distributions tax-free or at capital gain rates. Such a withdrawal before an installment sale may
have the advantage of allowing the shareholder's entire stock basis to offset the first payments received,
instead of requiring that the basis be spread over all the payments.

¶ 13.06[8] Sale to Commonly Controlled Corporation (Section 304)

¶ 13.06[8][a] Introduction

If the stock of an S corporation is sold to a commonly controlled corporation, Section 304 recasts the
transaction as a distribution by the acquiring corporation in redemption of its own newly issued stock. Section 304 generally applies both to sales of a parent corporation's stock to a subsidiary and to sales of a corporation's stock to a sister corporation. Because an S corporation cannot have a corporate shareholder, Section 304 applies to a sale of S corporation stock only in the brother-sister scenario, or when the stock of an S corporation parent is sold to a subsidiary C corporation. Moreover, in any sale of S corporation stock covered by Section 304, the corporation whose stock is being sold immediately loses its election under subchapter S.

¶ 13.06[8][b] Brother-Sister S Corporations With No Earnings and Profits

The consequences of Section 304 sales are relatively simple when both the issuing corporation and acquiring corporation are S corporations with no C corporation history. For purposes of determining whether the constructive redemption is treated as a sale of the acquiring corporation's stock rather than a distribution with respect to that stock, the selling shareholder's stock ownership before and after the transaction is tested under Section 302(b) with respect to the stock of the corporation whose shares were sold. Assuming that the sale is recast as a distribution covered by Section 301, Section 1368(b) takes over the proceedings and allows the shareholder's basis in the acquiring corporation's stock to offset the amount of the deemed redemption proceeds. The basis of the acquiring corporation's stock is increased by the basis of the issuing corporation's stock, which is treated as being contributed to the acquiring corporation in a transaction covered by Section 351. That basis increase is treated as occurring before the deemed distribution, thus bettering the chances of tax-free treatment of the distribution. Any distributed amount in excess of the selling shareholder's basis in all of the shareholder's stock in the acquiring corporation is treated as gain on the sale of that stock. No taxable dividend is possible because neither corporation has earnings and profits. Indeed, query whether Section 304 should even apply in such circumstances.

¶ 13.06[8][c] Sale to Sister C Corporation

If the acquiring corporation is a sister C corporation, Section 1368 is inapplicable to the deemed
distribution. For purposes of determining whether the constructive redemption is treated as a sale of the acquiring corporation's stock rather than a distribution with respect to that stock, the selling shareholder's
stock ownership before and after the transaction is tested under Section 302(b) with respect to the stock of the corporation whose shares were sold. Assuming that the sale is recast as a distribution covered by Section 301, the distribution is taxable as a dividend to the extent of the acquiring corporation's earnings and profits, and to the extent of the acquired S corporation's earnings and profits, if it has any. If the issuing S corporation also has an accumulated adjustments account, nothing in the statute expressly authorizes use of that account in determining the amount of the dividend. The distribution is treated as being made by the acquiring corporation, and not by the issuing corporation.

Any amount distributed beyond the dividend is treated as a return of the basis of all of the seller's stock of the acquiring corporation, which is increased prior to the distribution by the basis of the S corporation stock sold. Once the dividend is taxed and all of the C corporation stock basis is exhausted, any additional amount received by the selling shareholder is treated as gain on a sale of the C corporation's stock.

¶ 13.06[8][d] Sale to Sister S Corporation With Earnings and Profits Present

¶ 13.06[8][d][i] Acquiring corporation with earnings and profits.

If the acquiring corporation is an S corporation with a C corporation history, a deemed distribution under Section 301 is covered by Section 1368(b), and thus is treated as a tax-free return of basis (followed by gain on a sale of the acquiring corporation's stock), to the extent of that corporation's accumulated adjustments account. If the deemed distribution exceeds the accumulated adjustments account, nothing in the statute permits use of the issuing S corporation's accumulated adjustments account (if any) before the distribution is treated as being made from the acquiring corporation's accumulated earnings and profits, and thus a taxable dividend. Section 304 treats the payment as a distribution by the acquiring corporation, and not by the issuing corporation.

Because the positive earnings and profits accounts of the two S corporations are combined, any amount distributed beyond the acquiring corporation's accumulated adjustments account, and beyond its earnings and profits, is apparently treated as coming from the issuing corporation's earnings and profits (if any), and thus more taxable dividend. Once again, at least under the statutory language, the issuing corporation's accumulated adjustments account (if any) is of no utility, because the distribution is treated as being made by the acquiring corporation, and not by the issuing corporation.

Deemed distributions beyond the acquiring corporation's accumulated adjustments account and the combined earnings and profits of the two S corporations are treated as a tax-free return of the shareholder's basis in all of the acquiring corporation's stock under Section 1368(b). That stock basis is increased before the distribution by the basis of the issuing corporation's shares that are acquired. Once the basis of the stock in the acquiring corporation stock is exhausted, any additional amount received by the selling shareholder is treated as gain on the sale of the acquiring corporation's stock.

¶ 13.06[8][d][ii] Earnings and profits in issuing corporation only.

Section 1368's application in the Section 304 context is not always clear. Suppose that the acquiring S corporation has no accumulated earnings and profits, but the issuing S corporation does. Applied literally, Section 1368(c) would be inapplicable; thus, there would be no chance of a taxable dividend being present. Section 1368(b) would treat the distribution as a tax-free return of the shareholder's basis in the acquiring S corporation's stock. That stock basis is increased before the distribution by the basis of the issuing corporation's shares that are acquired. This result seems contrary to the policy on which Section 304 is based, especially its command that the earnings and profits of the two corporations be combined in computing taxable dividends. If the earnings and profits of the acquired S corporation somehow trigger application of Section 1368(c), the transaction is treated as a return of the shareholder's basis in the acquiring corporation's stock to the extent of that corporation's accumulated adjustments account. A distribution beyond the accumulated adjustments account is a taxable dividend to the extent of the acquiring corporation's
accumulated earnings and profits; Section 304(b)(2) specifies that the earnings and profits of both corporations are to be combined in making this determination. Nothing in the statute permits use of the issuing S corporation's accumulated adjustments account before the distribution is treated as being made from the issuing corporation's accumulated earnings and profits, and thus a taxable dividend. Section 304 treats the payment as a distribution by the acquiring corporation, and not by the issuing corporation. Because the acquiring S corporation has no accumulated earnings and profits, it may not have been keeping track of its accumulated adjustments account. However, it might have to reconstruct it in order to determine the proper amount of the deemed dividend under Sections 304(a)(1) and 1368(c). Under Section 1368(c), deemed distributions beyond the acquiring S corporation's accumulated adjustments account and the combined earnings and profits of the two S corporations are treated as a tax-free return of the shareholder's basis in all of the acquiring corporation's stock under Section 1368(b).

If, on the other hand, the literal reading of Section 1368 is correct, then Section 1368(b) applies, the accumulated adjustments accounts of the corporations are irrelevant, and the deemed distribution is treated as a return of the shareholder's basis in all the acquiring S corporation's stock. That basis is increased by the deemed contribution of the issuing S corporation's stock, under Sections 351 and 358. Under either reading of Section 1368, once the basis of the stock in the acquiring corporation stock is exhausted, any additional amount received by the selling shareholder is treated as gain on the sale of the acquiring corporation's stock.

**¶ 13.06[8][e] Sale of Parent S Corporation Stock to C Corporation Subsidiary**

When the stock of a parent S corporation is sold by a shareholder of the parent to a subsidiary (which, if recognized as a separate corporation at all, must be a C corporation), Section 304(a)(2) may treat the transaction as a redemption of the parent's stock by the parent. The tax consequences of redemptions of S corporation stock were discussed earlier in this chapter.

An additional wrinkle is created by Section 304(b)(2): The earnings and profits of both the acquiring corporation and the issuing corporation are consulted (in that order) in determining whether a deemed distribution under Section 301 is a dividend. Query how this rule would apply in a case in which the parent S corporation has no earnings and profits, but the subsidiary has earnings and profits. Section 1368(c), which opens the door to a taxable dividend, by its terms applies only to a distribution by an S corporation that itself has accumulated earnings and profits. Does incorporation of the subsidiary's earnings and profits by Section 304(b)(2) trigger application of Section 1368(c) in such a circumstance? If so, a deemed distribution that would otherwise be covered by the benign rules of Section 1368(b) could be turned into a taxable dividend under Section 1368(c)(2). And an S corporation parent with no C corporation history of its own could conceivably be required to reconstruct its accumulated adjustments account in order to determine how much of the deemed distribution should be considered a taxable dividend out of the subsidiary's earnings and profits.

**¶ 13.06[9] Sale of Controlling Interest (Including Sections 336(e) and 338)**

**¶ 13.06[9][a] Introduction**

Traditionally, buyers of a corporate business prefer to buy the corporation's assets, and sellers prefer to sell its stock. Thus, a buyer wishing to acquire ownership of an S corporation may prefer to buy the corporation's assets. In many cases, the shareholders of S corporations may be able to accommodate that preference because S corporations can sell their assets with no corporate-level tax. Indeed, being able to sell assets without a corporate-level tax is one of the major advantages of an S corporation over a C corporation. In other cases, however, the shareholders of an S corporation may strongly prefer to sell stock. A stock sale will be preferable if, for example, the S corporation would be liable for a substantial amount of built-in gain tax on a sale of assets or if the S corporation is not confident about its S status.
When control of an S corporation is transferred by means of a stock sale, an election may be available to treat the transaction as an asset sale for federal income tax purposes. The absence of a corporate-level tax on the target S corporation often makes such elections attractive.

¶ 13.06[9][b] Section 338 Elections

¶ 13.06[9][b][i] In general.

Section 338 treats an acquired corporation as if it had sold all its assets and then repurchased those assets, for an amount equivalent to their fair market values, as a new corporation. This special treatment is available only if an election is made. The election is available only if a corporation makes a “qualified stock purchase,” that is, the purchase during a twelve-month period of at least 80 percent of the total voting power and 80 percent of the value of the stock of another corporation. (Excluded are transactions between related persons, that is, those whose ownership of stock in a corporation would be attributed to each other (in either direction) under Section 318(a), other than under the option attribution rule of Section 318(a)(4).) Section 338 has several unique consequences if the acquired corporation is an S corporation.

¶ 13.06[9][b][ii] "Regular" election under Section 338.

An S corporation generally cannot have a corporate shareholder. Therefore, S status generally ends on the date that another corporation purchases any of the stock of an S corporation. As has been seen, the acquired corporation has two short-period years under Section 1362(e) when its S status ends during its regular taxable year. The first period is the S short year, which ends on the day before the date of termination. The second period is the C short year, which begins on the termination date. Under Section 338(a)(1), a deemed asset sale occurs, and the corporate taxable year ends, at the close of the acquisition date. The "acquisition date" is the day the purchasing corporation acquires control of the acquired corporation. The deemed asset purchase by the "new" corporation occurs (and its new taxable year begins) at the start of the next day.

Putting these two taxable year rules together leaves the acquired S corporation with the following results when control is obtained in a single purchase:

1. An S short year ending on the day before the acquisition of its stock;
2. A new C short year that both commences and ends on the day of the stock acquisition (that is, a one-day short year as a result of the Section 338 election); and
3. A new short year that begins on the day after the acquisition date.

Thus, an acquired corporation seems to have three taxable years as a result of the combination of Sections 1362(e)(1) and 338(a).

If an S corporation is the subject of a Section 338 election, the selling shareholders generally will want the books closed. Section 1362(e)(6)(D) automatically produces that result if there is a sale of 50 percent or more of the stock in the year of termination of the corporation's status as an S corporation. If there is not a sale of 50 percent or more of the stock in that year, the books will not be closed unless the corporation elects under Section 338. However, if the books remain open, a special rule protects the selling shareholders from being taxed on items of income generated by the buyer's election under Section 338. Section 1362(e)(6)(C) provides that items resulting from Section 338 are not subject to Section 1362(e)(2). Thus, all such items should be taxed to the purchased corporation in its one-day C short year.

It appears that virtually every case involving Section 338(a) and an acquired S corporation will result in a closing of the books, because the qualified stock purchase will be a single sale involving 80 percent or more of the S corporation's stock. If the purchase of control is spread out over more than one transaction on different dates, the target corporation's election under subchapter S would terminate upon
the first transaction, before the election under Section 338(a) took effect. If the election is made and an S corporation is its subject, the target corporation must file a "deemed sale return" as a C corporation. The corporation reports the "deemed sale gain" on that return. As the acquired corporation has become a subsidiary of the acquiring corporation, the resulting tax liability is the acquiring corporation's burden. Because the "new" C corporation is immediately taxable on this gain, whereas the target corporation would not be immediately taxable without the election, "regular" Section 338 elections for target S corporations (those not under Section 338(h)(10)) are of extremely limited utility.

¶ 13.06[9][b][iii] Election under Section 338(h)(10) regulations.

1. Background. Section 338(h)(10) authorizes the Service to create by regulations a separate election, under which a sale of stock is treated as a sale of assets, without recognition by the selling shareholders of the gain or loss on their stock. By its terms, Section 338(h)(10) applies only when a target corporation is a member of a group that files a consolidated return. An S corporation cannot be a member of such a group. However, the regulations helpfully permit the shareholders of an acquired S corporation to join in the purchasing corporation in making an election under Section 338(h)(10). The Section 338(h)(10) regulations generally treat the acquired corporation as selling its assets while it is still an S corporation and while the selling shareholders still own its stock. In the case of a shareholder that is a qualified subchapter S trust, the tax items resulting from the deemed asset sale pass through to the trust, rather than to the income beneficiary. The trust is also taxed on the gain or loss from the deemed liquidating distribution under Section 331.

By creating a deemed asset sale, the regulations override the normal treatment of the actual stock sale. Thus, the shareholders who sell stock in the qualified stock purchase do not recognize gain or loss on that sale.

Suppose that one or more S shareholders sell a controlling block of stock to a corporation for an installment note. If the S shareholders and the purchaser elect under Section 338(h)(10), will the deemed asset sale and deemed liquidation permit use of installment reporting under Section 453? The answer is generally affirmative, at both the corporate and shareholder levels.

2. Effects of election. Under the election, a deemed sale of assets occurs. The target corporation's S election ends just as it does under a "regular" Section 338 election. However, under the Section 338(h)(10) regulations, the final S corporation return includes any gain or loss resulting from the deemed sale, as the target corporation's S status continues through the end of the acquisition date. That gain or loss passes through to the shareholders and increases or decreases their stock basis.

The regulations then treat the shareholders as receiving the sale proceeds in a liquidation, perhaps resulting in further gain or loss under Section 331. As the acquired corporation's S status ends, its books are closed; thereafter, it is treated as a new corporation. If any shareholders of the target corporation retain their stock after the disposition date, they are treated as purchasing stock in the "new" corporation for fair market value on that date.

In the case of a shareholder that is a qualified subchapter S trust, the tax items resulting from the deemed asset sale pass through to the trust, rather than to the income beneficiary. The trust is also taxed on the gain or loss from the deemed liquidating distribution under Section 331.

By creating a deemed asset sale, the regulations override the normal treatment of the actual stock sale. Thus, the shareholders who sell stock in the qualified stock purchase do not recognize gain or loss on that sale.

In order to qualify for a Section 338 election, the "qualified" purchase of the S corporation's stock must occur in one transaction or simultaneous transactions. Otherwise, the first stock transfer to the acquiring corporation ends the target's S election, thus rendering the Section 338(h)(10) regulations inapplicable. If taxpayers are not completely certain that their transaction qualifies for a Section 338(h)(10) election, they may wish to make a protective Section 336(e) election to go with it. In some cases, transactions that do not qualify under Section 338(h)(10) may nonetheless qualify for similar treatment under Section 336(e). If a transaction is eligible for both elections, however, only the Section 338(h)(10) election is effective.
4. Analysis. Before consenting to an election under the Section 338(h)(10) regulations, S corporation shareholders should consider the consequences carefully. For an example, a shareholder who sells stock and consents to an election may have ordinary income from the sale of certain corporate assets, rather than the capital gain that generally results from the sale of stock. Further, a minority shareholder who does not sell stock should be wary about consenting to an election. The election may result in taxable income for the shareholder far beyond the pass-through of items actually recognized by the S corporation, and it may do so even though the shareholder has not sold or exchanged any property.

A Section 338(h)(10) election may produce major benefits for the buyer. Through such an election, the buyer may acquire a corporation that has an increased basis for its assets. Such basis generally results in cost recovery deductions of some type. The benefit is diminished or eliminated, however, if the target corporation is subject to the built-in gains tax under Section 1374 on any of its gains from the deemed asset sale. The deemed asset sale may trigger that tax, for which the S corporation is liable.

¶ 13.06[9][c] Section 336(e) Election

¶ 13.06[9][c][i] Background.

Similar to the Section 338(h)(10) regulations, but of wider scope, the Section 336(e) regulations create an election to treat the taxable disposition of controlling stock in an S corporation as a sale by the S corporation of its assets, followed by a liquidation. The target is then treated as a new corporation that acquired all of its assets in a cash purchase for an amount equivalent to the assets’ fair market values. The actual disposition of the S corporation stock is ignored.

The Section 336(e) election, like its counterpart under Section 338(h)(10), is a product of regulations and not of statute. Section 336(e) by its terms applies only when a target corporation is a controlled subsidiary of another corporation. An S corporation cannot have its stock owned by another corporation. However, the regulations helpfully permit the target corporation to make an election under Section 336(e). The Section 336(e) regulations generally treat the acquired S corporation as selling its assets while an S corporation and while the selling shareholders still own its stock.

¶ 13.06[9][c][ii] Differences from Section 338(h)(10).

A Section 336(e) election is more flexible than a Section 338(h)(10) election in several respects. Under Section 336(e), a deemed-asset-sale election can be made whenever shareholders sell an 80 percent stock interest in an S corporation over a one-year period, even if the purchaser is an individual or a partnership; even if there is more than one purchaser; even if the purchases take place at different times; and even if the taxable disposition of the target corporation's stock is something other than an actual sale. Under Section 336(e), S corporation stock sales by one group of individuals to another, with S status continuing, may be deemed asset sales. Moreover, the transfer of control need not be achieved in a single transaction or even as part of a unified plan. However, because the old target corporation is treated as liquidating and a new corporation is treated as coming into existence, all of the shareholders of the "new" corporation must consent to a fresh election under Section 1362 if S corporation treatment is desired after the deemed sale. By contrast, Section 338(h)(10) requires a corporate purchaser, which terminates the target corporation's S election (although if the purchaser is itself an S corporation buying all of the target company's stock, it may elect to treat the deemed new corporation as a qualified subchapter S subsidiary and thus a nonentity).

Moreover, under Section 338(h)(10), the qualified stock transaction must happen all at once. Section 338(h)(10) requires a corporate purchaser, but the acquired corporation must remain an S corporation, and therefore cannot have a corporation as a shareholder, right up until the "acquisition date" (namely, the date of the 80 percent stock sale). The Section 336(e) regulations similarly require that the target corporation maintain its status as an S corporation up until the "disposition date"—that is, the first day on which sales of its stock reach the 80 percent threshold, discussed shortly. If S status is lost during a
build-up to an 80 percent sale, neither Section 336(e) nor Section 338(h)(10) is available, because they require a corporate buyer whenever the target company is a C corporation. However, under Section 336(e), the acquiring party need not be a corporation. If all the acquiring shareholders are eligible to be S corporation shareholders, the target corporation can remain an S corporation through the deemed asset sale even though the stock dispositions are spread out over time.

¶ 13.06[9][c][iii] Effects of election.

When the Section 336(e) election applies, the S corporation target is deemed to sell all of its assets, resulting in corporate-level gains and losses, on the disposition date. The deemed sale items pass through to all of the old target corporation shareholders under Section 1366 and increase or decrease their stock basis under Section 1367. The regulations make clear that if the target corporation's S election is in effect immediately before the disposition date, it remains intact through the close of the disposition date. The character of gains and losses is determined at the corporate level, and the items retain that character as they pass through; thus, the target corporation's shareholders may have some ordinary income or loss as opposed to the pure capital gain or loss typically resulting from a stock sale.

The target corporation, still owned by the S shareholders, is then deemed to distribute all the asset sale consideration to those shareholders, typically as a liquidating distribution covered by Sections 336 and 331. The actual sale or exchange of the S corporation stock is ignored. If any shareholders of the target corporation retain their stock after the disposition date, they are treated as purchasing stock in the “new” corporation for fair market value on that date.

¶ 13.06[9][c][iv] Eligibility and election mechanics.

In order for a Section 336(e) election to be available, there must be a "qualified stock disposition"-that is, a disposition during a twelve-month period of at least 80 percent of the total voting power and 80 percent of the value of the stock of the S corporation. Dispositions include transactions other than cash sales, but there are several exclusions. Among these are transactions between related persons, that is, those whose ownership of stock in a corporation would be attributed to each other (in either direction) under Section 318(a), other than under the option attribution rule of Section 318(a)(4).

Also excluded are: transactions in which the basis of the stock in the hands of the transferee carries over in whole or in part from the seller; other transactions, described in regulations, in which the transferor does not recognize all of the realized gain or loss; and transactions covered by Section 351, Section 354, Section 355, or Section 356. Transfers of stock giving rise to a stepped-up or stepped-down basis upon the death of a decedent under Section 1014 are also ineligible for a Section 336(e) election. Further, if a transaction is eligible for either a "regular" Section 338 election or a Section 338(h)(10) election, it is disqualified from Section 336(e) treatment.

In order for a Section 336(e) election to be valid, the shareholders of the S corporation target must enter into a binding, written agreement with the target corporation to make the election. The agreement must be entered into prior to the due date of the target corporation's tax return that includes the disposition date. Similar to the regulations under Section 338(h)(10), the Section 336(e) rules require that all of the S corporation's shareholders enter into the agreement-not just those who are selling their stock. Unlike the procedure under Section 338(h)(10), however, the shareholders do not sign the Section 336(e) election form itself; the S corporation target files the election on its timely filed return that includes the disposition date.

¶ 13.06[9][c][v] Open questions.

When a "qualified stock disposition" takes place over time, the rules surrounding the Section 336(e) election are not entirely clear. Until these uncertainties are resolved, such "rolling" or "creeping"
dispositions of S corporation stock must be approached with extreme caution.

One unanswered question is the identity of the shareholders who must enter into the required agreement with the target corporation to make the election. Does this group include only those who sold their stock in the “qualified stock disposition,” or does it also include all those shareholders who purchased shares as part of that disposition prior to the disposition date? The answer may depend on which shareholders receive the pass-through of the S corporation’s tax items from the deemed asset sale, and from operations in the period leading up to the deemed asset sale. There too, however, questions lurk. The regulations are silent about allocating the S corporation’s pass-through income, deductions, and credits for the period (or periods) between one or more earlier stock sales and the disposition date. Presumably pass-through income and deductions from operations are allocated according to the normal rules for sales of S corporation stock, with some of them passing to the acquiring shareholder. However, the gains and losses on the deemed asset sale may be a different matter; it would seem that they should pass through to the shareholder who disposed of the stock, rather than to the acquiring shareholder.

Another question is identifying the stock that is included in the qualified stock disposition when the same shares are sold twice in transactions preceding the disposition date. Presumably, only the last sale of the same shares within the twelve-month disposition period is included, but the regulations are not specific about the question.

¶ 13.06[9][c][vi] Analysis.

The factors that influence the decision whether to make an election under the Section 338(h)(10) regulations are generally applicable to the decision whether to elect under the Section 336(e) regulations. A shareholder who sells stock and consents to an election may have ordinary income from the sale of certain corporate assets, rather than the capital gain that generally results from the sale of stock. For nonselling shareholders, the election may result in taxable income far beyond the pass-through of items actually recognized by the S corporation target, and it may do so even though the shareholder has not sold or exchanged any property. Moreover, the benefit of the election is diminished or eliminated if the target corporation is subject to the built-in gains tax under Section 1374 on any of its gains.

A purchaser and seller of S corporation stock may not know at the time of the sale that the stock being transferred will within a year become part of a “qualified stock disposition” as to which a Section 336(e) election may be made. Sellers of stock that would be affected by the election have the power to accept or reject it, but it appears that purchasers do not. Although the target corporation must include the election with its tax return, which will be filed after the change of control, not every purchaser may be in control of, or even privy to, what the tax return contains. Purchasers of any S corporation stock may wish to include in their purchase agreements provisions regarding the making of, or abstaining from, a Section 336(e) election.

Shareholders who sell their S corporation stock at different times within the disposition period and for different prices per share should be aware that the different prices they receive do not affect the allocation of income passing through to them when the deemed asset sale occurs. Nor apparently do they affect the amount of proceeds that the shareholders are deemed to receive in the S corporation’s constructive liquidation.

¶ 13.06[9][d] Qualified Subchapter S Subsidiary Election

If all of the stock of an S corporation is acquired by another S corporation, the acquiring corporation may make an election to treat the acquired corporation as a qualified subchapter S subsidiary, and thus a nonentity for almost all tax purposes. Such elections by an acquiring S corporation are discussed later in this chapter.

¶ 13.06[10] Transfer That Ends Grandfather Rules

The Subchapter S Revision Act of 1982 contained several grandfather rules. Certain transfers of stock
can end those grandfather rules, perhaps resulting indirectly in a loss of S status. If a corporation is planning to rely on any of these rules, it should monitor sales and other transfers of its stock carefully.

183 IRC § 1001(a). However, if the purchaser is a related corporation, IRC § 304(a)(1) may apply and produce a much different result.

184 IRC § 1367, discussed in Chapter 9. See, e.g., Ronnie L. Barber, 64 TC 314 n.1 (1975) (pass-through of income increased basis of stock that was sold in later year); Donald Merle Cram, P-H TC Memo ¶ 79,070 (1979) (same); Jack Ziegelheim, P-H TC Memo ¶ 67,087 (1967) (same). Under IRC § 1367(b)(2), however, certain income and losses may change the basis of shareholder-held debt rather than stock. See ¶ 9.03[1][e].

185 See IRC §§ 1312(7), 1311(b)(1). See also ¶ 16.06[2][b]. However, IRC § 1367(b)(1) limits a basis increase to the amount of income reported.

186 See, e.g., Kenneth D. Albert, P-H TC Memo ¶ 80,567 (1980) (taxpayers realized long-term capital gain on sale of stock, the basis of which had been reduced to zero by net operating loss in year of sale). IRC § 1367 offers little guidance regarding how basis should be adjusted in the year of sale. Treas. Reg. § 1.1367-1(d)(1) provides: “However, if a shareholder disposes of stock during the corporation’s taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.” See ¶¶ 9.03[1][i], 9.03[5].

187 See infra ¶ 13.06[5].

188 See ¶ 3.03[11][b][ii].


190 See IRC § 1222.

191 IRC § 1222(1), § 1222(2), § 1222(3), or § 1222(4) can apply only if a capital asset is sold or exchanged. See IRC § 1221 for the definition of “capital asset.” Stock of an S corporation should be a capital asset in a normal case.

192 A sale of Section 306 stock that completely terminates a shareholder's interest under IRC § 302(b)(3) does not trigger ordinary income. See IRC § 306(b)(1)(A). The presence of Section 306 stock is unlikely in the context of an S corporation, which cannot have preferred stock. But see IRC § 306(c)(1)(C) (Section 306 stock includes stock with carryover basis from other Section 306 stock).

193 IRC § 1254(b)(2); Treas. Reg. § 1.1254-4.

194 See infra ¶ 13.06[8].

195 IRC § 1248(e) might apply to an S corporation that held the stock of one or more foreign corporations. Regarding IRC § 1248(e), see Kuntz & Peroni, ¶ B6.10.

196 See infra ¶ 13.06[9].

197 But see IRC § 1254(b)(2); Treas. Reg. § 1.1254-4.

198 Contrast IRC § 751(a).

199 IRC § 1(h)(5)(B); Treas. Reg. § 1.1(h)-1.
See IRC §§ 1(h)(1) - 1(h)(5).

See Treas. Reg. § 1.1(h)-1(f), Ex. 4.

Treas. Reg. §§ 1.1(h)-1(b)(2)(ii) (first sentence) (transferor shareholder recognizes as collectibles gain "net gain (but not net loss)..."), 1.1(h)-1(f), Ex. 3. Regarding tiered entities, see Treas. Reg. § 1.1(h)-1(d); regarding stock with a split holding period, see Treas. Reg. § 1.1(h)-1(f), Ex. 5. For reporting rules, see Treas. Reg. § 1.1(h)-1(e).

IRC §§ 1222(2), 1222(4). See, e.g., Samuel Pollack, 47 TC 92, 111 (1966), aff'd, 392 F2d 409 (5th Cir. 1968) (sale of stock produced capital loss equal to original cost because corporation had failed to qualify under former IRC § 1371 and losses had not passed through to selling shareholder).

See IRC §§ 1222(3), 1222(4).

Regarding IRC § 1244, see ¶ 6.02[5][a]; Bittker & Eustice, ¶ 4.03[4].

Wilkes L. Harwell, P-H TC Memo ¶ 74,153 (1974) (corporation's qualification under subchapter S had no effect under IRC § 1244 on loss of shareholder who surrendered his stock); Eugene Coloman, P-H TC Memo ¶ 74,078 (1974), aff'd, 540 F2d 427 (9th Cir. 1976) (rejecting argument that corporation's attempt to qualify under former IRC § 1372 would somehow help a shareholder qualify under IRC § 1244).

See IRC § 904, discussed in Kuntz & Peroni, ¶ B4.16.

See Ltr. Rul. 9612017 (Dec. 20, 1995), applying partnership principles by virtue of IRC § 1373.

IRC § 1411(c)(1)(A)(iii).

See IRC §§ 1411(c)(2), 1411(c)(4). See infra ¶ 13.12.

See IRC §§ 1361(b)(1)(B), 1361(b)(1)(C), discussed at ¶¶ 3.03, 5.03; Rev. Rul. 73-478, 1973-2 CB 310 (sale of some stock to resident of Puerto Rico terminated corporation's S election). In the case of the sale of a controlling interest in the S corporation's stock, S corporation status may be preserved if the acquired corporation is immediately liquidated, either actually or constructively. See supra ¶ 13.05, infra ¶¶ 13.06[9][b][iii], 13.06[9][c][iii].

See IRC § 1361(b)(1)(A), discussed at ¶ 3.04. A sale that is not bona fide, however, does not terminate an S election. See Clarence L. Hook, 58 TC 267 (1972) (purported transfer of stock to attorney as retainer was not bona fide).

Regarding agreements to protect S status, see ¶ 6.08. For a form, see Appendix A, ¶ A.6.

IRC § 1362(d)(2)(B), discussed at ¶ 5.03[8][a].

IRC § 1362(e)(1)(A). See ¶ 5.09[1].

IRC § 1361(e)(1)(B). See ¶ 5.09[1].

See IRC § 1362(e)(5), discussed at ¶ 5.09[1][d].

IRC § 1362(e)(2). See ¶ 5.09[1][b].

IRC §§ 1362(e)(3) (election available upon termination of S status), 1377(a)(2) (election available if
shareholder's interest in corporation terminates). See ¶ 5.09[1][b][iii]. In addition, regulations may allow an election to close the books if at least 20 percent of a corporation's stock is sold within thirty days. See Treas. Reg. § 1.1368-1(g)(2), discussed at ¶ 7.07[6][c].

220 A corporation may have to close its books under the automatic rule of IRC § 1362(e)(6)(D), triggered by termination and a sale or exchange of 50 percent or more of the stock in the same year. See ¶ 5.09[1][b][ii].

221 See infra ¶ 13.06[5].

222 See Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2) (applicable by its terms only if S corporation becomes member of consolidated group and not if election under IRC § 338(g) is made).

223 See infra ¶ 13.06[9].

224 IRC § 1362(d)(2)(A).

225 IRC § 1362(d)(2)(B). For termination of S corporation status generally, see Chapter 5.

226 Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2) (second sentence). Without this regulation, IRC § 1362(e)(1)(A) would prescribe the end of the S short year on the day before the effective date of termination. When proposing this regulation, REG-106219-98, 1999-1 CB 648, 649, stated that it would keep IRC § 1362(e) from applying because of the lack of an S termination year, but would provide for similar results. See also Ltr. Ruls. 200411026 -200411027 (Nov. 20, 2003) (short year beginning on date of entry into consolidated group treated as same as full taxable year for purposes of five-year waiting period under IRC § 1362(g) for re-electing S corporation status).


229 Treas. Reg. § 1.1502-76(b)(4) . REG-106219-98, 1999-1 CB 648, 649, states: The Federal income tax return for the final taxable year of the S corporation will be due at the earlier of: (1) the date the S corporation return would have been due if the taxable year of the S corporation did not end or (2) the date the consolidated group's return for the taxable year that includes the acquisition is due.


232 See ¶ 7.07[6][a].

233 See, e.g., Glenn Hightower, RIA TC Memo ¶ 2005-274 (2005) , aff'd without pub. op., 101 AFTR2d 2008-836 (9th Cir. 2008) (not officially reported), cert. denied, 555 US 997 (2008) (held taxpayer was 50 percent shareholder of S corporation, taxable on half its income, until day the other shareholder issued checks to buy taxpayer's stock pursuant to "shotgun" buy-sell agreement; gain taxable in year checks were received).

234 See ¶ 7.07[2][c].
See ¶ 5.09[1][a] .


See IRC § 1362(e)(6)(D) , discussed at ¶ 5.09[1][b][ii] .

See IRC § 1362(e)(6)(C) , discussed infra ¶ 13.06[9] .

IRC § 1362(e)(3) , discussed at ¶ 5.09[1][b][iii] .

IRC § 1362(e)(3) , discussed at ¶ 5.09[1][b][iii] .

IRC § 1377(a)(2) , discussed at ¶ 7.07[6][b] .

Treas. Reg. § 1.1368-1(g)(2) , discussed at ¶ 7.07[6][c] .

See ¶ 7.07[6][a] .

See IRC § 1366(a) .

IRC § 1377(a)(2) allows the corporation to close its books on the date on which a shareholder’s interest in the corporation ends. Thus, the selling shareholder can cut off any effect of later operations on the items that pass through to the selling shareholder. However, certain shareholders must agree that IRC § 1377(a)(2) should apply. See ¶ 7.07[6][b] . A stock sale agreement should address this matter.

See supra ¶ 13.06[1] .


See Chapter 5.

See Chapter 7.

See supra ¶ 13.06[5][b] .

See IRC § 1362(e)(5) , discussed at ¶ 5.09[1][d] .

IRC § 446(e) .


The top federal income tax rate that the seller will pay on the corporation’s income is 39.6 percent. See IRC § 1. State and local income taxes may also apply.

See supra ¶ 13.06[5][a] .

This calculation assumes that the tax under IRC § 1411 does not apply. See infra ¶ 13.12 .

Former IRC § 1373(b). In Silvio Gutierrez, 53 TC 394, 397-398 (1969) , aff’d per curiam, 29 AFTR2d
72-358 (DC Cir. 1971), the Tax Court stated that Congress probably chose a year-end rule for former IRC § 1373(b) and for IRC § 551(b) to avoid allocation problems when shares changed hands. In Rev. Rul. 76-497, 1976-2 CB 128, the Service refused to allow a corporation to change its taxable year to end on the day before its stock was sold. However, dividends distributed to the selling shareholder were income to the seller and reduced the corporation's undistributed taxable income. See, e.g., Walker v. Comm'r, 544 F2d 419 (9th Cir. 1976).

E. Keith Owens, 64 TC 1 (1975), aff'd on this issue, 568 F2d 1233 (6th Cir. 1977) (seller of stock of S corporation that held only cash was taxed on corporation's income during year of sale; sale was not bona fide). The Owens case contained two theories for taxing the seller. The Service argued that the seller should be taxed on the "undistributed subchapter S income" of the corporation. Id. at 11. The court apparently found, however, that the seller should be taxed on constructive distributions from accumulated and current earnings and profits. Id. at 15, n.10.

Julian S. Danenberg, 73 TC 370 (1979) (acq.) (effective date of sale occurred after end of corporation's taxable year; therefore, undistributed taxable income passed through to selling shareholder); Arno Ragghianti, 71 TC 346 (1978) (acq.), aff'd without pub. op., 652 F2d 65 (9th Cir. 1981) (buyer of stock was beneficially owner on last day of corporation's taxable year).

See W. McKee et al., Federal Taxation of Partnerships and Partners ¶¶ 6.01 - 6.02 (Thomson Reuters/Tax & Accounting, 4th ed. 2007) (hereafter McKee).

In most cases, the election will be available only if the selling shareholders consent to it. See infra ¶ 13.06[9].

See IRC §§ 302(a), 303. See supra ¶ 13.02[3].

Compare, e.g., Thomas C. Stephens, 60 TC 1004 (1973), aff'd without pub. op., 506 F2d 1400 (6th Cir. 1974) (nonredeemed shareholders had distributions of dividends and previously taxed income when their corporation redeemed stock that nonredeemed shareholders were obligated to buy from other shareholders); Santulli v. United States, 38 AFTR2d 76-5869 (D. Md. 1976) (not officially reported) (buyer of all the stock of S corporation had dividend when corporation bought most of the stock from the buyer; court noted that result would have been more favorable if shares had been redeemed from the seller). But see IRC § 304(b)(3)(B).

The distribution rules are discussed in Chapter 8. In brief, distributions of money (and property) generally apply against stock basis under IRC § 1368(b)(1). Any excess amount is gain from the sale of property. However, if the distributing corporation has accumulated earnings and profits, dividend treatment under IRC § 1368(c)(2) can result if distributions exceed the corporation's accumulated adjustments account.

IRC § 1368(b)(1).

IRC § 1368(b)(2).

IRC § 1368(b)(1).

IRC § 453(c).

IRC §§ 304(a)(1) (first sentence), 1371(a) (applying rules of subchapter C, which includes IRC § 304, to S corporation unless they are inconsistent with subchapter S). See FSAs 200110004 (Nov. 14, 2000) (acquisition by S corporation with earnings and profits), 200041009 (June 30, 2000) (earlier ruling...
on same transaction, revealing it to be acquisition of sister C corporation's stock). Under prior law, confirmed that IRC § 304 could apply to transactions involving an S corporation. See also Richard E. Hurst, 124 TC 16, 28-35 (2005) (sale of stock of S corporation with earnings and profits to commonly controlled S corporation with earnings and profits; court did not decide IRC § 304 issue because the Service raised it too late).

"Control" is defined as ownership of 50 percent or more of either a corporation's voting power or the total value of its stock. IRC § 304(c)(1). The attribution rules of IRC § 318 apply, see IRC §§ 304(c)(3)(A), 318(b)(2), including stricter than usual attribution of ownership to and from C corporations. See IRC § 304(c)(3)(B).

271 IRC § 304(a)(2).

272 IRC § 304(a)(1). In case of an overlap, the parent-subsidiary rules prevail. See IRC § 304(a)(1) (first sentence) (IRC § 304(a)(1) applies only if IRC § 304(a)(2) does not).

273 IRC § 1361(b)(1)(B), discussed at ¶ 3.03[14].

274 IRC § 304(b)(1).

275 If the redemption is treated as a sale of the acquiring corporation's stock under IRC § 302(b)(1) or IRC § 302(b)(2), the tax consequences are generally as discussed supra ¶ 13.02. The acquiring corporation's basis in the acquired stock is apparently a cost basis under IRC § 1012.

276 IRC § 1368(b)(1).

277 See IRC § 304(a)(1) (second sentence); Treas. Reg. § 1.304-2(a) (fourth sentence) (under prior version of IRC § 304).

278 IRC § 1368(b)(2). The stock basis available to offset the deemed distribution is not limited to the basis of the stock constructively issued and redeemed under IRC § 304. See FSA 200110004 (Nov. 14, 2000).

279 One could conceivably argue that in such circumstances, IRC § 304(a)(1) is inconsistent with subchapter S, and thus not made applicable by IRC § 1371(a).

280 IRC § 304(b)(1).

281 If the redemption is treated as a sale of the acquiring corporation's stock under IRC § 302(b)(1) or IRC § 302(b)(2), the selling shareholder realizes a gain or loss on the sale, with no deemed distribution under IRC § 301. See generally Bittker & Eustice, ¶ 9.09.

282 IRC §§ 301(c), 304(b)(2).

283 However, given the policy behind the accumulated adjustments account rules, one could argue that that account should be applied first, before the issuing S corporation's earnings and profits are reached.

284 IRC § 301(c)(2).

285 See IRC § 304(a)(1) (second sentence); Treas. Reg. § 1.304-2(a) (fourth sentence) (under prior version of IRC § 304).

286 IRC § 301(c)(3).

287 IRC § 1368(c)(1). If the redemption is treated as a sale of the acquiring corporation's stock under
IRC § 302(b)(1) or IRC § 302(b)(2), the tax consequences are generally as discussed supra ¶ 13.02. The acquiring corporation's basis in the acquired stock is apparently a cost basis under IRC § 1012.

However, given the policy behind the accumulated adjustments account rules, one could argue that that account should be applied first, before the issuing S corporation's earnings and profits are reached.

IRC § 304(b)(2).

IRC § 1368(c)(3).

See IRC § 304(a)(1) (second sentence); Treas. Reg. § 1.304-2(a) (fourth sentence) (under prior version of IRC § 304).

IRC §§ 1368(b)(2), 1368(c)(3).

See IRC § 304(a)(1) (second sentence); Treas. Reg. § 1.304-2(a) (fourth sentence) (under prior version of IRC § 304).

See IRC § 304(b)(2).

IRC §§ 1368(b)(1), 1368(c)(1). See FSAs 200110004 (Nov. 14, 2000) (acquisition by S corporation with earnings and profits), 200041009 (June 30, 2000) (earlier ruling on same transaction, revealing it to be acquisition of sister C corporation's stock). See generally ¶ 8.04[2].

IRC § 1368(c)(2). See generally ¶ 8.04[3].

However, given the policy behind the accumulated adjustments account rules, one could argue that that account should be applied first, before the issuing S corporation's earnings and profits are reached.

IRC § 1368(c)(3). That stock basis is increased before the distribution by the basis of the issuing corporation's shares that are acquired. See IRC § 304(a)(1) (second sentence); Treas. Reg. § 1.304-2(a) (fourth sentence) (under prior version of IRC § 304).

IRC § 1368(b)(1).

See IRC § 304(a)(1) (second sentence).

IRC §§ 1368(b)(2), 1368(c)(3).

See IRC § 1361(b)(1)(B), discussed at ¶ 3.03[14].

See supra ¶ 13.02.

For additional discussion, see McMahon & Simmons, “When Subchapter S Meets Subchapter C,” 67 Tax Law. 231 (2014).

Regarding application of the built-in gains tax to asset sales, see ¶ 7.06[4][c].

Regarding the effects of improper S elections, see ¶ 4.01[1]. Regarding causes of termination, see ¶¶ 5.03 - 5.04.

For discussion of IRC § 338, see Bittker & Eustice, ¶¶ 10.42-10.43.

incorporating and modifying IRC § 318(a).


310 IRC § 1361(b)(1)(B). See ¶ 3.03[14].

311 IRC § 1362(d)(2)(B).

312 IRC § 1362(e)(1)(A).

313 IRC § 1362(e)(1)(B). See ¶ 5.09[1][a].

314 IRC § 338(a)(1).

315 IRC §§ 338(d)(3), 338(h)(2), 1504(a)(2).

316 IRC § 338(a)(2). See also Ltr. Rul. 8532076 (May 16, 1985) (IRC § 338 would apply to purchase of stock of S corporation).

317 If the stock is purchased over time, the first purchase by the acquiring corporation kills the target corporation’s S election, which renders the target company a C corporation by the time the election under IRC § 338 takes place.

318 The acquired corporation files a “deemed sale return” for this day. Treas. Reg. §§ 1.338-2(c)(8), 1.338-10(a)(3).

319 See IRC § 1362(e)(6)(D), discussed at ¶ 5.09[1][b][ii].

320 See ¶ 5.09[1][b][ii].

321 In such a case, the acquired corporation should be a former S corporation, not an S corporation.

322 Treas. Reg. § 1.338-2(d) (first sentence). The election is due by the fifteenth day of the ninth month starting after the month in which the acquisition occurs. IRC § 338(g)(1); Treas. Reg. § 1.338-2(d) (second sentence). The election is irrevocable. IRC § 338(g)(3); Treas. Reg. § 1.338-2(d) (third sentence).

323 Treas. Reg. §§ 1.338-2(c)(8), 1.338-10(a)(3).

324 Treas. Reg. § 1.338-10(a)(3).

325 IRC § 338(h)(10)(A) requires that the target corporation be a member of a “selling consolidated group.”

326 IRC § 1504(b)(8).


329 Treas. Reg. § 1.338(h)(10)-1(d)(3)(i) (fifth sentence) (“Old T realizes the deemed sale tax consequences from the deemed asset sale before the close of the acquisition date while old T is ... owned by the S corporation shareholders....”).

330 An S corporation generally may not have a corporate shareholder. IRC § 1361(b)(1)(B).

331 See supra ¶ 13.06[9][b][ii]. Because the corporation is treated as a new corporation following the election, the five-year waiting period in IRC § 1362(g) for re-electing under subchapter S is not applicable. Thus, if the corporation otherwise qualifies for another S election within the five-year period, it may make it. See Ltr. Ruls. 200506007 (Oct. 29, 2004), 200453007 (Aug. 13, 2004).

332 See TD 8515, 1994-1 CB 89, 91 (“The deemed sale gain is reported on T’s final S corporation return and therefore is taken into account under sections 1366 and 1367 in determining a T shareholder’s basis in the T stock and resulting gain or loss on the deemed liquidation of T.”).

333 Treas. Reg. § 1.338(h)(10)-1(d)(3)(i) (seventh sentence). This regulation also allows the status of any qualified subchapter S subsidiaries owned by the acquired S corporation to continue through the end of the acquisition date. Treas. Reg. § 1.338(h)(10)-1(d)(3)(i) (last sentence). Regarding other cases in which the Service will allow nonpermitted shareholders on a transitory basis, see ¶ 3.03[20].

334 Treas. Reg. § 1.338(h)(10)-1(d)(5)(i) (first sentence). For an example, see Treas. Reg. § 1.338(h)(10)-1(e), Ex. 10.

335 Treas. Reg. § 1.338(h)(10)-1(d)(5)(i) (last two sentences, incorporating Treas. Reg. § 1.338(h)(10)-1(d)(4)(i) ). For an example, see Treas. Reg. § 1.338(h)(10)-1(e), Ex. 10. The target S corporation is treated as ceasing to exist, and a new corporation is treated as coming into existence. See IRC § 338(a)(2). If an election is being made for a parent-subsidiary chain of corporations, the deemed sale of a parent's assets is deemed to precede the sale of its subsidiary's assets, Treas. Reg. § 1.338(h)(10)-1(d)(3)(ii) , and the liquidation of a subsidiary is deemed to precede the liquidation of its parent, Treas. Reg. § 1.338(h)(10)-1(d)(4)(ii) . Regarding liquidation of an S corporation generally, see supra ¶ 13.04.

336 See supra ¶ 13.06[9][b][ii].

337 Treas. Reg. § 1.338(h)(10)-1(d)(5)(ii). For examples, see Treas. Reg. § 1.338(h)(10)-1(e), Exs. 6, 10.


340 See supra ¶ 13.04[3].

341 IRC § 338(h)(10)(A); Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii).

342 See Treas. Reg. § 1.338(h)(10)-1(d)(8) . See generally IRC §§ 453(h), 453B(h) . For an example, see Treas. Reg. § 1.338(h)(10)-1(e), Ex. 10. To the extent that the S corporation holds assets, such as inventory or marketable securities, for which installment reporting is unavailable, the deemed sale of the assets apparently triggers immediate recognition of gain, which passes through to the shareholders. See supra ¶ 13.04[7]. And as in an actual sale of assets followed by liquidation of the S corporation, the regulations on allocation of stock basis among distributed assets may reduce the benefit of installment
reporting.

343 Treas. Reg. § 1.338(h)(10)-1(c)(3) (first sentence) (referring to Form 8023 and its instructions).

344 Treas. Reg. § 1.338(h)(10)-1(c)(3) (second sentence).

345 Treas. Reg. § 1.338(h)(10)-1(c)(3) (last sentence). The Service may be willing to grant an extension of time under Treas. Reg. § 301.9100-3, provided that the taxpayers have acted reasonably and in good faith. See, e.g., Ltr. Ruls. 201435002 (May 23, 2014), 201037013 (June 16, 2010), 200515010 (Dec. 23, 2004), 200504019 (Oct. 15, 2004), 200503015 (Oct. 4, 2004), 200348025 (Aug. 27, 2003).

346 Treas. Reg. § 1.338(h)(10)-1(c)(4).

347 For examples of elections that would have run aground for this reason were it not for the Service's excusing the inadvertent terminations of the target corporations' elections under subchapter S, see Ltr. Ruls. 201351017 (Aug. 16, 2013), 201035010 (Apr. 21, 2010), 200952015 (Sept. 23, 2009).


349 See infra ¶ 13.06[9][c].

350 Treas. Reg. § 1.336-1(b)(6)(ii)(A) (qualified stock purchase as defined in IRC § 338(d)(3) cannot be qualified stock disposition for purposes of IRC § 336(e)).

351 Regarding the taxable income that may result for a non-selling minority shareholder, see Treas. Reg. § 1.338(h)(10)-1(d)(5)(i) (deemed sale gain passes through from the S corporation under IRC § 1366; further gain for shareholder may result under IRC § 331 in deemed complete liquidation). The continuing shareholder holds stock with a fair market value basis and a new holding period. Treas. Reg. § 1.338(h)(10)-1(d)(5)(ii). For an example, see Treas. Reg. § 1.338(h)(10)-1(e), Ex. 10 (vii).


353 See Treas. Reg. § 1.336-1(a)(1) (fourth, fifth sentences) (results of elections under IRC §§ 336(e) and 338(h)(10) should generally be same). Regarding the Section 338(h)(10) election, see supra ¶ 13.06[9][b].


356 IRC § 336(e)(1) (incorporating stock ownership requirements of IRC § 1504(a)(2)).

357 IRC § 1361(b)(1)(B), discussed at ¶ 3.03[14].


360 See Treas. Reg. § 1.336-2(b)(1)(ii) (third sentence). If the target corporation has one or more
qualified subchapter S subsidiaries, new elections are apparently also necessary for the subsidiaries.

361 See supra ¶ 13.06[9][b][iii], infra ¶ 13.06[9][d].

362 IRC § 338(h)(2). See supra ¶ 13.06[9][b].

363 Treas. Reg. § 1.336-1(b)(8). See infra ¶ 13.06[9][c][iv].


365 The regulation also allows the status of any qualified subchapter S subsidiaries owned by the acquired S corporation to continue through the end of the acquisition date. See Treas. Reg. §§ 1.336-1(b)(3) (second sentence) (definition of "S corporation target"), 1.336-2(b)(1)(i)(A) (last two sentences) (S election and qualified subsidiary status preserved). Regarding other cases in which the Service will allow nonpermitted shareholders on a transitory basis, see ¶ 3.03[20].

366 See IRC § 1366(b).


368 For the possibility of other characterizations, see Treas. Reg. § 1.336-2(b)(1)(iii)(A) (third, fourth sentences). If an election is being made for a parent-subsidiary chain of corporations, the deemed sale of a higher-tier subsidiary's assets is deemed to precede the sale of its subsidiary's assets, Treas. Reg. § 1.336-2(b)(1)(i)(C), and the liquidation of a lower-tier subsidiary is deemed to precede the liquidation of a higher-tier subsidiary, Treas. Reg. § 1.336-2(b)(1)(iii)(B).


373 Treas. Reg. § 1.336-1(b)(5)(i)(C). The regulations incorporate the principles of IRC § 338(h)(3)(C) and the regulations thereunder. Treas. Reg. § 1.336-1(b)(5)(iii). Related-party sales are not included in the qualified stock disposition, and thus gains on such sales are recognized even if other transactions rise to the level of a qualified stock disposition. See Treas. Reg. § 1.336-2(b)(1)(i)(B)(3), Ex. 1.

374 Treas. Reg. §§ 1.336-1(b)(12) (first sentence), 1.336-2(k), Ex. 9. Attribution between a partner and a partnership under IRC § 318(a)(2)(A) or IRC § 318(a)(3)(A) is disregarded if the partner owns, directly or indirectly, partnership interests whose value is less than 5 percent of the value of the partnership. Treas. Reg. § 1.336-1(b)(12) (second sentence).

375 Treas. Reg. §§ 1.336-1(b)(5)(i)(A) - 1.336-1(b)(5)(i)(B). The Service reported in 2013 that it was continuing to study the potential for elections under IRC § 336(e) in nonrecognition transactions. See TD 9619, 2013-24 IRB 1212, 1218.


377 Treas. Reg. § 1.336-1(b)(6)(ii). If the target corporation's deemed asset sale includes stock of a controlled subsidiary, however, the deemed sale of the target subsidiary stock is a qualified stock disposition, eligible for an election under IRC § 336(e). See Treas. Reg. § 1.336-1(b)(6)(ii)(B). In such
cases, IRC § 338 is inapplicable. See Treas. Reg. § 1.338-1(a)(1) (fifth, sixth sentences).


379 Treas. Reg. § 1.338(h)(10)-1(c)(3) (S corporation target's nonselling shareholders, as well as its selling shareholders, must sign consent form). See supra ¶ 13.06[9][b][iii].


382 See supra ¶ 13.06[5].

383 See Treas. Reg. § 1.336-2(b)(1)(iii)(A) (first sentence) (pass-through of deemed asset sale consequences to shareholders "whether or not they sell or exchange their stock").

384 For further discussion, see Harvey, Harris & Kugler, "Deemed Asset Sales and S Corporations," 141 Tax Notes 1057 (2013). Similar issues arise when the target corporation in a "rolling" or "creeping" disposition covered by IRC § 336(e) is a member of a consolidated group. See Geracimos & Holtje, "Treating a Stock Sale as an Asset Sale for Tax Purposes: Old and New Tools," 41 Corp. Tax'n 3, 16-18 (Mar./Apr. 2014).

385 See supra ¶ 13.06[9][b][iii].

386 See IRC § 1374, discussed at ¶ 7.06[4].

387 For further discussion, see Schnee & Seago, "Maintaining Single Taxation: Sec. 336(e) and S Corporations," 45 Tax Adviser 178 (Mar. 2014).

388 For the election generally, see ¶ 3.08[3].

389 See infra ¶ 13.11[2][e].

390 See ¶ 5.05.

391 See ¶ 5.05.