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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Sandra Reid, Senior Attorney
CC:LM:NR:DAL:2

FROM: Associate Chief Counsel
(Passthroughs and Special Industries) CC:PSI

SUBJECT: Use of S Corporation Losses Following a
Statutory Merger with a C Corporation

This Chief Counsel Advice responds to your request for advice regarding the issue described below. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE

Is a shareholder of a target S corporation, who is also a shareholder of an acquiring C corporation, permitted to apply losses suspended under § 1366(d) against the shareholder's historic basis in the C corporation stock if the S corporation merges into the C corporation in a merger described in § 368(a)(1)(A)?

CONCLUSION

A shareholder of a target S corporation, who is also a shareholder of an acquiring C corporation, is permitted to apply losses suspended under § 1366(d) against the shareholder's historic basis in the C corporation stock. The shareholder is required to reduce the shareholder's historic basis in the C corporation stock for the losses taken.

FACTS

X, an S corporation, merges into Y, a C corporation, in a merger qualifying as an "A" reorganization under § 368(a)(1)(A). Prior to the merger, A, an individual, owns (i) stock in X with a basis of \$0 and (ii) stock in Y with a basis of \$100. A has \$150 of suspended losses under § 1366(d) at the time of the merger. After the merger,

PRENO-111832-02

A has two blocks of stock in Y-(i) the stock received in the merger with a basis of \$0 and (ii) his historic Y stock, with a basis of \$100. A makes no contributions to, and receives no distributions from, Y with respect to the Y stock during the post-termination transition period (PTTP).

LAW

Section 1366(a)(1) provides that in determining the tax of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, there is taken into account the shareholder's pro rata share of the corporation's (i) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability of any shareholder and (ii) nonseparately computed income or loss.

Under § 1366(d)(1), the aggregate amount of losses and deductions taken into account by a shareholder of an S corporation is limited to the sum of (i) the shareholder's adjusted basis in the stock of the S corporation and (ii) the shareholder's adjusted basis in the indebtedness of the S corporation. Section 1366(d)(2) provides that any loss or deduction which is disallowed under § 1366(d)(1) carries forward indefinitely to succeeding taxable years in which the corporation is an S corporation.

Section 1366(d)(3) provides a special rule for the carryover of suspended losses if a corporation's S election is terminated. Under § 1366(d)(3)(A), if losses have been disallowed in the last taxable year for which a corporation is an S corporation, the losses are "treated as incurred by the shareholder on the last day of any post-termination transition period."¹ Under § 1366(d)(3)(B), the aggregate amount of losses and deductions taken into account under § 1366(d)(3)(A) is limited to the adjusted basis of the shareholder's stock in the corporation determined on the last day of the PTTP. Any losses and deductions in excess of a shareholder's adjusted stock basis are permanently disallowed. Section 1.1366-2(b)(2).

The Senate Finance Committee Report on The Subchapter S Revision Act of 1982, P.L. 97-354, provides that subsequent to the termination of a subchapter S election, disallowed losses will be allowed if the shareholder's basis in his stock in the corporation is restored by the later of the following dates: (1) one year after the

¹ Section 1377(b)(1) and § 1.1377-2(a) define the PTTP as the period beginning on the day after the last day of the corporation's last taxable year as an S corporation, and ending on the later of (i) the day that is one year after such last day or (ii) the due date for filing the return for such last year as an S corporation. Section 1.1377-2(b) specifically provides that a PTTP arises the day after the last day that an S corporation was in existence if a C corporation acquires the assets of an S corporation in a transaction to which § 381(a)(2) applies, such as in an "A" reorganization.

PRENO-111832-02

effective date of the termination, or the due date for the last subchapter S return, whichever is later or (2) 120 days after a determination that the corporation's subchapter S election had terminated for a previous year. S. Rep. No. 97-640, 1982-2 C.B. 726 (emphasis added).

Regulations under § 1366(d)(3) explain the consequences of these rules where an S corporation's final year ends as a result of a statutory merger qualifying as an A reorganization. Section 1.1366-2(c)(1) provides as follows:

(c) Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions—(1) Liquidations and reorganizations. If a corporation acquires the assets of an S corporation in a transaction to which section 381(a) applies, any loss or deduction disallowed under paragraph (a) of this section [relating to the rule limiting losses to basis] with respect to a shareholder of the distributor or transferor S corporation is available to that shareholder as a shareholder of the acquiring corporation Where the acquiring corporation is a C corporation, a post-termination transition period arises the day after the last day that an S corporation was in existence and the rules provided in paragraph (b) of this section [relating to the carryover of disallowed losses to the PTTT] apply with respect to any shareholder of the acquired S corporation that is also a shareholder of the acquiring C corporation after the transaction.

Under § 1367(a)(1), the basis of each shareholder's stock in an S corporation is increased for any period by the sum of the following items determined with respect to that shareholder for such period: (i) items of income described in § 1366(a)(1)(A) and (ii) any nonseparately computed income determined under § 1366(a)(1)(B).

Under § 1367(a)(2), the basis of each shareholder's stock in an S corporation is decreased for any period (but not below zero) by the sum of the following items determined with respect to that shareholder for the period: (i) distributions by the corporation which were not includible in the income of the shareholder by reason of § 1368, (ii) the items of loss and deduction described in section 1366(a)(1) (A), and (iii) any nonseparately computed loss determined under § 1366(a)(1)(B).

ANALYSIS

Both the statute and the legislative history seem to contemplate a situation in which a shareholder may acquire additional basis during the PTTT. It is clear that a shareholder with losses suspended under § 1366(d) at the time of an S corporation-C corporation merger only can acquire additional basis during the PTTT if the shareholder makes additional capital contributions to the surviving corporation. There does not appear to be a compelling reason for reaching a different conclusion if the shareholder has historic C basis in the acquiring corporation. The

PRENO-111832-02

purpose of § 1366(d)(1) is to prevent shareholders from using losses that are not related to any corresponding economic outlay. Here, however, A has made economic outlays in the form of A's investment in the acquiring C corporation.

Accordingly, in the example described above, A is entitled to deduct \$100 of the \$150 suspended losses as a result of A's historic basis in the Y stock, and the remaining \$50 of suspended losses would be permanently disallowed. Under § 1367(a)(2)(B), A would be required to reduce A's basis in A's Y stock by \$100 to \$0 for the losses taken.

Please call if you have any further questions.

By: Associate Chief Counsel
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MATTHEW LAY
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