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subject: Consolidated Group's Acquisition of S Corporation's Assets

This Chief Counsel Advice responds to your request for taxpayer-specific advice. In accordance with § 6110(k)(3), this Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Oldco =

Newco =

Sub1 =

Holdco =

Parent =

State M =

Date0 =

Date1 =

Date2 =

Date3 =

Date 4 =

Date 5 =

Date 6 =

State Y =

State M Statute1 =

State M Statute2 =

$a =

$b =

$c =

$d =

$e =

FACTS

Background

Oldco, a C corporation incorporated in State M, made an election on Date1 to be treated as a qualified subchapter S corporation (“S Corporation”), effective as of Date0, under § 1361 of the Internal Revenue Code ("S Election"). Oldco owned the outstanding stock of Sub1 and elected to treat it as a qualified subchapter S subsidiary within the meaning of § 1361(b)(3)(B) ("QSub").

Parent, a State Y limited liability company, owned Holdco, and Holdco owned Newco, which was a C corporation incorporated on Date3 in State M. Pending further investigation by Exam, it is assumed that Holdco, a C Corporation, was incorporated and acquired the stock of Newco on or around Date3.

Transaction

Under an agreement among Parent, Holdco, Newco, Oldco, and Oldco shareholders (“Agreement”), Oldco merged with and into Newco ("Transaction"). The separate corporate existence of Oldco ceased, and Newco continued as the surviving wholly owned subsidiary of Holdco. In exchange for all of their stock, Oldco shareholders received cash and promissory notes, and the Oldco stock was cancelled.

The Agreement provided that the parties intended for the Transaction to qualify as: (1) a merger under the laws of State M effective on Date5, and (2) an asset sale for federal tax purposes. Moreover, the Agreement included a provision that required Oldco shareholders to indemnify Holdco and its affiliates for any “pre-closing taxes,” which were defined to include any built-in gain tax arising under § 1374.

Oldco's S election ceased to exist as of Date5, the effective date of the merger. See § 1362(d)(2); § 1.1362-2(b). As a result of Oldco ceasing to exist, Sub1's QSub election terminated. Newco did not make an S Election.

Oldco

Oldco timely filed a final Form 1120-S for a short taxable year beginning on Date2 and ending on Date5, in which it reported net unrealized built-in gain in the amount of $a as of Date0 and tax due under § 1374(a) in the amount of $b. Subsequently, on an amended final return, filed on behalf of Oldco, it reported net unrealized built-in gain in the amount of $a as of Date0 and tax due under § 1374(a) in the amount of $b but did not report any additional tax due.

Exam proposed to adjust Oldco’s tax liability due on its final return by the amount of $c based, in part, on its determination that the fair market value of Oldco’s appreciated assets held when it made its S Election ("Oldco's § 1374 assets") was $d rather than $e. The difference represents additional recognized built-in gain, within the meaning of § 1374 and subject to tax under § 1374(a) ("Proposed Adjustment"). In the absence of facts to the contrary, it is assumed that the entire Adjustment is attributable to assets held directly by Oldco and that it is expected to result in a tax deficiency.

Holdco Consolidated Group

Holdco filed an initial consolidated Form 1120 on behalf itself, Newco, and Sub1 for the short taxable year beginning Date5 and ending Date 6 ("Holdco Group"). A Form 851 was also filed on behalf of the group, although it appears that Holdco was inadvertently omitted from this form. [1]

ISSUES

1. Whether the Proposed Adjustment was attributable to Oldco's final taxable year beginning on Date2 and ending on Date5;

2. Whether Newco is the appropriate entity to whom Exam should send a statutory notice of deficiency (SNOD) with respect to the Proposed Adjustment;

3. Whether Holdco Group's initial consolidated return year began on Date5;

4. When did Newco and Sub1 become members of the Holdco Group;

5. Whether the overlap in short taxable years of Oldco and the Holdco Group affects which entity is liable for the additional tax arising from the Proposed Adjustment or which should receive the related SNOD.

CONCLUSIONS

1. The Proposed Adjustment was attributable to Oldco's final taxable year beginning on Date2 and ending on Date5.

2. It is appropriate to send the SNOD to Newco, as the successor-in-interest to Oldco.

3. Based upon all the facts provided, Holdco Group's initial consolidated return year began on or around Date3 rather than Date5.

4. Under the-end-of-the-day rule, set forth in §1.1502-76(b)(1)(ii)(A) for C corporations and in § 1.1361-5(a)(4), Ex. 5 for certain former QSubs, a subsidiary becomes a member of a consolidated group at the end of the day on which its status as a member changes, and its tax year ends at that time for all Federal income tax purposes. Newco became a member of the Holdco Group on Date3, and Sub1

[1] Because a Form 1120 treating Holdco as the common parent of Newco and Sub1 was filed, it is assumed that Holdco was correctly treated as the common parent of the Holdco Group for purposes of § 1501 et. seq. If stock holding 80% or more of the vote and value of Holdco is owned by an entity that is classified as a corporation for federal tax purposes, then such entity would properly be treated as the common parent of the Holdco group.

became a member on Date5.

5. The overlap in short taxable years of Oldco and the Holdco Group does not affect which entity is liable for the additional tax due or which should receive the related SNOD. Newco, as the successor-in-interest to Oldco, is primarily liable for Oldco's tax deficiency, but the other members of the Holdco group are not liable for Oldco's deficiency.

LAW AND ANALYSIS

Issue1

Asset Sale

For federal income tax purposes, the forward triangular merger of Oldco into Newco constituted a sale of Oldco's assets to Newco followed by a liquidation of Oldco. See Rev. Rul. 69-6, 1969-1 C.B. 104.

Short Taxable Year

Section 443(a)(2) provides that a return for a period of less than 12 months is required when the taxpayer is in existence during only part of what would otherwise be its taxable year. Oldco's final taxable year began on Date2 and ended on Date5 ("Oldco's Final Taxable Year").

Built-in Gain Tax

One of the benefits of S corporation tax status is that income earned by the entity generally escapes corporate-level taxation. See § 1363. Thus, an S corporation's income passes through the entity and is, generally, taxed only at the shareholder level on a pro rata basis. See §§ 1363, 1366. The general rule that S corporations are not subject to corporate-level tax, however, contains an exception for certain net recognized built-in gains for S corporations that were previously C corporations.

Section 1374 provides that "[i]f for any taxable year beginning in the recognition period an S corporation has a net recognized built-in gain, there is hereby imposed a tax ... on the income of such corporation for such taxable year."

Section 1374(d)(2) provides that the term "net recognized built-in gain" means, with respect to any taxable year in the recognition period, the lesser of (i) the amount which would be the taxable income of the S corporation for such taxable year if only recognized built-in gains and recognized built-in losses were taken into account, or (ii)

such corporation's taxable income for such taxable year (determined as provided in § 1375(b)(1)(B)).

Section 1374(d)(3) provides that the term "recognized built-in gain" means any gain recognized during the recognition period on the disposition of any asset except to the extent that the S corporation establishes that (A) such asset was not held by the S corporation as of the beginning of the first taxable year for which it was an S corporation, or (B) such gain exceeds the excess (if any) of (i) the fair market value of such asset as of the beginning of such 1st taxable year, over (ii) the adjusted basis of the asset as of such time.

Section 1374(d)(7)(A) provides in general that the term "recognition period" means the 10-year period beginning with the first day of the 1st taxable year for which the corporation was an S corporation.[2]

Section 1.1374-4(a)(1) provides that § 1374(d)(3) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for federal income tax purposes.

The merger constituted a disposition of Oldco's § 1374 assets on Date5. The 10-year recognition period for Oldco began on Date0, and the disposition occurred on Date5, which was within Oldco's recognition period. Notwithstanding termination of Oldco's corporate existence and the termination of its S election, any resulting § 1374 tax is still attributable to Oldco's Final Taxable Year.

Issue 2

Successor-in-Interest Liability

State M Statute1 permits a domestic corporation to merge with one or more corporations, resulting in a single corporation pursuant to a merger plan.

State M Statute2 prescribes the effects of such a merger, holding the surviving organization responsible for all the liabilities and obligations of each of the constituent organizations. Moreover, "a claim . . . against a constituent organization may be prosecuted as if the merger had not taken place, or the surviving organization may be substituted in the place of the constituent organization."

Here, Oldco and Newco were the constituent organizations, and Newco was the surviving organization under state law effective on Date5. Thus, Newco is the legal successor-in-interest, which is liable for Oldco's tax deficiency arising from the Proposed Adjustment subject to any applicable limitations on assessment and

[2] The years at issue are prior to the amendment of § 1374(d)(7). See § 1251(a) of American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5).

collection. § 6501 et. seq. Although the indemnification provision in the Agreement determined the rights and obligations of the signing parties among themselves, it has no effect on which party is liable under state law. Accordingly, Exam should issue the SNOD to Newco, as successor-in-interest to Oldco.[3]

Issue 3

In general, under § 1501, an affiliated group of corporations may elect to file a consolidated federal income tax return instead of separate tax returns (commonly referred to as "consolidated group").

Section 1504 prescribes the requirements in order to be an affiliated group: (1) the group must have a common parent, (i.e., the highest-tier domestic corporation), and every member of the group must be at least 80% owned (by voting power and value) by the common parent or another member of the group; § 1504(a); and, (2) each member of the group must be an includible corporation. § 1504(b).

Section 1504(b) further clarifies that an "includible corporation" generally means a corporation other than a tax exempt or foreign corporation or an insurance company.

Section 1.1502-76 provides guidance regarding the items to be included in a consolidated return. Specifically, § 1.1502-76(a) provides that the consolidated return of a group must be filed on the basis of the common parent's taxable year, and each subsidiary must adopt the common parent's annual accounting period for the first consolidated return year for which the subsidiary's income is includible in the consolidated return.

Section 1.1502-76(b)(1)(i) provides that a consolidated group's tax return must include the common parent's items of income, gain, deduction, loss, or credit for the entire consolidated return year and each subsidiary's items but only for the portion of the year for which the subsidiary is a member. Items for the portion of a year not included in the consolidated return must be included in a separate return.

Section 1.6012-2(a) generally provides that the first day of the new corporation's first taxable year is the date of incorporation. This is the date the corporation comes into existence, and the corporation is generally required to make a return for any part of a taxable year during which it was in existence. Id. The regulation grants an exception if the corporation has received a charter but has never perfected its organization, transacted no business, and has no income from any source, but it must present the facts in order to be relieved of the necessity of having to file a return for that period. § 1.6012-2(a)(2).

[3] We note that the State M statute provides that a claim against a constituent organization may be prosecuted against the constituent organization as if the merger had not taken place. Accordingly, as a protective measure, Exam may also choose to issue the SNOD to Oldco as well.

Although the facts provided are not entirely clear, it appears that Holdco was the intended common parent of the group. The exact date on which Holdco was incorporated was not provided, but it is assumed that Holdco was incorporated on or around Date3, the date on which Newco, Holdco's wholly owned subsidiary, was incorporated. It is also assumed that Holdco has not presented facts establishing that it is entitled to regulatory relief from filing a return as of that date. Based upon these assumptions, Holdco Group's initial consolidated taxable year began on or around Date3 rather than on Date5, although there may not be any substantive tax consequences from treating the later date as the first day of the taxable year if Holdco conducted no business before Date5.

Issue 4

The end-of-the-day rule governs when an otherwise eligible C corporation of an affiliated group may be considered to have joined the group during a consolidated return year.

End-of-the-Day Rule for C Corporations

Section 1.1502-76(b)(1)(ii)(A) generally states that if a C corporation becomes a member during the consolidated return year, it becomes a member at the end of the day on which it status changes, and its tax year ends at that time for all Federal income tax purposes ("end-of-the-day rule"). Consequently, a subsidiary's items for the period beginning on the day after it becomes a member of the consolidated group are generally included in the consolidated return of the group and items for the period prior to its becoming a member generally are included in a separate return.

End-of-the-Day Rule for certain former QSubs

Under § 1361(b)(3)(A), a corporation, for which a QSub election is in effect, is not treated as a separate corporation from its S corporation parent. Instead, all assets, liabilities, and income items of the QSub are generally treated as assets, liabilities, and income items of the S corporation.

Under § 1.1361-5(a)(1)(iii), the termination of a QSub election is effective, inter alia, as of the close of the day on which an event occurs that renders the subsidiary ineligible for QSub status.

Section 1361(b)(3)(C)[4] and § 1.1361-5(b)(1) generally provide that if a QSub election terminates, the former QSub is treated as a new corporation that, immediately before

[4]Section 8234 of the Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28, added § 1361(b)(3)(C)(ii) to clarify the tax treatment of the sale of stock in a QSub by the parent S corporation. Under this amendment, the stock sale is treated as a sale of an undivided interest in the subsidiary,

the termination, acquires all of its assets (and assumes all of its liabilities) from the S corporation in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction is determined under the Code and general principles of tax law, including the step transaction doctrine.

Section 1.1361-5(b)(3), Ex. 9, illustrates how the step transaction doctrine may apply to a transfer by an S corporation (X) of 100 percent of the stock of a QSub (Y) to a C corporation (Z). The example provides that the deemed formation of Y by X (as a consequence of the termination of Y's QSub election) is disregarded for federal income tax purposes. The transaction is treated as a transfer of the assets of *Y* to *Z*, followed by *Z*'s transfer of those assets to the capital of *Y* in exchange for *Y* stock.

Section 1.1361-5(a)(4), Ex. 5 describes when a QSub election terminates due to its acquisition by a consolidated group. In the example, the group acquires just the stock of the QSub on 6/1/2002. The QSub's election terminates as of the close of 6/1/2002. The example adopts an analogous end-of-day rule, treating the QSub as a member of the acquiring consolidated group as of the end of the day on 6/1/2002.

Holdco acquired all of the stock of Newco on or around Date3, and Newco acquired the stock of Sub1 on Date5. Newco and Sub1 constituted an affiliated group with Holdco as the common parent. Although the facts are somewhat unclear, it appears that Holdco, Newco, and Sub1 timely consented to file as a consolidated group. Oldco was never a member of the affiliated group, for neither Holdco nor Newco owned any of its stock. Therefore, the-end-of-the-day rule only applies to Newco and Sub1.

Newco's taxable year began on Date3 and it is assumed that it became a member of the Holdco consolidated group at the end of the day on Date3 at the earliest. Sub1's QSub election terminated as of Date5. At the end of the day on Date5, Newco is treated as transferring Sub1's assets to a newly formed corporation in exchange for Sub1 stock, at which time the newly formed Sub1 became a member of Holdco consolidated group.

Issue 5

Once an affiliated group has elected to file a consolidated return, § 1.1502-77(a) provides that the common parent is the sole agent for a consolidated return year subject to certain exceptions. Moreover, § 1.1502-77(a)(2)(viii) provides that a notice of deficiency with respect to the consolidated return year is only mailed to the common parent of the consolidated group.

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followed by a transfer of all the assets to a new corporation that is subject to the rules of § 351. The amendment was effective for tax years beginning after the years at issue here.

Section 1.1502-6 generally provides that the common parent and each subsidiary which was a member of the group during any part of the consolidated return year are severally liable for the resulting tax.

As discussed supra, Oldco was never a member of the affiliated group. Consequently, the gain from the sale of Oldco's § 1374 assets was only includible on Oldco's Final Taxable Year. Notwithstanding the overlap of Oldco's Final Taxable Year and the Holdco Group's initial consolidated return year, the above rules do not apply to hold the Holdco Group severally liable for the tax deficiency arising from Oldco's sale or to treat Holdco as Oldco's agent. Rather, as explained, supra, under issue 2, Newco, as successor-in-interest to Oldco, is primarily liable for any tax deficiency arising from the Proposed Adjustment. Accordingly, Exam should issue the related SNOD to Newco.

Please call (202) 622-7770 if you have any further questions.