Office of Chief Counsel
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memorandum

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to: Associate Area Counsel,
(Large Business & International)
Attn:

from: Branch Chief, Branch 2
(Passthroughs & Special Industries)

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subject:

This Chief Counsel Advice responds to an email request for assistance dated February 24, 2014. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Sub =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year =

N =

Government Agency =

Regulator =

ISSUE

After a mid-year S election termination, is the annual income of an S corporation (Taxpayer) with one QSub (Sub) pro-rated pursuant to § 1362(e)(2) or must the S corporation and the QSub use a closing of the books method? Must the parent and subsidiary follow the same method?

FACTS

Before Date 3, Taxpayer, a family-owned S corporation, was a holding company that held Sub. Taxpayer made a QSub election with respect to Sub. Effective Date 3, Taxpayer revoked its S corporation election by filing a revocation with the Service, and thereupon became a C corporation. Sub also became a C corporation. Sub had significant bank bad debts arise during Year, some of which occurred during the Sub's post termination C period. Taxpayer and its shareholders have sufficient AAA and basis to absorb the losses if we permit them to use the pro rata method, because under that method n/12 of the losses will be attributed to the short S year (Date 1 through Date 2).

On Date 4, Sub was closed by Government Agency, which appointed Regulator as receiver. In receivership, Taxpayer still held all of the Sub stock, but Regulator had functional control over Sub.

LAW

Section 1.1361-4(a)(1) provides that, in general, for Federal tax purposes--(i) a corporation that is a QSub shall not be treated as a separate corporation; and (ii) all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.

Section 1.1361-5(a)(1) provides that the termination of a QSub election is effective at the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under § 1.1362–2.

Section 1.1361-5(b)(1)(i) provides that if a QSub election terminates under § 1.1361-5(a), the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. For purposes of determining the application of

§ 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under § 1.1361–2(b) are disregarded in determining control for purposes of § 368(c) even if they are equity under general principles of tax law.

Section 1362(e)(1) provides that in the case of an S termination year, for purposes of Title 26-- (A) the portion of such year ending before the 1st day for which the termination is effective shall be treated as a short taxable year for which the corporation is an S corporation, (B) the portion of such year beginning on such 1st day shall be treated as a short taxable year for which the corporation is a C corporation.

Section 1362(e)(2) provides that except as provided in § 1362(e)(3) and § 1362(e)(6)(C) and (D), the determination of which items are to be taken into account for each of the short taxable years referred to in paragraph (1) shall be made-- (A) first by determining for the S termination year-- (i) the amount of each of the items of income, loss, deduction, or credit described in § 1366(a)(1)(A), and (ii) the amount of the nonseparately computed income or loss, and (B) then by assigning an equal portion of each amount determined under subparagraph (A) to each day of the S termination year.

Section 1362(e)(3)(A) provides that a corporation may elect to have paragraph (2) not apply.

Section 1362(e)(3)(B) provides that an election under § 1362(e)(3)(A) shall be valid only if all persons who are shareholders in the corporation at any time during the S short year and all persons who are shareholders in the corporation on the first day of the C short year consent to such election.

Section 1362(e)(5)(A) provides that the taxable income for the short year described in § 1362(e)(1)(B) shall be placed on an annual basis by multiplying the taxable income for such short year by the number of days in the S termination year and by dividing the result by the number of days in the short year. The tax shall be the same part of the tax computed on the annual basis as the number of days in such short year is of the number of days in the S termination year.

ANALYSIS

In general, a corporation does not close its books when its S status terminates. Rather, the corporation allocates items of income, gain, loss, deduction, and credit between the S short year and the C short year on a pro rata basis. Items allocable to the S short year pass through to the shareholders, and items allocable to the C short year are assumed by the C corporation. However, a corporation may elect to close its books rather than allocating its annual income pro rata.

For federal income tax purposes, Sub and Taxpayer were treated as the same entity until Taxpayer voluntarily revoked its S election on Date 3. After the termination of Taxpayer's S election, Sub and Taxpayer became two separate C corporations.

Pursuant to § 1.1361-5(b)(1)(i), after Taxpayer's S election termination, Sub became a new corporation (Newco) acquiring all of the assets of Sub immediately before the termination from Taxpayer in exchange for stock of the new corporation. Therefore, Sub became an entirely new corporation that did not exist prior to Taxpayer's S election termination. Taxpayer believes that the income allocation rules of § 1362(e)(2) apply to Newco, and that all items of income, gain, loss, deduction, and credit attributable to Taxpayer, Sub, and Newco are allocable pro rata during Year.

CONCLUSION

Following the termination of Taxpayer's S election, Taxpayer and Newco (formerly Sub) are two separate C corporations. Assuming all the requirements are met, Taxpayer's deemed transfer of all the assets and liabilities of Sub to Newco in exchange for Newco stock is treated as a § 351 transaction. Thereafter, unless Taxpayer and Newco elected to file on a consolidated basis, Newco's income must be separately accounted for on its own return. In other words, Newco's items of income, gain, loss, deduction, and credit cannot be combined with those of the Taxpayer for proration under § 1362(e)(2).

Note, however, if Taxpayer's deemed transfer of liabilities exceeded the fair value of the transferred assets, the transaction will not qualify for § 351 treatment. Section 351 requires a net value exchange where the fair value of assets transferred exceed the liabilities assumed by the transferee. See generally, *Meyer v. United States*, 129 Ct. Cl. 214, (1954); *H.G. Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941); Rev. Rul. 59-296.[1] If the deemed transfer of Sub's assets and liabilities to Newco fail to qualify under § 351, the transaction would be taxable. Accordingly, Taxpayer will need to recognize gain or loss on the transaction. Moreover, should any of the transferred assets have a basis in excess of fair value (a loss asset), the loss will be deferred under § 267(f)(2)(B) until the loss property is transferred outside the § 267(f) controlled group. In other words, Taxpayer can recognize the loss on the transferred assets, if any, when Regulator took over Newco on Date 4.

Thus, Newco (former Sub) cannot prorate any items that arose after the S election termination. However, the parent, Taxpayer, may choose to either prorate or close its books pursuant to § 1362(e)(2) and (3). In fact, the parent is required to prorate unless it elects otherwise, pursuant to § 1362(e)(2). Prorated items include all items of income, gain, loss, deduction, and credit that arose in either Taxpayer or Sub prior to the S election termination, as well as all items of income, gain, loss, deduction, and credit that arose in Taxpayer only after the S election termination.

[1] See the current thinking of the IRS as evidenced by Prop. Reg. § 1.351-1(a)(1)(iii).

This CCA does not address when or how or the extent to which any bad debts became deductible to the Taxpayer, Sub or Newco during Year.

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