

DUE DILIGENCE ISSUES ARISING IN CONNECTION WITH THE ACQUISITION OF AN S CORPORATION

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Due diligence items relating to the acquisition of S corporation stock include matters relating to the validity of the S election, allocation of income or loss in the year of sale, the amounts of the corporation's AAA and E&P, and the possibility of a Section 338(h)(10) election to treat a stock sale as an asset sale.

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Although due diligence for the acquisition of S corporation stock will involve many of the same due diligence items performed in connection with the acquisition of stock of a C corporation, because of the difference in structure and tax treatment of both S corporations and their shareholders, the purchaser of S corporation stock will want to tailor its tax due diligence and planning to focus on the special considerations applicable to S corporations, including:

- The election and termination of S corporation status.
- The eligibility rules governing shareholders.
- The single class of stock limitation.
- The built-in gain tax imposed under Section 1374.
- The determination of the allocation of income or loss of the S corporation in the year of disposition of its stock or termination of its S status.
- The S corporation's accumulated adjustments account (AAA) and its E&P, if any, and the effect of such items on S corporation distributions, redemptions, and taxation.
- The effect and advisability of making a Section 338(h)(10) election to treat a sale of stock of an S corporation as an asset sale.

Since planning for the acquisition or disposition of stock (or assets) of an S corporation takes into consideration all facets of S corporation taxation, this article perforce will be limited to highlighting the general considerations and

special problems faced by purchasers of S corporation stock. Although the focus will be primarily on due diligence that should be conducted by the purchaser of S corporation stock in a taxable stock acquisition, many (if not most) of such due diligence issues also will apply with respect to the acquisition of the stock of an S corporation in a tax-free merger and, to a lesser extent, a taxable acquisition of assets of an S corporation.

REPRESENTATIONS, WARRANTIES, AND INDEMNIFICATION PROVISIONS

With respect to many of the due diligence issues discussed in this article, clearly the purchaser will want the sellers of the S corporation stock to make representations and warranties in the stock acquisition agreement regarding such matters. These would include representations concerning the validity of the corporation's S election, the qualifications of the corporation's shareholders as eligible S corporation shareholders, whether the corporation is subject to the built-in gain tax, the amount of the corporation's AAA and E&P, etc.

In connection with such representations and warranties, strong indemnification provisions should provide the purchaser with the right of recovery in the event the purchaser sustains any losses as a result of the breach of any such representations and warranties. The inclusion of representations and warranties and indemnification clauses

EXHIBIT 1**Sample Representations, Warranties, and Indemnification and Offset Provisions****A. Sample Representations and Warranties Relating to S Corporation Items:**

- (a) That the Corporation has continuously been an S corporation within the meaning of Section 1361(b) of the Internal Revenue Code of 1986, as amended (the "Code") since the date of inception of the Corporation [or insert other date if not always an S corporation].
- (b) That the Corporation is a domestic corporation.
- (c) That the Corporation is not an ineligible corporation within the meaning of Section 1361(b)(1) of the Code.
- (d) That the Corporation does not have more than one hundred (100) shareholders.
- (e) That all shareholders of the Corporation are eligible S corporation shareholders under Subchapter S of the Code; and that any trusts which are shareholders of the Corporation timely filed any election required to be filed by such trust to qualify as an eligible S corporation shareholder (e.g., a QSST or ESBT Election).
- (f) That the Corporation does not have more than a single class of stock outstanding as provided in Section 1361(b)(1)(D) of the Code.
- (g) That all corporate subsidiaries of the Corporation constitute qualified Subchapter S subsidiaries ("QSubs") under Section 1361(b)(3)(B) of the Code and have made timely elections under Section 1361(b)(3)(B) of the Code and the Treasury Regulations promulgated thereunder to be treated as QSubs.
- (h) That the Corporation has a permitted tax year as required under Section 1378 of the Code.
- (i) That the Corporation is not subject to the built-in gain tax imposed under Section 1374 of the Code, whether as a result of the Corporation previously converting from C corporation status to S corporation status or as a result of the Corporation acquiring the assets of a C corporation or of an S corporation subject to the built-in gain tax in an exchanged basis transaction as provided in Section 1374(d)(8) of the Code.
- (j) That the taxable income of the Corporation through [insert date] is _____ Dollars (\$_____) and that the taxable income of the Corporation through the closing date is estimated to be _____ Dollars (\$_____).
- (k) That the accumulated adjustments account of the Corporation as of [insert date] is _____ Dollars (\$_____) and that the accumulated Subchapter C earnings and profits of the Corporation as of [insert date] is _____ Dollars (\$_____).
- (l) That set forth in Schedule ____, attached hereto and incorporated herein by reference, is a complete and accurate list of the Corporation's assets, the Corporation's tax basis in such assets, the character of such assets, and the Corporation's holding period for such assets.
- (m) That set forth in Schedule ____, attached hereto and incorporated herein by reference, is a list of the tax basis which each shareholder has in his shares of stock of the Corporation.

B. Sample Indemnification Provisions:

- (a) Shareholders, jointly and severally, agree to indemnify and hold Purchaser harmless against and in respect of any and all losses, damages, deficiencies, or liabilities incurred by Purchaser as a result of: (1) any actions or proceedings relating to or affecting the Purchased Stock or the Business which are subsequently brought against, relate to, or affect the Purchased Stock or the Business and which arise as a result of any action or circumstance existing or occurring prior to the Closing Date; (2) any claims made by (A) any governmental or regulatory authority with respect to any taxes of [the Target S Corporation] or relating to the Business accruing prior to the Closing Date, or (B) any person (including, but not limited to, any governmental or regulatory authority) relating to any employee benefit or ERISA representation or warranty in this Agreement; or (3) any misrepresentation, breach of warranty or nonfulfillment of any covenant or agreement on the part of a Shareholder under this Agreement, and other documents executed pursuant to this Agreement and any and all assessments, judgments, costs, and legal and other reasonable expenses incidental to any of the foregoing.
- (b) Purchaser agrees to indemnify and hold the Shareholders harmless against and in respect of any and all losses, damages, deficiencies, or liabilities incurred by the Shareholders as a result of any misrepresentation, breach of warranty, or nonfulfillment of any covenant or agreement on the part of Purchaser under this Agreement, and other documents executed pursuant to this Agreement, and any and all assessments, judgments, costs, and legal and other reasonable expenses incidental to any of the foregoing.
- (c) A party (hereinafter referred to as the "Indemnifying Party") indemnifying another party or parties (hereinafter referred to as the "Indemnified Party"), pursuant to this paragraph, indemnifies and holds the Indemnified Party harmless against any and all actions, suits, proceedings, demands, claims, assessments, costs, judgments, and legal and other expenses incidental to any of the foregoing (hereinafter referred to as a "Claim"). In the event a Claim is made upon the Indemnified Party, the Indemnified Party shall promptly give notice of such Claim to the Indemnifying Party, and shall promptly deliver to such Indemnifying Party all information and written material available to the Indemnified Party relating to such Claim. If such Claim is first made upon the Indemnifying Party, the Indemnifying Party shall promptly give notice of such Claim to the Indemnified Party.
- (d) The Indemnified Party will, if notified of the Indemnifying Party's election to do so within ten (10) days of the date of notice of a Claim, permit the Indemnifying Party to defend, with counsel reasonably acceptable to the Indemnified Party, in the name of the Indemnified Party any Claim in any appropriate administrative or judicial proceedings and take whatever actions may be reasonably requested of the Indemnified Party to permit the Indemnifying Party to make such defense and obtain an adjudication of such Claim on the merits, including the signing of pleadings and other documents, if necessary. Notwithstanding the foregoing, the Indemnified Party shall not be required to permit the Indemnifying Party to control the defense of any Claim unless the Indemnifying Party provides evidence in form and substance reasonably acceptable to the Indemnified Party that the Indemnifying Party can satisfy any judgment or settlement arising out of such Claim. In addition to the liability for the ultimate settlement or judgment, if any, arising out of such Claim under this paragraph, the Indemnifying Party shall be solely responsible for all the expenses

EXHIBIT 1**Sample Representations, Warranties, and Indemnification and Offset Provisions, cont'd**

incurred in connection with such defense or proceedings, regardless of their outcome. In the event that the Indemnifying Party does not accept responsibility to defend such claim as provided in this paragraph, then the obligation of the Indemnifying Party to indemnify the Indemnified Party shall be absolute.

C. Sample Right of Offset Provision:*Stock Acquisition Agreement*

- [] **Right of Offset.** Purchaser shall have the right to offset the amount of any claim, demand, damage, cost, expense, liability, or obligation for which Buyer is indemnified under this Stock Purchase Agreement, including, but not limited to, any liability or obligation for federal, state, or local excise taxes or any other taxes (together with interest and penalties thereon, if any), against any and all payments due to the Holder of that certain Promissory Note in the original principal amount of _____ Dollars (\$_____) to be executed and delivered by Purchaser to Seller as partial consideration for the purchase of the Shares to be purchased and sold hereunder (the "Promissory Note"), such offset to be applied against the monies first due and payable under the Promissory Note.

Promissory Note

- [] **Right of Offset.** The Maker shall have the right to offset the amount of any claim, demand, damage, cost, expense, liability, or obligation for which Maker is indemnified under that certain Stock Acquisition Agreement of even date herewith, by and between Maker as Purchaser and Payee as Seller, against any and all payments due to the Holder of this Note, such offset being applied against the monies first due and payable under this Note.

are no substitute for thorough due diligence, however, as an indemnification provision is only as good as the seller making such indemnification. Moreover, the underlying assumption is that the seller still will have adequate resources from which the purchaser could recover in the event of a breach of a representation or warranty under the indemnification provisions of the stock acquisition agreement.

In any situation in which the purchaser of S corporation stock is to pay the purchase price over time under a promissory note, a right of offset should be included both in the stock acquisition agreement and in the body of the promissory note itself. This right would enable the purchaser to offset any losses suffered by the purchaser as a result of the seller's breach of any representations or warranties made in the stock acquisition agreement against any payments due under the promissory note.

Even if the purchase price is to be paid in cash at closing, a portion of the purchase price should be held back in escrow for some specified period in order to provide security in the event of a breach of the representations and warranties. Sample representations and warranties, indemnification provisions, and rights of offset are set forth in Exhibit 1.

VALIDITY OF S ELECTION

Assuming the purchaser is interested in having the target corporation retain its status as an S corporation for tax purposes following the acquisition, one of the most important due diligence items will be to determine the validity of the corporation's S status. Due diligence items in this regard will include the following:

1. Original Articles of Incorporation and all amendments.
2. Original Bylaws and all amendments.
3. Minutes of Meetings and reports issued by shareholders (since date of inception).
4. Minutes of Meetings and reports issued by Board of Directors (since date of inception).
5. Minutes of Meetings and reports issued by any Executive, Audit, or other committee (since date of inception).
6. A copy of the filed Form 2553, Election by a Small Business Corporation.
7. A copy of the confirmation received by the S corporation from the IRS, stating that the corporation's S election has been accepted and the effective date of such election.
8. A list of the shareholders of the target S corporation.
9. A list of the authorized, issued, and outstanding shares of stock

owned by the S corporation shareholders and the classes of outstanding shares of stock of the S corporation, and the relative rights and preferences of such classes of stock.

10. A list of any outstanding indebtedness (including convertible debt) of the S corporation.

11. A list of any outstanding options or warrants of the S corporation and the terms of such options or warrants.

12. Copy of the stock transfer ledger (to determine who has been a shareholder of the S corporation).

13. Copy of Stock Powers, other stock transfer documents, and stock certificates of the S corporation (both presently outstanding stock certificates and cancelled stock certificates).

14. Copies of any trust documents with respect to shareholders of the S corporation that are trusts.

15. Copies of any qualified Subchapter S trust (QSST) elections made by any shareholder of the corporation that is a trust.

16. A copy of the confirmation received by the S corporation from the IRS stating that the trust's status as a QSST has been accepted.

17. Copies of any electing small business trust (ESBT) elections filed by any shareholder of the corporation that is a trust.

18. A copy of the confirmation received by the S corporation from the IRS stating that the trust's status as an ESBT has been accepted.

19. Verification of citizenship status or U.S. resident status of shareholders.

20. A list of all subsidiaries of the S corporation and the amounts and classes of stock or other equity interests held by the S corporation in such subsidiaries.

21. Copies of any qualified Subchapter S subsidiary (QSub) elections filed for any subsidiary of the S corporation.

22. Copies of confirmations received by the S corporation or any QSub from the IRS stating that such QSub elections have been accepted and the effective date of such elections.

23. A schedule of distributions made by the S corporation to or on behalf of each of its shareholders.

24. Any agreements or plans concerning outstanding or proposed stock options, warrants, or rights, including any employee stock ownership plans.

25. Any shareholder agreements, investor rights agreements, voting trusts, proxy agreements, or similar arrangements.

26. Any stock purchase agreements with shareholders.

27. Any agreements relating to preemptive rights or other preferential rights of shareholders.

28. Any agreements restricting the sale or other disposition of stock.

29. Any phantom stock, stock appreciation rights, or similar deferred benefit plan.

30. Any agreements relating to registration rights of shareholders.

All of these due diligence items will be equally important in connection with the acquisition of the membership interests of an LLC taxed as an S corporation.¹

In addition to actually examining the various forms, elections, and confirmations stated above, it is of critical importance that counsel for the purchaser confirm to its own satisfaction that all of the eligibility requirements for S corporation status

have been met. Consequently, a clear understanding of the eligibility requirements pertaining to S corporations and their shareholders is necessary in order to properly conduct due diligence in connection with the acquisition of the stock of an S corporation.

In today's litigious climate, it will be important for the tax practitioner advising the purchaser of S corporation stock to be familiar with the requirements that must be met in order for a corporation to qualify as an S corporation. This will help the tax practitioner demonstrate that all necessary due diligence has been conducted in determining the validity of the corporation's S election (not only to protect the client but also to protect the tax practitioner from potential malpractice claims).

Definition of small business corporation. An S corporation is defined under Section 1361(a)(1) as a "small business corporation" for which an election under Section 1362(a) is in effect. Under Section 1361(b)(1), a "small business corporation" is a "domestic corporation" that is not an "ineligible corporation" and which does not have (1) more than 100 shareholders, (2) as a shareholder a person (other than an estate, certain types of trusts or an organization described in Section 1361(c)(6)) who is not an individual,² (3) a nonresident alien as a shareholder, and (4) more than one class of stock.³

Limits on types of corporations. To be eligible, a corporation must be a "domestic corporation." Sections 7701(a)(3) and 7701(a)(4) define "domestic corporation" as a corpo-

ration that is created or organized in the U.S. or under the laws of the U.S. or of any state or territory thereof. Section 1361(b)(2) provides that "ineligible corporation" means any corporation that is a financial institution that uses the reserve method of accounting for bad debts under Section 585, an insurance company, a possessions corporation, or a DISC or former DISC.

Limits on taxable years. Under Section 1378, an S corporation must have a "permitted year," which is either a calendar year, a fiscal year for which the corporation establishes a sufficient business purpose, or a fiscal year permitted pursuant to an election under Section 444.

Section 444 permits an S corporation to elect a taxable year different from that required under Section 1378, provided that such taxable year does not result in a deferral of greater than three months and provided that the corporation makes the tax payments required under Section 7519 for each year the election is in effect. Under Section 7519(b), an S corporation electing under Section 444 must make annual payments to the IRS for approximately the same amount of taxes as the shareholders would have paid if the corporation were on a calendar year. The payments are due by May 15 following the calendar year in which the election year begins.

QSubs. Prior to the changes made by the Small Business Job Protection Act of 1996 (SBJPA), S corporations could not own 80% or more of the stock of another corporation without causing the termination of the parent corporation's S election. Fol-

¹ For a discussion of the issues relating to the operation of an LLC taxed as an S corporation, see Looney and Levitt, "Operating as an S Corporation Through a State Law Limited Liability Company," 66 NYU Inst. on Fed. Tax'n, Chapter 17 (2008).

² A full discussion of the eligibility requirements for S corporations is beyond the scope of this article. Considerations include limits on the number of shareholders under Section 1361(b)(1)(A) and limits on the types of eligible S corporation shareholders under Sections 1361(b)(1)(B) and (C), which are limited to individuals (other than nonresident

aliens), a decedent's estate, an individual's estate in bankruptcy, an organization described in Section 1361(c)(6), or certain types of trusts (grantor trusts, Section 678 trusts, testamentary trusts, voting trusts, QSSTs and ESBTs).

³ A full discussion of the second-class-of-stock rules under Section 1361(b)(1)(D) is beyond the scope of this article. In general, Reg. 1.1361-1(l)(1) provides that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distributions and liquidation proceeds.

lowing the SBJPA, S corporations may own any percentage of stock in a C corporation subsidiary without causing the termination of the parent corporation's S election. Furthermore, the S corporation parent may elect to treat a wholly owned subsidiary as a QSub.

Eligibility for QSub election. Reg. 1.1361-2(a) provides that a QSub means any domestic corporation that is not an ineligible corporation if the following two conditions are met:

1. 100% of the stock of such corporation is held by an S corporation.

2. The S corporation properly elects to treat the subsidiary as a QSub under Reg. 1.1361-3. A Form 8869, "Qualified Subchapter S Subsidiary Election," must be filed by the parent S corporation no later than two months and 15 days following the desired effective date of the QSub election.

Clearly, in addition to requesting all of the information discussed above in the due diligence checklist, it is crucial that the tax practitioner representing the purchaser of S corporation stock examine the qualification requirements independently and confirm that the corporation has a valid S election in effect, and that in situations in which the S corporation has a subsidiary, that the subsidiary is treated as a QSub and not taxed as a C corporation.

BUILT-IN GAIN TAX

Section 1374 imposes a corporate-level tax on the built-in gain of S corporations that were previously C corporations. This is an exception to the general rule that S corporations are not subject to taxation themselves but that all income flows through the S corporation and is

taxed once at the shareholder level. Consequently, in advising the purchaser of S corporation stock, it is essential that the tax practitioner determine whether the S corporation was previously a C corporation and, if so, whether it is subject to the built-in gain tax.

In addition, even if the corporation always has been an S corporation, it is necessary to determine whether the S corporation, in a tax-free reorganization under Section 368, has acquired the assets of a C corporation or another S corporation that itself is subject to the built-in gain tax.

Many (if not most) of the due diligence issues applicable to a taxable acquisition also apply to a tax-free merger and, to a lesser extent, a taxable acquisition of assets.

In the event the S corporation previously was a C corporation and has E&P from years in which it was a C corporation, the S corporation also is potentially subject to the "sting tax" on excess passive investment income imposed under Section 1375 and to the termination of its S corporation status under Section 1362(d)(3). When acquiring the stock of an S corporation, the following due diligence should be conducted with regard to the built-in gain tax:

1. Confirmation that the S corporation has been an S corporation since its inception and that its S election has not been terminated.
2. Confirmation that the S corporation has not acquired the assets of a C corporation (or an S corporation

subject to the built-in gain tax) in a tax-free reorganization.⁴

3. If the corporation previously was a C corporation or has acquired assets from a C corporation or an S corporation subject to the built-in gain tax, determine the date on which the conversion occurred and/or the date the asset acquisition occurred, and the amount of built-in gain at the time of such conversion and/or asset acquisition.

4. Examine the amount of net unrealized built-in gain reported on the corporation's initial tax return as an S corporation (Form 1120S, "U.S. Income Tax Return for an S Corporation," Schedule B, Line 6).

5. Request and review any work papers and memorandums prepared in connection with the conversion of the corporation from C corporation status to S corporation status.

6. Request and review any appraisals conducted in connection with the conversion of the corporation from C corporation status to S corporation status or in connection with the acquisition of the assets of a C corporation (or an S corporation subject to the built-in gain tax) in a tax-free reorganization.

7. Review and analyze any assets of the S corporation potentially subject to the built-in gain tax including, but not limited to:

- Real property.
- Furniture, fixtures, and equipment.
- Stock and other securities.
- Accounts receivable of a cash-method taxpayer.⁵
- Section 481 adjustments.⁶
- Cancellation of indebtedness income.⁷
- Income from the completed contract method of accounting.⁸
- Installment sales obligations.⁹
- Interests in partnerships.¹⁰
- Inventory items.¹¹
- Any assets contributed to the corporation immediately prior to its conversion to S corporation status (which could be subject to the anti-stuffing rules).¹²
- Goodwill of the business.

8. If the disposition occurred in 2009 or 2010, does the special seven-tax-year recognition period apply?

⁴ See Section 1374(d)(8).

⁵ See Section 1374(d)(5) and Reg. 1.1374-4(b). Also see Ltr. Rul. 200925005, where the IRS approved the so-called "bonus accrual method" to eliminate or offset built-in gains attributable to accounts receivable of a cash-method taxpayer.

⁶ See Reg. 1.1374-4(d).

⁷ See Reg. 1.1374-4(f).

⁸ See Reg. 1.1374-4(g).

⁹ See Reg. 1.1374-4(h).

¹⁰ See Reg. 1.1374-4(i).

¹¹ See Reg. 1.1374-7(a) and Reliable Steel Fabricators, Inc., TCM 1995-293.

¹² See Reg. 1.1374-9.

9. If the disposition occurs in 2011, does the special five-year recognition period apply?

An indemnification provision is only as good as the seller making it, and assumes that the seller still will have adequate resources from which the purchaser could recover.

In order for the tax practitioner to properly understand the potential application and effect of the built-in gain tax on the S corporation and conduct appropriate due diligence, the tax practitioner should be thoroughly familiar with the built-in gain tax rules.

General Rules

Section 1374 imposes a corporate-level tax on the built-in gain of S corporations that were previously C corporations. Section 1374 applies to built-in gain recognized by a corporation during the ten-year period following such corporation's conversion to S status.¹³

Reg. 1.1374-1(d) provides that the recognition period is the ten-calendar-year period, and not the ten-tax-year period, beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets under Section 1374(d)(8) in a carryover basis transaction.¹⁴ The tax rate is presently 35% (the highest rate of tax imposed under Section 11(b)) of the S corporation's "net recognized built-in gain."¹⁵

For corporations subject to the built-in gain tax, Section 1366(f)(2) provides for a reduction of the amount of gain that otherwise would pass through to the corporation's shareholders under Section 1366 by the amount of the built-in gain tax imposed under Section 1374. Reg. 1.1374-2(a) provides that a corporation's "net recognized built-in gain" for any tax year is the lesser of the following amounts:

1. The corporation's taxable income (using all rules applicable to C corporations) considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (the "pre-limitation amount").

2. The corporation's taxable income determined as if it were a C corporation computed without the benefit of the dividends-received deduction or the deduction for NOL carryovers (the "taxable income limitation").

3. The amount by which the corporation's net unrealized built-in gain (NUBIG) exceeds its net recognized built-in gain for all prior tax years (the "NUBIG limitation").

"Recognized built-in gain" means any gain recognized during the ten-year recognition period, beginning on the effective date of the corporation's S election, from the disposition of any asset except to the extent that (1) the S corporation can establish that the asset disposed of was not held by it as of the effective date of its S election, or (2) such asset's built-in gain (the excess of the FMV of the asset over the corporation's adjusted tax basis in the asset) as of the effective date of the S election was less than the gain recognized by the corporation on the disposition.

Similarly, "recognized built-in loss" means any loss recognized during the ten-year recognition period on the disposition of any asset to the extent that the S corporation can show that (1) such asset was held by it as of the effective date of its conversion to S status, and (2) the loss recognized does not exceed the amount of such asset's built-in loss (the excess of the corporation's adjusted tax basis in the asset over the asset's FMV) as of the effective date of the corporation's S election.¹⁶

In computing the built-in gain tax imposed under Section 1374, a corporation's net recognized built-in gain is reduced by any NOL carryforwards and any capital loss carryforwards arising in a tax year during which the corporation was a C corporation.¹⁷ Reg. 1.1374-5(a) provides that the loss carryforwards are

allowed as deductions against recognized built-in gain under Section 1374(b)(2) only to the extent their use is allowed under the rules applicable to C corporations. Any other loss carryforwards (such as charitable contribution carryforwards under Section 170(d)(2)) are not allowed as deductions against recognized built-in gain.

The tax computed under Section 1374 also may be reduced by business and AMT credit carryforwards arising from years in which the corporation was a C corporation.¹⁸ Reg. 1.1374-6(a) provides that the credits and credit carryforwards allowed as credits against the built-in gain tax under Section 1374(b)(3) are allowed only to the extent their use is allowed under the rules applicable to C corporations. Any other credits or credit carryforwards (such as foreign tax credits under Section 901) are not allowed as credits against the built-in gain tax. In addition, Reg. 1.1374-6(b) provides that the amount of business credit carryforwards and minimum tax credit allowed against the built-in gain tax are subject to the limitations described in Sections 38(c) and 53(c), respectively.¹⁹

Small Business Jobs Act of 2010

On 9/27/10, President Obama signed into law the Small Business Jobs Act of 2010 (P.L. 111-240; the "Jobs Act"). Jobs Act section 2014 amended Section 1374 to reduce the recognition period (during which corporations that converted from C corporation status to S corporation status) are subject to the built-in

¹³ Section 1374(d)(7).

¹⁴ See the text, below, for a discussion of the special five-year recognition period applicable to dispositions occurring in 2011 and the special seven-tax-year recognition period applicable to dispositions occurring in 2009 and 2010.

¹⁵ Section 1374(b)(1).

¹⁶ Sections 1374(d)(3) and (4).

¹⁷ Section 1374(b)(2).

¹⁸ Section 1374(b)(3)(B).

¹⁹ A full discussion of the built-in gain tax is beyond the scope of this article. For an extensive analysis of the BIG tax, see Looney and Levitt, "Reasonable Compensation and the Built-in-Gains Tax," 68 NYU Inst on Fed Tax'n ¶ 15.05 (2010).

gain tax from ten years to five years for tax years beginning in 2011. Specifically, the text of the amendment is very similar to the temporary reduction from ten years to seven years made by the American Recovery and Reinvestment Act of 2009 (P.L. 111-5, 2/17/09; the "Recovery Act"). The text of the Jobs Act amendment reads as follows:

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

The amendment is applicable to tax years beginning after 2010, and generally raises the same questions as were raised in connection with the reduction from ten years to seven years for tax years beginning in 2009 and 2010. The amendment, however, specifically uses the term "taxable year" in connection with the recognition period for tax years beginning in 2009 and 2010, but only uses the term "5th year" (not "taxable year") in connection with the recognition period for a tax year beginning in 2011. This seems to clarify that tax years rather than calendar years will apply for dispositions that occurred in 2009 and 2010.²⁰

ALLOCATION OF INCOME OR LOSS IN YEAR OF STOCK SALE

Another important consideration to be taken into account by the purchaser acquiring S corporation stock, which is not applicable to the acquisition of stock of C corpora-

tions, is the allocation of the income or loss of the S corporation among its shareholders in the year of the sale of stock. As will be discussed in more detail below, the income or loss of an S corporation can be allocated either on a per-share, per-day basis, or an election can be made with respect to certain sales of S corporation stock to close the books of the S corporation and allocate items of income or loss as if its tax year consists of two tax years, the first of which ends on the date of the disposition of the S corporation stock.

In particular, the making of, or failure to make, an election to close the books can substantially affect the *time* when income will be recognized by the shareholders as well as the *character* of the income recognized by the shareholders. Consequently, the tax practitioner advising the purchaser of S corporation stock should conduct appropriate due diligence with respect to the allocation of the income or loss of the S corporation for the year of the stock sale, specifically including the potential effect of allocating income or loss on a per-share, per-day basis vs. allocating income or loss based on an election to close the books of the S corporation.

Due Diligence Regarding Income or Loss Allocation

The tax practitioner should, at a minimum, obtain the following information as part of the due diligence process:

- The income or loss of the S corporation through the date of a sale of stock that terminates a shareholder's entire interest in the S corporation (or which constitutes a qualifying disposition).
- The estimated income or loss of the S corporation following the date of such sale.
- The amount of any distributions made by the S corporation to its shareholders prior to the date of the sale.
- The likelihood that the S corporation will sell its assets following the date of the sale (this is mostly

a concern for the *sellors* of the stock).

- Any provisions contained in a buy-sell, shareholder, stock restriction, or other agreement among the S corporation and its shareholders requiring the allocation of income or loss for the year during which there is a stock sale.

The same due diligence items will be equally important in connection with the acquisition of the membership interests of an LLC taxed as an S corporation.

Just as with other due diligence items, the tax practitioner should be thoroughly familiar with the allocation rules relating to the income and loss of an S corporation.²¹

Terminating Elections—Planning Opportunities and Problems

Because of the elective nature of Section 1377(a)(2) (as well as Reg. 1.1368-1(g)(2)), it can be a useful planning tool for the tax practitioner. Depending on the facts and circumstances of a particular situation, and the party being represented (the selling shareholder, the buying shareholder, or the other shareholders), the failure to make a terminating election under Section 1377(a)(2) (or under Reg. 1.1368-1(g)(2)), can be either advantageous from a tax standpoint or a major blunder resulting in disastrous tax consequences to the taxpayer. The following examples illustrate some of the planning opportunities and pitfalls associated with the Section 1377(a)(2) terminating election.

EXAMPLE 1: X incorporates, elects S corporation status, and issues 100 shares of stock to A and 100 shares of stock to B on 1/2/09. Exactly half way through the tax year, B sells all of his stock to C. During its 2009 tax year, X has a profit of \$100,000 through the date of B's sale of his X

²⁰ For a discussion of the special seven-tax-year recognition period implemented by the Recovery Act, see Klein and Looney, "American Recovery and Reinvestment Act of 2009 Provides for Temporary Reduction of Built-in-Gain Recognition Period—Clarification Still Needed," 11 Business Entities 53 (May/June 2009).

²¹ See Sections 1377(a)(1), 1377(a)(2), and 1362(e), and Reg. 1.1368-1(g)(2).

stock to C, and a loss of \$200,000 for the period after the date of such sale.

If no terminating election under Section 1377(a)(2) is made, X's non-separately computed loss of \$100,000 (\$100,000 profit through the date of the sale less \$200,000 loss following the date of the sale) will be allocated on a per-share, per-day basis. As such, \$50,000 of loss will be allocated to A since he owned 50% of the stock of X for the entire tax year (\$100,000 loss/364 days \times 50% \times 364 days). Another \$25,000 of loss will be allocated to B since he owned 50% of the stock of X for one-half of the tax year (\$100,000 loss/364 days \times 50% \times 182 days). The remaining \$25,000 of loss will be allocated to C since he owned 50% of the stock of X for the last half of the tax year (\$100,000 loss/364 days \times 50% \times 182 days).

If, however, a terminating election is made under Section 1377(a)(2), X will close its books on the date of B's sale of his stock to C for purposes of allocating all of X's items of income, loss, deduction, and credit for the tax year. As such, \$50,000 of loss will be allocated to A (50% of the \$100,000 income of X through the date of the sale of B's stock to C, less 50% of the \$200,000 loss of X following the date of the sale of B's stock to C). B will be allocated \$50,000 of income (50% of the \$100,000 income of X through the date of the sale). C will be allocated \$100,000 of loss (50% of the \$200,000 loss of X following the date of B's sale of his stock to C).

If the S corporation has E&P from years in which it was a C corporation, the S corporation also is potentially subject to the 'sting tax' on excess passive investment income.

Although the Section 1377(a)(2) terminating election has no effect on the net amount allocated to A, the effect of the terminating election on B and C is significant. B's ordinary income is *increased* by

\$75,000 as a result of the terminating election (allocation of \$50,000 of income if terminating election is made as compared to an allocation of \$25,000 of loss if no terminating election is made). Likewise, C's ordinary income is *decreased* by \$75,000 as a result of the terminating election (allocation of \$100,000 of loss if terminating election is made as compared to an allocation of \$25,000 of loss if no terminating election is made).

EXAMPLE 2: The facts are the same as in Example 1, except that instead of B selling his shares to C, B sells all of his stock to A exactly halfway through the 2009 tax year. The sales price is \$200,000, to be received over five years. B's basis in his stock is \$100,000, and B intends to report the \$100,000 gain he realized on the sale of his stock to A on the installment sales method under Section 453. Through the date of B's sale of his stock to A, X has no income or loss, but following the sale of B's stock to A, X sells substantially all of its assets to a third party resulting in a gain to X of \$1 million.

If no terminating election under Section 1377(a)(2) is made, \$750,000 of gain will be allocated to A since he owned 50% of the stock of X for one-half of the tax year and 100% of the stock of X for the remaining one-half of the tax year. B will be allocated \$250,000 of gain since he owned one-half of the shares of X for one-half of the tax year.

Even if the entire gain on the sale of X's assets is capital gain (so that there is no rate differential between the gain allocated to B attributable to the sale of X's assets and the gain realized by B on the sale of his stock to A), B nevertheless will have to report the \$250,000 gain on his 2009 income tax return. In turn, the \$250,000 of gain allocated to B will increase B's basis in his X stock under Section 1367 to \$350,000 (\$100,000 original basis plus \$250,000 gain), which will cause B to recognize a capital loss on the sale of his stock to A of \$150,000 (\$350,000 basis less \$200,000 sales price). This \$150,000 capital loss can be used by B to offset the \$250,000 of

capital gain allocated to him, so that the net amount of gain that must be recognized by B on his 2009 income tax return will be \$100,000.

If instead a terminating election under Section 1377(a)(2) was made in connection with the sale of B's stock to A, *none* of the gain on X's sale of its assets would be allocated to B, and B would be permitted to recognize the \$100,000 of gain realized by him on the sale of his stock to A under the installment sales method over five years, rather than recognizing the entire \$100,000 gain in 2009. A would be allocated the entire \$1 million of gain recognized by X on the sale of its assets.

EXAMPLE 3: The facts are the same as in Example 2, except that instead of X selling its assets for a gain of \$1 million, A contributes assets to X following the date of the sale of B's stock to A and those contributed assets produce \$1 million of ordinary income.

If no terminating election is made under Section 1377(a)(2), \$750,000 of ordinary income will be allocated to A since he owned 50% of the stock of X for one-half of the tax year, and 100% of the stock of X for the remaining one-half of the tax year. B will be allocated \$250,000 of ordinary income since he owned 50% of the stock of X for one-half of the tax year.

B will be required to include the \$250,000 of ordinary income on his 2009 income tax return, which also will result in an increase in the basis of his X stock to \$350,000 (\$100,000 original basis plus \$250,000 income). Again, this will result in a capital loss of \$150,000 (\$350,000 basis less \$200,000 sales price) on the sale of B's stock to A. Because the \$250,000 allocated to B is ordinary income rather than capital gain, B will *not* be permitted to offset the \$150,000 capital loss against the \$250,000 of ordinary income allocated to him except to the extent of \$3,000 per year. Additionally, B will be subject to the substantially higher tax rates imposed on ordinary income with respect to the \$250,000 of ordinary income allocated to him.

If, however, a terminating election under Section 1377(a)(2) is made with respect to B's sale of all of his stock to A, B will be allocated no portion of the \$1 million of ordinary income of X following the date of B's sale of his X stock to A. B therefore will receive capital gain treatment on the entire \$100,000 of gain realized by him on the sale of his stock to A. A, on the other hand, will be allocated the full \$1 million of ordinary income of X following the date of B's sale of his stock to A.

As is clearly illustrated by these examples, the Section 1377(a)(2) terminating election can have a significant impact both on the timing and characterization of income to both the seller and the buyer of S corporation stock. The seller can avoid having his or her tax consequences affected by the actions of the buyer after the date of the sale only by having the S corporation make a terminating election under Section 1377(a)(2).

At a minimum, the stock purchase agreement between the selling shareholder and the purchasing shareholder should deal with whether to make a Section 1377(a)(2) terminating election, an election under Reg. 1.1368-1(g)(2) in connection with a "qualifying disposition," or an election under Section 1362(e)(3) by which the sale terminates the corporation's S status. If so, the S corporation, as well as any other affected

shareholders who are not parties to the sale, should join in the execution of the stock purchase agreement for purposes of agreeing to consent to the applicable election.

The most practical solution may be to provide in a shareholders' agreement between the corporation and all of its shareholders that a Section 1377(a)(2) terminating election will be made in the event a shareholder terminates his entire interest in the corporation, makes a qualifying disposition under Reg. 1.1368-1(g)(2), or there is a termination of the corporation's S status in connection with the sale and purchase (without knowing whether such an election will be favorable or detrimental to the respective shareholders). Although this may be the most equitable approach, such a provision eliminates the planning opportunities available to the knowledgeable tax practitioner under Section 1377.

AAA AND E&P

Another important aspect of due diligence in connection with the acquisition of the stock of an S corporation is to ascertain the S corporation's AAA and accumulated Subchapter C E&P (AE&P), as these amounts can have a dramatic effect with regard to the taxability of distributions²² and redemptions²³ made by the S corporation, as well as with respect to the potential applica-

tion of the excess passive investment income rules.²⁴

In particular, the purchaser of the S corporation stock will be interested in the amount of the S corporation's AAA and AE&P in connection with the determination of the taxability of distributions made to the purchaser from the S corporation following the purchaser's acquisition of the S corporation stock. Under Section 1368(b)(1), distributions of cash or property made by an S corporation having no AE&P are received tax-free by shareholders to the extent of their basis in the S corporation stock. To the extent distributions exceed basis, however, Section 1368(b)(2) treats the excess as gain from the sale or exchange of property.

The recognition period is the ten-calendar-year period that begins on the first day the corporation is an S corp., or the day an S corp. acquires assets with a carryover basis.

Distributions made by S corporations having AE&P are subject to a five-tier system of taxation, which may be summarized as follows:

1. That portion of the distribution that does not exceed AAA is tax-free to the extent of the share-

²² There are two sets of rules governing the taxation of distributions from S corporations. One system applies to distributions from an S corporation that does not have AE&P. The other system applies to distributions from an S corporation that, at the end of the year of distribution, has AE&P.

²³ Non-exchange redemptions reduce (on a dollar-for-dollar basis) a corporation's AAA first and then the corporation's AE&P unless the corporation and its shareholders file an election under Section 1368(e)(3) to distribute AE&P first. Redemptions treated as a sale or exchange under Section 302(b) are charged to both AAA and AE&P accounts in direct proportion to the percentage of stock redeemed.

²⁴ Section 1375 imposes a "sting" tax on certain S corporations having excess passive investment income. The Section 1375 tax applies only if an S corporation has AE&P from years in which the corporation was a C corporation and more than 25% of the gross

receipts of the corporation are passive investment income.

In general, "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, and annuities. Gain from sales or exchanges of stock or securities are no longer treated as an item of passive investment income, effective for tax years beginning after 5/25/07, the date of enactment of the Small Business and Work Opportunity Act of 2007 (P.L. 110-28, the "2007 Act"). This provision will be useful to some S corporations with AE&P that wrestle yearly with ensuring that their passive investment income does not exceed specified levels.

The Section 1375 tax on excess net passive investment income is computed by multiplying the excess net passive income of the corporation by the highest marginal rate of tax imposed on corporations. The 2007 Act allows certain corporations that converted to S corporation status to eliminate "old" AE&P relating to pre-1983 S corporation history.

More specifically, for any corporation that was not an S corporation for its first tax year beginning after 1996, the AE&P of the corporation as of the beginning of the first tax year beginning after 5/25/07 is reduced by the AE&P (if any) accumulated in a tax year beginning before 1983 for which the corporation was an electing small business corporation under Subchapter S. A prior provision allowed a corporation that was an S corporation for its first tax year beginning after 1996, to eliminate this old AE&P. The 2007 Act provision merely extends the ability to eliminate the old AE&P to corporations that have converted "back" to S corporation status more recently.

In addition to the sting tax imposed under Section 1375 on an S corporation's excess passive investment income, if a corporation has excess passive investment income and undistributed AE&P for three consecutive tax years, Section 1362(d)(3) provides that the corporation's S election will be terminated as of the first day of the following year.

holder's stock basis (Sections 1368(c)(1) and 1368(b)(1)).

2. That portion of the distribution that does not exceed AAA, but that does exceed the shareholder's stock basis, is capital gain (Sections 1368(c)(1) and 1368(b)(2)).

3. That portion of the distribution that exceeds AAA is a dividend to the extent of the S corporation's AE&P (Sections 1368(c)(2) and 301).

4. That portion of the distribution that exceeds AAA and the AE&P of the S corporation is tax-free to the extent of the shareholder's residual stock basis (the shareholder's adjusted basis in his S corporation stock less any reductions made in his stock basis for any first-tier distributions) (Sections 1368(c)(3) and 1368(b)(1)).

5. That portion of the distribution that exceeds AAA, the AE&P of the S corporation, and the shareholder's residual stock basis is capital gain (Sections 1368(c)(3) and 1368(b)(2)).

The greater the amount of the corporation's AAA, and the lesser the amount of the corporation's AE&P, the better for the purchaser. Consequently, the following information should be obtained as part of the due diligence process:

- Computation and workpapers relating to the S corporation's AAA.
- Computation and workpapers relating to the S corporation's AE&P, if any.
- Federal tax returns for most recent five years and any other open years.
- State tax returns for most recent five years and any other open years.
- Any material municipal tax returns for most recent five years and any other open years.
- Description of any pending or potential issues with tax authorities, specifically including any is-

issues relating to S corporation status, the built-in gain tax, or the tax on excess passive investment income.

- Tax basis of assets of the company and of capital stock and assets of its subsidiaries.
- Closing letters and any other material IRS documents and tax assessment documents.
- Any tax contingencies recorded in the financial statements.
- Most recent year-to-date financial statements.
- Financial statements for past five years (audited, if available).

Ordering of Adjustments to Basis

Before the tax treatment of distributions to S corporation shareholders can be determined, the basis of the distributee shareholder in his S corporation stock will be increased by items of S corporation income described in Section 1367(a)(1). The distributee shareholder's basis will *not* be decreased by items of S corporation loss and deduction described in Section 1367(a)(2) until after the tax treatment of the distribution has been determined.

In addition, Section 1368(e) provides that in determining the corporation's AAA available to cover distributions made during the tax year, the amount of AAA as of the close of the tax year will be determined without regard to any "net negative adjustment." This is the excess of reductions to AAA for the tax year over increases to AAA for the tax year.

Accumulated E&P

An S corporation may have AE&P from several sources:

1. AE&P from tax years during which the corporation was a C corporation.
2. AE&P carried over from another corporation pursuant to Section 381 in connection with a tax-free acquisition (e.g., a merger under Section 368(a)(1)(A)).
3. An S corporation's AE&P account is to be adjusted to take into account redemptions, liquidations, reorganizations, investment tax

credit recapture liability, and distributions that are treated as dividends under Section 1368(c)(2).

Accumulated Adjustments Account

A corporation's AAA generally consists of the accumulated gross income of the S corporation less deductible expenses and prior distributions. The AAA is essentially a running total of the S corporation's income, losses, deductions, and distributions.

AAA bypass election. Under Section 1368(e)(3), an S corporation that has AE&P can make an election to change the ordinary distribution rules discussed above. If a Section 1368(e)(3) election ("AAA bypass election") is made, the distributions from the corporation to its shareholders will first be treated as coming out of the corporation's AE&P to the extent thereof, then out of the corporation's AAA. The Section 1368(e)(3) election requires the consent of any shareholder to whom a distribution was made by the S corporation during the tax year.

A Section 1368(e)(3) election is useful for an S corporation with AE&P that wishes to purge such AE&P to avoid the Section 1375 sting tax²⁵ and the possible termination of S corporation status under Section 1362(d)(3) (which applies where passive investment income of an S corporation with AE&P exceeds 25% of gross receipts in three consecutive years). Because of the 15% tax rate applicable to dividend distributions through 2012,²⁶ the distribution of AE&P to purge AE&P is more palatable to taxpayers than when dividends were taxed at ordinary income rates.

In addition, because of the 15% tax rate applicable to dividend distributions, it may make sense in some situations for the corporation to make a Section 1368(e)(3) election. This could free-up suspended losses to offset other ordinary income of the shareholder, since such distributions will be taxed at the 15% tax rate and will *not* reduce the shareholder's stock basis. As such, the election would allow losses that otherwise might be suspended to

²⁵ *Id.*

²⁶ Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312, 12/17/10).

flow through and offset other ordinary income of the shareholder (which otherwise would be subject to a maximum marginal income tax rate of 35%).

EXAMPLE 4: *No Section 1368(e)(3) election.* S is an S corporation with a single shareholder, B. As of 1/1/11, S has AE&P of \$1,000 and AAA of \$2,000. On 4/1/11, S makes a \$2,000 distribution to B. For 2011, S has \$2,000 of income and \$3,500 of deductions. As of 1/1/11, B owned 100 shares of S stock with a basis of \$20 in each share. S does not make an election under Section 1368(e)(3) and Reg. 1.1368-1(f)(2).

Under Section 1368(e)(1)(C) and Reg. 1.1368-2(a)(5), in applying adjustments to AAA to determine the taxability of distributions, AAA is determined without regard to any net negative adjustment. For purposes of the distribution, the AAA of S is \$2,000 (\$2,000 + \$2,000 (income) - \$2,000 (loss) not to exceed the 2011 income). Therefore, the \$2,000 distribution to B is out of AAA. The AAA is further reduced by the remaining \$1,500 loss to a negative \$1,500.

For purposes of determining taxability of the distribution, B's beginning basis of \$2,000 is increased by \$2,000 of income, under Section 1368(d). The \$2,000 distribution reduces the basis of B's S stock to \$2,000 (\$2,000 + \$2,000 - \$2,000). The basis of B's S stock is further reduced by the \$2,000 of loss. The remaining \$1,500 loss in excess of B's basis in his shares is suspended and will be treated as incurred by S in the succeeding tax year with respect to B.

In sum, the \$2,000 distribution is not taxable to B. B is passed through \$2,000 of income and \$2,000 of loss. Finally, B has \$1,500 of suspended losses.

EXAMPLE 5: *Section 1368(e)(3) election.* The facts are the same as in Example 4, except that S elects under Section 1368(e)(3) and Reg. 1.1368-1(f)(2) to distribute AE&P first.

The \$2,000 distribution by S is deemed to be made first out of

Practice Notes

At a minimum, the stock purchase agreement between the selling shareholder and the purchasing shareholder should deal with whether to make a Section 1377(a)(2) terminating election, an election under Reg. 1.1368-1(g)(2) in connection with a "qualifying disposition," or an election under Section 1362(e)(3) by which the sale terminates the corporation's S status. If so, the S corporation, as well as any other affected shareholders who are not parties to the sale, should join in the execution of the stock purchase agreement for purposes of agreeing to consent to the applicable election.

The most practical solution may be to provide in a shareholders' agreement between the corporation and all of its shareholders that a Section 1377(a)(2) terminating election will be made in the event a shareholder terminates his entire interest in the corporation, makes a qualifying disposition under Reg. 1.1368-1(g)(2), or there is a termination of the corporation's S status in connection with the sale and purchase (without knowing whether such an election will be favorable or detrimental to the respective shareholders). Although this may be the most equitable approach, such a provision eliminates the planning opportunities available to the knowledgeable practitioner under Section 1377.

AE&P of \$1,000 and is a dividend to B. (See Reg. 1.1368-3, Example 7.) The remaining \$1,000 distribution is made out of AAA and constitutes a tax-free return of basis. Under Reg. 1.1367-1(f):

Beginning basis	\$2,000
Increase for income items	2,000
Decrease for distribution not includable in shareholder's income (\$2,000 distribution - \$1,000 portion treated as dividend)	(1,000)
Decrease for noncapital, nondeductible expense	0
Decrease for items of loss or deduction described in Sections 1367(a)(2)(B) and (C) (but not in excess of basis)	(3,000)
Remaining basis	0

The remaining \$500 of loss in excess of B's basis in his shares of S stock is suspended and will be treat-

ed as incurred by S in the succeeding tax year with respect to B.

In sum, B has \$1,000 of dividend income taxed at maximum rate of 15% under Section 1(h). B has \$2,000 of pass-through income and \$3,000 of pass-through loss. Assuming B is taxed at the maximum marginal rate of 35% and loss items are fully deductible by B, he has a net savings of \$200 (excess of [\$1,000 × .35] over [\$1,000 × .15]).

SECTION 338(h)(10) ELECTION

One of the most substantial disadvantages to the purchaser who acquires stock of an S corporation rather than its assets is that the purchaser will *not* receive a stepped-up basis in the assets of the S corporation. Rather, the S corporation will continue to have the same basis as it had in its assets prior to the transaction. Nevertheless, a purchaser can obtain a stepped-up basis in the assets of an S corporation on the purchase of its stock if the parties make a Section 338(h)(10) election.

In the event that the purchaser desires to make a Section 338(h)(10) election in connection with the acquisition of stock of an S corpora-

tion, there may be different tax consequences to the sellers between the actual sale of stock and the deemed sale of the assets under Section 338(h)(10). As a result, it is likely that the sellers will request that any additional tax be paid by the purchaser to the sellers in the form of additional purchase price.

Loss carryforwards are allowed as deductions against recognized built-in gain to the extent their use is allowed under the rules applicable to C corporations.

Therefore, it is critical for the tax practitioner advising the purchaser of S corporation stock for which a Section 338(h)(10) election will be made to be able to properly analyze and determine the potential additional tax that will be incurred by the sellers if the transaction is taxed as an asset sale rather than as a stock sale. In this regard, the following items should be examined as part of the due diligence process:

1. The S corporation's tax basis in each of its assets.
2. The holding period of such assets.
3. The character of such assets.
4. Each selling shareholder's basis in his S corporation stock.
5. Whether the S corporation is subject to the built-in gain tax.
6. Whether acquisition of the S corporation's stock constitutes a "qualified stock purchase."
7. Negotiate the content of the final Form 1120S to be filed for the target S corporation and follow up on its timely filing as well as the issuance of Schedules K-1 to the former shareholders.

²⁷ See Elliott, "Economic Substance Concerns Over Common Planning Tool May be Legitimate, Official Says," 2010 TNT 216-7 (11/9/10), for a discussion of concerns relating to the use of a one-day note strategy to avoid gain recognition in conjunction with a Section 338(h)(10) election.

8. Confirm the consent of the purchaser corporation and *all* shareholders of the S corporation on Form 8023, "Election Under Section 338 for Corporations Making Qualified Stock Purchases," and follow up to make sure it is timely filed.

9. Completion and filing of Form 8883, "Asset Allocation Statement Under Section 338."

10. Calculation of the aggregate deemed selling price (ADSP) and the adjusted grossed-up basis (AGUB) of the assets.

11. If the consideration received for the S corporation stock includes an installment obligation,²⁷ determine whether the installment obligation is marketable or payable on demand (this is principally a concern for the *selling* shareholders rather than the purchaser), and

- Determine that the Section 453(i) depreciation recapture rule is properly applied;
- Determine whether Section 453A applies to such installment obligations; and
- Determine applicability of Sections 453(h) and 453B(h) on distribution of installment notes in deemed liquidation.

Qualified stock purchase. In order for an acquiring corporation to be eligible to make a Section 338(h)(10) election, it must satisfy the requirements of a "qualified stock purchase," i.e., any transaction or series of transactions in which stock (pursuant to Section 1504(a)(2), i.e., 80% or more by vote and value) of one corporation is acquired by another corporation by purchase during a 12-month acquisition period. This election may be made only for a target which is a domestic corporation that, but for the sale of its stock, is a member of an affiliated group of corporations (whether or not the group files consolidated returns) *or is an S corporation*.

Consequently, it is critical that a target corporation meet the definition of an S corporation in order to make a Section 338(h)(10) election (if the target is not part of a consolidated group of corporations). Tax practitioners therefore will

have to satisfy themselves that the eligibility requirements previously discussed in this article are met with respect to the target corporation.

Effect of 338(h)(10) election. Where a Section 338(h)(10) election is made, the target S corporation ("Old Target") recognizes gain or loss as though it sold its assets on the acquisition date to "New Target" and then Old Target distributed its assets to its shareholders in liquidation of Old Target. The target S corporation shareholders generally recognize no gain or loss on selling target's stock to the purchasing corporation. If the gain inherent in the target shareholders' stock is similar in amount to the gain inherent in the target's assets, Section 338(h)(10) may provide a step-up in asset basis at a tax cost not significantly greater than would be incurred without an election.

Consent requirements. Regulations provide for deemed asset sale treatment for shareholders of a target S corporation provided *all* shareholders of the target consent. The Section 338(h)(10) election must be made no later than the 15th day of the ninth month after the month in which the acquisition date occurs. Once made, the election is irrevocable. Certain consistency rules also apply under the Regulations.

Deciding to Make the Election

The decision as to whether it is more advantageous and to what extent the target should agree to make a Section 338(h)(10) election in connection with the purchase or sale of stock requires consideration of the following issues:

- A comparison of inside (asset) basis vs. outside (stock) basis.
- Analysis of the character of gain differential between an "inside" sale vs. an "outside" sale (which would all be long-term capital gain).
- Whether a corporate-level tax would be imposed because of the deemed sale (i.e., is the built-in gain tax applicable to the target S corporation).

EXHIBIT 2
Diligence Checklist for Acquisition of S Corporation Stock

Following is a list of the documents and other items the Purchaser and its attorneys, accountants, and other advisors should require in connection with the proposed acquisition of the stock of an S Corporation (and any subsidiary thereof) by the Purchaser. The following is *not* intended to be a comprehensive checklist of all due diligence items that should be requested in connection with the acquisition of stock of a corporation (S corporation or C corporation).

S CORPORATION ELIGIBILITY REQUIREMENTS

Articles and Bylaws:

1. Original Articles of Incorporation and all amendments.
2. Original Bylaws and all amendments.

Minutes of Meetings and Reports Issued by (since date of incorporation):

1. Shareholders.
2. Board of Directors.
3. Any Executive, Audit or other Committee.

Other S Corporation Eligibility Items:

1. A copy of the filed Form 2553, "Election by a Small Business Corporation."
2. A copy of the confirmation received by the S corporation from the Internal Revenue Service ("IRS") stating that the S corporation's S election has been accepted and the effective date of such election.
3. A list of the shareholders of the target S corporation.
4. A list of the authorized, issued, and outstanding shares of stock owned by the S corporation shareholders and the classes of outstanding shares of stock of the S corporation, and the relative rights and preferences of such classes of stock.
5. A list of any outstanding indebtedness (including convertible debt) of the S corporation.
6. A list of any outstanding options or warrants of the S corporation and the terms of such options or warrants.
7. Copy of the stock transfer ledger (to determine who has been a shareholder of the S corporation).
8. Copy of Stock Powers, other stock transfer documents, and stock certificates of the S corporation (both presently outstanding stock certificates and cancelled stock certificates).
9. Copies of any trust documents with respect to shareholders of the S corporation that are trusts.
10. Copies of any qualified subchapter S trust ("QSST") elections made by any shareholder of the corporation that is a trust.
11. A copy of the confirmation received by the S corporation from the IRS stating that the trust's status as a QSST has been accepted.
12. Copies of any electing small business trust ("ESBT") elections filed by any shareholder of the corporation that is a trust.
13. A copy of the confirmation received by the S corporation from the IRS stating that the trust's status as an ESBT has been accepted.
14. Verification of citizenship status or U.S. resident status of shareholders.
15. A list of all subsidiaries of the S corporation and the amounts and classes of stock or other equity interests held by the S corporation in such subsidiaries.
16. Copies of any QSub elections filed for any subsidiary of the S corporation.
17. Copies of confirmations received by the S corporation or any QSub from the IRS stating that such QSub elections have been accepted and the effective date of such elections.
18. A schedule of distributions made by the S corporation to or on behalf of each of its shareholders.
19. Any agreements or plans concerning outstanding or proposed stock options, warrants, or rights, including any employee stock ownership plans.
20. Any shareholder agreements, investor rights agreements, voting trusts, proxy agreements, or similar arrangements.
21. Any stock purchase agreements with shareholders.
22. Any agreements relating to preemptive rights or other preferential rights of shareholders.

EXHIBIT 2

Diligence Checklist for Acquisition of S Corporation Stock, cont'd

23. Any agreements restricting the sale or other disposition of capital stock.
24. Any phantom stock, stock appreciation rights, or similar deferred benefit plan.
25. Any agreements relating to registration rights of shareholders.

APPLICABILITY OF BUILT-IN GAIN TAX

1. Confirmation that the S corporation has been an S corporation since its inception and that its S election has not been terminated.

2. Confirmation that the S corporation has not acquired the assets of a C corporation (or an S corporation subject to the built-in gain tax) in a tax-free reorganization.

3. If the corporation was previously a C corporation or has acquired assets from a C corporation or an S corporation subject to the built-in gain tax, determine the date on which the conversion occurred and/or the date the asset acquisition occurred and the amount of built-in gain at the time of such conversion and/or asset acquisition.

4. Examine the amount of net unrealized built-in gain reported on the corporation's initial tax return as an S corporation (Form 1120S, "U.S. Income Tax Return for an S Corporation," Schedule B, Line 6).

5. Request and review any workpapers and memorandums prepared in connection with the conversion of the corporation from C corporation status to S corporation status.

6. Request and review any appraisals conducted in connection with the conversion of the corporation from C corporation status to S corporation status or in connection with the acquisition of the assets of a C corporation (or S corporation subject to the built-in gain tax) in a tax-free reorganization.

7. Review and analyze any assets of the S corporation potentially subject to the built-in gain tax including, but not limited to:

- Real property.
- Furniture, fixtures and equipment.
- Stock and other securities.
- Accounts receivable of a cash-method taxpayer.
- Section 481 adjustments.
- Cancellation of indebtedness income.
- Income from the completed contract method of accounting.
- Installment sales obligations.
- Interests in partnerships.
- Inventory items.
- Any assets contributed to the corporation immediately prior to its conversion to S corporation status (to determine applicability of anti-stuffing rules).
- Goodwill of the corporation.

8. If disposition occurred in 2009 or 2010, does special seven-tax-year rule apply?

9. If disposition occurs in 2011, does special five-year rule apply?

AAA, E&P, AND OTHER FINANCIAL INFORMATION

AAA and E&P:

1. Computation and workpapers relating to the S corporation's accumulated adjustments account.
2. Computation and work papers relating to the S corporation's Subchapter C E&P, if any.

General Tax Materials:

- Federal tax returns for most recent five years and any other open years.
- State tax returns for most recent five years and any other open years.
- Any material municipal tax returns for most recent five years and any other open years.
- Description of any pending or potential issues with tax authorities, specifically including any issues relating to S corporation status, the built-in gain tax, or the tax on excess passive investment income.
- Tax basis of assets of the company and of capital stock and assets of its subsidiaries.
- Closing letters and any other material IRS documents and tax assessment documents.
- Any tax contingencies recorded in the financial statements.

EXHIBIT 2
Diligence Checklist for Acquisition of S Corporation Stock, cont'd

Financial Information:

- Most recent year-to-date financial statements.
- Financial statements for past five years (audited if available).

INFORMATION RELEVANT TO ALLOCATION OF S CORPORATION INCOME IN YEAR OF SALE

1. The income or loss of the S corporation through the date of a sale of stock that terminates a shareholder's entire interest in the S corporation (or which constitutes a qualifying disposition).
2. The estimated income or loss of the S corporation following the date of such sale.
3. The amount of any distributions made by the S corporation to its shareholders prior to the date of the sale.
4. The likelihood that the S corporation will sell its assets following the date of the sale (this is mostly a concern for the *sellers* of the stock).
5. Any provisions contained in a buy-sell, shareholder, stock restriction, or other agreement among the S corporation and its shareholders requiring the allocation of income or loss for the year during which there is a stock sale.

INFORMATION RELEVANT TO SECTION 338(h)(10) ELECTION

- The S corporation's tax basis in each of its assets.
- The holding period of such assets.
- The character of such assets.
- Each selling shareholder's basis in his S corporation stock.
- Whether the S corporation is subject to the built-in gain tax.
- Determine whether acquisition of the S corporation's stock constitutes a "qualified stock purchase."
- Negotiate content of final Form 1120S to be filed for target S corporation and follow up on timely filing of same and issuance of Forms K-1 to former shareholders.
- Confirm consent of purchaser corporation and *all* shareholders of the S corporation on Form 8023, "Election Under Section 338 for Corporations Making Qualified Stock Purchases," and follow up to make sure it is timely filed.
- Completion and filing of Form 8883, "Asset Allocation Statement Under Section 338."
- Calculation of aggregate deemed selling price ("ADSP") and adjusted grossed-up basis ("AGUB") of assets.
- If the consideration received for the S corporation stock includes an installment obligation, determine whether the installment obligation is marketable or payable on demand (*this is principally a concern for the selling shareholders rather than the purchaser*).
- Determine that the Section 453(i) depreciation recapture rule is properly applied.
- Determine whether Section 453A applies to such installment obligations.
- Determine applicability of Sections 453(h) and 453B(h) on distribution of installment notes in deemed liquidation.

- Whether (and to what extent) the installment method of reporting is available.

Where the target has been a qualified electing small business corporation for its entire history and has not acquired the assets of a C corporation (or another S corporation subject to the built-in gain tax) within the past ten years in a basis-exchange transaction, then the corporate-level gain from an asset sale is, for federal (and most state) income

tax purposes, passed through to the shareholders and results in a single level of tax. The amount realized is allocated among the basis of the individual assets in accordance with the residual method of valuation in accordance with Section 1060 and the Section 338 Regulations, to the extent applicable.

Allocated gain or loss is characterized by reference to the nature of the corporation's purpose in holding the particular asset sold, e.g., depre-

ciable real property used in a trade or business or Section 1231 property, inventory, depreciation subject to recapture, property held for investment, including corporate goodwill. Where the corporation has acquired assets in a C corporation (or another S corporation subject to the built-in gain tax) in a tax-free reorganization within the past ten years and/or otherwise converted to Subchapter S within the past ten years, the built-in gain tax would apply on the asset

sale deemed to occur under Section 338(h)(10).²⁸

Allocation of Basis Among Deemed Purchased Assets

As mandated by Section 1060, the residual method of valuation is required to allocate the purchase price in deemed asset sales under Section 338(h)(10). Sellers will tend to allocate to assets that produce long-term capital gain, or, on the other hand, ordinary loss.

As to purchased goodwill and similar items, Section 197 has eliminated the issues of whether an intangible's useful life can be estimated with reasonable accuracy and, if so, the length of that useful life. If an intangible is covered by Section 197(a), its cost is amortized over 180 months, regardless of the period during which the intangible is expected to be useful in the business.

In order to trigger application of Section 1060, the acquisition must involve the purchase of any "active trade or business" (as defined under Section 355) or any other group of assets where "goodwill or going concern value could under any circumstances attach to such group." Under Section 1060, the allocation of the purchase price is to be made based on the following classes, in the following order:

1. Cash and general deposit accounts (including savings and checking accounts) ("Class I").

2. "Actively traded personal property" under Section 1092(d)(1) (with some modifications), including publicly traded stock and U.S. government securities, as well as CDs and foreign currency ("Class II").

3. Accounts receivable, mortgages, and credit card receivables from customers ("Class III").

4. Inventory, stock in trade, and property held for sale to customers in the ordinary course of business ("Class IV").

5. All assets other than Class I, Class II, Class III, Class IV, Class VI, and Class VII assets, which would include property, plant and equipment ("Class V").

6. Section 197 intangible assets, except goodwill and going concern value ("Class VI").

7. Goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a Section 197 intangible ("Class VII").²⁹

CONCLUSION

Although the tax practitioner advising the purchaser of S corporation stock should insist that adequate representations and warranties, indemnification provisions, and (if ap-

plicable) offset rights be included in the stock acquisition agreement, such provisions are no substitute for extensive due diligence of the target S corporation based on a thorough knowledge of the requirements that must be met to qualify as an S corporation and the special rules applicable to S corporations. Such due diligence not only protects the purchaser-client, but should go a long way in protecting the tax practitioner advising the purchaser of S corporation stock from any potential malpractice claim.

A list of specific items to be included in a Due Diligence Checklist for the acquisition of S corporation stock is in Exhibit 2. This list is *not* intended to be a comprehensive checklist of all due diligence items which should be included in a Due Diligence Checklist for the acquisition of stock of a corporation (whether an S corporation or a C corporation). ☞

²⁸ An alternative to making a Section 338(h)(10) election would be for the shareholders of an existing S corporation to contribute their stock to a newly formed corporation in exchange for all of the stock of the newly formed corporation, have the newly formed corporation make a QSub election for the original S corporation, and then sell the stock of the QSub to the purchaser. See Ltr. Rul. 201115016. See generally Letter Rulings, "Despite Related Transactions, Split-Up of S Corp. Using QSub Rules Qualified as F Reorganization," 114 JTAX 374 (June 2011).

²⁹ See generally Reg. 1.338-6(b)(2).