New York State Bar Association

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September 18, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section commenting on proposed regulations dealing with qualified subchapter S subsidiaries ("QSSS").

We believe that the proposed regulations do a good job of describing the consequences of making and terminating a QSSS election. However, we are concerned that the broad application of the step-transaction doctrine in the proposed regulations may result in adverse tax consequences that could have been avoided with more careful planning. This is particularly troublesome for small businesses, which are often organized as subchapter S corporations and may not have access to sophisticated tax advisors. We, therefore, recommend that the final regulations limit the application of the step transaction doctrine in the case of the making and termination of QSSS elections.

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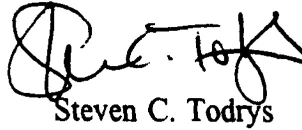
Please let me know if we can be of any further assistance in addressing these issues.

Sincerely,



Steven C. Todrys

Enclosure

cc: Internal Revenue Service
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Department of the Treasury
The Honorable Jonathan Talisman
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NEW YORK STATE BAR ASSOCIATION TAX SECTION

PROPOSED REGULATIONS CONCERNING QUALIFIED SUBCHAPTER S SUBSIDIARIES

This report[1] comments on Proposed Regulation Sections 1.1361-2, 1.1361-3, 1.1361-4 and 1.1361-5 (the "Proposed Regulations"), which address the federal income tax treatment of a "qualified subchapter S subsidiary" (a "QSSS") and the federal income tax consequences of making and terminating a QSSS election under Section 1361(b)(3).[2]

I. Summary

We believe the Proposed Regulations, for the most part, set forth clear statements of the consequences of making and terminating a QSSS election. We particularly commend the rules concerning the timing of the constructive liquidation resulting from making a QSSS election -- rules that avoid creating an interim C corporation taxable period when making the election for an existing S corporation or triggering an excess loss account when making the election

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1. This report was prepared by members of the Committee on Pass-Through Entities of the New York State Bar Association Tax Section. The principal author of this report is Marc L. Silberberg. Helpful comments were received from Kimberly S. Blanchard and Robert A. Jacobs.

2. All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), all "Treas. Reg. §" references are to the Treasury Regulations promulgated thereunder, and all "Prop. Reg. §" references are to the regulations proposed thereunder.

for a consolidated group member. Our principal concerns with the Proposed Regulations relate to the unrestricted application of the step-transaction doctrine to the constructive liquidation and constructive incorporation transactions that are deemed to occur by reason of making and terminating a QSSS election.

We agree that the QSSS regulations should maintain parity between an S corporation that makes or terminates a QSSS election for a subsidiary and an S corporation that actually liquidates a subsidiary or incorporates a division. The QSSS rules also should fulfill the following objectives: to provide certainty and simplicity for small businesses; to facilitate the operation of businesses by an S corporation through one or more wholly owned subsidiaries without undue tax cost; and to establish and maintain consistency with the treatment of elections (and terminations thereof) involving other single member entities that are disregarded for federal income tax purposes ("Disregarded Entities"), where consistency is not precluded by statutory constraints. Some of the Proposed Regulations' examples illustrating the application of the step-transaction doctrine go beyond what is necessary to achieve parity, producing unduly harsh tax results and traps for the unwary. We are also concerned that, given the inherent vagueness of the step-transaction

doctrine, a lack of clarity as to its potential application will diminish the utility of a QSSS election by engendering unneeded uncertainty and complexity.

We believe the legitimate interests of the Internal Revenue Service (the "Service") in maintaining parity can be protected while ameliorating some of the inequities and potential complexity of the Proposed Regulations. To this end, we present the following recommendations:

1. The QSSS regulations should provide that, where an S corporation that owns less than 100% of the stock of another corporation acquires (whether by purchase or contribution) the remaining stock of the subsidiary and makes a QSSS election with respect thereto, the plan of liquidation for the subsidiary corporation will not be deemed to have been adopted prior to the S corporation's acquisition of 100% of the stock of the subsidiary. As a result, the 80% ownership requirement of Section 332 would always be deemed to have been satisfied in connection with the constructive liquidation caused by a QSSS election.

2. The QSSS regulations relating to the consequences of making a QSSS election should apply the step-transaction doctrine only to determine whether an acquisition of shares of a corporation that precedes the

making of such election (and the resulting constructive liquidation of such corporation) constitutes a reorganization within the meaning of Section 368(a).

3. Where a QSSS election terminates by reason of the disposition by an S corporation of shares in its QSSS to a third party acquiror, the QSSS regulations should treat the transaction as a disposition by the S corporation of an undivided interest in the QSSS' assets (subject to a proportionate share of its liabilities) to the third party acquiror, followed by the transfer of assets (subject to proportionate liabilities) by the S corporation and the third party to a new corporation in a Section 351 transaction. To the extent that such result is precluded by the language of Section 1361(b)(3)(C), we would support a technical correction to permit such treatment.

In addition, we recommend that the regulations under Section 1361(b)(3), when finalized, include guidance concerning the application of Section 368(a) to transactions involving QSSSs. In general, we believe such guidance should be consistent with the rules ultimately adopted that apply Section 368 to transactions involving other Disregarded Entities. Such guidance requires a determination whether a state law merger of a corporation into a corporate-owned Disregarded Entity can be given

effect as a merger into the parent of the Disregarded Entity for purposes of Section 368(a)(1)(A).[3] As stated in the Report on Reorganizations Involving Disregarded Entities, dated August 27, 1998, prepared by the Committee on Reorganizations of the New York State Bar Association Tax Section, a majority of that committee believes such a merger should so qualify under Section 368(a)(1)(A), provided a merger into the corporate parent of the Disregarded Entity would have so qualified. We believe such conclusion is even more compelling when the merger is into a Disregarded Entity which is a state law corporation (such as a QSSS).

II. Discussion

A. Effect of QSSS Election

Under the Proposed Regulations, if an S corporation makes a valid QSSS election for a wholly-owned subsidiary, the subsidiary is deemed to have liquidated into the S corporation. The constructive liquidation of the QSSS comports with the Section 1361(b)(3) legislative history, which states that when the parent corporation makes the election, the subsidiary is deemed to have liquidated under Sections 332 and 337 immediately before the election is

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3. The Service has treated a merger of a corporation into a "qualified REIT subsidiary" as a merger into the parent REIT under Section 368(a)(1)(A). *See* Private Letter Rulings 8903074, 9411035 and 9512020.

effective.[4] This constructive liquidation approach also is consistent with the rules governing "qualified REIT subsidiaries"[5] and with Prop. Reg. § 301.7701-3(g)(3), which governs the conversion of an association to a Disregarded Entity under the check-the-box regime.

If the S corporation owns less than 100% of the stock of the subsidiary on the day before the QSSS election is effective, the Proposed Regulations provide that the constructive liquidation occurs immediately after the time when the S corporation first owns 100% of the stock.[6] The Proposed Regulations further state that, except as provided in the transition rule described below, the tax treatment of the liquidation, or of a larger transaction that includes the liquidation, will be determined under the Code and "general principles of tax law, including the

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4. S. Rep. No. 281, 104th Cong., 2d Sess. 53 (1996); H.R. Rep. No. 586, 104th Cong., 2d Sess. 89 (1996).

The legislative history accompanying the 1997 technical correction to Section 1361(b)(3)(A) suggests that regulations thereunder may provide exceptions to the deemed liquidation rule.

5. Section 856(i); General Explanation of Tax Legislation Enacted in 1997, Staff of Joint Committee on Taxation, (December 17, 1997) at 393.

6. Prop. Reg. § 1.1361-4(b)(2).

step transaction doctrine."[7]

The transition rule[8] provides that the step-transaction doctrine will not apply to determine the tax consequences of an acquisition by an S corporation of some or all of the stock of another corporation if the S corporation and the other corporation (referred to as the "related corporation") are persons specified in Section 267(b) prior to the acquisition, and the S corporation makes a QSSS election for the related corporation following the acquisition.[9]

The potential application of the step-transaction doctrine to acquisitions followed by a QSSS election is suggested in the examples that illustrate the transition rule. In the first example, an individual ("A") owns 100% of the stock of an S corporation ("S"). S owns 79% of the stock of a C corporation ("C"), and A owns 21% of the C stock. A contributes his 21% interest in C to S, and S makes a QSSS election for C immediately following such transfer. The example concludes that, during the transition

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7. Prop. Reg. § 1.1361-4(a)(2). Comparable language appears in Prop. Reg. § 301.7701-3(g)(2) for elective changes under the check-the-box regulations.

8. The transition rule is applicable to QSSS elections effective prior to the 60th day after the publication of the final QSSS regulations in the Federal Register.

9. Prop. Reg. § 1.1361-4(a)(5).

period, the liquidation will be respected as an independent step, separate from the stock acquisition. Therefore, the contribution by A of the C stock qualifies under Section 351 and the tax consequences of the deemed liquidation are determined under Sections 332 and 337.

Service representatives have indicated that, absent the application of the transition rule, the foregoing transaction should be treated as a fully taxable failed "C" reorganization,[10] applying the reasoning of Bausch and Lomb Optical Co. v. Comm., 267 F.2d 75 (2d Cir. 1959), cert. denied, 361 U.S. 835 (1959).[11]

In the second example illustrating the transition rule, an individual ("A") owns 100% of the stock of two solvent S corporations, "X" and "Y". A contributes the

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10. Tax Notes, June 8, 1998, at pp. 1229-30.

11. In Bausch and Lomb, the Second Circuit Court of Appeals upheld the Service's contention that the parent corporation's acquisition of the assets of its 79.9%-owned subsidiary in exchange for the parent's voting stock, followed by the dissolution of the subsidiary and the distribution of the parent's voting stock was, in substance, a liquidation of the subsidiary that did not qualify for nonrecognition treatment under the predecessor of Section 332; the court rejected the taxpayer's argument that the transaction qualified as a reorganization under Section 368(a)(1)(C), concluding instead that the stock of the subsidiary surrendered by the parent was boot. Rev. Rul. 54-396, 1954-2 C.B. 147, reaches the result of Bausch and Lomb on similar facts. Those holdings would not apply, however, were the transaction also to qualify under Section 368(a)(1)(D). Rev. Rul. 85-107, 1985-2 C.B. 121.

stock of Y to X, and X immediately makes a QSSS election for Y. Under the transition rule, the contribution and the deemed liquidation are treated as separate steps. The contribution by A of Y stock to X would qualify under Section 351, and the constructive liquidation would qualify under Sections 332 and 337.

Absent the application of the transition rule, the same transaction presumably would be treated as a reorganization under Section 368(a)(1)(D), and if Y has liabilities in excess of basis, that excess would be taxable gain under Section 357(c).

We believe that, in the first example, whether or not the transition rule applies, the deemed liquidation of C that results from the QSSS election should be treated as a valid liquidation described in Sections 332 and 337, and that the step-transaction doctrine should not apply. We can conceive of no policy or governmental interest that is protected by treating the first example as a failed "C" reorganization in which the contribution of C stock to S, coupled with the deemed liquidation of C, is treated as an acquisition by S of the assets of C. It appears that the potential application of the step-transaction doctrine to these facts is predicated on an assumption that a "plan of

liquidation" was adopted for C at the time A contributed the C stock to S.

Given that the liquidation itself is a tax fiction that occurs only by filing the QSSS election for C and that S is not entitled to file the election unless and until it owns 100% of the C stock, there is no reason to infer that S adopted a plan of liquidation for C before S acquired its 100% stock interest in C. The Service has held that a sale of stock between stockholders does not constitute the adoption of a plan of liquidation merely because the sale was followed by, and intended to permit, a liquidation of the acquired company under Section 332.[12] Accordingly, we believe that the Proposed Regulations go beyond what is necessary to achieve parity with actual transactions. Moreover, if this example is treated as a failed "C" reorganization, the result constitutes a trap for the unwary that is avoidable with proper tax planning. For example, assuming (as we believe should be the case) that a merger into a QSSS should be treated as a merger into its S corporation parent, S could form a new QSSS into which C

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12. Rev. Rul. 75-521, 1975-2 C.B. 120, which held that Section 332(a) applied to the liquidation of a corporation where its 50% corporate shareholder purchased from the other stockholders for cash the 50% of the stock it did not already own and immediately thereafter adopted a plan of complete liquidation.

could be merged under state law. That merger may qualify as an "A" reorganization.

The Proposed Regulations should be modified to clarify that, for purposes of applying Section 332 to the constructive liquidation resulting from a QSSS election, the S corporation will be deemed to adopt a plan of liquidation for its subsidiary as of the effective date of the election, which should not precede the acquisition by the S corporation of 100% of the stock of the subsidiary.

We do not perceive a policy reason for applying a different rule where the subsidiary itself redeems a more than 20% minority interest prior to the making of the QSSS election. We are aware, however, of the Service's view that such a redemption may imply a prior adoption of a plan of liquidation that would negate the application of Sections 332 and 337 to a subsequent actual liquidation of the subsidiary into its parent. See Rev. Rul. 70-106, 1970-1 C.B. 70.[13]

We acknowledge the Service's legitimate interest in applying the step-transaction doctrine to a purported

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13. See, however, George L. Riggs, Inc. v. Comm., 64 T.C. 474 (1975), in which the Tax Court held that a valid Section 332 liquidation of a corporation occurred following a redemption by the corporation of its stock held by its minority stockholders that increased its corporate stockholder's ownership above 80%.

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tax-free acquisition of shares followed by a constructive liquidation for purposes of testing whether the acquisition constitutes a reorganization described in Section 368(a). For example, in the second example cited above, absent the application of the step-transaction doctrine, a corporation may be able to avoid recognition of gain under Section 357(c) to the extent its liabilities exceed its tax basis in its assets. Similarly, we recognize that an acquisition by an S corporation of stock of another corporation, which acquisition purports to be a "B" reorganization, must be tested under the "C" reorganization rules if the target company is completely liquidated into its acquiror as part of the same plan.[14] These concerns may be addressed without creating undue uncertainty as to the application of the QSSS rules by applying the step-transaction doctrine only to determine whether an acquisition of an interest in a corporation, followed by a QSSS election for the corporation, constitutes a reorganization under Section 368(a).[15]

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14. Rev. Rul. 67-274, 1967-2 C.B. 141.

15. We agree with the result that the formation of a subsidiary by an S corporation and the immediate election of QSSS status for the subsidiary should not produce a deemed liquidation of the subsidiary. Prop. Reg. § 1.1361-4(a)(2). We do not believe, however, that such result justifies an expansive application of the step-transaction doctrine to the consequences of making a QSSS election.

Where the acquisition does not constitute a reorganization (after appropriate application of step-transaction principles), we believe the safe harbor approach described above concerning the timing of the adoption of the plan of liquidation should govern to protect the application of Section 332 to the constructive liquidation, irrespective of whether the stock of the subsidiary is acquired by the S corporation in a contribution to which section 351 applies, by reason of a redemption of a minority shareholder, or pursuant to a taxable purchase. For example, we believe the step-transaction doctrine should not apply in the context of Section 338 except to the extent required to determine whether a purchase of stock is a qualified stock purchase. In particular, the final QSSS regulations should not permit any inference that the Kimbell-Diamond doctrine, itself an example of the step-transaction doctrine, could apply to recharacterize a qualified stock purchase followed by a QSSS election as an acquisition of assets. To the extent our recommendation would impose a stricter limitation on the application of the step-transaction doctrine than currently applies to actual liquidation transactions, we believe such limitation is justified by the purpose of providing clarity,

simplicity and tax-efficiency to small businesses that avail themselves of the Subchapter S regime.

B. Effect of Termination of QSSS Election

A QSSS election may terminate by means of (i) the revocation of the election, which revocation may be effective retroactive to up to 2 months and 15 days prior to the date on which the revocation statement is filed (and up to 12 months after the date on which the revocation statement is filed),[16] (ii) the termination of the parent's S corporation election, or (iii) the occurrence of an event that renders the subsidiary ineligible for QSSS status, such as the disposition by the parent of any of the subsidiary's shares to a third party (other than another of its QSSSs) or the issuance by the QSSS of shares of its stock to a person other than the S corporation parent.

The Proposed Regulations provide that if a QSSS election terminates, the former QSSS is treated as a new corporation that acquires all its assets, and assumes all its liabilities, as they exist immediately before the termination, from the former QSSS' S corporation parent in exchange for the stock of the new corporation.[17] The Proposed Regulations do not distinguish among the causes of

16. Prop. Reg. § 1.1361-3(b)(1) and (2).

17. Prop. Reg. § 1.1361-5(b)(1).

termination. They provide that the tax treatment of the constructive incorporation transaction, or a larger transaction that includes the constructive incorporation, will be determined under the Code and "general principles of tax law, including the step transaction doctrine."[18]

The Proposed Regulations illustrate the application of the step-transaction doctrine to a termination event involving the transfer of more than 20% of the stock of a QSSS to a third party.[19] The Proposed Regulations treat this transaction as a transfer of the QSSS' assets and liabilities by the S corporation parent to a new corporation that fails to satisfy the requirements of Section 351 because the S corporation parent lacks "control immediately after" the transfer. We do not believe this is an appropriate result, either as a matter of parity or economic substance.

Putting aside the issue of statutory construction and authority, the result reached by the Proposed Regulations is not the most reasonable characterization of a sale of QSSS stock that terminates the QSSS election. A sale of QSSS stock to the third party is more appropriately treated like a sale of a partnership interest followed by

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18. Id.

19. Prop. Reg. § 1.1361-5(b)(3) Example 1.

one of the incorporation transactions described in Rev. Rul. 84-111. In none of those transactions would the threshold sale (of a partnership interest or an undivided interest in partnership assets) defeat tax-free treatment of the subsequent incorporation described in Section 351. Put another way, the sale of QSSS stock to a third party can as easily be viewed as a sale by the S corporation parent of an undivided interest in the assets of the QSSS, followed by a transfer by the S corporation parent and the third party of their respective undivided interests in such assets to the new corporation in a Section 351 transaction. Under any of these characterizations, the S corporation seller would recognize gain or loss on the sale of the stock or undivided interest in the assets of the QSSS as if it had sold assets. Section 351 would protect the S corporation from gain recognition, and prevent loss recognition, in respect of the proportionate interest in the former QSSS' assets retained by the S corporation through its stock ownership of the former QSSS.

Applying the step-transaction doctrine in the manner provided by the Proposed Regulations creates a lack of parity between an S corporation's ownership of a QSSS and its ownership of a single member limited liability company ("LLC"). Were the owner of a single member LLC to sell an

interest in the LLC to a third party, the seller should be treated as having sold an undivided interest in the LLC's assets. The same result should flow from a sale of QSSS stock. We do not believe a lack of parity is warranted as a matter of tax policy.

The application of the step-transaction doctrine to a constructive incorporation also creates unnecessary uncertainty. For example, how will the step-transaction doctrine be applied when a QSSS election is revoked with a retroactive effective date (e.g., any date up to 2 months and 15 days prior to filing the revocation)? Will the analysis take into account those circumstances in effect at the later date when the revocation is filed, or only those circumstances existing at the earlier effective date of the revocation? Prop. Reg. § 1.1361-3(b)(3) provides that the S corporation parent may not revoke a QSSS election after the occurrence of an event that renders the subsidiary ineligible for QSSS status. It is unclear whether any event short of a disposition of QSSS shares (e.g., the execution of a contract for the sale of shares) would be taken into account in testing whether a retroactive revocation qualifies as a tax-free incorporation under Section 351(a).

If the step-transaction doctrine is applied in this instance, additional guidance as to its application would be appropriate.

Well-advised taxpayers should be able to avoid the harsh result of the Proposed Regulations by causing the third party to acquire its more-than-20% interest in the QSSS directly from the QSSS, in which case both the S corporation parent and the third party would have been treated as transferors, and the "control" requirement would have been satisfied.[20] Given the ease with which a well-advised taxpayer can avoid these harsh -- and perhaps unexpected -- results, we recommend the adoption of an approach that is more consistent with the economic reality of the transaction.

We recognize that the characterization of the incorporation transaction that we propose might be considered inconsistent with the language of Section 1361(b)(3)(C), to the extent that the provision contemplates that the hypothetical new corporation acquires all its

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20. Prop. Reg. § 1.1361-5(b)(3) Example 2. Alternatively, in addition to purchasing to some QSSS stock from the S corporation seller, the third party could transfer enough property to the QSSS to avoid being treated as an accommodation transferor (i.e., by transferring property having a value at least equal to 10% of the purchase price it pays for the shares of the QSSS). Rev. Proc. 77-37, Section 3.07, 1977-2 C.B. 568.

assets immediately before such cessation "from the S corporation" in exchange for its stock. Similarly, we are aware that such provision is intended to conform to the rules governing qualified REIT subsidiaries under Section 856(i).[21]

Nevertheless, we believe Section 1361(b)(3)(C) can be limited to cases in which the S corporation continues to own 100% of the stock of the former QSSS following a termination event that includes revocation of an election. The statutory language does not appear specifically to contemplate the case where termination of the QSSS election occurs by reason of a sale of the stock to a third party. The statutory language, in any event, does not address the step-transaction doctrine. Although we believe that clarification of the statutory authority for our recommended approach should be unnecessary, we believe a technical correction to Section 1361(b)(3)(C) to permit regulatory exceptions thereto would be appropriate to the extent considered necessary to provide the requisite statutory authority.

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21. The legislative history to Section 856(i) contemplates that a sale by a REIT of all the stock of a qualified REIT subsidiary to a third party would be a "busted" Section 351 transaction. H.R. Rep. No. 99-481, 99th Cong. 2d Sess., at II-214.