

S Corporation Corner

By Nelson A. Toner

The S Corporation, the QSub and the F Reorganization*

I have always been intrigued by the concept of a "disregarded" entity. For state business laws, the disregarded entity is a business entity separate and distinct from its owner and must follow all the appropriate business laws to remain a valid and viable entity. For federal income tax rules, the disregarded entity is generally not a separate and distinct entity from its owner.¹ Rather, the disregarded entity is treated as a division of its owner.

In the S corporation world, a qualified subchapter S subsidiary (QSub) is a disregarded entity if all the requirements of a QSub are met, including an election made by the sole shareholder of the subsidiary corporation.² Specifically, the subsidiary corporation must be a domestic corporation, must not be an ineligible corporation as defined in Code Sec. 1361(b)(2), and must have as its sole shareholder an S corporation.³ All the assets and liabilities and all the tax items of the subsidiary are treated as the assets and liabilities and tax items of the parent corporation.⁴ The Regulations describe the deemed movement of assets of the subsidiary to the parent corporation when the QSub election is made.⁵ When a QSub election is terminated, the subsidiary is treated as a new corporation for income tax purposes, which acquires all its assets and liabilities from its parent corporation in exchange for stock of the new corporation.⁶

In more and more circumstances, a disregarded entity is a party to a transaction and a tax practitioner carefully needs to determine the tax consequences of the transaction on all persons involved in the transaction including the disregarded entity. Of particular interest for this article are the tax consequences of the presence of an S corporation and its QSub in a reorganization



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transaction. A recent private letter ruling⁷ provides some insights into the relationship between the S corporation rules, the presence of a disregarded entity, and the application of the reorganization rules when the transaction is an F reorganization. This article will review these relationships and the published tax consequences.

In PLR 201007043, the parent corporation ("Parent") is an S corporation. The Parent formed and funded a subsidiary corporation and made a QSub election for the subsidiary corporation ("Subsidiary 1"). Because of the QSub election, all the assets and liabilities and the tax items of Subsidiary 1 are treated as the assets and liabilities and the tax items of Parent. It appears from the facts of the ruling that each of Parent and Subsidiary 1 has business assets and ongoing operations.

The Parent also purchased all of the stock of another corporation and made a QSub election for the purchased subsidiary (Subsidiary 2).

The ruling states that Parent and Subsidiary 1 wish to combine. The purposes of the combination are to take advantage of planned efficiencies and to reduce expenses and redundancies. Because of certain legal restrictions, Subsidiary 1 cannot merge into Parent, so the shareholders decide to merge Parent "downstream" into Subsidiary 1. In the transaction, the shareholders of Parent will exchange their stock in Parent for the stock of Subsidiary 1, such that after the transaction the shareholders of Parent will have an identical ownership of Subsidiary 1. The taxpayer making the ruling asks, among other questions, whether the transaction qualifies as an F reorganization.

The private letter ruling holds that the transaction described in the ruling qualifies as an F reorganization based upon the several representations made by the taxpayer.⁸ However, the last two conclusions in the ruling cover the S corporation and the QSub issues arising from the transaction. Ruling 10 holds that an F reorganization will not adversely affect the Parent's S corporation status and Ruling 11 holds that Subsidiary 2's status as a QSub will not terminate as a result of the F reorganization. The two rulings demonstrate the unique relationship between the S corporation rules, the QSub requirements and the F reorganization rules.

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F Reorganization Rules

An F reorganization is defined as a "mere change in identity, form or place of organization of one corporation, however effected."⁹ The final Regulations under Code Sec. 368 do not cover the F reorganization transaction. In 2004, the Treasury issued proposed Regulations, which describe the particular requirements of an F reorganization.¹⁰ The proposed Regulations have not been finalized. The proposed Regulations provide that a transaction qualifies as an F reorganization only if the following four requirements are met:

- All the stock of the resulting corporation, including stock issued before the transfer, must be issued in respect of stock of the transferring corporation.
- There must be no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation.
- The transferring corporation must liquidate completely in the transaction.
- The resulting corporation must not hold any property or have any tax attributes immediately before the transfer.¹¹

The proposed Regulations allow the resulting corporation to have issued a nominal amount of stock

and to hold a nominal amount of assets to facilitate its organization or to preserve its existence.¹² In addition, the resulting corporation may hold the proceeds of borrowings undertaken with respect to the F reorganization transaction.¹³ Example 4 in the proposed Regula-

tions specifically holds that the merger of a holding company into a subsidiary operating an ongoing business is not an F reorganization because the resulting corporation (the subsidiary with the ongoing operations) held property and had tax attributes in its assets immediately prior to the transaction.¹⁴

In PLR 201007043, the first three requirements of the proposed Regulations are satisfied in the taxpayer representations. However, the fourth requirement is not satisfied by a representation. Parent and Subsidiary 1 are treated as one corporation under the QSub rules and each is an active corporation with property and ongoing businesses. If one of these corporations

is treated as the resulting corporation, then it appears that the fourth requirement cannot be met. Although the proposed Regulations are mere guidance and not substantive, they do give the tax practitioner a glimpse into the thinking of Treasury with respect to the topics raised therein. Therefore, a tax practitioner should be able to show that the fourth requirement is met in the transaction set forth in PLR 201007043. If not, the transaction in PLR 201007043 is not an F reorganization under the proposed Regulations, which is contrary to the holding in the ruling. Perhaps a review of the analysis behind Ruling 10 and Ruling 11 will clarify the application of the F reorganization rules to the proposed transaction.

F Reorganization Does Not Affect Parent's Status as an S Corporation

Ruling 10 concludes that the F reorganization will not adversely affect Parent's status as an S corporation and, accordingly, Parent's S corporation election will continue with respect to Subsidiary 1 after the proposed transaction.¹⁵ The ruling indicates that Ruling 10 is based upon Rev. Rul. 64-250.¹⁶

One of the basic fact patterns for an F reorganization is the change in place of organization. Rev. Rul. 64-250 describes a situation where an S corporation reincorporates in another state. In the ruling, the shareholders of M, an S corporation, decide to form a new corporation N in another state. Corporation M is merged into corporation N. The ruling holds that the transaction is an F reorganization. The ruling also states that corporation N met the requirements of an S corporation under the Code at the time of the transaction.¹⁷ Based upon the facts in the ruling, the ruling concludes that the transaction did not cause a termination of M's S corporation election. Therefore, in a horizontal transfer of assets and liabilities from corporation M to corporation N where the transaction qualifies as an F reorganization, the S corporation election of corporation M transfers and applies to corporation N if corporation N otherwise satisfies the requirements of an S corporation (except the requirement of an election).

The tax practitioner should note that the transaction described in Rev. Rul. 64-250 meets the fourth requirement of an F reorganization in the proposed Regulations and that the revenue ruling was issued well before the issuance of the QSub. The fact pattern

in Rev. Rul. 64-250 is different from the fact pattern in PLR 201007043. Rev. Rul. 64-250 deals with a horizontal merger where the resulting corporation does not have any assets prior to the transaction and PLR 201007043 deals with a vertical or downstream merger where the resulting corporation appears to have assets and ongoing business operations prior to the transaction.

The conclusion of Rev. Rul. 64-250 has been expanded to a vertical transaction in Rev. Rul. 2008-18.¹⁸ In situation 1 of this ruling, B, an individual, owns all the stock of Y corporation, an S corporation. B forms Newco and contributes all B's stock in Y corporation to Newco in exchange for all Newco stock. After the transaction, Newco owns all the stock of Y corporation. The facts of the ruling provide that Newco meets the requirements for qualification as an S corporation and timely makes a QSub election for Y corporation. The facts also provide that the transaction qualifies as an F reorganization.¹⁹ Based upon Rev. Rul. 64-250, the ruling concludes that Y corporation's S corporation election does not terminate because of the transaction and the S corporation election continues for Newco.

For income tax purposes, Y corporation will not be treated as a separate corporation from Newco and Newco will own all the assets and liabilities of Y corporation.²⁰ Moreover, when Newco made the QSub election, Y corporation was treated as liquidating into Newco.²¹ Technically, the transaction in Rev. Rul. 2008-18 meets the fourth requirement of an F reorganization under the proposed Regulations. Newco did not have any property prior to the transaction. Therefore, although this ruling deals with a vertical transaction, this ruling does not quite answer the questions arising from the fact pattern in PLR 201007043 because in the private letter ruling the resulting corporation did own assets and had an ongoing business.

Contained in the analysis section of PLR 201007043 is a reference to the Regulations concerning the termination of QSub status. In particular, the ruling cites an example dealing with the merger of a parent corporation into its wholly owned subsidiary which is a QSub.²² In this example, X corporation, an S corporation, owns all of the stock of Y corporation. X has made a QSub election for Y corporation. X corporation merges into Y corporation, which causes the subchapter S subsidiary election for Y corporation to terminate. The example concludes that the merger of X corporation into Y corporation can qualify as

an F reorganization if all of the requirements of an F reorganization are satisfied.

This example is the key to Ruling 10 in PLR 201007043. The rules for the termination of the QSub status give the necessary factual situation to satisfy the fourth requirement of the proposed Regulations. The Regulations provide that when a QSub election is terminated, the subsidiary is treated as a new corporation for income tax purposes which acquires all of its assets and liabilities from its parent corporation in exchange for stock of the new corporation.²³ For tax law purposes, Subsidiary 1 is formed just prior to the F reorganization transaction and therefore does not have any property prior to the transaction. Like example 8 described above, the QSub election of Subsidiary 1 terminated when Parent merged into Subsidiary 1 and at that time Subsidiary 1 acquires all its business and operating assets and liabilities from Parent.²⁴ This approach is consistent with the QSub rules, the revenue rulings cited by PLR 201007043 and with Ruling 10 in the private letter ruling. Therefore, the disregarded status of Subsidiary 1 creates the proper factual and tax setting for the transaction in PLR 201007043 to be treated as an F reorganization and to allow Parent's S corporation election to pass to Subsidiary 1.

Effect of Reorganization on the QSub Status

Ruling 11 provides that Subsidiary 2's status as a QSub will not terminate as a result of the F reorganization. Under the facts of the private letter ruling, Parent merged into Subsidiary 1, a wholly owned subsidiary for state business law purposes and a disregarded entity for income tax purposes. One of the assets of Parent was all the stock of Subsidiary 2. Prior to the transaction, Parent had elected QSub status for Subsidiary 2. Based upon the facts stated in the private letter ruling and the rulings therein, the stock of Subsidiary 2 transferred to Subsidiary 1 and Subsidiary 2 became a wholly owned subsidiary of Subsidiary 1.

The basis of Ruling 11 is Rev. Rul. 2004-85.²⁵ In Situation 1 described in the ruling, X is a State A

corporation and X owns all the stock of Sub 1. X has elected to treat Sub 1 as a QSub. The shareholders of X form new corporation U in another state. Corporation X merges into corporation U in a transaction that qualifies as an F reorganization. The ruling states that Corporation U is eligible to make an S corporation election. The ruling holds that the election to treat Sub 1 as a QSub does not terminate because Corporation X merged into Corporation U in a transaction that qualifies as an F reorganization.

The ruling cites the Regulations issued under Code Sec. 381 to provide that in the case of an F reorganization, the acquiring corporation is treated just as the transferor corporation would have been treated if there had been no reorganization.²⁶ Specifically, (1) the taxable year of the transferor corporation does not end on the date of the transaction, (2) the net operating loss of the acquiring corporation for any taxable year after the transaction may be carried back to compute the taxable income of the transferor corporation for any year ending before the year of the transaction, and (3) the tax attributes of

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the transferor corporation (enumerated in Code Sec. 381(c)) shall be taken into account by the acquiring corporation as if there had been no reorganization.²⁷ In other words, the acquiring corporation inherits all the tax attributes, assets and liabilities of the transferor corporation immediately before the reorganization transaction. In PLR 201007043, Subsidiary 1 inherits the attributes, assets and liabilities of Parent. One of the inherited attributes is the election to treat Subsidiary 2 as a QSub.

The ruling also cites Rev. Rul. 64-250.²⁸ This Revenue Ruling is described earlier in this article. Under this Rev. Rul., the S corporation status of a corporation that merges into another corporation in a transaction that qualifies as an F reorganization does not terminate if the surviving corporation qualifies to make an S corporation election. In PLR 201007043, the shareholders of Parent elected S corporation status for Parent. As part of the transaction, the shareholders of Parent exchange their Parent stock for stock of Subsidiary 1. Under the holding of Rev. Rul. 64-250,

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the S corporation status of Parent passes to Subsidiary 1 so long as Subsidiary 1 qualifies to make an S corporation election.

After the completion of the transaction in PLR 201007043, Subsidiary 1 is an S corporation because it has taken over the S corporation election made by Parent. Moreover, based upon the Regulations issued under Code Sec. 381, the election to treat Subsidiary 2 as a QSub is held by Subsidiary 1. Therefore, the QSub status is not terminated.

Situation 2 of Rev. Rul. 2004-85 shows that the same result is not reached if the transaction is not an F reorganization. In situation 2 described in the ruling, Y is an S corporation which owns all the stock of Sub 2. Y has elected to treat Sub 2 as a QSub. Corporation Y transfers all its assets (including the stock of Sub 2) to Corporation M in a transaction that qualifies as a sale or reorganization (other than an F reorganization). Because the transaction to transfer the assets of Corporation Y to Corporation M is not an F reorganization, the Regulations under Code Sec. 381 do not treat Corporation M as Corporation Y just before the transaction. After the transaction, Corporation Y no longer owns the stock of Sub 2 and its election to treat Sub 2 as a QSub does not transfer to Corporation M. Therefore, the QSub election is terminated unless Corporation M makes a new election.²⁹

In both Situation 1 and Situation 2 of Rev. Rul. 2004-85, the subsidiary corporation was a disregarded entity and the ownership of the stock of the subsidiary

corporation passed to a new owner in a transaction that qualifies as a reorganization. However, only when the reorganization is an F reorganization does the QSub election of the subsidiary corporation carry over to and continue with the acquiring corporation. Tax practitioners should be aware of this distinction when planning reorganization transactions when the merging corporation has made a QSub election for its subsidiary corporation.

PLR 201007043 provides a view into the relationship between the F reorganization rules, the S corporation rules and the workings of a QSub. The tax practitioner is reminded that proposed Regulations can provide guidance on the proper tax results and that rulings issued prior to the establishment of the "disregarded entity" and the QSub still can be used to described situations and transactions where disregarded entities and these types of subsidiaries are important parties to the transaction. Although Ruling 10 and Ruling 11 in PLR 201007043 appear to be simple conclusions, understanding the tax law behind them can help the tax practitioner with other more complicated tax transactions.

ENDNOTES

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¹ Reg. §301.7701-2(c)(2).

² Code Sec. 1361(b)(3)(B).

³ Code Sec. 1361(b)(3)(B)(i).

⁴ Code Sec. 1361(b)(3)(A)(ii).

⁵ Reg. §1.1361-4(a)(2).

⁶ Reg. §1.1361-5(b)(1)(i).

⁷ LTR 201007043 (February 19, 2010).

⁸ *Id.*

⁹ Code Sec. 368(a)(1)(F).

¹⁰ REG-106889-04, 69 Fed. Reg. 49,836 (8/12/2004).

¹¹ Prop. Reg. §1.368-2(m)(1).

¹² Prop. Reg. §1.368-2(m)(1)(ii)(B).

¹³ *Id.*

¹⁴ Prop. Reg. §1.368-2(m)(5), example 4.

¹⁵ LTR 201007042 (ruling 10) (Nov. 6, 2009).

¹⁶ Rev. Rul. 64-250, 1964-2 CB 333.

¹⁷ Former Code Sec. 1371(a).

¹⁸ Rev. Rul. 2008-18, IRB 2008-13, 674.

¹⁹ It also appears that the transaction can be cast as a tax-free incorporation under Code Sec. 351.

²⁰ Code Sec. 1361(b)(3)(A).

²¹ Reg. §1.1361-4(a)(2).

²² Reg. §1.1361-5(b)(3), example 8.

²³ Reg. §1.1361-5(b)(1)(i).

²⁴ Reg. §1.1361-5(b)(1).

²⁵ Rev. Rul. 2004-85, IRB 2004-33, 189.

²⁶ Reg. §1.381(b)-1(a)(2).

²⁷ *Id.*

²⁸ Rev. Rul. 64-250, 1964-2 CB 333.

²⁹ Reg. §1.1361-5(a)(1)(iii) and Reg. §1.1361-5(c)(2).