2018 Update Memorandum For

FEDERAL INCOME TAXATION OF CORPORATIONS

FOURTH EDITION

by

MARTIN J. MCMAHON, JR.
Professor of Law and
James J. Freeland Eminent Scholar in Taxation
University of Florida

DANIEL L. SIMMONS
Emeritus Professor of Law
University of California at Davis

Paul R. McDaniel
Late Professor of Law and
James J. Freeland Eminent Scholar in Taxation
University of Florida

CHARLENE D. LUKE
UF Research Foundation Professor
University of Florida

BRET WELLS
George R. Butler Research Professor of Law
University of Houston Law Center

FOUNDATION PRESS
2018

PREFACE

This 2018 Update to Federal Income Taxation of Corporations provides users of the text with materials reflecting developments in federal income taxation of corporations since January 31, 2014, (the date as of which the materials in the text are current). This update is current as of April 15, 2018 and includes all significant federal income tax legislation, Treasury Regulations, judicial decisions, and Internal Revenue Service rulings promulgated after January 31, 2014 and before April 15, 2018.

MARTIN J. MCMAHON, JR.
DANIEL L. SIMMONS
CHARLENE D. LUKE
BRET WELLS

May 1, 2018

TABLE OF CONTENTS

Preface ii
Table of Internal Revenue Code Sections vi
Table Of Treasury Regulations vii
Table of Cases and Rulings viii

PART 1 TAXATION OF CORPORATIONS AND SHAREHOLDERS 1

Chpater 1. Taxation of Corporate Income and Identifying Taxable Corporate Formation of the Corporation 1

Chpater 2. Formation of the Corporation 7
Section 1. Receipt of Stock for Property 7
A. Basic Principles 7
C. "Solely for Stock"—The Receipt of Other Property 7
Section 2. "Solely" for Stock: Assumption of Liabilities 8
A. Basic Principles 8

Chpater 3. The Capital Structure of the Corporation 9
Section 1. Debt Versus Equity 9
A. General Principles Governing Classification as Debt or Equity 9
B. Deductions for Loss of Investment in a Corporation 14

Chpater 4. Dividend Distributions 15
Section 1. Introduction 15
Section 4. Disguised Dividends 16
Section 5. Intercorporate Dividends 18

Chpater 5. Stock Redemptions 20
Section 1. Introduction 20
Section 6. Redemptions Through the Use of Related Corporations 20

Chpater 6. Stock Dividends 22
Section 1. Taxable Versus Nontaxable Stock Dividends 22
B. The Statutory Structure 22

Chpater 7. Corporate Liquidations 24
Section 3. Treatment of Shareholders 24
Section 4. Liquidation of Subsidiary Corporations—Section 332 25

PART 2. ELECTIVE PASSTHROUGH TAX TREATMENT 26

Chpater 8. S Corporations 26
Section 1. Introduction..26
Section 2. Eligibility, Election and Termination..32
E. Coordination With Subchapter C 32
Section 3. Effect of the Subchapter S Election by a Corporation
with No C Corporation History 33
A. Passthrough of Income and Loss 33
(1) General Principles...33
(2) Effect of Indirect Contributions on Limitation of Loss
Deductions to Shareholder Basis..36
B. Distributions...36
Section 4. Qualified Subchapter S Subsidiaries...37
Section 5. S Corporations That Have a C Corporation History 38
B. Built-in Gain Tax...38
C. Passive Investment Income of an S Corporation with
Accumulated Earnings and Profits...38

PART 3. **AFFILIATED CORPORATIONS**...39

Chpater 9. Affiliated Corporations 39
Section 1. Tax Reduction with Multiple Corporate Taxpayers 39
Section 2. Consolidated Returns..399

PART 4. CORPORATE ACQUISITION TECHNIQUES................41

**Chpater 10. Taxable Acquisitions: The Purchase and Sale of a
Corporate Business 41**
Section 1. Assets Sales and Acquisitions...42
Section 2. Stock Sales and Acquisitions..43

Chpater 11. Tax-Free Acquisitive Reorganizations 44
Section 2. The Fundamental Rules Governing Reorganizations 44
A. The Basic Statutory Scheme 44
B. The Continuity of Shareholder Interest Requirement 44
(1) Qualitative and Quantitative Aspects 44
(2) "Remote Continuity Of Interest" And "Party To A
Reorganization"...45
D. Judicial Limitations..45
(2) Step Transaction Doctrine 45
Section 4. Stock for Assets Acquisitions: Type (C) Reorganizations 46

Section 6. Acquisitive Type (D) Reorganizations 46

PART 5. . NONACQUISITIVE REORGANIZATIONS..................48

Chpater 13. Single-Corporation Reorganizations 48

Section 3. Changes in Identity, Form, or Place of Organization:
Type (F) Reorganizations 48

Chpater 14. Corporate Divisions: Spin-Offs, Split-Offs, and Split-Ups...59

Section 2. "Active Conduct of a Trade or Business," "Device," and Other Limitations...59

B. Active Conduct of a Trade or Business 59

C. The "Device" Limitation 61

Section 4. Consequences to Parties to a Corporate Division 63

PART 6CORPORATE ATTRIBUTES IN REORGANIZATIONS..65

Chpater 15. Carry Over and Limitation of Corporate Tax Attributes 65

Section 1. Carry Over of Tax Attributes...65

TABLE OF INTERNAL REVENUE CODE SECTIONS

UNITED STATES CODE

26 U.S.C. – Internal Revenue Code

Sec. Page
1(h)(11) ... 15, 16
11 ... 2, 3, 15, 16, 39
118(b) ... 7
168(k) ... 14, 43
172 ... 36, 66
199 ... 2, 5
199A ... 2, 4, 5, 13, 14, 28, 29, 30, 31
243(a) ... 15
243(c) ... 15, 19
338 ... 43, 56
355 ... 59
355(a)(1)(C) ... 61
355(b) ... 61
355(h) ... 59
368(a)(1) ... 11, 48, 49, 54, 55, 56, 57, 58
368(a)(1)(D) ... 47, 57
368(a)(2)(H)(i)) ... 47
381 ... 51, 53, 54, 55, 57, 58, 65, 66
385 ... 9, 10, 11, 12
461(l) ... 35
481(d) ... 32, 37
1014 ... 4, 5
1060 ... 42
1201 ... 2
1202 ... 4, 5
1361(b) ... 32
1367(a)(2 ... 33
1367(b)(2) ... 33
1371(a) ... 32
1371(f) ... 33, 37
1411(a) ... 3, 17
1504(a) ... 10
1561 ... 39

TABLE OF TREASURY REGULATIONS

TREASURY REGULATIONS

Sec.	Page
1.305-1	16
1.305-3	16
1.305-7	16
1.355–2(d)(2)(iv)	56
1.358-1	40
1.358-2	40
1.368-2(k)	39
1.368-2(l)	40
1.368-2(m)	43, 53
1.381(a)-1(b)(2)	60
1.385-1	3
1.385-1(b)	4
1.385-1(e), -4(b),	4
1.385-2	3, 4
1.385-2(d)	4
1.385-3	3, 5, 6
1.385-3(f)	5
1.1366-2	9, 10, 12, 131
1.1366-2	27, 28, 29, 30
1.1502-19(b)(2)(i)	16, 34
1.1502-32(c)(5)	34
1.1502-32(c)(5)	16

TEMPORARY REGULATIONS

Sec.	Page
1.385-3T(b)(3)(vii)	11
1.385-4T	10

PROPOSED REGULATIONS

Sec.	Page
1.304-2(a)(4)	20
1.304-2(a)(5)	21
1.305-7(c)	22
1.355–2(d)(5)	62
1.355–9	61
1.358-3(b)(4	11
1.368–1(b)(1)	44
1.385-2(b)(1)	11

TABLE OF CASES AND RULINGS

	Page.
Ball v. Commissioner	31
Bross Trucking, Inc. v. Commissioner	18
Commissioner v. Danielson	36
Estate of Mixon v. U.S.	28
Geftman v. Commissioner	28
Helvering v. Southwest Consolidated Corp	46
Hitchins v. Commissioner	28
Key Carpets, Inc. v. Commissioner	11
Knetsch v. United States	28
Litton Business Systems, Inc. v. Commissioner	28
Maloof v. Commissioner	28
Meruelo v. Commissioner	28
Notice 2018-28	7, 22
Peco Foods, Inc. v. Commissioner	36
Rev. Rul. 2015-10	39, 41
Rev. Rul. 67-274	41
Rev.Rul. 83–98	4
Revenue Ruling 68-55	1
Spencer v. Commissioner	28
Stinnett's Pontiac Serv., Inc. v. Commissioner	12
T.D. 7747	4
Trugman v. Commissioner	26
Vest v. Commissioner	2

2018 Update Memorandum

FEDERAL INCOME TAXATION OF CORPORATIONS

PART 1

TAXATION OF CORPORATIONS AND SHAREHOLDERS

CHAPTER 1

TAXATION OF CORPORATE INCOME AND IDENTIFYING TAXABLE CORPORATE FORMATION OF THE CORPORATION

SECTION 1. THE CORPORATE INCOME TAX

Pages 4–5:

Delete from the fourth sentence in the second full paragraph on page 4 through the first full paragraph on page 5; replace with the following:

Legislation enacted in 2017 ("2017 Tax Act"), Pub. L. No. 115-97, § 11001 (2017), changed the corporate tax rate to a flat 21%, including for personal service corporations.

Page 6:
Delete the last two sentences of the carryover paragraph.

The 2017 Tax Act struck § 1201 for taxable years beginning after December 31, 2017.

Page 6:

Delete first full paragraph.

The 2017 Tax Act repealed § 199 for taxable years beginning after December 31, 2017.

Page 8:

Immediately before the detailed analysis, insert the following:
The 2017 Tax Act complicates business planning. Prior to 2017, the double taxation of corporate earnings coupled with the near equivalency of the top corporate marginal tax rate of 35% and the top individual marginal income tax rate of 39.8% made it compelling under old law in most situations for business owners to conduct business activities in pass-through entity structures. However, current law provides a substantially lower corporate tax of 21% under § 11 versus a top individual marginal tax rate of 37% for individuals under § 1. This tax rate differential creates a complex set of trade-offs that should be considered before deciding whether to conduct business activities in a passthrough entity or in a C corporation. Section 199A (discussed in detail in this Update, Chapter 8, pgs. 28–31) provides a potential 20%

deduction for net qualified business income from passthroughs, which further complicates the analysis.

If a C corporation earns income that is subject to corporate level taxation at a 21% corporate rate, then the after-tax corporate earnings would be equal to 79% of the corporation's taxable income. This 79% after-tax corporate earnings could then be distributed to the shareholder as a qualified dividend. Under currently law, individual shareholders are entitled to obtain concessionary capital gains rates under § 1(h) for qualified dividends, resulting in a maximum shareholder tax rate of 20%. The individual shareholder also would be subject to a 3.8% surtax under § 1411(a) upon receipt of that dividend. Thus, the all-in corporate tax cost would be 21%, and the all-in shareholder level tax cost of distributing a qualified dividend would be 18.8%.[1] Thus, the combination of the corporate level tax and shareholder level tax results in a combined tax cost of 39.8%. Thus, earning business income within a C corporation and then distributing the after-tax corporate earnings as a qualified dividend to an individual shareholder who is subject to the top individual marginal tax rate of 37% creates a double tax cost that is slightly higher than the top individual marginal income tax rate of 37%. However, this straightforward comparison is subject to several important caveats that can further complicate the choice of business entity analysis.

For example, assume that the C corporation will delay distributing its corporate earnings for five years and assume that the business owner has a 10% cost of capital. The deferral benefit of delaying the shareholder level tax cost of 18.8% for five years causes the present value of this shareholder level tax cost to be only of 11.67%.[2] Thus, in this scenario, the present value cost of earning income in the C corporation is only 32.67% (i.e., 21% corporate tax plus 11.67% which again represents the present value cost of the 18.8% shareholder level tax that is deferred for five years. If the deferral period were twice as long, then the present value cost of

[1] The 18.8% is calculated by taking the after-corporate tax earnings of 79% (100%- 21% corporate tax) and multiplying that amount by the all-in 23.8% shareholder level tax arising from the 20% capital gains rate that applies on qualified dividends and the 3.8% surtax on net investment income under section 1411(a).

[2] The 11.67% represents the present value of the 18.8% shareholder level tax in the situation where it is deferred for five years with a 10% cost of capital tax deferred for 5 years = $\frac{18.8\%}{(1+10\%)^5}$).

the 18.8% cost would be less than 7.25%.[3] Thus, in a situation where a business owner intends to reinvest earnings back into the business for a significant period of time and will defer the incurrence of the shareholder level tax cost, the deferral benefit time with respect to the shareholder level tax can substantially reduce the present value impact of that second level of taxation.

Moreover, if the individual shareholder does not distribute corporate earnings but instead disposes of the C corporate stock in a transaction that would allow the individual shareholder to claim an exemption for half of the capital gain for small business stock by reason of § 1202 , then the all-in tax cost would be limited to only the corporate level tax cost of 21% plus half of the preferential capital gains rate for the shareholder. Alternatively, if the C corporation withheld distributions of corporate earnings until the shareholder's death, then the shareholder's stock would have its basis increase to its fair market value at the time of shareholder's death under § 1014 with the consequence that the shareholder's estate or beneficiaries then could dispose of the stock without any shareholder level tax cost. In either of these two situations, the benefit of earning income in a C corporation that is subject to the relatively low 21% corporate tax rate and then avoiding the shareholder level tax (or deferring that shareholder level tax for a significant period of time) could result in a combined tax cost that is lower than simply earning that business income in a passthrough entity outside of the C corporation.

But the benefits of earning income in a passthrough entity structure that is eligible for a 20% deduction under § 199A provides a counter benefit that must be considered. Of course, § 199A has various limitations on its availability, but consider if business income were earned by an individual who would otherwise be subject to the top individual marginal income tax rate but who is eligible to claim the maximum § 199A deduction. Then the individual taxpayer could achieve an effective tax rate on this pass-through income of 29.6%.[4] This 29.6% rate is higher than the 21% tax rate applicable to C corporations, but it is lower than the all-in tax rate for earning income in a C corporation and distributing dividends to owners after a 5 year

[3] For example, if one were to assume a ten year deferral period of the 18.8% shareholder level tax, then the present value cost of that shareholder level tax that is deferred for ten years would be approximately 7.25%.

[4] The 29.6% rate is computed by taking the top individual marginal income tax rate for individuals of 37% and multiplying this by 80% under the assumption that the individual shareholder was entitled to the maximum 20% deduction against taxable income under section 199A.

deferral period (i.e., 32.67% all-in cost). However, if one's assumptions were to change, then a different result could arise. For example, if the shareholder level tax were deferred for ten years or could be minimized or avoided at the shareholder level by reason of § 1202 or § 1014, then the combined cost of earning income in a C corporation would be less than the tax cost of earning income in a passthrough entity structure.

The point of these examples is to illustrate that the choice of business entity decision matrix now has complex trade-offs under current law. Yes, corporate earnings generally are subject to taxation at both the shareholder level and the corporate level, but the 21% corporate level tax rate is substantially lower than the individual tax rate for earning business income in passthrough entities even with the benefit of utilizing a § 199A deduction. The extra shareholder level tax cost of 18.8% could cause the C corporate alternative to be less desirable unless the shareholder level tax were deferred for a significant period of time or could be avoided or minimized through other strategies. Thus, a careful discussion of the client's planning assumptions is now likely to be needed.

Finally, the assumptions one makes about the sustainability of current law can also impact the business entity structure decision. In this regard, the 2017 Act was passed on a strictly party-line vote. So, one might question whether the corporate tax rate of 21% might increase in the future. If one were concerned that corporate tax rates might increase to 25% or higher, then the potential benefit of earning income in a C corporation would be substantially diminished versus earning income in a passthrough entity structure that entitles its owner to § 199A benefits. Thus, in this scenario, the added double taxation at the shareholder level may well cause C corporations to be less tax efficient than a passthrough entity structure.

Pages 8–12:

Delete all of Detailed Analysis 1 and all of Detailed Analysis 2

The 2017 Tax Act repealed § 199 for taxable years beginning after December 31, 2017.

The 2017 Tax Act repealed the corporate alternative minimum tax for taxable years beginning after December 31, 2017.

SECTION 2. IDENTIFYING TAXABLE CORPORATE ENTITIES

Page 18:

Delete the first sentence of Section 2 and replace with the following:

Under current law, corporate income is taxed at a flat rate of 21%, while the maximum individual marginal tax rate is 37% (in the absence of new legislation, the maximum individual tax rate will revert to 39.6% in 2026).

CHAPTER 2

FORMATION OF THE CORPORATION

SECTION 1. RECEIPT OF STOCK FOR PROPERTY

A. BASIC PRINCIPLES

Page 62:

Delete the last sentence of Detailed Analysis 5.2 and replace with the following:

If property is transferred as a contribution to capital by persons other than stockholders in aid of construction or any other contribution as a customer or potential customer or by a governmental entity or civic group (other than a contribution made by a shareholder as such), then § 118(b) excludes such payments from being treated as a capital contribution with the consequence that the corporation must treat these amounts as gross income.

C. "SOLELY FOR STOCK"—THE RECEIPT OF OTHER PROPERTY

Page 71:

Replace the first table in Revenue Ruling 68-55 with the following:

	Asset I	*Asset II*	*Asset III*
Character of asset.	Capital asset held more than 6 months.	Capital asset held not more than 6 months.	Section 1245 property.
Fair market value.	$22*x*	$33*x*	$55*x*
Adjusted basis.	40*x*	20*x*	25*x*
Gain (loss).	($18*x*)	$13*x*	$30*x*
Character of gain or loss.	Long-term capital loss.	Short-term capital gain.	Ordinary income.

Page 74:

After the citation to Guenther v. Commissioner, insert:

In Vest v. Commissioner, T.C. Memo. 2016-187, the Tax Court held that to avoid the application of § 453(g) a taxpayer can satisfy his burden of proof only by submitting evidence that clearly negates an income-tax-avoidance plan, with "more weight to objective facts than to the taxpayer's mere denial of tax motivation," and that the enhanced depreciation deductions available to the related buyer is relevant in deciding whether the seller had a principal purpose of avoiding tax.

SECTION 2. "SOLELY" FOR STOCK: ASSUMPTION OF LIABILITIES

A. BASIC PRINCIPLES

Page 82:

After the carryover paragraph from page 81, add the following:

The proposed net value regulations were withdrawn in July 2017. 82 F.R. 32,281, 32,282. The withdrawal notice provides: "The Treasury Department and the IRS are of the view that current law is sufficient to ensure that the reorganization provisions and section 351 are used to accomplish readjustments of continuing interests in property held in modified corporate form."

CHAPTER 3

THE CAPITAL STRUCTURE OF THE CORPORATION

SECTION 1. DEBT VERSUS EQUITY

A. GENERAL PRINCIPLES GOVERNING CLASSIFICATION AS DEBT OR EQUITY

Page 124:

After the heading, insert the citation:

INTERNAL REVENUE CODE: Section 385.
REGULATIONS: Sections 1.385-1 (a)–(c), -2 (a)–(d), (f), -3 (a), (b)(1)–(b)(4), (c)(4).

Page 151:

After the fourth paragraph, insert:

7A. 2017 SECTION 385 REGULATIONS

Attempts in Congress to define debt and equity when the 1954 Code was enacted were rejected by the Senate. The Senate Finance Committee Report stated that "any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments." S.Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954). In the 1969 Act, however, Congress enacted § 385 in an attempt to transfer the problem of definition to the Treasury. Section 385(a) authorizes the IRS and Treasury to "prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." Section 385(b) suggests a list of factors that might be taken into account in promulgating regulations.

Final § 385 regulations were issued in December 1980, applicable to instruments issued after April 30, 1981. T.D. 7747, 1981–1 C.B. 141. The effective date was extended several times and the regulations were withdrawn on August 5, 1983. T.D. 7920, 1983–2 C.B. 69. The regulations focused primarily on proportionality and valuation as the keys to debt/equity distinctions. An instrument in the form of debt that was not held in proportion to stock was generally treated as debt. Proportionately held obligations were treated as debt if the debt was not excessive (thin capitalization), the interest rate was commercially reasonable, or if interest was not reasonable, the obligation was issued for money repayable at a fixed time. Although elegant in structure and theoretical underpinning, the regulations were difficult to apply in the myriad of situations that they were required to cover. The § 385 regulations expired under the weight of their complexity, particularly in the small business context, and because enterprising taxpayers developed financial instruments that would have successfully taken advantage of the regulations' bright line classification of hybrid instruments. See Rev.Rul. 83–98, 1983–2 C.B. 40. No new regulations had been issued or proposed under § 385 until 2016, and the debt versus equity classification issue thus continued to turn on judicial authority.

Regulations promulgated in 2016 narrowly focus the regulatory debt versus equity characterization regime only on instruments issued between related corporations. T.D. 9790, Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 F.R. 72858 (October 21, 2016). For this purpose, the regulations adopt a definition of related party that includes an expanded group of corporations identified under § 1504(a), discussed in the text at page 442, to include corporations related through ownership of stock representing 80 percent of voting power and value, expanded to apply to corporations related by ownership of 80 percent of vote *or* value, and including exempt entities, foreign corporations and partnerships. Treas. Reg. § 1.385-1(c). However, none of the rules in the regulations apply to indebtedness between members of a consolidated group (discussed in Chapter 9, Section 2) during the period the corporations are members of the consolidated group, unless the debt instrument is transferred outside the consolidated group. Temp. Reg. § 1.385-4T; Treas. Reg. § 1.385-2(d)(2)(ii)(A). Thus, the rules are designed principally to deal with debt instruments between related domestic and foreign corporations where the borrower is a U.S. corporation.

Treas. Reg. § 1.385-2 provides detailed requirements for documentation and financial analysis of instruments issued as indebtedness between related parties, similar to what generally would be expected on issuance of debt instruments between unrelated parties. For an instrument to be treated as debt, documentation and information must be developed at the time an instrument is issued to demonstrate (1) an unconditional binding obligation to repay, (2) that the creditor has the typical legal rights of a creditor to enforce the terms of the instrument including rights to trigger a default and accelerate payments, (3) evidence of a reasonable expectation of repayment, including cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages), and (4) timely evidence of an on-going debtor-creditor relationship. The documentation rules only apply if (1) the instrument is issued by a "covered member" (i.e., a U.S. corporation) or a disregarded entity owned by a covered member; and (2) threshold limitations are reached. The threshold limitations limit the rules to "large taxpayer groups," meaning the stock of any member of the expanded group is publicly traded, all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million, or the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million.

As a general rule, Treas. Reg. § 1.385-3 treats an expanded group debt instrument as per se stock to the extent it is issued by a corporation to a member of the corporation's expanded group (1) in a distribution (including a redemption distribution), (2) in exchange for expanded group stock (subject to certain exceptions), or (3) as boot in an asset reorganization described in § 368(a)(1)(A), (C), (D), (F), or (G) (discussed in Chapter 12 of the text). All or a portion of an issuance of a debt instrument may be described in more than one prong of the general rule without changing the result that follows from being described in a single prong.

Treas. Reg. § 1.385-3(b)(3), the "funding rule," extends the per se stock rule to treat as stock an expanded group debt instrument to the extent that it is issued, for property, including cash, when the debt instrument is issued to an affiliate with a principal purpose of funding (1) a distribution of cash or other property to a related corporate shareholder, (2) an acquisition of affiliate stock from an affiliate, or (3) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization. A per se rule automatically recharacterizes as equity any related party debt issued in the 36-month period before or after a distribution or acquisition described in the general rule. (However, certain short-term debt and loans in the ordinary course of business are excluded from this recharacterization rule. See Temp. Reg. § 1.385-3T(b)(3)(vii)). As a back-up, Treas. Reg. § 1.385-3(b)(4) provides an anti-abuse rule providing that a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the proposed regulations.

The per se stock rules of Treas. Reg. § 1.385-3 apply only when the debt that would be converted to equity exceeds $50 million. Exceeding the $50 million threshold would have a cliff effect; if the threshold is exceeded, all of the debt, and not merely the excess over $50 million would be treated as equity.

The new administration has signaled that it is likely to revisit the § 385 regulations and it has already delayed the documentation rules. The Treasury's Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, 82 F.R. 48,013, 48,016–17 (Oct. 16, 2017), explains:

> Treasury and the IRS do not believe that taxpayers should have to expend time and resources designing and building systems to comply with rules that may be modified to alleviate undue burdens of compliance. Accordingly . . . Treasury and the IRS announced in Notice 2017–36 that application of the documentation rules would be delayed until 2019.
>
> After further study of the documentation regulations, Treasury and the IRS are considering a proposal to revoke the documentation regulations as issued. Treasury and the IRS are actively considering the development of revised documentation rules that would be substantially simplified and streamlined in a manner that will lessen their burden on U.S. corporations, while requiring sufficient legal documentation and other information for tax administration purposes. In place of any revoked regulations, Treasury and the IRS would develop and propose streamlined documentation rules, with a prospective effective date that would allow time for comments and compliance. Consideration is being given, in particular, to modifying significantly the requirement, contained in the documentation regulations, of a reasonable expectation of ability to pay indebtedness. This aspect of the documentation regulations proved particularly problematic. The treatment of ordinary trade payables under the documentation regulations is also being reexamined.
>
> . . . .
>
> [A]fter careful consideration, Treasury believes that proposing to revoke the existing distribution regulations before the enactment of fundamental tax reform, could make existing problems worse. If

> legislation does not entirely eliminate the need for the distribution regulations, Treasury will reassess the distribution rules and Treasury and the IRS may then propose more streamlined and targeted regulations.

Page 151:

Delete section 7.2.2.2 and replace with the following:

7.2.2.2 LIMITATION ON BUSINESS INTEREST

Section 163(j) imposes a new limitation on the deductibility of interest expense. Under this provision, an interest deduction for business interest shall not exceed the sum of the taxpayer's business interest income plus 30 percent of the taxpayer's adjusted taxable income plus the taxpayer's floor plan financing interest.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business. Notice 2018-28 states that for a C corporation, all interest paid or accrued by the corporation will be business interest, and all interest on indebtedness held by a C corporation that is includible in its gross income will constitute business interest income. Floor plan financing interest is defined as interest paid to finance motor vehicles that are held for sale or lease.

Adjusted taxable income is defined in § 163(j)(8) as the taxpayer's taxable income computed without regard to nonbusiness deductions, any business interest income, any net operating loss deduction, the deduction allowed under § 199A, and for the allowance of depreciation. However, for tax years beginning on or after January 1, 2022, the allowance for depreciation is not added back.

In scope, § 163(j)'s restriction on the deductibility of interest expense applies across-the-board regardless of the form of business entity utilized to conduct the business. However, § 163(j)(3) provides an exception for small businesses, which § 163(j)(3) defines by cross-reference to § 448(c) as a business with average annual gross receipts (computed over 3 years) of $25 million or less. For passthrough entities, the restriction on the interest expense deduction is computed at the passthrough entity level but the restriction is placed on the partner or shareholder (see this Update, Chapter 8, pgs. 26–28, for a more detailed discussion regarding § 163(j)'s application to S corporations). Furthermore, § 163(j)(7) provides further exceptions to § 163(j) because that section narrows § 163(j)'s applications trade or businesses other than the following: (i) a trade or business of performing services as an employee, (ii) any electing real property trade or business (cross-referenced to the definition in § 469(c)(7)(C)), (iii) any electing farming business (cross-referenced to § 263A(e)(4) or for cooperatives to § 199A(g)(2)), or (iv) the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

If a real estate business elects to be exempt from § 163(j), then § 168(i)(8) requires that real estate business to utilize the alternative depreciation system for its real property, thus causing it to have a longer recovery period. Because real estate businesses making the election allowed by § 163(j)(7)(B) must use the alternative depreciation system for so-called qualified improvement property (among other categories), electing out of the § 163(j)'s interest expense limitation makes these electing real estate businesses ineligible claiming bonus depreciation under § 168(k) with respect to any qualified improvement property.

Any disallowed interest expense is allowed to be carried forward indefinitely under § 163(j)(2) and utilized in a subsequent year to the extent that the taxpayer has excess limitation when the limitation calculation is made for that later year.

B. DEDUCTIONS FOR LOSS OF INVESTMENT IN A CORPORATION

Page 152:

Replace the citations to the REGULATIONS with the following:

REGULATIONS: Sections 1.165-5; 1.1244(a)-1(a)−(b); 1.1244(b)-1(a)−(b); 1.1244(c)-1(a), (c)−(d); 1.1244(c)-2(a)(1)−(3).

CHAPTER 4

DIVIDEND DISTRIBUTIONS

SECTION 1. INTRODUCTION

Page 177:

Replace the second sentence of the third paragraph with the following:

Instead, § 243(a)(1) provides a corporation that is a shareholder in another corporation with a deduction equal to 70 percent of intercorporate dividends received; § 243(c) increases the deduction to 65 percent if the shareholder corporation owns at least twenty percent of the stock of the payor corporation; and § 243(a)(3) extends this deduction to 100 percent for affiliated corporations that so elect."

Page 181:

Replace the third sentence of the third paragraph with the following:

Absent any other transactions, at a 37 percent marginal tax rate this $200,000 gain would result in a tax of $74,000.

Page 181:

Third paragraph, in lines 18-19:

Replace "39.6" with "37" and '$79,200" with "$74,000".

Page 182:

Replace the carryover paragraph with the following:

benefit of "$34,000," even though it produced a break-even before-tax cash flow. Under § 1(h)(11)(B)(ii), however, because the minimum holding period has not been met, the dividend would have been taxed at 37 percent—resulting in a $74,0000 tax—instead of at 20 percent, and the $34,000 tax arbitrage benefit is eliminated.

Page 182:

Lines four and five of paragraph that carries over to page 183:

Replace "39.6" with "37" and replace "$277,200" with "$259,000"

SECTION 4. DISGUISED DIVIDENDS

Page 214:

Delete third paragraph and replace with the following:

The incentive to pay compensation to the point at which the corporation has no taxable income, which existed under prior law and undergirds many of the historic excessive compensation classes, no longer is a significant incentive under current law. It is true that a corporation which pays compensation to its shareholders in their capacity as an employee is generally entitled to claim a corporate level deduction for reasonable compensation whereas dividends paid to shareholders are not deductible at the corporate level. In addition, a qualified dividend is taxable at the shareholder level at the preferential tax rate set forth in § 1(h).[8] But, even though corporate earnings distributed to shareholders are technically subject to double taxation, current law has largely equated the tax consequences of dividends with compensation paid to shareholders. In this regard, if a corporation makes payments to shareholders as compensation, the corporation obtains a deduction, but the shareholder is taxable at regular individual tax rates of up to 37%, and this compensation may also be subject to additional FICA taxes and would be subject to Medicare taxes. Said differently, even if the shareholder's compensation exceeds the maximum FICA cap for the year, the shareholder would be subject to a 37% regular

[8] See I.R.C.§ 1(h)(11).

shareholder level taxes plus the incremental Medicare taxes of up to 2.35%[9] for a total of 39.35%.

Now, contrast the above 39.35% tax result with a situation where the corporation is taxable on the business earnings and distributes those earnings as a qualified dividend to its shareholder. In this situation, because dividends are not deductible at the corporate level, the C corporation is subject to corporate level taxation at a 21% tax rate on the business income. The after-tax corporate earnings of 79% could then be distributed to the shareholder as a qualified dividend. Under current law, individual shareholders are entitled to obtain concessionary capital gains rates under section 1(h) for qualified dividends, resulting in a maximum shareholder tax rate of 20%. The individual shareholder would also be subject to a 3.8% surtax under section 1411(a) upon receipt of that dividend. Thus, the all-in corporate tax cost would be 21%, and the all-in shareholder level tax cost on the shareholder's receipt of the qualified dividend distribution of the 79% after-tax earnings amount would be 18.8%.[10] In combination, the corporate level tax and shareholder level tax results create a combined tax cost of 39.8%.

Thus, unlike for much of the US tax history, the combination of the substantially lower corporate tax rate versus the individual rate, plus the concessionary tax rate at the shareholder level for qualified dividends, has combined to largely eliminate the double tax disparity of earning business income in a corporation and distributing the after-tax income as a dividend versus the alternative of paying those amounts out to the shareholder as compensation payments.

Page 222:

After the second paragraph, insert:

In Key Carpets, Inc. v. Commissioner, T.C. Memo. 2016-30, a single shareholder owned all the stock of two corporations. One corporation, Key Carpets, Inc., sold carpets to businesses. The other corporation, Clean Hands Co., Inc., was

[9] See I.R.C.§ 3101(b).

[10] The 18.8% is calculated by taking the after-corporate tax earnings of 79% (100%- 21% corporate tax) and multiplying that amount by the all-in 23.8% shareholder level tax arising from the 20% capital gains rate that applies on qualified dividends and the 3.8% surtax on net investment income under section 1411(a).

attempting to develop a voice-activated hand washing monitoring system based on a patent owned by the shareholder. Clean Hands employed a computer technician who developed the voice-activated hand washing monitoring system. In addition to assisting with the development of the hand washing monitoring system, the Clean Hands computer technician provided information technology services to Key Carpets. Clean Hands paid the computer technician a salary of $100,000. The computer technician spent 85 percent to 95 percent of his time working on the Clean Hands hand washing monitoring system. Key Carpets paid Clean Hands $130,000 purportedly for "computer service and consulting." The IRS asserted deficiencies against both Key Carpets and the shareholder on the grounds that the payments by Key Carpets to Clean Hands were not ordinary and necessary business expenses, but were constructive dividends. The Tax Court upheld the deficiencies with respect to 85 percent of the amounts of the payments; only 15 percent of the amounts paid to Clean Hands by Key Carpets were actually paid for information technology services provided to Key Carpets by Clean Hands' computer technician. Because Key Carpets had no actual ownership interest in the hand washing monitoring system, Key Carpets' transfer of funds to Clean Hands provided significant economic benefit to the shareholder and Clean Hands. Thus, following Stinnett's Pontiac Serv., Inc. v. Commissioner, T.C. Memo. 1982-314, aff'd, 730 F.2d 634 (11th Cir. 1984), the payments were for the personal benefit of the common shareholder and thus a constructive dividend to that shareholder. Section 6662 accuracy related penalties were upheld.

SECTION 5. INTERCORPORATE DIVIDENDS

Page 224:

After the second sentence of the first full paragraph, add the following sentence:

In 2017, Congress reduced this rate to 65% for intercorporate dividends paid to corporate shareholders that own more than 20% but less than 80% of the distributing corporation.

Page 224:

Before the last sentence of the first full paragraph, add the following:

In 2017, Congress again modified §243(c) to reduce the intercorporate dividend deduction to 50% for corporate shareholders that do not own 20 percent or more (in value and voting power) of the distributing corporation's stock.

Page 224:

Delete second full paragraph and replace with the following sentence:

The maximum rate of tax on intercorporate dividends where the corporate shareholder owns less than 20% of the distributing corporation generally is 10.5 percent (21 percent times the 50 percent of the dividend included in income).

Page 224:

Delete the fourth and fifth sentences of the first paragraph of section 1 of the Detailed Analysis and replace with the following:

However, if the interest paid to finance the acquisition and 50 percent of the dividends received from the debt-financed portfolio stock are both deductible, then the corporation will have an after-tax profit, even if the stock does not increase in value, because it will recognize income of $100,000, but claim $150,000 of deductions. For example, if X Corporation were in the 21 percent marginal tax bracket, the excess deductions would yield tax savings of $10,500 (21 percent of $50,000).

Page 226:

In the fourth and fifth lines of the carryover paragraph from page 225, replace as follows:

Replace "35 percent (saving $70,000 of tax)" with "21 percent (saving $42,000 of tax)" and "an after-tax benefit of $49,000" with "an after-tax benefit of $21,000"

CHAPTER 5

STOCK REDEMPTIONS

SECTION 1. INTRODUCTION

Page 232:

Replace the third, fourth, and fifth sentences of the first full paragraph with the following:

Assume, for example, that X corporation owns less than 20 percent of the stock of Y Corporation (and thus is eligible for the 50 percent dividends received deduction under § 243) and 10 shares of Y Corporation owned by X Corporation, having a basis of $40, are redeemed for $100. If § 302(a) applies, X Corporation recognizes a $60 gain, taxed at normal corporate tax rates (currently, 21 percent). But if § 302(a) does not apply, and the $100 distribution is taxed as a dividend, after the resulting $50 dividend received deduction, only $50 is taxed at normal corporate tax rates.

Page 233:

In the first line of the second full paragraph, replace "312(f)" with "312(n)(7)".

Page 234:

In the second line of the third full paragraph, replace "302" with "301".

SECTION 6. REDEMPTIONS THROUGH THE USE OF RELATED CORPORATIONS

Page 281:

After the carryover sentence at the top of the page, insert.

See Prop.Reg. § 1.304-2(a)(4), (c), Ex.(2).

Page 283:

After the first sentence of the second paragraph, insert.

See Prop.Reg. § 1.304-2(a)(5).

CHAPTER 6

STOCK DIVIDENDS

SECTION 1. TAXABLE VERSUS NONTAXABLE STOCK DIVIDENDS

B. THE STATUTORY STRUCTURE

Page 302:

In the fifth line of the second paragraph, change "Treas.Reg. § 1.301-1(b)(1)" to "Treas.Reg. § 1.305-1(b)(1)".

Page 308:

After the last paragraph, insert:

2.10.3 *Proposed Regulations Regarding Adjustments to Conversion Rights*

Proposed amendments to Regs. §§ 1.305-1, 1.305-3, and 1.305-7 deal with distributions of warrants, subscription rights, options, convertible instruments that give the holder a right to convert the instruments into shares of stock in the issuing corporation, and similar instruments and adjustments to a convertible instrument that increase the number of shares of stock a holder would receive upon conversion that correspond to distributions of stock, cash, or other property made to actual shareholders, as well as rights to acquire stock that prevent actual shareholders' interests from being diluted as a result of distributions of stock, cash, or other property to deemed shareholders (i.e., holders of rights to acquire stock). REG–133673–15, Deemed Distributions Under Section 305(c) of Stock and Rights to Acquire Stock, 81 F.R. 21795 (April 4, 2016). The proposed regulations provide that a deemed distribution of a right to acquire stock will be treated as a distribution of additional rights to acquire stock, the amount of which is the fair market value of the right. When an adjustment is or results in a deemed distribution under Prop.Reg. § 1.305-7(c)(1) or (2), the deemed distribution occurs at the time the adjustment occurs (pursuant to the terms of the relevant instruments), but in no event later than the date of the distribution of cash or property that results in the deemed distribution. For rights with respect to publicly-traded stock, if the relevant instrument does not provide when the adjustment occurs, the deemed distribution would occur immediately prior to the opening of business on the ex-dividend date for the distribution of cash or property that results in the deemed distribution.

CHAPTER 7

CORPORATE LIQUIDATIONS

SECTION 3. TREATMENT OF SHAREHOLDERS

Page 340:

After the carryover paragraph, insert:

In Bross Trucking, Inc. v. Commissioner, T.C. Memo. 2014-107, for many years Mr. Bross had owned and operated Bross Trucking, Inc., using leased vehicles. Bross Trucking's principal customers were three businesses owned by other Bross family members. Bross Trucking did not have any formal written service agreements with its customers, relying instead on Mr. Bross's close personal relationships with the owners of the customer businesses. Due to violations of state regulatory law, Bross Trucking was in danger of losing its hauling authority. As a result, Bross's sons—who were owners of Bross Trucking's customers—formed a new trucking company, LWK Trucking, 98.2 percent of which was owned by Bross's sons' and the remainder of which was owned by an unrelated third party. Mr. Bross was not involved in managing LWK Trucking. LWK Trucking hired several Bross Trucking employees and leased trucks that formerly had been leased to Bross Trucking. Until the vehicles were repainted (or magnetic signs installed) they bore the Bross Trucking logo. The IRS asserted that Bross Trucking had distributed "its operations," including "(1) goodwill; (2) established revenue stream; (3) developed customer base; (4) transparency of the continuing operations between the entities; (5) established workforce including independent contractors; and (6) continuing supplier relationships," all of which the court collectively described as "goodwill" to Mr. Bross, triggering gain to the corporation (which did not liquidate until several years later) under § 311(b) and that Mr. Bross in turn had made a taxable gift of that goodwill to his sons. The Tax Court, based on analogizing the facts in the instant case to the differences in the facts and results in Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998), and Solomon v. Commissioner, T.C. Memo. 2008-102, concluded that except for workforce in place Bross Trucking had no goodwill at the time of the "alleged transfer." Although it "might have had elements of corporate goodwill at some point ... through various regulatory infractions Bross Trucking lost any corporate goodwill because of an impending suspension and the negative attention brought by the Bross Trucking name." Judge Paris went on to find that "The remaining attributes assigned to Bross Trucking's goodwill all stem from Mr. Bross's personal relationships. Bross Trucking's established revenue stream, its developed customer base, and the transparency of the continuing operations were all spawned from Mr. Bross's work in the road construction industry."

> A company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee. See MacDonald v. Commissioner, 3 T.C. 720, 727 (1944); Norwalk v. Commissioner, T.C. Memo. 1998-279. Unlike the taxpayer's products in Solomon v. Commissioner, T.C. Memo. 2008-102, Bross Trucking's products did not contribute to developing the goodwill.

Furthermore, "Mr. Bross did not transfer any goodwill to Bross Trucking through an employment contract or a noncompete agreement." No other Bross Trucking intangible assets were transferred because Bross Trucking's prior customers became LWK's customers and no longer wanted to deal with Bross Trucking due to its regulatory problems, and "LWK Trucking did not benefit from any of Bross Trucking's assets or relationships. LWK Trucking was independently licensed and developed a wholly new trucking company."

SECTION 4. LIQUIDATION OF SUBSIDIARY CORPORATIONS—SECTION 332

Page 348:

After the first full paragraph, add the following:

The proposed regulations were withdrawn in July 2017. 82 F.R. 32,281, 32,282. The withdrawal notice provides: "With respect to section 332, the holdings of H.K. Porter Co.. . . [and] . . . Spaulding Bakeries Inc. . . . continue to reflect the position of the Treasury Department and the IRS."

PART 2

ELECTIVE PASSTHROUGH TAX TREATMENT

CHAPTER 8

S CORPORATIONS

SECTION 1. INTRODUCTION

Page 358:

After the first full paragraph, add the following:

Limitation on Business Interest.

The 2017 Tax Act added a new limitation on the deductibility of interest properly allocable to a trade or business. § 163(j). The generally applicable provisions are discussed in this Update, Chapter 3, pgs. 13–14. Section 163(j) contains special rules for partnerships, and provides that "[r]ules similar to the rules" relating to "adjusted taxable income" and "excess taxable income" applicable to partnerships "shall apply with respect to any S corporation and its shareholders." § 163(j)(4)(D). Section 163(j) will apply at the S corporation level and "any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the [S corporation]." § 163(j)(4)(A). Although taking an entity-level approach can lead to administrative simplification, in this case it does not. Instead, this approach brings with it an additional set of complex rules. First, a shareholder needs to be prevented from using the shareholder's share of S corporation taxable income to increase the shareholder's adjusted taxable income for purposes of applying the 30% limitation rule to business interest paid by the shareholder's other businesses, such as a sole proprietorship. Otherwise, the shareholder will be able to use the corporation's taxable income twice—once when the S corporation determines the limitation for its business and once when the shareholder determines the limitation as to other businesses. Second, the S corporation may have business interest that is less than the maximum amount the S corporation is allowed (i.e., the business interest is less than 30% of the S corporation's adjusted taxable income). In such a situation, a shareholder should be allowed to use the shareholder's share of the S corporation's excess taxable income for purposes of applying the 30% limitation to the business interest paid by through other businesses.

Section 163(j) resolves these two issues by requiring a shareholder to determine "adjusted taxable income" for purposes of applying the 30% limitation to any other businesses by disregarding *all* of the shareholder's S corporation tax items and then adding back in the shareholder's share, if any, of the "[S corporation's] excess taxable income." § 163(j)(4)(A)(ii). A shareholder's share of the excess taxable income is to be determined in the same manner as the shareholder's share of the nonseparately stated taxable income or loss of the S corporation. *Id.* "Excess taxable income" is determined through a formula. The S corporation must create a fraction, the numerator of which is 30% of the S corporation's adjusted taxable income minus the amount of business interest it paid that exceeds its business interest income. The denominator is 30% of the S corporation's adjusted taxable income. The fraction is then applied to the S corporation's adjusted taxable income to obtain the "excess taxable income." For example, if as S corporation had $100,000 of adjusted taxable income, $20,000 of business interest paid, and $10,000 of business interest income, the excess taxable income would be $66,667, computed as follows: $100,000 x [(30% of $100,000 – $20,000 + $10,000)/30% of $100,000]. A shareholder with a one-third interest in the S corporation would increase taxable income for purposes of applying the 30% rule to the shareholder's other businesses by $22,222 (and change).

The statute is silent with respect to another potential problem: a shareholder's use of the shareholder's pro rata share of S corporation business interest income to offset business interest paid through other businesses or of the shareholder's pro rata share of the S corporation's "floor plan financing" to increase the shareholder's deduction. The statutory rules described in the preceding paragraphs regarding taxable income are insufficient to address these issues. Notice 2018-28 (emphasis added) provides:

> The Treasury Department and the IRS intend to issue regulations providing that, for purposes of calculating a partner's annual deduction for business interest under section 163(j)(1), a partner cannot include the partner's share of the partnership's business interest income for the taxable year except to the extent of the partner's share of the excess of (i) the partnership's business interest income over (ii) the partnership's business interest expense (not including floor plan financing). Additionally, the Treasury Department and the IRS intend to issue regulations providing that a partner cannot include such partner's share of the partnership's floor plan financing interest in determining the partner's annual business interest expense deduction limitation under section 163(j). Such regulations are intended to prevent the double counting of business interest income and floor plan financing interest for purposes of the deduction afforded by section 163(j) and are consistent with general principles of Chapter 1 of the Code. Similar rules will apply to any S corporation and its shareholders.

If the deduction of business interest is limited by § 163(j), the disallowed business interest is carried forward. § 163(j)(2), (4). Section 163(j)(4)(B) contains special carryover rules for partnerships, but this subsection is not listed in the provision stating that similar rules will apply to S corporations. § 163(j)(4)(D) (listing only (j)(4)(A) and (C) as applying to S corporations and their shareholders).

Notice 2018-28 also provides that the Treasury and the IRS have the intention to enact regulations that will specify that "all interest paid or accrued by" a C corporation will be business interest paid, and "all interest on indebtedness held by the C corporation that is includible in gross income" will be business interest income. The Notice states that the regulations will make clear that these presumptions will not apply to S corporations.

Section 199A.

Section 199A was added by the 2017 Tax Act and applies for taxable years beginning after December 31, 2018, and before December 31, 2025. § 199A(i). The provision allows taxpayers other than C corporations to deduct up to 20% of the "qualified business income" from pass-through businesses, including sole proprietorships, tax partnerships, and "S" corporations. § 199A(b)(2). The § 199A deduction is not an itemized deduction, but it reduces taxable income and does not reduce adjusted gross income. § 63(b)(3), (d)(3). (Adjusted gross income is frequently used in other Code sections for purposes of setting thresholds and phase-outs.) The provision is among the most complex of the new rules added by the 2017 Tax Act, and it has generated a great deal of uncertainty. (It has already been amended to deal with a glitch relating to cooperatives. Pub. L. No. 115-141, Div. T, § 101(b).)

A "qualified trade or business" means any trade or business other than those specifically excepted. § 199A(d)(1). The trade or business of being an employee is not a qualified business, without exception. Similarly, although located in a different subsection of § 199A, "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business" is not qualified business income. The legislative history indicates that this provision is intended to apply to S corporation shareholders. The phrase "reasonable compensation" evokes the problem of S corporation shareholders deliberately limiting compensation in order to reduce Medicare taxes. *See* Joseph Radtke, S.C. v. United States, 712 F. Supp. 143 (E.D. Wis. 1989); Rev. Rul. 74–44.

Certain "specified service" businesses are also not qualifying businesses, but for this category, a threshold tied to taxpayer income applies (described in greater detail below). A "specified service" business means any trade or business "involving the performance of services in the fields of health, law, . . . accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees" and involving "the performance of services that consist of investing and investment management, trading, or dealing in securities. . ., partnership interest, or commodies." (The first ellipsis in the first quote indicates the deliberate removal of engineering and architecture from the list.)

Qualified business income means the "net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer." § 199A(c)(1). The amount is determined separately for each trade or business, and the reference to deductions and losses suggest that it may be a negative amount for a particular business (provision of a carryover provision also supports this conclusion). These tax items must be effectively connected with a U.S. trade or business and must be "included or allowed in determining taxable income for the taxable year." § 199A(c)(3)(A). The quoted language appears to mean that the § 199A amount is determined after application of various loss limitation rules applies, such as the passive activity loss limitation of § 469 and the new excess business loss limitation of § 461(l), but the statute does not contain any guidance on this coordination issue. Certain items do not qualify; these include short- or long-term capital gains and losses; dividends, dividend equivalents and payments in lieu of dividends; interest income, other than business interest income; and gains and losses from certain commodities transactions, foreign currencies, and certain notional principal contracts; amounts received from a non-business annuity; and "[a]ny item of deduction or loss properly allocable" to the preceding list. § 199A(c)(3)(B). Finally, qualified REIT dividends and qualified publicly traded partnership income is not treated as "qualified business income," although such items are eligible for the § 199A deduction via another subsection. § 199A(b)(1)(B), (c)(1).

For each qualifying business, a percentage is applied to its net qualifying busines income. That percentage is the lesser of (1) 20% or (2) the greater of (a) 50% of the W-2 wages of the qualifying business or (b) 25% of the W-2 wages of the qualifying businss, plus 2.5% of the "unadjusted basis immediately after acquisition of all qualified property." § 199A(b)(2). (As discussed below, taxpayers below a certain income threshold use 20% as the percentage without the need to compare it W-2 wages or unadjusted basis.) W-2 wages are essentially the compensation paid to employees of the business and as to which the business is required to provide an information return. § 199A(b)(4). "Qualified property" is depreciable tangible property that is "held by, and available for use in" the qualified business, used "at any point during the taxable year in the production of qualified business income," and whose depreciable period has not ended before the close of the taxable year. § 199A(b)(6)(A). "Depreciable period" is defined as the later of 10 years after the property is placed in service or "the last day of the last full year of the applicable recovery period" that applies under § 168 (ignoring the alternative depreciation system).

Section 199A states that it "shall be applied at the partner or shareholder" level, but the provision contemplates that the determination of whether there is a qualifying business is determined at the S corporation level (the statute does not contain rules for how to determine whether an S corporation, or any taxpayer, has a single qualifying business or multiple qualifying businesses). Section 199A(f)(1)(a)(ii) states that "each partner or shareholder shall take into account such person's share of each qualified item of income, gain, deduction, and loss." In addition, each shareholder must be assigned a share of the S corporation's W-2 wages and unadjusted basis in order to complete the § 199A computation. The statute provides that S corporation W-2 wages and unadjusted basis is allocated using “the shareholder’s pro rata share of an item.”

Once the maximum amount for each qualifying business is determined, the amounts from each business are then aggregated into the “combined qualified business income amount.” § 199A. If the taxpayer has qualified REIT dividends or qualifying publicly traded partnership income, 20% of those items is included in the combined qualified business income amount. If there is an aggregate loss, the loss is carried over and treated as a qualified loss item for “**a** qualified trade or business” in the subsequent year. § 199A(c)(2)(emphasis added). The legislative history suggests this means that 20% of the carryover will reduce the combined qualified business income in the subsequent year. (The carryover provision is (confusingly) included in the section defining qualified business income rather than in the section on computing the combined amount, but it applies if the net amount “with respect to qualified trade**s** or businesse**s** of the taxpayer” is “less than zero.” *Id.* (emphasis added).) If a qualifying business has net negative business income, no additional guidance is provided regarding the rule that determines whether the percentage to apply is 20% or some lower amount determined by W-2 wages and/or unadjusted basis.

Even after the taxpayer determines the “combined qualified business income,” an overall limitation may limit the taxpayer’s ability to deduct the entire amount. § 199A(a). The final deduction is the lesser of (1) the taxpayer’s combined qualified business income or (2) 20% of the excess of the taxpayer’s taxable income over the taxpayer’s net capital gain. § 199A(a).

Taxpayers below certain income thresholds benefit through the relaxation of two of the rules discussed above. First, such taxpayers are able to treat “specified service” businesses as qualified businesses. Second, such taxpayers are able to take 20% of their net qualifying items from a qualifying business without being subject to the W-2 or unadjusted basis limitation. These benefits are lost gradually (and through complicated formulas) for taxpayers within a particular taxable income range. This range begins at $157,500 ($315,000 for joint filers), and the benefits are lost completely at $207,500 ($415,000 for joint filers). § 199A(b)(3), (d)(3), (e)(2). These ranges are indexed for inflation after 2018.

SECTION 2. ELIGIBILITY, ELECTION AND TERMINATION

E. COORDINATION WITH SUBCHAPTER C

Page 375:

After the first full paragraph of section E, insert:

Section 1371(a) provides that, except when specifically displaced, the normal Subchapter C rules, including the rules governing corporate distributions, are applicable to Subchapter S corporations. This is in contrast to § 1361(b), which provides that subject to certain exceptions, the taxable income of an S corporation is computed in the same manner as an individual's taxable income. Trugman v. Commissioner, 138 T.C. 390 (2012), held that the first time homebuyer's credit under now-expired § 36, which was available to an "individual" who had no present ownership interest in a principal residence during the three year period ending on the date of the purchase, was not allowable to an S corporation that purchased a home for its shareholders, notwithstanding that the § 36 credit was not one of the listed exceptions in § 1363(b). The court held that a corporation could not be an "individual" for purposes of § 36, and election of subchapter S status did not change that characterization. The court reasoned that only individuals can have a principal residence—a corporation has a principal place of business. Thus, before concluding that a provisions that applies to individuals also applies to S corporations, the statutory provision in question must be carefully examined.

Page 376:

Add after the carryover paragraph:

The 2017 Tax Act reduced the corporate tax rate from 35% to 21%. As a result, existing S corporations may find it advantageous to terminate S corporation status and become C corporations. The 2017 Tax Act provides two provisions that facilitate such a termination.

The 2017 Tax Act added § 481(d), which provides a rule allowing an "eligible terminated S corporation" to take into account over a 6-year period any § 481 adjustment required as a result of conversion. (Section 481 applies to accounting changes and requires that taxpayers take into account adjustments that are necessary "to prevent amounts from being duplicated or omitted.") An eligible terminated S corporation is a C corporation that was an S corporation on the day "before the date of the enactment of the Tax Cuts and Jobs Act," and terminates through revocation of its election under § 1362(a) during the following two year period. The 2017 Tax Act was signed into law on December 22, 2017. (Owing to a decision by the Senate parliamentarian, the 2017 Tax Act was, however, not named the Tax Cuts and Jobs Act; instead it is technically "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.") The owners of the stock when the revocation election is made must be "the same owners (and in identical proportions) as on the date" of the enactment of the legislation. § 481(d)(2)(B).

Section 1371(f) is the second provision, and it is discussed in this Update, Chapter 8, pg. 37.

SECTION 3. EFFECT OF THE SUBCHAPTER S ELECTION BY A CORPORATION WITH NO C CORPORATION HISTORY

A. PASSTHROUGH OF INCOME AND LOSS

(1) GENERAL PRINCIPLES

Page 382:

After the first full paragraph, insert:

In the case of a charitable contribution of property by an S corporation, under § 1367(a)(2), the shareholders' basis is decreased by the shareholder's proportionate share of the adjusted basis of the contributed property.

Page 384:

After the first full paragraph, insert:

4.1.1 Basis of Shareholder Indebtedness of Corporation

As amended in 2014, Treas.Reg. § 1.1366-2 provides that the basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in Reg. § 1.1011-1 and as provided in § 1367(b)(2)) in any "bona fide indebtedness of the S corporation that runs directly to the shareholder." Whether indebtedness is "bona fide indebtedness" to a shareholder is determined under general tax principles and depends on "all of the facts and circumstances." Treas.Reg. § 1.1366-2(a)(2)(i).

The regulations do not attempt to clarify the meaning of "bona fide indebtedness," or provide any examples of relevant facts and circumstances, but rely on "general Federal tax principles." This leaves somewhat ambiguous what might replace the "actual economic outlay" by the shareholder test for creating basis of indebtedness, applied in cases such as Maloof v. Commissioner, 456 F.3d 645 (6th Cir. 2006); Spencer v. Commissioner, 110 T.C. 62, 78-79 (1998), aff'd without published opinion, 194 F.3d 1324 (11th Cir. 1999); Hitchins v. Commissioner, 103 T.C. 711 (1994); and Perry v. Commissioner, 54 T.C. 1293 (1970). The preamble to the proposed regulations refers to Knetsch v. United States, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); Geftman v. Commissioner, 154 F.3d 61 (3d Cir. 1998); Estate of Mixon v. U.S., 464 F.2d 394 (5th Cir. 1972); and Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367 (1973), as relevant authorities. In the preamble to the final regulations, the Treasury department expressly declined to accept a commentator's suggestion that the final "regulations provid[e] that actual economic outlay is no longer the standard used to determine whether a shareholder obtains basis of indebtedness," but "[w]ith respect to guarantees, however, the final regulations retain the economic outlay standard." In a recent Tax Court memorandum decision (Meruelo v. Commissioner, T.C. Memo. 2018-16), Judge Lauber weighed in:

> [T]he controlling test under prior case law, as under the new regulation, dictates that basis in an S corporation's debt requires proof of "bona fide indebtedness of the S corporation that runs directly to the shareholder." . . . Requiring that the shareholder have made an "actual economic outlay" is a general tax principle that may be employed under the new regulation, as it was applied under prior case law, to determine whether this test has been met.

Treas.Reg. § 1.1366-2(a)(2)(iii), Ex. (2), blesses a basis increase resulting from a back-to-back loan in which one S corporation lends money to the shareholder who in turn lends the loan proceeds to a second S corporation, if the loan to the second S corporation "constitutes bona fide indebtedness" from the borrower S corporation to the shareholder. Treas.Reg. § 1.1366-2(a)(2)(iii), Ex. (3), blesses a basis increase resulting from a distribution to a shareholder by one S corporation (S1) of a note evidencing the indebtedness of a second S corporation (S2) if after the distribution S2 is indebted to the shareholder and "the note constitutes bona fide indebtedness" from S2 to the shareholder where under local law the distribution relieved S2 of its obligation to S1 and S2 was liable only to the shareholder; however, whether S2 is indebted to the shareholder rather than S1 is determined under general federal tax principles and depends upon all of the facts and circumstances. Treas.Reg. § 1.1366-2(a)(2)(iii), Ex. (1), provides that a bona fide indebtedness from an S corporation to a disregarded entity (LLC) owned by the shareholder results in an increase in basis of indebtedness for the shareholder.

Finally, Treas. Reg. § 1.1366-2(a)(2)(ii) expressly provides that:

> A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase its basis of indebtedness to the extent of that payment.

Treas.Reg. § 1.1366-2(a)(2)(iii), Ex. (4), illustrates that the basis increase from satisfaction of a guarantee occurs pro tanto as serial payments on the guarantee are made.

Page 390:

After the last line, add the following:

For taxable years beginning after December 31, 2017, and before January 1, 2026, the 2017 Tax Act adds a limitation on the deduction of business losses for noncorporate taxpayers, including individual partners and S corporation shareholders. Pub. L. No. 115-97, § 11012(a) (2017). Section 461(l) disallows the deduction of a taxpayer's "excess business loss." This is defined in § 461(l)(3) to mean the taxpayer's aggregate deductions for the year that are "attributable to trades or business of such taxpayer" over the sum of (1) the taxpayer's aggregate gross income or gain for the year attributable to the taxpayer's trades and (2) $250,000 (or $500,000 for joint filers), adjusted for inflation after 2018. Section 461(l) specifies that it applies after § 469.

Section 461(l) applies at the partner or shareholder level (for S corporations) and provides:

> [E]ach partner's or shareholder's allocable share of the items of income, gain, deduction, or loss of the partnership or S corporation for any taxable year from trades or businesses attributable to the partnership or S corporation shall be taken into account by the partner or shareholder in applying [§ 461(l)] to the taxable year of such partner or shareholder with or within which the taxable year of the partnerhsip os S corporation ends.

The statute explains that for S corporation shareholders, "allocable share" means their "pro rata share" of an item. § 461(l)(4).

If a taxpayer's deductions are disallowed, the disallowed amount is treated as a § 172 net operating loss in the subsequent year. § 462(l)(2). The 2017 Tax Act also changed the carryback and carryforward rules of § 172. For all taxpayers (other than certain insurance companies and farming businesses), the ability to carry back NOLs is eliminated and the carryover is limited to 80% of the taxpayer's taxable income. § 172(a)(2), (b)(1).

As is true of many (if not most) of the new rules contained in the 2017 Tax Act, guidance is needed regarding the definition of key terms and the coordination of § 461(l) with other statutory provisions.

(2) EFFECT OF INDIRECT CONTRIBUTIONS ON LIMITATION OF LOSS DEDUCTIONS TO SHAREHOLDER BASIS

Pages 393-405 of this subsection.

The cases and Rulings discussed in this section have been superseded by the 2014 amendments to Treas.Reg. § § 1.1366-2(a)(2), discussed in Detailed Analysis 4.1.1, in this Supplement at page reference 384.

B. DISTRIBUTIONS

Page 408:

After the last paragraph, add the following:

Section 1371(f) was added to the Code by the 2017 Tax Act and has an effective date of December 22, 2017. It provides:

> In the case of a distribution of money by an eligible terminated S corporation (as defined in section 481(d)) after the post-termination transition period, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of such accumulated adjustments account bears to the amount of such accumulated earnings and profits.

This provision will have the effect of allowing shareholders to continue to treat at least a portion of any distributions as though they do not derive from C corporation earnings and profits and instead are in part from the terminated S corporation, thus allowing partial continuation of the privilege of tax-free distributions. The definition of "eligible terminated S corporation" is discussed in this Update, Chapter 8, pg.32.

SECTION 4. QUALIFIED SUBCHAPTER S SUBSIDIARIES

Page 411:

At the end of the carryover paragraph, insert:

The Tax Court's decision in *Ball* was affirmed by the Third Circuit. Ball v. Commissioner, 742 F.3d 552 (3d Cir. 2014). The court reasoned that gains that are not recognized by virtue of a specific Code provision are not items of gross income, citing Treas.Reg. § 1.61-6(b)(1), and § 332 specifically provides nonrecognition on the liquidation of a controlled subsidiary. Thus, making the QSub election did not give rise to an item of gross income.

SECTION 5. S CORPORATIONS THAT HAVE A C CORPORATION HISTORY

B. BUILT-IN GAIN TAX

Page 416:

At the end of the first full paragraph, insert:

[Ed: The 2015 Act permanently shortens the recognition period of § 1374(d)(7) to five years.]

Page 417:

In the fourth full paragraph, at the end of the first line, substitute "five year**" for "**ten year**".**

C. PASSIVE INVESTMENT INCOME OF AN S CORPORATION WITH ACCUMULATED EARNINGS AND PROFITS

Page 422:

In the last paragraph, change the computation to:

$$(\$360{,}000\text{-}\ \$60{,}000) \text{ x } \frac{\$360{,}000\ \text{-}(\$960{,}000 \text{ x } .25)}{\$360{,}000} = \$100{,}000$$

PART 3.

AFFILIATED CORPORATIONS

CHAPTER 9

AFFILIATED CORPORATIONS

SECTION 1. TAX REDUCTION WITH MULTIPLE CORPORATE TAXPAYERS

Pages 432-436:

Delete the entirety of Section A and of Section B

The 2017 Tax Act replaced the prior multiple § 11 rate brackets with a single, flat 21% rate tax. As a result, corporations will no longer have an incentive to use multiple, controlled corporations to gain access to lower rate brackets. Section 1561 was substantially modified (with the details of its current form outside the scope of this casebook).

SECTION 2. CONSOLIDATED RETURNS

Page 447:

At the end of the last full paragraph, add:

See Treas. Reg. § 1.1502-32(c)(5), Ex. 1(a), (b), (d).

Page 449:

At the end of the carryover sentence at the top of the page, insert:

See Treas. Reg. § 1.1502-19(b)(2)(i).

PART 4.

CORPORATE ACQUISITION TECHNIQUES

CHAPTER 10

TAXABLE ACQUISITIONS: THE PURCHASE AND SALE OF A CORPORATE BUSINESS

Page 467:

Replace the sixth and seventh sentences of the third paragraph with the following:

If this gain were taxed at the maximum tax rate of 21 percent, X Corporation would pay taxes of $84 and make a $616 liquidating distribution to A, who would recognize a capital gain of $416. A would pay a tax, at the preferential capital gains rate of 20 percent (assuming that A would be required to pay at this highest net capital gain rate), of $83.20 and would receive net after-tax proceeds of $532.80.

Page 468:

In the first full paragraph, eleventh line, replace "$560" with "$532.80.

SECTION 1. ASSETS SALES AND ACQUISITIONS

Page 476:

At the tenth line of the first full paragraph, delete the discussion of Peco Foods and insert:

In Peco Foods, Inc. v. Commissioner, T.C. Memo. 2012-18, aff'd, 522 Fed. Appx. 840 (11th Cir. 2013), the taxpayer entered into an agreement with the sellers of two poultry processing plants that allocated a large portion of the purchase price to processing plants on which the taxpayer claimed depreciation deductions as nonresidential real property with a MACRS life of 39 years. The agreements separately listed agreed-upon prices for land, buildings, and machinery and equipment. Subsequently, after a cost segregation study, the taxpayer attempted to change its method of accounting to separate out components of the buildings as equipment and machinery and claim accelerated depreciation on the basis of shorter MACRS recovery periods. The Tax Court held that under § 1060 and Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), the taxpayer was bound by the purchase price allocation agreement unless it could show fraud, undue influence, duress, etc. The court rejected the taxpayer's argument that nothing in § 1060 precluded the taxpayer from segregating components of assets broadly described as a production plant into components consisting of the real property and related equipment and machinery. The court also refused to accept the taxpayer's assertion that the agreements with the sellers should be disregarded because the use of the terms "Processing Plant Building" and "Real Property: Improvements" were ambiguous. Finally the court agreed with the IRS that the IRS did not abuse its discretion in prohibiting the taxpayer from adopting depreciation schedules that were inconsistent with the terms of the purchase agreements. The Court of Appeals affirmed the Tax Court's decision. The Court of Appeals noted that (1) "both agreements contain the statement that the original allocation shall be used 'for all purposes (including financial accounting and tax purposes),'" (2) in one agreement, "[t]he parties allocated the purchase price among three assets: 'Real Property: Land,' 'Real Property: Improvements,' and 'Machinery, Equipment, Furnitures [sic] and Fixtures,'" (3) "Peco intended 'Processing Plant Building' to be treated as a single asset when it entered the [other] agreement," and (4) the term "Processing Plant Building" in the agreement was unambiguous.

SECTION 2. STOCK SALES AND ACQUISITIONS

Page 485:

After the last sentence of the carryover paragraph from 484, add the following:

The 2017 Tax Act (temporarily) expanded bonus depreciation under § 168(k). One of the changes included allowing used property, such as equipment, to be eligible for bonus depreciation. In evaluating whether a § 338 election should be made, changes to § 168(k) should be considered; these changes are likely, however, to cause the circumstances in which a § 338 election makes economic sense to shift only from "very unusual" to "quite unusual."

Page 485:

Replace the second and third full paragraphs with the following revised example:

Suppose that individual C owns all of the stock of T Corporation. C's basis for the stock is $2,000. T Corporation's sole asset has a basis of $1,000 and a fair market value of $4,000. If T Corporation sold the asset to A Corporation for $4,000, it would owe taxes of $630 on its $3,000 gain (assuming that T Corporation was subject to a flat corporate tax of 21 percent) and would distribute $3,370 to C in a liquidating distribution. C would pay taxes of $274 (assuming a 20 percent rate) on the $1,370 gain, leaving C with $3,096 of net proceeds.

Alternatively, A Corporation could pay C $3,370 in cash for the stock, again leaving C with $3,096 after taxes. A Corporation could make a § 338 election, which would give rise to a $630 tax liability on the deemed sale of T Corporation's asset. The asset would acquire a $4,000 basis, which under 334(b) would carry over to A corporation if it liquidated T Corporation pursuant to § 332. Again, A Corporation has paid a total of $4,000 to acquire T Corporation's asset with a basis of $4,000.

CHAPTER 12

TAX-FREE ACQUISITIVE REORGANIZATIONS

SECTION 2. THE FUNDAMENTAL RULES GOVERNING REORGANIZATIONS

A. THE BASIC STATUTORY SCHEME

Page 539:

At the end of the carryover paragraph, add the following:

The proposed regulations, Prop.Reg. § 1.368–1(b)(1) and –1(f), were withdrawn in July 2017. 82 F.R. 32,281, 32,282. No explanation was provided regarding the withdrawal of the § 368 net value regulations.

B. THE CONTINUITY OF SHAREHOLDER INTEREST REQUIREMENT

(1) QUALITATIVE AND QUANTITATIVE ASPECTS

Page 550:

After the second full paragraph, add the following:

Rev. Proc. 2018-12 implements valuation methods and explains:

> The Treasury Department and the IRS received comments on the 2011 Proposed Regulations to the effect that parties to potential reorganizations frequently use average trading price methods to value Issuing Corporation stock in determining the amount and/or the mix of consideration to be exchanged for Target stock. The IRS agrees that such methods often produce a more reliable estimate of the fair market value of Issuing Corporation stock than its trading price on a

> single date. Accordingly, the IRS has concluded that, in certain circumstances, taxpayers should be able to rely on such methods for purposes of determining whether the COI requirement is satisfied. The IRS also agrees with commenters that taxpayers should be able to rely on such methods regardless of whether the Signing Date Rule or the Closing Date Rule applies to a particular transaction.

The Rev. Proc. then goes on to provide "certain Safe Harbor Valuation Methods and Measuring Periods."

(2) "REMOTE CONTINUITY OF INTEREST" AND "PARTY TO A REORGANIZATION"

Page 551:

Replace the citation to the REGULATIONS with:

REGULATION: Sections 1.368-2(k)

D. JUDICIAL LIMITATIONS

(2) STEP TRANSACTION DOCTRINE

Page 598:

After the carryover paragraph, insert:

In Rev. Rul. 2015-10, 2015-21 I.R.B. 973, the IRS illustrated its willingness to both disregard and apply the step transaction doctrine in the same multi-part integrated transaction. Pursuant to plan the parent corporation transferred all of its interest in a wholly owned limited liability company, which was taxed as a corporation, to a subsidiary for stock, which in turn transferred the LLC to a second subsidiary for stock. The second subsidiary transferred the LLC to a third subsidiary. The LLC thereupon elected to be a disregarded entity, which is treated as a corporate liquidation of the LLC. The ruling concludes that notwithstanding the integrated nature of the transaction, the first two steps would be recognized as § 351 transfers, but that the third transfer, rather than be treated as a § 351 transfer followed by a corporate liquidation under § 332, would be treated as a single type D reorganization (discussed in the text at page 660). The ruling states that "an analysis of the transaction as a whole does not dictate that . . . [it] be treated other than in accordance with its form in order to reflect the substance of the transaction."

SECTION 4. STOCK FOR ASSETS ACQUISITIONS: TYPE (C) REORGANIZATIONS

Page 630:

After the first sentence of the last paragraph, add:

(The proposed net value regulations, Prop.Reg. § 1.368–1(b) and –1(f) were withdrawn in July 2017. 82 F.R. 32,281, 32,282.)

SECTION 6. ACQUISITIVE TYPE (D) REORGANIZATIONS

Page 660:

After the first full paragraph, insert:

2.2.1 *Allocation of Basis in All Cash D Reorganizations*

Treas.Reg. § 1.358-2 deals with stock basis in all cash type D reorganizations. If an actual shareholder of the acquiring corporation is deemed to receive a nominal share of stock of the issuing corporation described in Treas.Reg. § 1.368-2(*l*), that shareholder must, after allocating and adjusting the basis of the nominal share in accordance with the rules of Treas.Reg. § 1.358-1, and after adjusting the basis in the nominal share for any transfers described in Treas.Reg. § 1.358-1, designate the share of stock of the acquiring corporation to which the basis, if any, of the nominal share will attach. Under these rules, the ability to designate the share of stock of the acquiring corporation to which the basis of the surrendered stock or securities of the target will attach applies only to a shareholder that actually owns shares in the issuing corporation. Thus, for example, if in an all cash type-D reorganization, Y Corporation, a first tier subsidiary of P Corporation, acquires the assets of T Corporation, a second tier subsidiary of P Corporation, owned by X Corporation, a first tier subsidiary of P Corporation, X Corporation cannot designate any share of Y Corporation stock to which the basis, if any, of the nominal share of Y Corporation stock will attach; and P Corporation cannot designate a share of Y Corporation stock to which basis will attach because P Corporation's basis in the nominal share of Y Corporation stock (deemed to have been distributed to it by X Corporation) is zero (its fair market value).

After the paragraph for Detailed Analysis 2.3, insert:

2.4 *Section 351 Transaction versus Reorganization.*

Rev. Rul. 2015-10, 2015-21 I.R.B. 973, dealt with the characterization of a transaction in which pursuant to a plan (1) a parent corporation transferred all of the interests in its wholly-owned limited liability company that was taxable as a corporation to its subsidiary (first subsidiary) in exchange for additional stock, (2) the first subsidiary transferred all of the interests in the limited liability company to its subsidiary (second subsidiary) in exchange for additional stock, (3) the second subsidiary transferred all of the interests in the limited liability company to its subsidiary (third subsidiary) in exchange for additional stock, and (4) the limited liability company elected to be disregarded as an entity separate from its owner for federal income tax purposes effective after it was owned by the third subsidiary. The ruling concluded that the series of events was properly treated as two transfers of stock in exchanges governed by § 351, followed by a § 368(a)(1)(D) reorganization. Even though the parent's transfer was part of a series of transactions undertaken as part of a prearranged, integrated plan involving successive transfers of the LLC interests, the transfer satisfied the formal requirements of § 351, including the requirement that the transferor control the subsidiary immediately after the exchange. Viewing the transaction as a whole did not dictate that the parent's transfer be treated other than in accordance with its form. Section 351 similarly, applied to the first subsidiary's transfer of the LLC interests to its subsidiary. But the transfer by the second subsidiary to the third subsidiary, coupled with the LLC's election to become a disregarded entity was characterized as a § 368(a)(1)(D) reorganization. If an acquiring corporation acquires all of the stock of a target corporation from a person controlling the acquiring corporation (within the meaning of § 304(c), via § 368(a)(2)(H)(i)) in an exchange otherwise qualifying as a § 351 exchange, and as part of a prearranged, integrated plan, the target corporation thereafter transfers its assets to the acquiring corporation in liquidation, the transaction is more properly characterized as a reorganization under § 368(a)(1)(D), to the extent it so qualifies. See Rev. Rul. 67-274, 1967-2 C.B.141.

Page 661:
Delete the second paragraph of 3.2 *Control and Continuity of Interest.*

PART 5

NONACQUISITIVE REORGANIZATIONS

CHAPTER 13

SINGLE-CORPORATION REORGANIZATIONS

SECTION 3. CHANGES IN IDENTITY, FORM, OR PLACE OF ORGANIZATION: TYPE (F) REORGANIZATIONS

Page 692:

Replace the citation to PROPOSED REGULATIONS: Section 1.368-2(m) with the following:

REGULATIONS: 1.368-2(m).

Page 693-696:

Replace PROPOSED RULES with the following:

Reorganizations Under Section 368(a)(1)(F); Section 367(a) and Certain Reorganizations Under Section 368(a)(1)

Treasury Decision 9739.
80 F.R. 56904 (Sept. 21, 2015).

SUMMARY: This document contains final regulations that provide guidance regarding the qualification of a transaction as a corporate reorganization under section 368(a)(1)(F) by virtue of being a mere change of identity, form, or place of organization of one corporation (F reorganization).

* * *

Background

1. Introduction

* * *

Section 368(a)(1) describes several types of transactions that constitute reorganizations. One of these, described in section 368(a)(1)(F), is "a mere change in identity, form, or place of organization of one corporation, however effected" (a Mere Change). One court has described the F reorganization as follows:

> [The F reorganization] encompass[es] only the simplest and least significant of corporate changes. The (F)-type reorganization presumes that the surviving corporation is the same corporation as the predecessor in every respect, except for minor or technical differences. For instance, the (F) reorganization typically has been understood to comprehend only such insignificant modifications as the reincorporation of the same corporate business with the same assets and the same stockholders surviving under a new charter either in the same or in a different State, the renewal of a corporate charter having a limited life, or the conversion of a U.S.-chartered savings and loan association to a State-chartered institution.

Berghash v. *Commissioner,* 43 T.C. 743, 752 (1965) (citation and footnotes omitted), *aff'd,* 361 F.2d 257 (2d Cir. 1966).

Although the statutory description of an F reorganization is short, and courts have described F reorganizations as simple, questions have arisen regarding the requirements of F reorganizations. In particular, when a corporation changes its identity, form, or place of incorporation, questions have arisen as to what other changes (if any) may occur, either before, during, or after the Mere Change, without affecting the status of the Mere Change (that is, what other changes are compatible with the Mere Change). These questions can become more pronounced if the transaction intended to qualify as an F reorganization is composed of a series of steps occurring over a period of days or weeks. Moreover, changes in identity, form, or place of organization are often undertaken to facilitate other changes that are difficult to effect in the corporation's current form or place of organization.

* * *

Explanation of Revisions

1. Overview

. . . The Final Regulations provide that a transaction that involves an actual or deemed transfer of property by a Transferor Corporation to a Resulting Corporation is a Mere Change that qualifies as an F reorganization if six requirements are satisfied (with certain exceptions). The Final Regulations provide that a transaction or a series of related transactions to be tested against the six requirements (a Potential F Reorganization) begins when the Transferor Corporation begins transferring (or is deemed to begin transferring) its assets to the Resulting Corporation, and ends when the Transferor Corporation has distributed (or is deemed to have distributed) the consideration it receives from the Resulting Corporation to its shareholders and has completely liquidated for federal income tax purposes. The concept of a Potential F Reorganization was added to the Final Regulations to aid in determining which steps in a multi-step transaction should be considered when applying the six requirements to a potential mere change (that is, which steps are "in the bubble").

In the context of determining whether a Potential F Reorganization qualifies as a Mere Change, deemed asset transfers include, but are not limited to, those transfers treated as occurring as a result of an entity classification election under paragraph § 301.7701-3(c)(1)(i), as well as transfers resulting from the application of step transaction principles. One example of such a transfer would be the deemed asset transfer by the Transferor Corporation to the Resulting Corporation resulting from a so-called "liquidation-reincorporation" transaction. *See, for example, Davant* v. *Commissioner,* 366 F.2d 874 (5th Cir. 1966); § 1.331-1(c) (liquidation-reincorporation may be a tax-free reorganization). Another example of such a deemed asset transfer would include the deemed transfer of the Transferor Corporation's assets to the Resulting Corporation in a so-called "drop-and-check" transaction in which a newly formed Resulting Corporation acquires the stock of a Transferor Corporation from its shareholders and, as part of the plan, the Transferor Corporation liquidates into the Resulting Corporation. *See, for example,* steps (d) and (c) of Rev. Rul. 2015-10, 2015-21 IRB 973; Rev. Rul. 2004-83, 2004-2 CB 157; Rev. Rul. 67-274, 1967- 2 CB 141.

. . . Viewed together, [the] six requirements ensure that an F reorganization involves only one continuing corporation and is neither an acquisitive transaction nor a divisive transaction. Thus, an F reorganization does not include a transaction that involves a shift in ownership of the enterprise, an introduction of assets in exchange for equity (other than that raised by the Transferor Corporation prior to the F reorganization), or a division of assets or tax attributes of a Transferor Corporation between or among the Resulting Corporation and other acquiring corporations. An F reorganization also does not include a transaction that leads to multiple potential acquiring corporations having competing claims to the Transferor Corporation's tax attributes under section 381.

Certain exceptions, … apply to these six requirements. Three of these exceptions allow de minimis departures from the six requirements for purposes unrelated to federal income taxation.

2. F Reorganization Requirements and Certain Exceptions

A. Resulting Corporation Stock Issuances and Identity of Stock Ownership

[T]he first and the second requirements of the Final Regulations reflect the Supreme Court's holding in *Helvering* v. *Southwest Consolidated Corp, supra,* that a transaction that shifts the ownership of the proprietary interests in a corporation cannot qualify as a Mere Change. Thus, the Final Regulations provide that a transaction that involves the introduction of a new shareholder or new equity capital into the corporation "in the bubble" does not qualify as an F reorganization.

[T]he first requirement in the Final Regulations is that immediately after the Potential F Reorganization, all the stock of the Resulting Corporation must have been distributed (or deemed distributed) in exchange for stock of the Transferor Corporation in the Potential F Reorganization. … The Treasury and the IRS believe … that a focus on the distribution of the stock of the Resulting Corporation better matches the transactions that occur (or are deemed to occur) in reorganizations.

[T]he second requirement is that, subject to certain exceptions, the same person or persons own all the stock of the Transferor Corporation at the beginning of the Potential F Reorganization and all of the stock of the Resulting Corporation at the end of the Potential F Reorganization, in identical proportions.

Notwithstanding these requirements … the Final Regulations allow the Resulting Corporation to issue a de minimis amount of stock not in respect of stock of the Transferor Corporation, to facilitate the organization or maintenance of the Resulting Corporation. This rule is designed to allow, for example, reincorporation in a jurisdiction that requires minimum capitalization, two or more shareholders, or ownership of shares by directors. It is also intended to allow a transfer of assets to certain pre-existing entities, for reasons explained further in section 2.B. of this Explanation of Revisions.

In addition, the Final Regulations allow changes of ownership that result from either (i) a holder of stock in the Transferor Corporation exchanging that stock for stock of equivalent value in the Resulting Corporation having terms different from those of the stock in the Transferor Corporation or (ii) receiving a distribution of money or other property from either the Transferor Corporation or the Resulting Corporation, whether or not in redemption of stock of the Transferor Corporation or the Resulting Corporation. In other words, the corporation involved in a Mere Change may also recapitalize, redeem its stock, or make distributions to its shareholders, without causing the Potential F Reorganization to fail to qualify as an F reorganization. These exceptions reflect the determination of the Treasury Department and the IRS that allowing certain transactions to occur contemporaneously with an F reorganization is appropriate so long as one corporation could effect the transaction without undergoing an F reorganization. These exceptions also reflect the case law … holding that certain transactions qualify as F reorganizations even if some shares are redeemed in the transaction, and rulings by the IRS that a recapitalization may happen at the same time as an F reorganization. See, for example, Rev. Rul. 2003-19, 2003-1 CB 468, and Rev. Rul. 2003-48, 2003-1 CB 863 (both providing that certain demutualization transactions may involve both E reorganizations and F reorganizations).

B. Resulting Corporation's Assets or Attributes and Liquidation of Transferor Corporation

[T]he third requirement (limiting the assets and attributes of the Resulting Corporation immediately before the transaction) and the fourth requirement (requiring the liquidation of the Transferor Corporation) under the Final Regulations reflect the statutory mandate that an F reorganization involve only one corporation. Although the Final Regulations generally require the Resulting Corporation not to hold any property or have any tax attributes immediately before the Potential F

Reorganization, … the Resulting Corporation is allowed to hold a de minimis amount of assets to facilitate its organization or preserve its existence (and to have tax attributes related to these assets), and the Resulting Corporation is allowed to hold proceeds of borrowings undertaken in connection with the Potential F Reorganization.

A commenter… stated that the Final Regulations should allow the Resulting Corporation to hold, in addition to the proceeds of borrowings, cash proceeds of stock issuances before the Mere Change. The Treasury Department and the IRS do not believe that the Resulting Corporation should be allowed to issue more than a de minimis amount of stock before a transaction constituting a Mere Change because that would allow a substantial investment of new capital and/or new shareholders, or an acquisition of assets from more than one corporation. This rule does not, however, preclude the Transferor Corporation from issuing new stock before a Potential F Reorganization constituting an F reorganization. Nor does it preclude the Resulting Corporation from issuing new stock after the Potential F Reorganization.

Under the fourth requirement in the Final Regulations, the Transferor Corporation must completely liquidate in the Potential F Reorganization for federal income tax purposes. Nevertheless, … the Transferor Corporation is not required to legally dissolve and is allowed to retain a de minimis amount of assets for the sole purpose of preserving its legal existence.

C. One Section 381(a) Acquiring Corporation, One Section 381(a) Transferor Corporation

The fifth requirement under the Final Regulations is that immediately after the Potential F Reorganization, no corporation other than the Resulting Corporation may hold property that was held by the Transferor Corporation immediately before the Potential F Reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in section 381(c). Thus, a transaction that divides the property or tax attributes of a Transferor Corporation between or among acquiring corporations, or that leads to potential competing claims to such tax attributes, will not qualify as a Mere Change.

The sixth requirement under the Final Regulations is that immediately after the Potential F Reorganization, the Resulting Corporation may not hold property acquired from a corporation other than the Transferor Corporation if the Resulting Corporation would, as a result, succeed to and take into account the items of such other corporation described in section 381(c). Thus, a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations (such as the transaction described in Rev. Rul. 58-422, 1958-2 CB 145) will not qualify as a Mere Change.

* * *

[N]otwithstanding the overall flexibility provided with respect to transactions occurring contemporaneously with a Mere Change, the Final Regulations provide that a Mere Change cannot accommodate transactions that occur at the same time as the Potential F Reorganization if those other transactions could result in a corporation other than the Resulting Corporation acquiring the tax attributes of the Transferor Corporation.

… Consistent with the statutory language of section 368(a)(1)(F), the Treasury Department and the IRS believe that a Mere Change involves only one Transferor Corporation and one Resulting Corporation. Thus, the Final Regulations provide that only one Transferor Corporation can transfer property to the Resulting Corporation in the Potential F Reorganization. If more than one corporation transfers assets to the Resulting Corporation in a Potential F Reorganization, none of the transfers would constitute an F reorganization.

3. Series of Transactions

In some cases, business or legal considerations may require extra steps to complete a transaction that is intended to qualify as a Mere Change. … [T]he Treasury Department and the IRS concluded that the words "however effected" in the statutory definition of F reorganization reflect a Congressional intent to treat a series of transactions that together result in a Mere Change as an F reorganization, even if the transfer (or deemed transfer) of property from the Transferor Corporation to the Resulting Corporation occurs indirectly. The Final Regulations confirm this conclusion by providing that a Potential F Reorganization consisting of a series of related transactions that together result in a Mere Change may qualify as an F reorganization, whether or not certain steps in the series, viewed in isolation, might, for example, be treated as a redemption under section 304(a), as a complete liquidation under section 331 or section 332, or as a transfer of property under section 351. For example, the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation. However, *see* § 1.368-2(k) for completed reorganizations that will not be recharacterized as a Mere Change as a result of one or more subsequent transfers of assets or stock, such as where a Transferor Corporation transfers all of its assets to its parent corporation in liquidation, followed by the parent corporation's retransfer of those assets to a new corporation. *See also* Rev. Rul. 69-617, 1969-2 CB 57 (an upstream merger followed by a contribution of all the target assets to a new subsidiary corporation is a reorganization under sections 368(a)(1)(A) and 368(a)(2)(C)).

4. Mere Change Within Larger Transaction

[T]he Treasury Department and the IRS recognized that an F reorganization may be a step, or a series of steps, before, within, or after other transactions that effect more than a Mere Change, even if the Resulting Corporation has only a transitory existence following the Mere Change. In some cases an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the Transferor Corporation before the commencement of the F reorganization. Although an F reorganization may facilitate another transaction that is part of the same plan, the Treasury Department and the IRS have concluded that step transaction principles generally should not recharacterize F reorganizations because F reorganizations involve only one corporation and do not resemble sales of assets. From a federal income tax perspective, F reorganizations are generally neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c) without a limitation on the carryback of losses. *See, for example,* Rev. Rul. 96- 29…

The Final Regulations adopt the Related Events Rule …, which provided that related events preceding or following the Potential F Reorganization that constitutes a Mere Change generally would not cause that Potential F Reorganization to fail to qualify as an F reorganization. Notwithstanding the Related Events Rule, in the cross-border context, related events preceding or following an F reorganization may be relevant to the tax consequences under certain international provisions that apply to F reorganizations….

The Final Regulations also … [provide] that the qualification of a Potential F Reorganization as an F reorganization would not alter the treatment of other related transactions. For example, if an F reorganization is part of a plan that includes a subsequent merger involving the Resulting Corporation, the qualification of a Potential F Reorganization as an F reorganization will not alter the tax consequences of the subsequent merger.

5. Transactions Qualifying Under Other Provisions of Section 368(a)(1)

A comment … stated that, in some cases, an asset transfer that would constitute a step in an F reorganization is also a necessary step for characterizing a larger transaction as a nonrecognition transaction that would not constitute an F reorganization. For example, assume that corporation P acquires all of the stock of unrelated corporation T in exchange for consideration consisting of $50 cash and P voting stock with $50 value (without making an election under section 338), and, immediately thereafter and as part of the same plan, T is merged into corporation S, a newly-formed corporation wholly owned by P. Viewed in isolation, the merger of T into S appears to constitute a Mere Change. Provided the requirements for Asset Reorganization treatment are otherwise satisfied, however, the step transaction doctrine is applied to integrate the steps and treat the transaction as a statutory merger of T into S in which S acquires T's assets in exchange for $50 cash, $50 of P voting stock and assumption of T's liabilities, and T distributes the cash and P stock to its shareholders. This merger qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), and P's momentary ownership of T stock is disregarded. *See* Situation 2 of Rev. Rul. 2001-46, 2001- 2 CB 321 (same). The stock of S is not treated as issued for the assets of T; the historic shareholders of T are replaced by P as the shareholder of the resulting corporation (S); and the transaction is not a Mere Change.

To clarify this and similar situations, the Treasury Department and the IRS have determined that, if the Potential F Reorganization or a step thereof involving a transfer of property from the Transferor Corporation to the Resulting Corporation is also a reorganization or part of a reorganization in which a corporation in control (within the meaning of section 368(c)) of the Resulting Corporation is a party to the reorganization (within the meaning of section 368(b)), the Potential F Reorganization is not a Mere Change and does not qualify as an F reorganization. This rule will apply to transactions qualifying as reorganizations (i) under section 368(a)(1)(C) by reason of the parenthetical language therein, (ii) under section 368(a)(1)(A) by reason of ,and section 368(a)(2)(D), and (iii) under sections 368(a)(1)(A) or (C) by reason of section 368(a)(2)(C).

The IRS has long taken the position that, if a Transferor Corporation's transfer of property qualifies as a step in both an F reorganization and another type of reorganization in which the Resulting Corporation is the acquiring corporation, the transaction qualifies for the benefits accorded to an F reorganization. *See, for* *example,* Rev. Rul. 57-276, 1957-1 CB 126 (section 381(b) applies such that the parts of the Transferor Corporation's taxable year before and after an F reorganization constitute a single taxable year of the Acquiring Corporation, notwithstanding that the transaction also qualifies as another type of reorganization under section 368(a)(1)); Rev. Rul. 79-289, 1979-2 CB 145 (section 357(c) does not apply to an F reorganization even if the transaction also qualifies as another type of reorganization to which section 357(c) applies); § 1.381(b-1(a)(2) (providing for rules applicable to F reorganizations, regardless of whether such reorganizations also qualify as another type of reorganization).

To avoid confusion in the application of the reorganization provisions, the Treasury Department and the IRS have decided that, except as provided earlier in this section 5. of the Explanation of Revisions, if a Potential F Reorganization qualifies as a reorganization under section 368(a)(1)(F) and would also qualify as a reorganization under section 368(a)(1)(A), 368(a)(1)(C), or 368(a)(1)(D), then for all federal income tax purposes the Potential F Reorganization qualifies only as a reorganization under section 368(a)(1)(F). This rule does not apply to a reorganization within the meaning of sections 368(a)(1)(E) (*see* Rev. Rul. 2003-19, 2003-1 CB 468, and Rev. Rul. 2003-48, 2003-1 CB 863 (providing that certain demutualization transactions may involve both E Reorganizations and F reorganizations)) or 368(a)(1)(G) (*see* section 368(a)(3)(C)).

6. Distributions

* * *

Although the Treasury Department and the IRS considered whether a distribution occurring during a Potential F Reorganization should prevent it from qualifying as an F reorganization, the Treasury Department and the IRS determined to allow flexibility for such distributions. Nevertheless, unlike other types of reorganizations, which generally involve substantial changes in economic position, F reorganizations are mere changes in form. Accordingly, the Treasury Department and the IRS have concluded that any concurrent distribution should be treated as a transaction separate from the F reorganization. *See* § 1.301-1(l); *see also Bazley* v. *Commissioner,* 331 U.S. 737 (1947) (distribution in the context of a purported E reorganization treated as a dividend).

An F reorganization is a Mere Change involving only one continuing corporation and is neither an acquisitive transaction nor a divisive transaction. From a federal income tax perspective, F reorganizations generally are neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c). A distribution that occurs at the same time as a Mere Change is, in substance, a distribution from one continuing corporation and is functionally separate from the Mere Change. The Treasury Department and the IRS believe that a distribution from one continuing corporation should not be treated the same as an exchange of money or other property for stock of a target corporation in an acquisitive reorganization. Instead, the distribution should be treated as a separate transaction occurring at the same time. . . .[T]he Treasury Department and the IRS believe it is sufficient to treat the distribution as a separate transaction that occurs at the same time as the F reorganization.

7. Entities Treated as Corporations for Federal Tax Purposes

As explained in this preamble, the first requirement of the Final Regulations is that all of the stock of the Resulting Corporation be distributed in exchange for stock of the Transferor Corporation. Certain entities may be treated as corporations for federal tax purposes even though they do not have owners that could be treated as shareholders for federal tax purposes to whom the profits of the corporation would inure (for example, some charitable organizations described in section 501(c)(3)). Nevertheless, these entities may be able to engage in corporate reorganizations. Thus, no inference should be drawn from the use of the terms "stock" or "shareholders" in these Final Regulations with respect to the ability of such entities to engage in reorganizations under section 368(a)(1)(F).

* * *

Pages 696-703:

All of the authorities discussed in these pages have been superseded by Treas.Reg. § 1.368-2(m), discussed above.

CHAPTER 14

CORPORATE DIVISIONS: SPIN-OFFS, SPLIT-OFFS, AND SPLIT-UPS

SECTION 2. "ACTIVE CONDUCT OF A TRADE OR BUSINESS," "DEVICE," AND OTHER LIMITATIONS.

B. ACTIVE CONDUCT OF A TRADE OR BUSINESS

Page 729:

After the second full paragraph, insert:

As a related matter, the 2015 Act added § 355(h), which provides that § 355 does not apply if either the distributing corporation or the controlled corporation is a Real Estate Investment Trust (REIT). However, the distribution may still qualify under § 355 if both the distributing corporation and the controlled corporation are REITs immediately after the distribution or if during the three year period ending on the date of the distribution the controlled corporation was a REIT subsidiary of the distributing corporation at all times and the distributing corporation controlled the controlled corporation at all times.

Page 732:

After the carryover paragraph, insert:

Rev. Rul. 2017-9, 2017-21 IRB 1244, dealt with whether the step transaction doctrine applied if a parent corporation (P) transferred property constituting an active trade or business to its controlled subsidiary (D) for the purpose of assuring that D met the requirements of § 355(b)(1)(A), and pursuant to the same overall plan, the transfer was followed by a distribution by D of the stock of its controlled subsidiary (C) to P. In the ruling, P had been engaged in an active business A for more than 5 years, and C had been engaged in an active business B for more than 5 years. Both businesses met the active conduct of a trade or business test of of § 355(b). However, D is not engaged in the active conduct of a trade or business, directly or through any member of its separate affiliated group (within the meaning of § 355(b)(3)) other than C. The ruling held that the two transactions are not stepped together. Each is independently respected. The first transaction was treated as an exchange under § 351, and the second transaction qualified as a distribution governed by § 355. If the transactions had been stepped together into a single exchange, P would be treated as transferring the business property to D in exchange for a portion of the C stock in an exchange to which § 1001 applied. Gain or loss would have been recognized to P on the transfer of the property to D; gain or loss would have been recognized to D, under § 1001(a), upon its transfer of the C stock to P in exchange for the property transferred to it. In addition, because the value of the business transferred from P to D equaled 25 percent of the value of C, § 355 would not have applied to any part of the distribution of C stock because D would not have distributed stock constituting § 368(c) control of C. Gain would have been recognized to D, under § 311(b) upon the distribution of the remaining 75 percent of the C stock with respect to P's stock in D to which § 301 would have applied. The ruling reasoned as follows:

> The transfer of property permitted to be received by D in a nonrecognition transaction has independent significance when undertaken in contemplation of a distribution by D of stock and securities described in § 355(a)(1)(A). The transfer thus is respected as a separate transaction, regardless of whether the purpose of the transfer is to qualify the distribution under § 355(b). See, e.g. , Rev. Rul. 78-330; § 1.355-6(d)(3)(v)(B), Example 1; and Athanasios v. Comm'r, T.C. Memo 1995-72. Back-to-back nonrecognition transfers are generally respected when consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy. See, e.g., Rev. Rul. 2015-9, 2015-21 I.R.B. 972, and Rev. Rul. 2015-10, 2015-21 I.R.B. 973.
>
> P's transfer on Date 1 is the type of transaction to which § 351 is intended to apply. Analysis of the transaction as a whole does not indicate that P's transfer should be properly treated other than in accordance with its form. Each step provides for continued ownership in modified corporate form. Additionally, the steps do not resemble a sale, and none of the interests are liquidated or otherwise redeemed. On these facts, nonrecognition treatment under § § 351 and 355 is not inconsistent with the congressional intent of these Code provisions. The effect of the steps in Situation 1 is consistent with the policies underlying § § 351 and 355. Accordingly, the Date 1

> and Date 2 transfers described in Situation 1 will be respected as separate transactions for federal income tax purposes. Therefore, § 351 applies to P's transfer on Date 1 and § 355 applies to D's transfer on Date 2.

In contrast, the ruling held that, where a dividend was paid by C to D pursuant to a plan that included a transfer by D of appreciated assets to C and a distribution by D of the C stock that qualified under § 368(a)(1)(D) and 355, the step transaction applied to integrate all the three transactions. Because D retained the money and property distributed pursuant to the dividend declaration, that money and property was taxable boot received by D in the § 368(a)(1)(D) reorganization.

Page 734:

After the first full paragraph, insert:

2.4 Proposed Minimum Size for Five Year Business

Prop. Reg. § 1.355–9 (2016) would provide a new minimum size requirement for an active business to qualify under § 355. The requirements of §§ 355(a)(1)(C) and 355(b) would be satisfied with respect to a distribution only if the five-year-active-business asset percentage (as defined in the regulations) of each of Distributing and Controlled is at least five percent.

C. THE "DEVICE" LIMITATION

Page 747:

After the second full paragraph, insert:

A proposed amendment to the nature and use of assets device factor in Treas.Reg. § 1.355–2(d)(2)(iv) would focus on assets used in a business (as defined in Prop. Reg. § 1.355–2(d)(2)(iv)(B) (2016)) rather than only assets used in an active business meeting the five-year history requirement of § 355(b). The preamble to the proposed regulations states that the Treasury and IRS have concluded that the presence of business assets, whether or not held for five years, generally does not raise any more device concerns than the presence of assets used in a five-year active business. REG-134016-15, Guidance Under Section 355 Concerning Device and Active Trade or Business, 81 F.R. 46004 (July 15, 2016).

Conversely, the Treasury and IRS have concluded that device potential exists if either (1) Distributing or Controlled owns a large percentage of assets not used in business operations compared to total assets or (2) Distributing's and Controlled's percentages of these assets differs substantially. REG-134016-15, Guidance under Section 355 Concerning Device and Active Trade or Business, 81 F.R. 46004 (July 15, 2016). Accordingly, proposed regulations would provide thresholds for determining whether the ownership of nonbusiness assets and/or differences in the nonbusiness asset percentages (the percentage of a corporation's total assets that are nonbusiness assets) for Distributing and Controlled are evidence of device. If neither Distributing nor Controlled has nonbusiness assets that are 20 percent or more of its total assets, the ownership of nonbusiness assets ordinarily would not be evidence of device. Furthermore, a difference in the nonbusiness asset percentages for Distributing and Controlled ordinarily would not be evidence of device if such difference is less than 10 percentage points or, in the case of a non-pro rata distribution, if the difference is attributable to a need to equalize the value of the Controlled stock and securities distributed and the consideration exchanged therefor by the distributees.

Page 749:

After the carryover paragraph, insert:

4. Proposed "Per Se" Device Rule

Prop. Reg. § 1.355–2(d)(5) (2016) would provide that a transaction is a per se device (notwithstanding the presence of any other nondevice factors, for example, a corporate business purpose or stock being publicly traded and widely held) if designated percentages of Distributing's or Controlled's total assets are nonbusiness assets. The test is multi-pronged. A per se device exists if both (1) the nonbusiness asset percentage of Distributing or Controlled is 66⅔ percent or more, and (2) the nonbusiness asset percentage of Distributing or Controlled is (a) 66⅔percent or more but less than 80 percent, and the nonbusiness asset percentage of the other corporation (Controlled or Distributing, as the case may be) is less than 30 percent, (b) 80 percent or more but less than 90 percent, and the nonbusiness asset percentage of the other corporation is less than 40 percent; or (c) 90 percent or more, and the nonbusiness asset percentage of the other corporation is less than 50 percent.

SECTION 4. CONSEQUENCES TO PARTIES TO A CORPORATE DIVISION

Page 771:

After the first full paragraph of *Detailed Analysis* 4.1, insert:

Rev. Rul. 2017-9, 2017-21 IRB 1244, dealt with whether the step transaction doctrine applied to integrate a dividend from a controlled corporation to a distributing corporation with a § 368(a)(1)(D) reorganization related to a § 355 distribution. On Date 1, C transferred $15X of money and property having a fair market value of $10X to D, pursuant to a dividend declaration, and D retained the money and property. On Date 2, D transferred to C property having a basis of $20X and a fair market value of $100X, and D distributed all the C stock to P in a transaction qualifying as a reorganization under § § 368(a)(1)(D) and 355. C and D planned and executed the Date 1 transfer in pursuance of the plan of reorganization. The ruling held that because the distribution was made pursuant to the plan of reorganization, the step transaction doctrine applied to integrate the Date 1 and Date 2 transactions. The "tax treatment of the transaction will follow its substance." Thus, the distribution of money and other property was treated as boot received by D in the § 368(a)(1)(D) reorganization that was subject to recognition of gain under § 361(b). The ruling reasoned as follows:

> [I]n Estates of Bell v. Comm'r [, T.C.M. 1971-285], the Tax Court explained that the boot rules are "the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident of a reorganization." See also American Manufacturing. Co. v. Comm'r, 55 T.C. 204 (1970). Section 361 broadly looks to whether transfers of money or other property occur " in pursuance of the plan of reorganization" or " in connection with the reorganization." In Situation 2, the distribution is made in pursuance of the plan of reorganization. A distribution of money and other property in pursuance of the plan of reorganization will be treated as boot subject to recognition of gain, consistent with the congressional intent underlying § 361.

> Therefore, the federal income tax treatment of the transaction will follow its substance, and the distribution of money and property by C to D will constitute a distribution of boot under § 361(b).

In contrast, the ruling held that the step transaction doctrine did not apply where a parent corporation (P) transferred property constituting an active trade or business to its controlled subsidiary (D) for the purpose of assuring that D met the requirements of § 355(b)(1)(A), and pursuant to the same overall plan, the transfer was followed by a distribution by D of the stock of its controlled subsidiary (C) to P.

PART 6

CORPORATE ATTRIBUTES IN REORGANIZATIONS

CHAPTER 15

CARRY OVER AND LIMITATION OF CORPORATE TAX ATTRIBUTES

SECTION 1. CARRY OVER OF TAX ATTRIBUTES

Page 797:

Replace the second full paragraph with the following:

As amended in 2014, Treas.Reg. § 1.381(a)-1(b)(2) provides that for purposes of determining the corporation that succeeds to the target corporation's tax attributes, including earnings and profits, in a tax-free reorganization, the acquiring corporation is the corporation that, pursuant to the plan of reorganization, directly acquires the assets transferred by the transferor corporation, even if that corporation ultimately retains none of the assets so transferred. According to the preamble to the proposed regulations (which were largely unchanged when finalized):

> The [prior] regulations under section 381 yield an identical result, except when a single controlled subsidiary of the direct transferee corporation acquires all of the assets transferred by the transferor

> corporation pursuant to a plan of reorganization. In that case, the [prior] regulations treat the subsidiary as the acquiring corporation, a result that effectively permits a taxpayer to choose the location of a transferor corporation's attributes by causing the direct transferee corporation either to retain or not to retain a single asset. The IRS and the Treasury Department believe the [amended provision] produces more appropriate results because it . . . eliminate[s] this electivity.

Acquiring Corporation for Purposes of Section 381, 79 F.R. 26190 (May 7, 2014).

Page 797:

After the first sentence of the paragraph that carries over to page 798, add the following:

Section 172(a) now provides that a net operating loss carryforward is allowed to create a deduction in the carryforward year in an amount equal to the lesser of the aggregate of the net operating loss carryovers or 80 percent of taxable income in the carryforward year. Thus, a limitation is imposed within § 172(a) on the amount of a net operating loss carryforward that can be used to only eighty percent of the corporaton's taxable income before the allowance of the net operating loss carryforward. Section 382 also imposes a limitation on the use of tax attributes after an ownership change. Although an explicit ordering rule is not provided, it would seem that the taxpayer should subject its net operating losses to the limits afforded under Section 172(a) first and then should apply the further limitation on the usage of a net operating loss under § 382 thereafter.

In addition, § 172(b)(1) provides that the net operating loss carryforward can be carried forward indefinitely, but in a change from prior law the net operating can no longer be carried back. The inability to carryback a net operating loss curtails the ameliorative effects of the net operating loss provisions in a fact pattern where the corporation has income and then sustains losses during the trough of the business cycle.