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Memorandum

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subject: Tax-Exempt Income Under § 1366(a)

This advice responds to your request for assistance in responding to a position taken by taxpayers on a case currently in Appeals. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice may not be used or cited as precedent.

ISSUE

Whether, upon the election by an S corporation to treat its wholly owned subsidiary as a qualified subchapter S subsidiary (QSub), the shareholders of the S corporation increase their stock bases under § 1367(a)(1)(A) by the amount of the S corporation's built-in gain in the stock of the subsidiary as a result of the subsidiary's deemed liquidation under § 332?

CONCLUSION

A QSub election and the resulting deemed § 332 liquidation do not give rise to an item of income under § 1366(a)(1)(A), and, therefore, do not increase the electing S corporation shareholders' stock bases under § 1367(a)(1)(A).

FACTS

In , electing small business trusts (Taxpayers), created for the benefit of various members of a family formed corporation (Parent), elected S corporation status for Parent. Also during , Taxpayers contributed to Parent all of the shares of a C corporation they had previously owned outright (Sub).

On , Parent filed an election to treat Sub as a QSub retroactive to . Such election is treated as a deemed liquidation of Sub into Parent. At the time of the QSub election, the Taxpayers' combined basis in Parent's stock was approximately $, Parent's basis in Sub's stock was close to zero, and the approximate fair market value of Sub's stock was $.

One day after filing the QSub election for Sub, Parent and Taxpayers signed a letter of intent to sell Parent's stock to (Purchaser), contingent on the parties' obtaining various regulatory approvals. Six months later, Taxpayers sold all of Parent's stock to affiliates of Purchaser in exchange for a combination of notes, stock, and $ cash. In total, Taxpayers received consideration worth approximately $ for their stock in Parent.

Taxpayers take the position that the QSub election for Sub increased their bases in Parent's stock under § 1367(a)(1)(A) by $, the amount by which the value of the Sub's stock exceeded its basis, and that therefore they recognized a loss rather than a gain on the sale of their Parent stock to Purchaser. Taxpayers' theory is that the nonrecognized gain on the Sub stock at the time of the deemed liquidation caused by the QSub election produced an item of income under § 1366(a)(1), notwithstanding that no gain was recognized in the § 332 liquidation.

LAW AND ANALYSIS

I. Law

Section 61(a) and (a)(3) provide that, except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including, among other items, gains derived from dealings in property.

Section 331(a) provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. Section 331(c) cross-references § 1001 for purposes of determining the amount of gain or loss recognized.

Section 332 provides generally that no gain or loss is recognized by a parent corporation on property distributed in complete liquidation of a subsidiary whose ownership by the parent meets the 80 percent test of § 1504(a)(2) (both 80 percent of the total voting power of the corporation's stock and 80 percent of the total value of the corporation's stock).

Section 336(a) provides generally that a liquidating corporation must recognize gain or loss on the distribution of its property as if the property was sold to its distributee at its fair market value. However, § 337(a) provides that no gain or loss is recognized to the liquidating corporation on the distribution to the 80 percent distributee (i.e., the parent) of any property in a § 332 liquidation.

Section 334(b) provides that the basis of property received by a corporate distributee in a distribution in a complete liquidation to which § 332 applies has the same basis in the hands of the distributee as it would have in the hands of the transferor, subject to certain exceptions. Section 381(a)(1) provides that the parent corporation in a § 332 liquidation succeeds to and takes into account the subsidiary's tax attributes listed in § 381(c).

Section 1001 provides rules for determining gain or loss on sales or other dispositions of property. Section 1001(a) provides the general rule that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1001(c) provides that, except as otherwise provided in Subtitle A of the Internal Revenue Code, the entire amount of gain or loss that is determined under § 1001 on the sale or exchange of property shall be recognized.

Section 1.1002-1(c) of the Income Tax Regulations provides that exceptions to the general rule in § 1001(a) (requiring recognition of gain or loss realized upon the sale or exchange of property) are made, for example, by §§ 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035, and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

Section 1361(b)(3) provides that an S corporation may elect to treat a 100 percent owned subsidiary meeting certain requirements as a qualified subchapter S subsidiary (a QSub), in which case the QSub will not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the subsidiary will be treated as assets, liabilities, and tax items of the S corporation.

Section 1.1361-4(a)(2) provides that an S corporation's QSub election for a subsidiary results in the deemed liquidation of the subsidiary into the S corporation, with its tax treatment determined under the Code and general principles of tax law, including the step transaction doctrine.

Section 1366(a)(1) provides that an S corporation shareholder's tax liability is determined by taking into account the shareholder's pro rata share of the corporation's
(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
(B) nonseparately computed income or loss.

Section 1.1366-1(a)(2) provides that each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately.

Section 1.1366-1(a)(2)(viii) provides that, for purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. For example, income that is excludible from gross income under § 101 (certain death benefits) or § 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under § 108 (income from discharge of indebtedness) or § 109 (improvements by lessee on lessor's property) is not tax-exempt income.

Section 1367(a)(1)(A) provides that a shareholder's basis in the stock of an S corporation is increased by the items of income described in § 1366(a)(1)(A), and § 1367(a)(1)(B) provides that a shareholder's basis is increased by any nonseparately computed income determined under § 1366(a)(1)(B).

In Gitlitz v. Commissioner, 531 U.S. 206 (2001) (Gitlitz), the Supreme Court held that cancellation of indebtedness (COD) income excludible under § 108 is an "item of income" that increases an S corporation shareholder's stock basis under § 1367(a)(1)(A). The Court rejected the Service's argument that COD income under § 108 is not an "item of income," noting that § 61(a)(12) lists COD income among the items of gross income and § 108 is an exception to § 61(a)(12). The Court also rejected the argument that COD income excluded under § 108 was "tax deferred" rather than "tax-exempt" because tax attributes must be reduced by that income; rather, the Court held that § 1366(a)(1)(A) is worded broadly enough to include income, even tax-deferred income, that could affect the liability for tax of any shareholder. The specific holding in Gitlitz regarding the § 108 exclusion was overruled by Congress in the Job Creation and Worker Assistance Act of 2002, which amended § 108(d)(7)(A). Additionally, during 1991, the tax year at issue in Gitlitz, the § 1366 regulations did not contain the definition of "tax-exempt income" in § 1.1366-1(a)(2)(viii); that definition was added in 1999.

II. Legislative Purpose of §§ 1366, 1367 and 332

In applying the provisions of §§ 1366, 1367, and 332, it is essential to understand the statutes' roles in the subchapter S regime and the nature of a § 332 liquidation in the subchapter C regime.

A. Subchapter S

A corporation electing to be taxed under subchapter S is not generally subject to tax at the corporate level. Instead, the S corporation passes through its items of income, loss, deduction, and credit to its shareholders, who are subject to tax on their allocable share of these items regardless of whether the corporation makes any distributions to its shareholders. Distributions to S corporation shareholders are generally not subject to tax by application of the provisions of § 1368.

Sections 1366 and 1367 operate together to preserve single-level taxation. Section 1366 provides for the pass through of tax items to S corporation shareholders, who must include those items in their individual income. Then, in order to ensure the shareholders are subject only to that shareholder level tax, § 1367 provides for adjustments to the shareholders' stock bases to reflect the items passed through under § 1366. Specifically, § 1367 provides that a shareholder's basis is increased by the amount of income that is passed through to the shareholder, and decreased by the amount of losses and deductions that are passed through, as well as by the amount of any distributions to the shareholder that were not includible in the shareholder's income by reason of § 1368. Thus, in the case of taxable income, a basis increase is necessary to ensure that only one tax is paid on that income. In the case of tax-exempt income, such as interest on state and local bonds exempt from tax under § 103, in order to preserve the tax-exempt character of the income, a basis increase is necessary to prevent any tax from ever being imposed on that income.

B. Subchapter C

In Subchapter C, § 332 applies to a liquidation of a subsidiary into its parent corporation, a transaction that combines two commonly-owned corporate entities into one. This section was originally enacted with the purpose of allowing the simplification of complex corporate structures by permitting the liquidation of unnecessary subsidiaries without the recognition of gain. See Message of President Roosevelt to Congress dated June 19, 1935, reprinted in S. Rep. No. 74-1240, 74th Cong., 1st Sess. 4 (1935); and Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 10.20 (2009). The statutory regime provided by § 332, together with §§ 334(b), 337 and 381, essentially allows a corporate parent to reverse the effects of a prior tax-free § 351 transaction. Section 332 reflects Congress's belief that the complete liquidation of a subsidiary effects a change in form rather than a change in substance and thus should be tax neutral. See Bittker & Eustice, supra.

When enacting the 1954 Code, Congress continued the rules in the predecessor of § 332. See Senate Rep. No. 1622, 83rd Cong., 2d Sess. 255-56 (1954). The legislative history of the Tax

Reform Act of 1986, which continued the § 332 rules on tax-free liquidations, explains that "the property (together with the other attributes of the liquidated subsidiary) is retained within the economic unit of the affiliated group" and that because "such an intercorporate transfer within the group is a nonrecognition event, carryover basis follows. . . . [T]he corporate-level tax will be paid if the distributed property is disposed of by the recipient corporation to a person outside the group." Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-202 (1986).

In order to effect such a simplification of corporate structures in a tax neutral manner, Congress created a statutory framework which provides that (i) under § 332, no gain or loss is recognized by the parent on property distributed to it in liquidation, (ii) under § 334(b) the parent takes the subsidiary's assets with a carryover basis, and (iii) under § 381 the parent succeeds to the subsidiary's tax attributes. The subsidiary stock is canceled and, as a necessary corollary, the basis in that stock also disappears. The net effect of these provisions is to eliminate from the tax system the subsidiary stock and its basis, and thus any potential gain or loss in the stock, because such gain or loss can never result in economic gain that enriches the parent corporation. Because the parent receives the assets with a carryover basis, not a fair market value basis, the appreciation in the assets will be recognized by the parent when the assets are sold.

III. Analysis

A. Taxpayers' position

Taxpayers' argument contains two parts: first, that §§ 61(a)(3) and 331(a) apply to the QSub election/deemed liquidation to produce an item of income within the meaning of § 1366(a)(1)(A), and second, that the income is tax-exempt by application of § 332. Taxpayers conclude further that the gain on the Sub stock deemed exchanged for the deemed liquidation proceeds falls within § 1.1366-1(a)(2)(viii)'s definition of "tax-exempt income" because § 332's nonrecognition provision causes a permanent exclusion of that income. However, Taxpayers contend that it is not necessary to determine whether or not the stock gain constitutes "tax-exempt income" within the regulation's definition, because that gain is clearly an "item of income" by application of §§ 61(a)(3) and 331(a) to the QSub election, and characterization of the deemed liquidation proceeds as income is sufficient under § 1366(a)(1)(A) to increase Taxpayers' basis in Parent.

Taxpayers rely heavily on the Supreme Court's opinion in Gitlitz, which concerned a taxable year that predated the promulgation of § 1.1366-1(a)(2)(viii). In Gitlitz, the Court held that "discharge of indebtedness of an insolvent S corporation is an item of income for purposes of § 1366(a)(1)(A)," notwithstanding § 108's application to prevent recognition of that income during the year at issue. 531 U.S. at 216. In arriving at this conclusion, the Court rejected the Commissioner's argument that § 1366(a) applies to "tax-exempt income," but not "tax-deferred income," and instead adopted a broad interpretation of § 1366:

> Section 1366 applies to "items of income." This section expressly includes "tax-exempt" income, but this inclusion does not mean that the statute must therefore exclude "tax-deferred" income. The section is worded broadly enough to include

> any item of income, even tax-deferred income, that "could affect the liability for tax of any shareholder." § 1366(a)(1)(A).

Id.

B. Service's Position

Taxpayers' position is incorrect, and their reliance on Gitlitz is misplaced.

1. Because the Code does not define "income" or "item of income," we must look to § 332 to determine whether a liquidation of a subsidiary into its parent generates income that should be taxed. The legislative history of § 332 makes clear that a § 332 liquidation changes only the form of property ownership and, therefore, provides no § 1366 item of income.

While the Code defines "gross income" and "taxable income," the more basic concept of "income" or "item of income" is not defined in the Code. The Supreme Court has acknowledged the difficulty in crafting a single definition that would be equally relevant to all contexts. See, e.g., Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); United States v. Kirby Lumber Co., 284 U.S. 1 (1931); and Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918). While the exact issue raised by the Taxpayers has not been previously addressed, there are Supreme Court opinions that provide guidance on this issue. For instance, in Commissioner v. Glenshaw Glass Co., the Supreme Court held that punitive damages awarded in private antitrust actions are taxable income. In so ruling, the Court broadened its earlier definitions of gross income to encompass "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Glenshaw Glass, 348 U.S. at 431. See also United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (corporation had income when it retired its own bonds for less than their issue price); and Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918) (income includes profit gained through a sale or conversion of capital assets). In more recent cases, the Supreme Court has described the definition of gross income as extending "broadly to all economic gains not otherwise exempted." Commissioner v. Banks, 543 U.S. 426, 433 (2005) (finding that a litigant's income includes the portion of the recovery paid to an attorney as a contingent fee). See also Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 209 (1990) (finding deposits to electric company are not income subject to federal income tax upon receipt). Given the lack of a statutory definition of "income" or "item of income" that controls in all contexts and the Court's acknowledged difficulty in fashioning such a definition, it is necessary to examine the legislative history of the provision in question to ascertain whether, in a given case, an instance of undeniable accession to wealth has been clearly realized and should be taxed.

The legislative history of § 332, discussed in section II (B) above, indicates that liquidations governed by that provision are nonrecognition transactions that simply effect a change in the form of owning property and do not produce an accession to wealth that should be taxed. Nonrecognition provisions differ from income exclusion provisions such as § 103 (excluded state and local bond interest) and § 108(a) (excluded COD income) because they represent changes in the form of owning property and a continuation of an investment rather than the receipt of pecuniary economic benefit. As § 1.1002-1(c) describes, the policy of the Code's nonrecognition

provisions is to distinguish formal changes from economic ones, and to impose a tax only on economically meaningful events:

> These sections [for example, §§ 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035, and 1036] describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

Section 332 illustrates the policies described in § 1.1002-1(c). Section 332 allows a parent corporation owning 80 percent or more of the stock of a subsidiary to change the form of owning the business of the subsidiary without a taxable recognition event. When a parent corporation liquidates a subsidiary, the parent switches from owning the stock of the subsidiary (which is an indirect interest in the subsidiary's assets) to owning the subsidiary's assets directly. By liquidating the subsidiary in form, the parent still continues its investment in the subsidiary's business as an economic matter. The parent's direct ownership of the assets after the transaction continues what was previously the parent's indirect ownership of the assets through the subsidiary's stock. The transaction is a change in form that adds no value to the parent; there is no accession to wealth.

When a business receives $100 in tax-exempt bond interest, it is economically wealthier by $100 and it is appropriate to treat it as tax-exempt income. Also, when a business has a loan forgiven and realizes $100 of COD income excluded under § 108(a) (the type of income at issue in Gitlitz), the business will have its debt reduced by $100 and its financial position is improved by the forgiveness. However, when a wholly-owned subsidiary with a potential gain in its stock of $100 is combined with its parent, the overall business is no wealthier, nor will the $100 ever enrich the business. After the liquidation, the parent may sell the subsidiary's assets (as the subsidiary also could have done), but it may no longer sell the subsidiary's stock and therefore cannot realize that $100 of income. The $100 potential gain has disappeared.

Congress clearly viewed a § 332 transaction as a tax-free simplification of a corporate structure and did not believe that it produces income by itself. The legislative history to § 332 gives no indication that Congress intended the nonrecognition of gain on the subsidiary stock (whose basis disappears) to be an income item. Instead, Congress intended that gain may be produced later, when the assets distributed in the § 332 liquidation are disposed of by the parent outside the affiliated group. Conf. Rep. No. 99-841, supra. Based on the legislative history, it is unlikely that Congress would have intended for nonrecognized gain from a § 332 transaction to produce income for purposes of § 1366. This conclusion is consistent with the Supreme Court's analysis of the scope of gross income, which looks to "instances of undeniable accessions to wealth" and has considered so much as "all economic gains not otherwise exempted." See Glenshaw Glass,

348 U.S. at 431, and Banks, 543 U.S. at 433. Even if we were to apply these broad definitions of gross income to the § 1366(a)(1)(A) term "items of income," the § 332 liquidation of a subsidiary into the parent would not produce income to the parent under § 1366, because such a liquidation changes only the form of property ownership, and the continuing investment provides no accession to wealth, no economic benefit, and thus no § 1366 item of income – "tax-exempt" or otherwise.

The earnings and profits system for subchapter C corporations also supports this interpretation of § 332. For subchapter C corporations, earnings and profits (E & P) are the amount of corporate earnings that are taxable to the shareholders as dividends. Under § 1.312-6, which defines E & P, interest on state bonds, although not taxable at the corporate level, is included in E & P. However, § 312(f)(1) states that gain on the sale or other disposition of property increases E & P only to the extent it is recognized in computing taxable income under applicable tax law. Therefore, gains not recognized under § 332 and other nonrecognition provisions are not included when computing earnings and profits.

2. Taxpayers' reliance on Gitlitz is misplaced because Gitlitz involved cancellation of indebtedness income, which produces a clear accession to wealth. Applying Gitlitz to this case – where there is no accession to wealth – would produce a result inconsistent with general principles of statutory construction.

The Taxpayers would have us focus on Gitlitz, in which the Supreme Court held that COD income excluded from gross income under § 108 is an "item of income" that increases an S corporation shareholder's stock basis under § 1367(a)(1)(A). However, the Court's decision in Gitlitz concerned the § 108 exclusion of cancellation of indebtedness income, an item that produces a clear accession of wealth to a taxpayer that has been relieved of a debt. Such is hardly the case here. Because the stock gain not recognized under § 332 disappears, allowing a basis step-up for this gain is uneconomic and creates "phantom" basis. This basis step-up would be possible only because the business is organized as a parent and a subsidiary before the § 332 liquidation; it would not be available if the same business assets were in a single corporation. Taxpayers' position would allow an S corporation to create phantom basis by forming a subsidiary and later liquidating it (or making a QSub election), and this phantom basis could be multiplied by creating additional lower-tier subsidiaries and also liquidating them. Such a result is clearly not contemplated by the reference to "tax-exempt income" in § 1366(a)(1)(A), and Taxpayers' attempt to interpret the statute in a manner that could produce an absurd result is inconsistent with general principles of statutory construction. See Specking v. Commissioner, 117 T.C. 95, 107 (2001), aff'd sub nom. and by Umback v. Commissioner, 357 F.3d 1108 (10th Cir. 2003) , aff'd sub nom. without opinion, 2003-2 USTC ¶ 50,626 (9th Cir. 2003) ("we do not examine the statutory provision in isolation; rather, guided by common sense, we consider the provision in context, with a view to its place in the overall statutory scheme").

In Nathel v. Commissioner, 131 T.C. 262 (2008), aff'd, 615 F.3d 83 (2d Cir. 2010), the Tax Court rejected a taxpayer's attempt to apply Gitlitz broadly to extend the definition of "income" under § 1366(a)(1). In Nathel, the taxpayers, shareholders in an S corporation, argued that their basis in the S corporation's indebtedness was increased under § 1367(b)(2) because their capital

contributions constituted tax-exempt income within the scope of § 1366(a)(1)(A).[1] The taxpayers argued that, because § 118 excluded the capital contributions from the S corporation's gross income in all circumstances, the contributions were "permanently excludible" and therefore "tax-exempt income" within the definition set forth in § 1.1366-1(a)(2)(viii). The taxpayers then cited Gitlitz in support of their proposition that an exclusion from income under § 118 would not be necessary were the capital contributions not otherwise income, and therefore the contributions must be regarded as items of income.

The Tax Court rejected the taxpayers' argument to apply Gitlitz to capital contributions, because, in the court's opinion, doing so would undermine "cardinal and longstanding principles of tax law." 131 T.C. No. 17 at 5. These principles included a distinction between the tax treatment of debt and equity in a corporation, and the proposition that a contribution to a corporation's capital is not income to the corporation. The court found Gitlitz distinguishable because discharge of indebtedness income is specifically included in gross income under § 61(a)(12), whereas the regulations under § 118 provide specifically that capital contributions to a corporation do not constitute income. In affirming the Tax Court's opinion under substantially the same theory, the Second Circuit rejected the taxpayer's interpretation of Gitlitz as requiring that any item excluded by the Code from income was necessarily an "item of income," stating, "Gitlitz did not create any new items of income. Gitlitz only held that the nature of discharge of indebtedness income was not changed by the exclusion in § 108(a)." No. 09-1955-ag, slip op. at 19.

Although the issues in Nathel are different from the issues in this case, Nathel indicates that courts are reluctant to apply Gitlitz broadly. In particular, it indicates that a court would likely be reluctant to apply Gitlitz when the claimed basis step-up for an asserted item of "tax-exempt income" produces an absurd result, and, as in this case, when a taxpayer's position undermines "cardinal and longstanding principles of tax law," such as the principle that a liquidation of a subsidiary into its parent is a change in form that does not result in the economic recognition of gain.

3. Congress intended that § 332 provide a timing benefit and not a permanent exclusion from income. Taxpayers' position would frustrate the Congressional purpose underlying both § 332 and § 1374.

It is also clear from the legislative history of § 332 that Congress believed it was providing a timing benefit (a delay in taxing the gain on appreciated assets of the liquidated subsidiary) and not a permanent exclusion from income. Taxpayers' position would, in many cases, result in a permanent exclusion and not just a timing benefit, a result that Congress did not intend. For example, suppose that an S corporation formed a C corporation subsidiary and contributed to it $1 million. The C corporation's business is successful and its value increases to $10 million, which includes assets worth $ 4 million that the C corporation holds at a basis of $2 million. Then the C corporation subsidiary is liquidated (or a QSub election is made). Later, the S corporation parent distributes $9 million of assets to its shareholders, including the assets with the $2 million

[1] The IRS determined that the contributions did increase the shareholders' stock basis, and therefore the shareholders' basis in the S corporation's stock was not at issue in Nathel.

built-in gain. Under § 311, the $2 million gain is recognized on the distribution and passed through to the shareholders as gains. However, under Taxpayers' theory, the shareholders would have increased their stock basis by $9 million on the liquidation, which could reduce or eliminate tax on the subsequent asset distribution under the § 1368 rules, reduce gain or create loss on the eventual sale of their stock, or claim a greater share of passed through losses (including prior year suspended losses). These tax benefits would offset the tax paid by the shareholders under § 311, so that the $2 million gain would not just be deferred, but effectively eliminated.

Taxpayers' position would similarly allow avoidance of tax on gain that must be recognized by the S corporation under § 1374. In order to prevent a C corporation from avoiding corporate-level tax on asset sales by converting to an S corporation, § 1374 taxes the S corporation (at the corporate level) on certain "net recognized built-in gains" on assets of the former C corporation sold within 10 years (7 years for certain gains recognized in 2009 or 2010) of the C-to-S conversion. Because a carryover-basis asset acquisition from a C corporation (including a § 332 liquidation) also could avoid corporate-level gain for the acquired assets, § 1374(d)(8) applies the § 1374 corporate-level tax rules to the former C corporation assets, with the gain recognition period beginning on the day the S corporation acquires the assets. In addition to the corporate-level tax, the gains also pass through and are recognized by the shareholders under § 1366 and offset by a loss under § 1366(f)(2) in the amount of the § 1374 tax.

Assume that an S corporation liquidates its subsidiary C corporation and that the subsidiary's stock had a potential gain of $1.5 million, and its assets had a potential gain of $1 million. Under § 1374(d)(8), the subsidiary's asset gains will be recognized at the corporate level if the parent S corporation sells the assets and realizes the gains within 10 (or 7) years of acquiring the assets in the deemed liquidation. In this case, the $1 million gain should be recognized by the parent on the sale of the assets under § 1374, and the $1 million should pass through to the parent's shareholders along with the §1374 tax paid by the parent. However, under Taxpayers' theory, the shareholders would increase their stock basis by $1.5 million, which could reduce or eliminate tax on a distribution under § 1368, reduce or eliminate gain on the eventual sale of their stock, or claim additional passed through losses. These tax benefits would offset the burden of the corporate-level § 1374 tax, which would defeat the purpose of Congress to require a two-level tax on the former C corporation asset gains.[2]

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[2] We recognize that this concern about § 1374 does not apply in the case at hand because

However, our concern could apply to other cases (for example, if the corporation retained S status after its stock was sold to eligible S corporation shareholders, and the sellers claimed a basis step-up for a § 332 liquidation).