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Nondocketed Case Advice
Post Termination Transition Distributions
from an "S" Corporation

This memorandum responds to your request for advice in connection with the treatment of distributions made by a corporation which changed its status from an "S" corporation to a "C" corporation. This memorandum should not be cited as precedent.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

1. Does the issuance of notes by a corporation constitute non-taxable cash post termination distributions under I.R.C. §1371(e), or are such notes taxable dividends to the extent of the corporation's earnings and profits?

2. If the notes are to be treated as dividends, what would be the effect of the interest deducted by the corporation with respect to those notes payable?

FACTS

A Schedule "C" corporation (the acquiring corporation) which was 100% family owned decided to acquire another corporation. This same family owned the second corporation (the acquired corporation), which began as a Schedule "C" corporation, but

which elected Subchapter "S" status on [REDACTED]. The "S" corporation had earnings and profits and maintained an accumulated adjustments account (hereinafter "AAA"). On [REDACTED], the "S" corporation declared distributions payable from its AAA not to exceed \$ [REDACTED]. On that same date, the "S" corporation issued notes to its shareholders totaling \$ [REDACTED]. These notes were to be paid over an [REDACTED] year period and bore interest at [REDACTED] % annually. Also on that same date, the "S" corporation terminated its Subchapter "S" election.

On [REDACTED] (the next day), the acquiring "C" corporation and the acquired "C" corporation (the former "S" corporation) entered into a Contribution Agreement which provided for an exchange of stock pursuant to I.R.C. §351. Following that exchange, during the year [REDACTED] the acquired "C" corporation paid \$ [REDACTED] as principal and interest to its shareholders on the notes which it had issued just prior to the termination of its Subchapter "S" status.

The questions which you have raised concern whether the issuance of the notes and the amounts paid on the notes should be treated as non-taxable post termination transition distributions or whether they should be treated as taxable dividends to the shareholders.

DISCUSSION

Code §§1361 and 1362 provide for the creation of small business corporations upon the election of the taxpayer. Under §§1363 and 1366, such "S" corporations are not subject to regular corporate taxation; instead, their income is passed through to their shareholders in much the same manner as partnership income passes through to partners. §1367 provides for basis adjustments in each shareholder's stock for items of income or loss. §1368 deals with distributions made by an "S" corporation. This section also provides for an accumulated adjustments account, which is essentially the amount of earnings and profits of the "S" corporation upon which the shareholders have been taxed, but which has not been distributed to them by the corporation. This section sets forth the treatment of distributions made by "S" corporations which do not have earnings and profits and by those that do have earnings and profits. For an "S" corporation that has earnings and profits, the portion of the distribution to its shareholders that does not exceed the accumulated adjustments account is not includable in their gross income, but instead reduces their basis in the corporation's stock.

Under the law prior to the Subchapter "S" Revision Act of 1982, an "S" corporation that had terminated its "S" election was allowed to distribute its undistributed taxable income (UTI) within 2 months and 15 days after the end of its last year as an "S" corporation. The distribution of UTI reduced the shareholder's basis and was not included in gross income. However, an effective distribution of UTI had to be a cash distribution. A distribution of property, including a corporate obligation, was considered to be a taxable dividend.

Under current law, while a corporation's "S" election is in effect, it can make a distribution of cash or other property from its AAA, which is basically the same as the former UTI. §1371(e) provides that any distribution of money by a corporation with respect to its stock during a post-termination transition period reduces the adjusted basis of the shareholder's stock to the extent that the amount of the distribution does not exceed the AAA. §1377(b) replaced the earlier 2 months and 15 days post termination period of the old law with a period beginning on the first day after the last day of the "S" corporation's last year (or short period) as an "S" corporation and ending on the later of one year from that first day or the due date for filing the return for such last year (or short period) as an "S" corporation. The requirement that the distribution during the post termination transition period be in cash to avoid treatment as a taxable dividend remained under the new law.

CONCLUSIONS

The following conclusions are based solely upon the facts which you presented to us.

Your first question, whether the notes issued constituted cash post termination transition distributions or taxable dividends, assumes that the notes were issued during the post termination transition period. From the facts presented, the distribution of the notes occurred on [REDACTED] while the acquired corporation was still an "S" corporation. Distribution of a note may be treated as a distribution of property in the amount of the face value of the note if the note has adequately stated interest. Mertens Law of Federal Income Tax, §41B:182. Accordingly, the distribution of the notes was a non-taxable distribution to the extent that their value did not exceed the AAA, which reduced the shareholders' bases in their stock. As long as the indebtedness was valid, which it appears to be from

the information which you supplied to us¹, the shareholders should not be taxed on the distribution of the notes or on the subsequent principal payments on the notes as dividends. The interest which they received on the notes is interest income taxable under §61 and has no effect on the AAA or their bases.

Further support for this position is found in Zimco Electric Supply Co. v. Commissioner, T.C. Memo. 1971-215. In that case, the corporation terminated its "S" status on November 1, 1963 and issued a promissory note to its shareholder on January 4, 1964. The Commissioner asserted that the issuance of the note was a taxable dividend. The taxpayer argued that the loan was really made on October 31, 1963, the day before the "S" status was terminated, and that the issuance of the note on January 4, 1964 was a formality evidencing the previous indebtedness. The Tax Court held that the note was merely evidence of the indebtedness and that the distribution constituted a distribution of previously taxed income. The facts in the instant case are better for the taxpayer because the notes in our case were issued during the period when the corporation was still an "S" corporation.

Since we have concluded that the distribution of the notes and the subsequent payments are not taxable as dividends, your second question, concerning the effect of dividend treatment on the interest deductions claimed by the corporation on the notes, is moot. Under the facts presented, the interest is an allowable deduction as claimed.

If you have any questions concerning this memorandum, please call Attorney John E. Becker, Jr. at 215-597-3442. Our advice is subject to the Office of Chief Counsel's ten day post-review procedures. If the Office of Chief Counsel alters or revises our advice they will contact us within ten working days from their receipt of our advice.

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cc: Senior Legal Counsel (HQ) Harve M. Lewis
Associate Area Counsel (PFTG) Michael P. Corrado
Associate Chief Counsel (Procedure and Administration)
Technical Services Section

¹ You should check to see if the █ stated interest rate equals or exceeds the applicable Federal interest rate.