The Third Circuit Looks At Basis Adjustments and Q-Sub Elections, Part I.

An S Corporation is a pass-through entity. Under Section 1366 of the Internal Revenue Code, its shareholders are taxed on their pro rata shares of its income. When an S Corporation makes a distribution to its shareholders, the tax treatment of that distribution will initially depend upon whether the corporation has accumulated earnings and profits (in which case some or all of the distribution is treated as a dividend). I.R.C. § 1368(c). To the extent that a distribution is not a dividend then it is only taxable to the extent that it exceeds the shareholder's basis in the S Corporation stock. I.R.C. § 1368(b). Each stockholder's basis is subject to adjustment under Section 1367, with income items increasing basis and losses or non-taxable distributions reducing it.

While these rules sound straightforward, their application can get tricky, particularly in more complex corporate structures. A recent Third Circuit case involving a qualified Subchapter S subsidiary or Q-Sub, demonstrates the potential for complexity. *See Ball v. Comm'r,* 2014 U.S. App. LEXIS 2594 (3d Cir. Feb. 12, 2014).

To understand *Ball,* a little background on Q-Subs is necessary. If an S Corporation owns 100% of the stock of another corporation, it may be able to elect to treat that entity as a Q-Sub. I.R.C. § 1361(b)(3)(B). If the election is made, then for tax purposes, the separate existence of the Q-Sub is extinguished, and all of its assets, income and other tax attributes are deemed to belong to the parent S Corporation. I.R.C. § 1361(b)(3)(A)(i), (ii). The result is a deemed liquidation that is governed by Section 332 of the Code, which means that no income or loss is recognized on the transaction. *Ball* focused on whether the deemed liquidation that results from a Q-Sub election triggers an adjustment in the basis of the stockholders of the parent S Corporation.

The case involved as series of transactions. In 1999, a group of trusts that owned all the shares of American Insurance Service, Inc. ("AIS") set up an S Corporation, Wind River, contributing the shares of AIS that they held, which were then worth approximately $5.6 million, and receiving 100% of Wind River's common stock in exchange. 2014 U.S. App. LEXIS 2594, slip. op. at *3-*4. In February 2003, Wind River elected to treat AIS as a Q-Sub; at that point the Trusts had a total adjusted basis of approximately $15.25 million. *Id.,* slip op. at *5. Based upon the deemed liquidation of AIS, each of the Trusts adjusted its basis in its Wind River holdings to reflect the fair market value of the assets of AIS at the time of the deemed liquidation, which increased their aggregate basis to $242,481,544. *Id.,* slip op. at *5 & n. 7.

In September 2003, the Trusts sold their interests in Wind River to a third party, realizing a total of $230,111,857. Since this was less than their adjusted basis, the Trusts filed returns that claimed an aggregate loss of $12,247,229, reflecting the difference between the amount realized from the sale of Wind River and their aggregate adjusted basis. *Id.,* slip op. at *5-*6.

The IRS took a different view, determining that the Trusts should not have adjusted their basis in the Wind River shares following the Q-Sub election; as a consequence, the sale of Wind River was treated as generating a capital gain of approximately $214 million and the Trusts were assessed with a large tax deficiency.

The case reached the Court of Appeals after the Tax Court had ruled against the Trusts and sustained the government's position that the basis adjustment following the Q-Sub election was improper. The Third Circuit sustained the government's position as well. I will walk through its analysis in a separate post.