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S Corporation Acquisitions Under Sections 332 and 338

by Robert W. Wood • Bancroft & McAlister

In the absence of reform legislation that would make the increasingly popular S corporation vehicle eligible for more flexible acquisition techniques, practitioners have long had to gerrymander transactions in order not to run afoul of the restrictions applicable to such corporations. Fortunately, the IRS has now issued *Ltr. Rul.* 9245004, which creates an opportunity for S corporations to engage in Section 338 and 332 transactions.

In the ruling, Target was a C corporation using the first in, first out

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(“FIFO”) inventory method. Target was owned 60% by X, a wholly owned subsidiary of W; 33% by Y, an unrelated corporation; and 7% by S, an S corporation owned by an individual. S purchased all the Target shares owned by X and Y, thus becoming the 100% owner of Target. Immediately thereafter, S caused Target to dissolve and distribute all of its assets to S. Then, the name of S was changed to New Target.

Qualified Stock Purchase

The technical glitch with such a transaction is the rule under Section 1371(a) that an S corporation is treated as an individual for purposes of Sections 338 and 332. After an exhaustive analysis of the legislative history of Section 1371 and its interaction

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with Subchapter C, the Service concluded that Congress did not intend to prevent S corporations from making qualified stock purchases under Section 338 or receiving property in Section 332 liquidations. The ruling notes that the Service had previously concluded that Section 1371(a)(2) does not prevent an S corporation that momentarily holds the stock of a controlled or acquiring corporation from engaging in a divisive reorganization under Sections 368(a)(1)(D) and 355. The ruling concludes that the same flexibility should be applied to Section 338 and 332 transactions.

S Election Remains

The ruling also explicitly addresses the question of whether S's purchase of the Target stock, followed by Target's immediate liquidation, terminates the S election. The S eligibility provisions (Section 1361) prevent a corporation from electing S status if it qualifies as a member of an affiliated group. Relying on *Rev. Rul. 72-320*, 1972-1 CB 270, the Service concluded that the momentary ownership of the Target stock did not terminate the acquiring corporation's S election.

The bottom line of this sensible ruling is that S corporations can now make qualified stock purchases under Section 338, and actually liquidate the target under Section 332. ■

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