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In this report, Cannon explains why tax years matter, and he discusses relevant tax-year-end rules that advisers must master.

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In many mergers and acquisitions transactions, the tax year of the target entity will come to a close in connection with the transaction. The rules that govern whether and when (for example, beginning of day or end of day) are complex (resembling a patchwork quilt) and frequently not intuitive. Yet tax advisers to M&A participants must be well versed in these technical rules to properly advise their clients, both as it concerns the substantive consequences of the transaction (for example, will income from the date of closing be reported on the seller's consolidated return or be reported on a stand-alone return?) and the provisions of a purchase and sale agreement (for example, whether restrictions on post-closing buyer actions on the closing date should be built into the agreement).

I. Tax Year-Ends — Background

Accounting periods are one of the primary building blocks of the U.S. federal income tax system.[1] They are almost always 12 months or fewer.[2] Many annual accounting periods correspond to calendar years, but some don't (for example, many taxpayers compute their annual income based on a fiscal year, such as April 1 of year 1 until March 31 of year 2).[3] Some transactions or events can lead to what is referred to as a "short" tax year,[4] which is basically an accounting period that does not last for the normal

[1] Section 441(a) ("Taxable income shall be computed on the basis of the taxpayer's taxable year.").

[2] *See* section 441(b). *But see* section 441(f) (providing for some taxpayers to elect a tax year consisting of 52-53 weeks); *see also* reg. section 1.441-1(a)(2) (stating that, subject to exceptions (*e.g.*, for 52-53-week tax years), a tax year may not cover more than 12 months).

[3] *See generally* section 441; *see also* section 7701(a)(23) ("The term 'taxable year' means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A. 'Taxable year' means, in the case of a return made for a fractional part of a year under the provisions of subtitle A or under regulations prescribed by the Secretary, the period for which such return is made."); reg. section 1.441-1(b)(5) (defining "fiscal year" as a period of 12 months ending on the final day of a month other than December). *But see, e.g.*, section 706(b)(1)(C) (imposing limitations on the tax year that a partnership can select).

[4] Section 443(a).

duration. Thus, for example, if a corporation was formed on October 1 and elected an annual accounting period corresponding to the calendar year, the year of its formation would be a short year (because the tax year would extend only from October 1 through December 31).[5] Similarly, if a corporation with a tax year corresponding to the calendar year liquidated on June 30 of year 2, it would have a short tax year running from January 1 through June 30.[6]

Tax periods (and, by extension, "short" tax periods) have several consequences. For example, tax return filing due dates generally turn on when the relevant accounting period ends.[7] Moreover, tax return filing due dates generally dictate when tax is due.[8] In the same vein, tax accounting periods dictate when a taxpayer is required to report the consequences of a transaction (for example, two calendar-year taxpayers might engage in substantively similar transactions, one on December 31 of year 1 and one on January 1 of year 2, but the results of those transactions would be reportable on tax returns for different years for the two taxpayers, despite occurring just one day apart).

Significantly, just like the formation of an entity or the termination of an entity, an M&A transaction can result in a short tax year. The existence (or lack thereof) of a short tax year for a target has many implications that are relevant to deal participants and their tax advisers. For example, as discussed further below, if a parent of a U.S. consolidated group sells a subsidiary to a buyer, the tax year of the subsidiary will end on the date of the acquisition (in particular, at the end of the day).[9] This rule applies even when the closing of such an M&A transaction occurs before the end of the day, meaning that transactions that occur after closing but on the closing date may need to be reported on the consolidated return of the seller. If seller's tax counsel fails to appreciate this fact and does not negotiate appropriate restrictions on post-closing activities, seller could end up with an unpleasant surprise.

Moreover, in a deal in which there is no short tax year (such as in a transaction in which one private equity fund (classified as a partnership for tax purposes) sells a corporate portfolio company to another private equity fund (also classified as a partnership for tax purposes)), tax advisers need to recognize that the tax period in which the closing occurs will straddle the closing date (meaning a portion of the tax period will be *before* the closing date, and a portion of the tax period will be *after* the closing date) for U.S. federal tax purposes. Transactional tax lawyers generally refer to those periods (including in purchase and sale agreements) as "straddle periods." Tax advisers need to make sure their clients are satisfied with what the purchase and sale agreement provides regarding matters such as apportionment of taxes (between the pre- and post-closing portions of the straddle period) for indemnification purposes (including the treatment of transaction expenses), allocation of responsibility for preparing the straddle period return (and responsibility for payment of taxes reflected on that return) and allocation of responsibility for straddle period tax contests (for example, audits and litigation).

II. Tax Year-End Minutiae

A. Introduction

The tax year-end implications of an M&A transaction turn on many factors, but none is more important than the U.S. federal income tax classification of the target. Thus, this report is organized into main headings by target type. Within each major heading, further nuances are presented, including discussion of how the tax

[5] Section 443(a)(2) ("A return for a period of less than 12 months . . . shall be made . . . when the taxpayer is in existence during only part of what would otherwise be his" tax year.).

[6] *Id.*

[7] *See generally* section 6072 (setting forth the rules related to return filing deadlines and tax year-ends).

[8] *See generally* section 6151(a).

[9] Reg. section 1.1502-76(b)(1)(ii)(A)(1).

classification of a buyer can affect the tax year-end consequences of the transaction and discussion of the effect of various special elections on these determinations.[10]

B. C Corporations

C corporations are subject to entity-level U.S. federal income tax on their income.[11] C corporations can be acquired in various ways, but the most straightforward one is a simple stock purchase for cash that is taxable to the selling shareholders.[12] The general rule (which, as discussed below, is subject to various exceptions) is that an acquisition of C corporation stock (whether that acquisition involves a purchase of all or only part of the stock) does not terminate the tax year of the target corporation.

As a practical matter, when the general rule described in the preceding sentence applies, the year of acquisition is generally a "straddle period" (with a portion of the tax period occurring before the purchase and a portion occurring after the purchase).[13] The general rule described in that sentence, however, is subject to several potential exceptions, depending on factors such as who the seller is, who the buyer is, and elections the buyer makes. Many of the most commonly encountered variations are described below.

1. Corporate seller disposes of consolidated sub; no section 336(e), 338(g), or 338(h)(10) election.

When the target corporation is being purchased from a corporate consolidated group (meaning that it is owned by one or more corporate sellers that are eligible to and do file a consolidated return[14]), the target's tax year ends in connection with the acquisition.[15] This rule is logical because it would not make sense for the results of the target's operations to continue to be reported on the consolidated return of the selling consolidated group after the target was no longer owned by the selling consolidated group. Under the consolidated return regulations, the target company is part of the selling consolidated group until the end of the closing date, and its short tax year begins the next day.[16]

[10] This report focuses on the types of regarded (for U.S. federal income tax purposes) entities that are most frequently bought and sold in M&A transactions: (1) corporations, (2) S corporations, (3) qualified subchapter S subsidiaries, and (4) partnerships. Entities that are disregarded for such tax purposes are also frequently bought and sold, but a disposition of a disregarded entity is treated (for U.S. federal income tax purposes) as a disposition of assets, which results in no end of a tax year. *Cf.* reg. section 301.7701-2(a) (third sentence). A discussion of the tax year-end rules that apply to non-U.S. targets is outside the scope of this report, as is a discussion of the rules applicable to tax-free reorganizations. *But see* section 381(b)(1) (explaining that except in the case of "F" reorganizations, in a reorganization transaction the tax year of the distributor or transferor corporation ends on the date of distribution or transfer).

[11] *See generally* section 11(a). Regulated investment companies and real estate investment trusts are C corporations that can eliminate their taxable income through dividends paid deductions.

[12] A reverse subsidiary merger (where a purchaser uses a transitory merger subsidiary that merges with and into the target corporation with the target corporation surviving) is generally treated the same (for U.S. federal income tax purposes) as a simple stock purchase. *See* Rev. Rul. 73-427, 1973-2 C.B. 301 (ruling that a taxable reverse subsidiary merger was treated as a stock acquisition for U.S. federal income tax purposes).

[13] As noted above, acquisition agreements generally include special provisions dealing with straddle periods.

[14] The consolidated return requirements are complex, but in general "includible corporations" that are "affiliated" are eligible to elect to file a consolidated tax return. *See* section 1504(a); reg. section 1.1502-75 (providing the rules related to electing to file a consolidated return). Section 1504 explains that most domestic corporations are "includible corporations," but does exclude several types of entities (*e.g.*, tax-exempt corporations, subchapter S corporations, REITs). *See* section 1504(b) (specifying the types of corporations that are excluded). Foreign corporations are generally not "includible corporations," see section 1504(b)(3), subject to narrow exceptions for Canadian and Mexican corporations, section 1504(d); Rev. Rul. 69-182, 1969-1 C.B. 218. "Includible corporations" are "affiliated" only when there is a common parent (itself an "includible corporation") that directly owns stock meeting the requirements of section 1504(a)(2) in at least one other "includible corporation." Stock ownership meets the requirements of section 1504(a)(2) when there is ownership of at least 80 percent of the total voting power and at least 80 percent of the total value of the stock of a corporation. For further discussion of the consolidated return rules, see Kevin A. Duvall et al., "Married or Just Living Together: The Consolidated vs. Separate Choice for Affiliated Groups," *Tax Notes*, Jan. 19, 2004, p. 379.

[15] *See* reg. section 1.1502-76(b)(1)(i) (explaining that a "consolidated return must include the common parent's items of income, gain, deduction, loss and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. If the consolidated return includes the items of a corporation for only a portion of its tax year determined without taking this section into account, items for the portion of the year not included in the consolidated return must be included in a separate return (including the consolidated return of another group).").

[16] *Id*. at reg. section 1.1502-76(b)(1)(ii)(A)(1).

Example 1: T has been a member of the consolidated group whose parent is X. P purchases 100 percent of T's stock on January 31 (with the closing occurring at 10 a.m.). T will be a member of the consolidated group whose parent is X through the end of the day on January 31, and its operations through the end of the closing date will be reported on the consolidated return of the group whose parent is X.[17]

2. Corporate seller disposes of a consolidated sub, section 338(g) election.

When a consolidated group disposes of a consolidated corporate subsidiary,[18] and the corporate buyer makes an election under section 338(g), this election does not impact the seller (or sellers), who are treated as selling their stock to the buyer on the closing date.[19] From the perspective of the buyer, however, the target (OldCo), is treated as having sold all its assets at the close of the acquisition date at fair market value in a single transaction to a different corporation (NewCo).[20] As a result of this deemed sale transaction, OldCo recognizes gain or loss on the disposition of all its assets. NewCo is treated as purchasing OldCo's assets at the beginning of the day after the acquisition date.[21]

In connection with a transaction of this type, the target's tax year ends at the end of the closing date (but, importantly, before the deemed sale transaction). The deemed sale transaction is reported on a separate return (and is the only item included on that return), and a new tax period begins the next day (or, if the target enters a buyer's consolidated group, the target joins the buyer's consolidated group at the beginning of the next day).[22]

Example 2: T is a member of a consolidated group whose parent is X. X is a calendar-year filer. P (the common parent of a different consolidated group) acquires T on January 31 (and T enters P's consolidated group). P makes a section 338(g) election for its acquisition of T. T is a member of X's consolidated group through the end of the acquisition date (that is, January 31), but the deemed asset sale resulting from the section 338(g) election is not reported on the consolidated return filed by X. Instead, the tax consequences of the deemed asset sale are reported on a short, stand-alone return for T covering a period that includes a portion of the acquisition date. The only items reported on that return are the results of the deemed asset sale. T enters the P consolidated group on February 1 (and the results of its operations starting on that day are reported on the P consolidated return).

3. Noncorporate seller sells corporation to corporate buyer, section 338(g) election.

When a noncorporate seller sells a target corporation to a corporate buyer (which may either be an S corporation or a C corporation) and the corporate buyer makes a section 338(g) election,[23] the election does not affect the seller (or sellers), who are treated as selling their stock to the buyer on the closing date.[24] From the perspective of the buyer, however, the target (OldCo) is treated as having sold all its assets at the close of the acquisition date at FMV in a single transaction to a different corporation (NewCo).

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[17] It bears noting, however, that under the "next-day rule," some transactions that occur on the closing date but following the closing will be treated as occurring on the beginning of the following day. *Id*. at reg. section 1.1502-76(b)(1)(ii)(B). A detailed discussion of the next-day rule is outside the scope of this report, but tax advisers must master the rule to properly advise their M&A participant clients. For further discussion of the rule, see generally Deanna Walton Harris, Mark Hoffenberg, and Jeff Vogel, "Questioning the IRS's Application of the Next-Day Rule," *Tax Notes*, Oct. 13, 2014, p. 235; *see also* prop. reg. section 1.1502-76(b)(1)(ii)(A).

[18] When, during a 12-month period, a corporate purchaser buys at least 80 percent of a target's stock, the corporate buyer is eligible to make a section 338(g) election, whether the target was previously part of a consolidated group. Section 338(d)(3). To reach this 80 percent threshold, the purchaser must acquire at least 80 percent of the voting power and 80 percent of the value of the target. For domestic targets, section 338(g) elections are made infrequently. Although they can produce an asset-level basis step-up, this step-up comes at the cost of two layers of tax (*i.e.*, one at the shareholder (when the target shareholders sell their shares), and the other at the corporate level, as a result of the deemed asset sale). Triggering these multiple layers of tax is generally not efficient, absent special circumstances (*e.g.*, substantial target net operating losses that will be available to shelter the gain on the deemed sale).

[19] Reg. section 1.338-10(a)(2) (explaining that even when the target has been a member of a consolidated group, "old target" is treated as being "disaffiliated from the group immediately prior to the deemed asset sale").

[20] Section 338(a)(1).

[21] Section 338(a)(2).

[22] Reg. section 1.338-10(a)(2); *see also id*. at reg. section 1.338-10(a)(5) (providing that target may not be considered a member of buyer's consolidated return for purposes of reporting the deemed asset sale resulting from a section 338(g) election).

[23] *See supra* note 18, for a discussion of when a buyer is eligible to make such an election.

[24] *Cf.* reg. section 1.338-10(a)(2), *supra* note 19.

As a result of this deemed sale transaction, OldCo recognizes gain or loss on the disposition of all its assets.

When the target is acquired by a corporate entity (and, after the acquisition, the target is included in the consolidated group of the acquiror), the relevant rules require that the taxable income recognized as a result of the deemed disposition of OldCo's assets be reported on OldCo's return, rather than on the consolidated return of the acquiror.[25]

Thus, the target has a short tax year ending on the closing date, and its taxable income for the date of sale (including the gain or loss from the deemed sale) is reported on the target's final, short-period return.[26] This is the case regardless of whether the target filed a stand-alone return or was the common parent of a consolidated group.[27] (The applicable rules that apply if the target was a subsidiary in a consolidated group were described previously.[28])

Example 3: Corp. T (a calendar-year filer) is owned by a partnership. Strategic Acquirer Corp. P purchases 100 percent of the stock of Corp. T on August 10 and makes a section 338(g) election in connection with this acquisition. As a result, Corp. T files a "short" period tax return covering the period from January 1 through August 10[29] (including the deemed sale consequences resulting from the section 338(g) election), and Corp. T joins the Strategic Acquirer Corp. P consolidated group on August 11.

4. Corporate seller disposes of a consolidated sub, section 338(h)(10) election.

When a consolidated group disposes of a consolidated corporate subsidiary to a corporate buyer,[30] and the buyer and the parent of the consolidated group make a joint election under section 338(h)(10),[31] for U.S. federal income tax purposes the following steps are deemed to occur:

1. The target (OldCo), while it is still a member of the selling consolidated group,[32] is treated as selling all its assets in a single transaction to a new entity (NewCo) in consideration for the sales price.[33]
2. OldCo is deemed to have liquidated.[34]

Despite the deemed consequences that result from the making of the election, the basic tax year-end rules are the same as the ones (described above) that apply when a consolidated subsidiary is purchased out of a consolidated group without a section 338(h)(10) election. That is, the target is treated as a member of the selling consolidated group until the end of the closing date (meaning that the results of the deemed asset sale by OldCo to NewCo are reported on the consolidated return

[25] Section 338(h)(9).

[26] Reg. section 1.338-10(a)(1).

[27] *Id*.

[28] *See supra* discussion at Section II.B.2.

[29] Despite the general rule that transactions on the closing date are reported on the short-year return for the target's tax period ending on the closing date, under reg. section 1.338-1(d), if the target engages in a "transaction outside the ordinary course of business on the acquisition date" but after the qualified stock purchase, the transaction is deemed to have occurred at the beginning of the day following the qualified stock purchase.

[30] A corporate acquirer is eligible to make a section 338(h)(10) election if the purchaser makes a "qualified stock purchase" of a target that was a member of a consolidated group. *See supra* discussion at note 14 (discussing consolidated groups). A qualified stock purchase requires a purchase of 80 percent or more of the target's stock, by vote and value. Section 338(d)(3). Note that it is also possible to make a section 338(h)(10) election in connection with an acquisition of an "affiliated target" from a "selling affiliate" (*i.e.*, a domestic corporation that owns an amount of stock sufficient to allow it to consolidate with the target, but that does not join in the filing of a consolidated return with the target).

[31] Reg. section 1.338(h)(10)-1(c)(3). In the event that an "affiliated target" is being acquired, the "selling affiliate" and the buyer are required to jointly make the election. *See id*.

[32] Although the deemed asset sale is reported on the consolidated tax return of the selling group, tax advisers should always keep in mind that NewCo remains liable for the tax liabilities of OldCo (including those resulting from the deemed sale). *See id.* reg. section 1.338(h)(10)-1(d)(2); *see also id*. reg. section 1.1502-6(a). The rule specifying that the target is liable for the deemed sale consequences takes on particular significance when the target is an "affiliated target" being acquired from a "selling affiliate." Unlike in a circumstance involving a selling consolidated group, when the members of the consolidated group are jointly and severally liable for the gain on the deemed asset sale (and when, as a practical matter, the IRS is likely to seek to collect the tax from the parent of the consolidated group), an "affiliated target" is arguably the only entity liable for the deemed asset sale consequences, meaning that unless a purchaser secures an appropriate tax indemnity, the purchaser could inherit a significant tax liability.

[33] *Id.* reg. section 1.338(h)(10)-1(d)(3). The sales price (for this purpose) is determined under the rules set forth in reg. section 1.338-4.

[34] *Id*. reg. section 1.338(h)(10)-1(d)(4)(i). Note that as a result of these deemed steps, the selling consolidated group recognizes no gain or loss on the actual sale of its stock. *Id.* reg. section 1.338(h)(10)-1(d)(5)(iii).

of the selling consolidated group),[35] and the target enters the buyer's consolidated group on the date following the transaction date (or, if the corporate buyer does not file a consolidated return with the target, the target's short tax year begins on the date following the acquisition date).[36]

5. Corporate seller disposes of a consolidated sub, section 336(e) election.

When there is a "qualified stock disposition"[37] with respect to a consolidated subsidiary target, and the seller and the target make a joint election under section 336(e),[38] the actual stock disposition by the seller is not regarded from the perspective of the seller.[39] Instead, for U.S. federal income tax purposes, the following steps are deemed to occur:

3. The target (OldCo) is treated as selling all its assets to an unrelated person (NewCo) in a single transaction at the close of the disposition date while OldCo is still a member of the selling consolidated group.[40]
4. OldCo is deemed to liquidate at the conclusion of the disposition date.[41]

Thus, when a section 336(e) election is made with respect to a corporation being acquired from a consolidated group, the general tax year-end rule for targets acquired from a consolidated group applies.[42] As noted above, under this rule, the target remains a member of the seller's consolidated group until the conclusion of the acquisition date, and it has a new tax year beginning on the next day.

6. Noncorporate seller sells target corp to a corporate buyer, no section 338(g) election, target enters buyer's consolidated group.

When a noncorporate seller (for example, a private equity fund classified as a partnership for tax purposes) disposes of a corporation to a corporate buyer (for example, a strategic buyer or a corporate subsidiary of another private equity fund) and, as a result of the transaction, the target enters the consolidated group of which the buyer is a member, the rule is that the target's tax year ends at the end of the closing date.[43]

Example 4: PE Fund Seller sells all the stock of Corp. T to Corp. P, the common parent of a consolidated group, on June 15 (with the closing occurring at 10 a.m.). T's tax year closes as of the end of the day on January 15 (and its operations through the end of that day will be reported on a stand-alone T return[44]), and T will join P's consolidated group at the beginning of January 16.

C. S Corporations

Like a C corporation, the general rule is that the acquisition of the stock of an S corporation[45] does not close the tax year of the S corporation, although the S corporation is permitted to functionally (but not actually) close its tax year by making a special election under section 1377(a)(2)

[35] *Id.* reg. section 1.338(h)(10)-1(d)(3).

[36] In the event that an "affiliated target" is acquired from a "selling affiliate" when a section 338(h)(10) election is made, the section 338(h)(10) regulations state that the "principles" of reg. section 1.338-2(c)(1) and -10(a)(1), (5), and (6)(i) apply. *Id.* Under these rules, the deemed sale tax consequences are reported on a final, stand-alone return of "old" target for the tax period deemed to end at the close of the acquisition date. The "new" target either enters the buyer's consolidated group or has a "short" tax period that begins on the date following the acquisition.

[37] *See id.* reg. section 1.336-1(b)(6)(i) (defining "qualified stock disposition").

[38] It bears noting that due to the overlap rule in reg. section 1.336-1(b)(6)(ii), which provides that when there is both a "qualified stock purchase" (giving rise to the ability to make a section 338 election) and a "qualified stock disposition" (giving rise to the ability to make a section 336(e) election), the "qualified stock purchase" will take precedence; section 336(e) elections are most frequently made in circumstances involving a noncorporate buyer of a corporation.

[39] *Id.* reg. section 1.336-2(b)(1)(i)(A).

[40] *Id.* reg. section 1.336-2(b)(1)(i) and -4.

[41] *Id.* reg. section 1.336-2(b)(1)(iii)(A). Regarding the purchaser, the regulations state that the purchaser will be treated as acquiring the target's stock on the purchase date. *Id.* reg. section 1.336-2(c).

[42] *See supra* discussion in Section II.B.1.

[43] Reg. section 1.1502-76(b)(1)(ii)(A).

[44] It bears noting, however, that under the "next-day" rule, some transactions that occur on the date when a target corporation is acquired, but after the time of its acquisition, are required to be treated as though they occurred at the beginning of the day following the acquisition date. *See supra* discussion at note 17. Moreover, although the end of a tax year precipitated by the target's joining of a consolidated group generally requires a closing of the books, in some circumstances the purchaser and the target are permitted to make a special ratable income allocation election. Reg. section 1.1502-76(b)(2)(i) (providing the general rule); *Id.* reg. section 1.1502-76(b)(2)(ii) (describing the ratable income allocation election).

[45] Unlike a C corporation, an S corporation is not generally subject to entity-level tax. *See generally* section 1363(a). *But see* sections 1374-1375. Instead, the S corporation's income flows through to its shareholders in proportion to their stock ownership. *See* Mark Wright Cochran, "S Corporation Stock Sales: Tax Efficiency and Transaction Costs," *Tax Notes*, July 19, 2010, p. 309 (describing the relatively inflexible rules related to S corporation income allocation and how these rules lead to potential distortions).

when an S corporation shareholder completely terminates its interest.[46] Also, just like the general rule for C corporations, the general rule for S corporations is subject to several exceptions. Adding to this complexity is the fact that only some individuals are eligible to own an S corporation.[47] When a non-eligible owner acquires an interest in an S corporation, not only will the S corporation's tax year-end, but the entity's status as an S corporation will terminate.[48]

1. Acquisition by eligible S corporation shareholder, no section 336(e), 338(g), or 338(h)(10) election.

When some or all of the stock of an S corporation is acquired by one or more eligible S corporation shareholders, the general rule described in the introductory paragraph applies. That is, in general, the S corporation's tax year does not end. The S corporation's classification as an S corporation continues, and the year of purchase is generally a straddle period.[49]

As noted, however, when one of the shareholders of an S corporation actually terminates his, her, or its interest, a special election may be made to "close the books" of the S corporation such that the S corporation's income will be allocated as if the S corporation tax year was comprised of two tax periods.[50] If stock in an S corporation interest is transferred to a different shareholder, the transferor and transferee must agree to make this election. If the S corporation redeems all of a shareholder's stock, *all* of the S corporation shareholders must agree to make this election.[51]

2. Acquisition by eligible S corporation shareholder, section 336(e) election.

If an eligible S corporation shareholder acquires the stock of an S corporation and a section 336(e) election is made in connection with the acquisition,[52] then the acquisition is generally treated as though the S corporation (OldCo) sold its assets to a new corporation (NewCo) at the conclusion of the acquisition date and then liquidated.[53] NewCo will be classified as a C corporation (whose tax year begins on the date following the acquisition date) unless the acquirer files a timely election to classify NewCo as an S corporation.[54]

Example 5: Individual A buys 100 percent of the stock of calendar-year filer[55] S Corp. Target on January 15, and a section 336(e) election is made in connection with the acquisition. The tax year of S Corp. Target ends on January 15, and a short, C corporation tax year (or, if individual A makes an S election for target, a short, S corporation tax year) begins on January 15.

3. S corporation stock acquired by ineligible S corporation shareholder, no section 336(e), 338(g), or 338(h)(10) election.

When the stock of an S corporation is acquired by an ineligible S corporation shareholder[56] and no section 336(e), 338(g), or 338(h)(10) election is made, the corporation's status as an S corporation terminates effective beginning on the date when the S corporation ceases to so qualify.[57] This results in a short S tax year that ends on the date *before* the

[46] Section 1377(a)(2) provides: "Under the regulations prescribed by the Secretary, if any shareholder terminates the shareholder's interest in the corporation during the taxable year and all affected shareholders and the corporation agree to the application of this paragraph, paragraph (1) [which provides for a pro rata allocation of the S corporation's income among the days of a tax year] shall be applied to the affected shareholders as if the taxable year consisted of 2 taxable years the first of which ends on the date of the termination." The "affected shareholders" include all the shareholders if the S corporation redeems a shareholder, but only include the transferor and transferee in the cash of a transfer to a party other than the S corporation.

[47] *See* section 1361(b)(1).

[48] Section 1362(d)(2). When the termination is attributable to the S corporation ceasing to qualify as an S corporation, the termination is effective beginning on the date when the S corporation ceases to so qualify. *See* reg. section 1362(d)(2)(B). This results in a "short" S year that ends on the date before the disqualifying event and a C corporation year that begins on the date of the disqualifying event. Section 1362(e)(1).

[49] As explained previously, the "straddle period" designation is a commercial designation, not a tax term. *See supra* discussion at Section I.

[50] Section 1377(a)(2).

[51] Reg. section 1.1377-1(b). Under the regulations, the shareholders who must consent to the election are referred to as "affected" shareholders.

[52] Reg. section 1.336-2(h)(3) sets forth the mechanical requirements for making the section 336(e) election for an S corporation target. A section 336(e) election is available when the S corporation shareholder (or shareholders) makes a "qualified stock disposition" for S corporation stock. *See* reg. section 1.336-2(a). Qualified stock disposition is defined in reg. section 1.336-1(b)(6)(i).

[53] Reg. section 1.336-2(b).

[54] *Id*. reg. section 1.336-2(b)(1)(i).

[55] Section 1378(b) describes the permitted tax years for an S corporation.

[56] *See infra* at Section II.C.5, however, for special rules that apply when the ineligible shareholder is a corporation and the target enters the buyer corporation's consolidated group.

[57] Section 1362(d)(2)(B).

disqualifying event, and a C corporation year that begins the next day (that is, on the acquisition date).[58]

The general rule is that income must be allocated between the "short" S year (ending on the date before the acquisition date) and the C corporation year (beginning on the acquisition date) by applying the daily proration rule that applies for purposes of allocating S corporation income between days in its tax year.[59] This rule, however, is inapplicable when there is either (1) a sale of at least 50 percent of the S corporation's stock or (2) all shareholders of the S corporation (at any time during its tax year) and of the C corporation (on the first day of the short C corporation tax year) consent.[60]

Example 6: Private Equity Firm Partnership purchases 100 percent of the stock of Target, a calendar-year filer S corporation on September 17 and does not make a section 336(e), 338(g), or 338(h)(10) election in connection with the acquisition. Target has a short S corporation tax year for the period from January 1 through September 16 (and includes all income earned during the short period on such return), and files a C corporation return for the period beginning September 17 (and includes all income earned during the short period beginning on September 17 on such return).

4. Acquisition by ineligible S corporation shareholder, section 338(h)(10) election.

When a section 338(h)(10) election is made regarding the acquisition of an S corporation target,[61] the purchase of S corporation stock is disregarded, and the transaction is treated as a purchase (by a new subsidiary of the acquirer) of the S corporation target's assets followed by a deemed liquidation of the old S corporation.[62]

As a result of this transaction, the tax year of the S corporation target terminates at the end of the acquisition date.[63] Unless the acquirer is itself an S corporation (and makes a qualified subchapter S subsidiary election for the target), the tax year of the new C corporation that is treated as formed as a result of the acquisition commences on the following day.[64]

Example 7: BigCo Corp. purchases 100 percent of the stock of calendar-year S corporation on September 17 and makes a section 338(h)(10) election in connection with the acquisition. As a result, S corporation has a short tax year for the period from January 1 through September 17 (and reports all income earned during the short period, including the deemed sale consequences resulting from the section 338(h)(10) election, on the return for the short tax period from January 1 through September 17), and is included in the BigCo Corp. consolidated return for the period beginning September 18.

5. S corporation stock acquired by corporate buyer, former S corp enters consolidated group, no section 338(h)(10) election.

Although the general rule is that a corporation that is acquired by a consolidated group enters that group at the *end* of the acquisition date, under a special rule for S corporation acquisitions that is aimed at preventing there from being a one-day, stand-alone C corporation return covering the acquisition date,[65] the S corporation target enters the buyer's consolidated group at the *beginning* of the acquisition date.[66]

Example 8: Consolidated BigCo Corp. purchases 100 percent of the stock of calendar-year S Corp. on April 14 and does not make a section 336(e), 338(g), or 338(h)(10) election in connection with the acquisition. As a result, S Corp. has a short S corporation tax year for the period from January 1 through April 13 (and includes all income earned during the short

[58] Section 1362(e)(1).

[59] Section 1362(e)(2).

[60] Section 1362(e)(3) and (e)(6)(D). When the general rule does not apply, tax is determined under normal tax accounting rules (meaning that there is a closing of the books).

[61] Reg. section 1.338(h)(10)-1(c)(1) describes when a section 338(h)(10) election is available in connection with the acquisition of an S corporation target. Reg. section 1.338(h)(10)-1(c)(3) describes how to make an election.

[62] Reg. section 1.338(h)(10)-1(d).

[63] *Id*. reg. section 1.338(h)(10)-1(d)(3).

[64] *Id.*

[65] This one-day, stand-alone return would arise under the general S corporation termination rule. Under this rule, which is described in Section II.C.3 above, the S corporation's tax year ends on the date before the occurrence of the event causing S corporation status to terminate.

[66] Reg. section 1.1362-3(a); *see also id*. reg. section 1.1502-76(b)(1)(ii)(A)(2), (b)(2)(v), and (b)(5), Example 7.

period on such return) and is included in Consolidated BigCo Corp.'s consolidated return beginning on April 14.

6. S corporation stock acquired by ineligible S corporation shareholder, section 336(e) election.

Making a section 336(e) election generally has the same tax year-end consequences as making a section 338(h)(10) election. See Section II.C.4 above for further discussion.

7. S corporation stock acquired by ineligible S corporation shareholder, section 338(g) election.

Section 338(g) elections are not generally made for the acquisition of an S corporation because making this type of election would trigger two layers of tax. If, however, a section 338(g) election were to be made in connection with an S corporation acquisition, the tax year of the S corporation target would end on the date before the acquisition date, and a C corporation return would need to be filed reflecting the target's operations on the acquisition date (including the deemed asset sale consequences from the section 338(g) election).[67]

D. Qualified Subchapter S Subsidiaries

An S corporation that owns 100 percent of a corporate subsidiary can elect to treat that subsidiary as a QSub.[68] A QSub is treated for almost all U.S. federal income tax purposes as a division of its S corporation parent.[69] As a result, a QSub does not have a separate tax year, so this section of the report is substantially shorter than the preceding sections.

Nonetheless, an acquisition of a QSub often gives rise to a short tax year, because a QSub that is not a 100 percent corporate subsidiary of an S corporation is no longer eligible to be treated as a QSub. Under section 1361(b)(3)(C)(ii), when an S corporation disposes of all of the stock of a QSub, the transaction is generally treated as a sale of the QSub's assets followed by a transfer (by the purchaser) to a new corporation.[70] Similarly, when less than all of the QSub's stock is sold, the transaction is treated as a sale of an undivided interest in each of the QSub's assets (for example, if 50 percent of the QSub's stock is sold, a 50 percent interest in each of its assets is treated as having been sold), followed by transfer (by the historic S corporation and the purchaser) to a new corporation. In either case (that is, sale of part or all of the QSub's stock), the termination of the QSub election occurs at the close of the day on which the acquisition takes place.[71]

Example 9: S Corp. Seller owned 100 percent of the stock of QSub Target and sold QSub Target's stock to Private Equity Partnership Purchaser on January 15. QSub Target's status as a QSub would terminate at the close of January 15, and QSub would file a return as a C corporation for the period beginning on January 16.

If, however, an S corporation acquires 100 percent of the stock of a QSub target and makes a QSub election that is effective immediately following the acquisition, there will be no deemed contribution to a different corporation (as a result of the purchase) and liquidation of that corporation (as a result of the new QSub election). Instead, the QSub target's status as a QSub is just treated as having continued. In that situation, there is no period between the termination of the QSub election and deemed liquidation during which the QSub is treated as a C corporation.[72]

Moreover, if a QSub is acquired indirectly (because a consolidated group acquires the S corporation that owns the QSub), the QSub's

[67] *Id.* reg. section 1.338-10(a)(3).

[68] Section 1361(b).

[69] Section 1361(b)(3).

[70] Section 1361(b)(3)(C)(ii) was enacted by the Small Business and Work Opportunity Act of 2007 and changed the rule that previously applied to QSub terminations. *See* Joint Committee on Taxation, "Technical Explanation of the 'Small Business and Work Opportunity Tax Act of 2007' and Pension Related Provisions Contained in H.R. 2206," JCX-29-07, at 25 (May 24, 2007) (explaining that the rule, before the enactment of the Small Business and Work Opportunity Act of 2007 was that "if the subsidiary corporation ceases to be a QSub (*e.g.*, fails to meet the wholly-owned requirement) the subsidiary is treated as a new corporation acquiring all its assets (and assuming all of its liabilities) immediately before such cessation from the parent S corporation in exchange for its stock").

[71] Reg. section 1.1361-5(a)(1)(iii); *id.* reg. section 1.1361-5(a)(4), Example 2. Note that this rule applies even when the QSub is acquired by a consolidated group. *See id.* reg. section 1.1361-5(a)(4), Example 5.

[72] Rev. Rul. 2004-85, 2004-2 C.B. 189.

status as a QSub terminates at the end of the day before the acquisition.[73]

Example 10: BigCo Parent Corp. acquires 100 percent of S Corp. Target (which owns QSub Indirect Target) on January 15. As a result, both S Corp. Target's S election and QSub Indirect Target's QSub election terminate as of the close of January 14 (that is, the date before the acquisition date), and both S Corp. Target and QSub Indirect Target become members of BigCo Parent Corp.'s consolidated group at the beginning of January 15.

E. Partnerships

Partnerships are perhaps the type of entity whose tax year is least likely to close in connection with an acquisition.[74] Even when the acquiring entity is a different entity for state law purposes, in many instances the partnership will be treated as a continuation of the predecessor partnership under the exceedingly broad rule in section 708(b)(1), which provides that a partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.[75]

Nonetheless, despite the breadth of the continuation rule, there are scenarios in which a partnership terminates in connection with an M&A transaction, thereby terminating its tax year.[76] This section briefly describes a few potential variations.

1. Termination of partnership resulting from acquisition by third party of all the outstanding partnership interests.

Rev. Rul. 99-6, 1999-1 C.B. 432, Situation 1, describes the tax consequences that result when one partner in a partnership acquires 100 percent of the outstanding interests in the partnership that are held by the other partners.

In a Rev. Rul. 99-6, Situation 1 transaction, the partnership is treated as terminating on the date of the applicable acquisition.[77] Income attributable to the tax period ending on the acquisition date is reflected on the partnership's tax return.[78]

Example 11: Partnership (which is a calendar-year filer) has two 50 percent partners, A and B. B acquires 100 percent of A's interests in Partnership on April 15. As a result of B's acquisition, Partnership has a short tax year extending from January 1 through April 15.

2. Termination of partnership resulting from acquisition by one partner of all interests of other partner(s).

Rev. Rul. 99-6, Situation 2, describes the tax consequences that result when a third party acquires 100 percent of the outstanding interests in a partnership from the current partners.

Like in a Rev. Rul. 99-6, Situation 1 transaction, the partnership is treated as terminating on the date of the applicable acquisition.[79] Income attributable to the tax period

[73] *See* reg. section 1.1361-5(a)(3); *id.* reg. section 1.1361-5(a)(4), Example 4.

[74] Partnership terminations (and tax year-ends) in M&A transactions were once much more common, due to the "technical termination" rules. Under these rules (which applied for partnership years that began before January 1, 2018), a partnership would terminate if 50 percent or more of the total interests in partnership capital and profits were sold or exchanged in a 12-month period (as often occurs in connection with an M&A transaction), generally resulting in an obligation to file a short-year tax return. *See* Notice 2001-5, 2001-1 C.B. 327. These rules, however, were repealed by P.L. 115-97, section 13504(a). For further background discussion on technical terminations, see Eric Sloan, Mark Opper, and Teresa Lee, "Let's Get Technical: Partnership Terminations," *Tax Notes*, Oct. 15, 2012, p. 263; Sloan, Opper, and Lee, "Let's Get Technical: Partnership Terminations, Part 2," *Tax Notes*, Oct. 22, 2012, p. 389.

[75] A detailed discussion of the contours of the partnership continuation rules is beyond the scope of this report. For an excellent discussion of continuations, see Phillip Gall, "Nothing From Something: Partnership Continuations Under Section 708(a)," University of Chicago Federal Tax Conference (2016).

[76] Like S corporations, even when a partnership does not terminate as a result of an acquisition, the acquisition of an interest in a partnership raises income allocation issues that are similar to year-end issues. A discussion of these issues is outside the scope of this report. For an excellent discussion of these issues, see Eric B. Sloan and Matthew J. Sullivan, "Partnerships — Taxable Income: Allocation of Distributive Shares; Capital Accounts," in *BNA Tax Mgmt. Portfolio*, 712-4th T.M.

[77] *Id.* reg. section 1.708-1(b)(1) (describing a scenario in which A and B sell their interests to the other partner in a partnership on November 20, 1956, and noting that the partnership is terminated as of November 20, 1956).

[78] *Id.* reg. section 1.708-1(b)(3); *id.* reg. section 1.706-1(c)(1).

[79] Reg. section 1.708-1(b)(1) (describing a scenario in which A and B sell their interests to the other partner in a partnership on November 20, 1956, and noting that the partnership is terminated as of November 20, 1956).

ending on the acquisition date is reflected on the partnership's tax return.[80]

Example 12: Partnership (which is a calendar-year filer) has two 50 percent partners, A and B. C acquires 100 percent of their respective Partnership interests on April 15. Partnership has a short tax year extending from January 1 through April 15.

3. Termination of partnership resulting from partnership merger or consolidation.

Special rules apply when multiple partnerships merge or consolidate. In particular, in a circumstance involving such a merger or consolidation, the resulting partnership is treated as the continuation of the merging or consolidating partnership, the partners of which own an interest of more than 50 percent of the capital and profits of the resulting partnership.[81] If the resulting partnership could be treated (under the greater-than-50-percent rule) as the continuation of more than one merging partnership, a special tie-breaker rule applies — the partnership is a continuation of the partnership that is credited with the contribution of assets having the greatest FMV.[82] Any partnership that is *not* treated as continuing under either of these rules, is treated as having terminated.[83] An extension of this principle is that if none of the merging or consolidating partnerships has partners with an interest of greater than 50 percent in the capital and profits of the resulting partnership, *all* the merged or consolidated partnerships are treated as terminating.[84]

The regulations explain that the tax year of any partnership that is considered terminated under the rules described in the preceding paragraph is to be closed in accordance with section 706(c), and that any terminated partnerships are to file their returns for a tax year ending on the date of termination (that is, the date when the merger or consolidation occurs).[85]

Example 13: Partnership 1 (which is a calendar-year filer) has two 50 percent partners, A and B. Partnership 2 (which is also a calendar-year filer) has two 50 percent partners, C and D. Partnership 1 and Partnership 2 consolidate under state law on April 15, forming BigCo Partnership. Following the consolidation, C and D each have 35 percent interests in BigCo Partnership, and A and B each have 15 percent interests in BigCo Partnership. Because C and D have a collective interest of 70 percent in BigCo Partnership, BigCo Partnership is treated as a continuation of Partnership 2. On the other hand, because A and B collectively have only a 30 percent interest in BigCo Partnership, Partnership 1 is treated as terminating as a result of the consolidation. Thus, Partnership 1 has a short tax year, extending from January 1 through April 15.

III. Conclusion

As illustrated in the foregoing pages, in many M&A transactions, the tax year of the entity being acquired will close in connection with the acquisition. As illustrated, however, the relevant year-end rules can vary significantly depending on the type of target and the manner in which an acquisition is structured, so tax advisers should proceed cautiously when answering the question "is the tax year of the target over?" Tax advisers who master these rules will be well positioned to advise their clients on the substantive impact of the year-end rules. These advisers will also be able to make sure their clients are appropriately protected, as a contractual matter, against tax year-end risks under the definitive documents for an M&A transaction.

IV. Appendix — Tax Year-End Rules Summary

A. C Corporation Target

Acquisition Type	Tax Year-End Rule
Corporate seller disposes of consolidated Target subsidiary when no section 336(e), 338(g), or 338(h)(10) election is made.	Target is part of the selling consolidated group until the end of the closing date, and its "short" tax year begins the next day.

[80] *Id.* reg. section 1.708-1(b)(3); *id.* reg. section 1.706-1(c)(1).

[81] *Id.* reg. section 1.708-1(c)(1).

[82] *Id.*

[83] *Id.*

[84] *Id.*

[85] *Id.* reg. section 1.708-1(c)(2).

Acquisition Type	Tax Year-End Rule
Corporate seller disposes of a consolidated Target subsidiary when the buyer makes a section 338(g) election.	Target's tax year ends at the end of the closing date (but, importantly, before the deemed sale transaction), the deemed sale transaction is reported on a separate return (and is the only item included on that return), and a new tax period begins the next day (or, if Target enters a buyer's consolidated group, Target joins buyer's consolidated group at the beginning of the next day).
Noncorporate seller sells Target to a corporate buyer (with a section 338(g) election).	Target has a short tax year ending on the closing date, and its taxable income for the date of sale (including the gain or loss from the deemed sale) is reported on Target's final, short-period return.
Corporate seller disposes of consolidated Target subsidiary with a section 338(h)(10) election.	Target is treated as a member of the selling consolidated group until the end of the closing date. Target enters the buyer's consolidated group on the date following the transaction date (or, if the corporate buyer does not file a consolidated return with Target, Target's short tax year begins on the date following the acquisition date).
Corporate seller disposes of consolidated Target subsidiary with a section 336(e) election.	Target remains a member of the seller's consolidated group until the conclusion of the acquisition date and has a new tax year beginning on the next day.
Noncorporate seller sells Target to a corporate buyer (without a section 338(g) election) when Target enters buyer's consolidated group.	Target's tax year ends at the end of the closing date, and Target enters buyer's consolidated group the next day.

B. S Corporation Target

Acquisition Type	Tax Year-End Rule
Acquisition by eligible S corporation shareholder without a section 336(e), 338(g), or 338(h)(10) election.	Target's tax year does not end. However, a special election may be made to "close the books" of Target such that Target's income will be allocated as if Target's tax year were comprised of two tax periods.
Acquisition by eligible S corporation shareholder with a section 336(e) election.	Tax year of Target ends at the conclusion of the acquisition date. A short C corporation tax year begins on the date following the acquisition date, unless the acquirer files a timely election to classify Target as an S corporation (in which case a short S corporation tax year begins on the date following the acquisition date).
Acquisition by ineligible S corporation shareholder without a section 336(e), 338(g), or 338(h)(10) election.	Target has a short S tax year that ends on the date *before* the acquisition date and a short C corporation year that begins the next day (that is, on the acquisition date).
Acquisition by ineligible S corporation shareholder with a section 338(h)(10) election.	Target's tax year ends at the conclusion of the acquisition date, and the tax year of the new C corporation that is treated as formed as a result of the acquisition commences on the date following the acquisition.
Target acquired by corporate buyer when Target enters corporate buyer's consolidated group (no section 338(h)(10) election).	Target's tax year ends at the conclusion of the date before the acquisition date. Target enters the buyer's consolidated group at the *beginning* of the acquisition date.
Target acquired by ineligible S corporation shareholder with a section 336(e) election.	Same tax year-end consequences as acquisition by ineligible S corporation shareholder with a section 338(h)(10) election.

Acquisition Type	Tax Year-End Rule
Target acquired by ineligible S corporation shareholder with a section 338(g) election.	Target's S corporation tax year ends on the date before the acquisition date. A C corporation return for Target needs to be filed reflecting Target's operations beginning on the acquisition date (including the deemed asset sale consequences from the section 338(g) election).

C. QSub Target

Acquisition Type	Tax Year-End Rule
Acquisition of 100 percent of Target's stock by non-S corporation acquirer (or by S corporation acquirer that does not elect QSub status for acquirer).	Termination of Target's QSub election occurs at the close of the day on which the acquisition takes place. Target files a C corporation return for the period beginning on the date following the acquisition date.
Acquisition of less than 100 percent of Target's stock by non-S corporation acquirer.	Same tax year-end rule as the one described in the preceding row.
S corporation acquires 100 percent of Target and makes a QSub election that is effective immediately following the acquisition.	There is no tax year-end connected with the acquisition.
Target is acquired indirectly (because a consolidated group acquires the S corporation that owns Target).	Target's QSub election terminates as of the close of the date before the acquisition date. Target becomes a member of acquirer's consolidated group at the beginning of the acquisition date.

D. Partnership Target

Acquisition Type	Tax Year-End Rule
Acquisition by one partner of all of Target's equity interests owned by the other partner(s) (that is, Rev. Rul. 99-6, Situation 1 transaction).	Target's tax year terminates at the end of the acquisition date.
Acquisition of 100 percent of Target's equity interests by a third party (that is, Rev. Rul. 99-6, Situation 2 transaction).	Same tax year-end rule as the one described in the preceding row.
Partnership merger or consolidation.	The resulting partnership is treated as the continuation of the merging or consolidating partnership, the partners of which own an interest of more than 50 percent of the capital and profits of the resulting partnership. If the resulting partnership could be treated (under the more-than-50-percent rule described above) as the continuation of more than one merging or consolidating partnership, a special tie-breaker rule applies — the resulting partnership is a continuation of the partnership that is credited with the contribution of assets having the greatest FMV. Any partnership that is *not* treated as continuing under the rules described in the preceding paragraphs is treated as having terminated at the end of the acquisition date.

■