

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

This post will continue my [coverage](#) of the Third Circuit's decision in *Ball v. Commissioner*, 2014 U.S. App. LEXIS 2594 (Feb. 12, 2014).

The Internal Revenue Code provides that a stockholder's basis in shares of an S Corporation is subject to adjustment, for (among other things) "the items of income described in subparagraph (A) of section 1366(a)(1)." I.R.C. § 1367(a)(1)(A). Consequently, the basic question before the Third Circuit was whether the deemed liquidation associated with Wind River's Q-Sub election gave rise to an "item of income." *Ball*, 2014 U.S. App. LEXIS 2594, slip op. at *11.

The Trusts argued that the gain from the liquidation created income under Section 61(a) of the Code and that it was realized under Section 331 of the Code, which treats amounts received by a shareholder in a complete liquidation as full payment in exchange for its stock. As a consequence, in the Trusts' view, the gain, calculated in accordance with Section 1001 of the Code, was an item of income. *Id.*, slip op. at *12.

In contrast, the government's argument was that to qualify as an "item of income," the gain not only had to be realized, it had to be recognized as well. *Id.*, slip op. at *18. Since the complete liquidation of a wholly-owned subsidiary falls within Section 332 of the Code, no income is recognized and, consequently, there is not "item of income" to pass through to shareholders. *Id.*

On the merits, the Court of Appeals affirmed the Tax Court, ruling that income that is not recognized is not an "item of income" that results in an adjustment in a stockholder's basis. *First*, the court noted that Section 332 of the Code controlled, not Section 331. *Id.*, slip op. at *21-*23. *Second*, the court noted that the gain at issue was not recognized and therefore not income. *Id.*, slip op. at *23-*27.

The Court of Appeals was plainly influenced by the economic realities, as it commented that deemed liquidation resulting from the Q-Sub election "did not add wealth." *Id.*, slip op. at *17.

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