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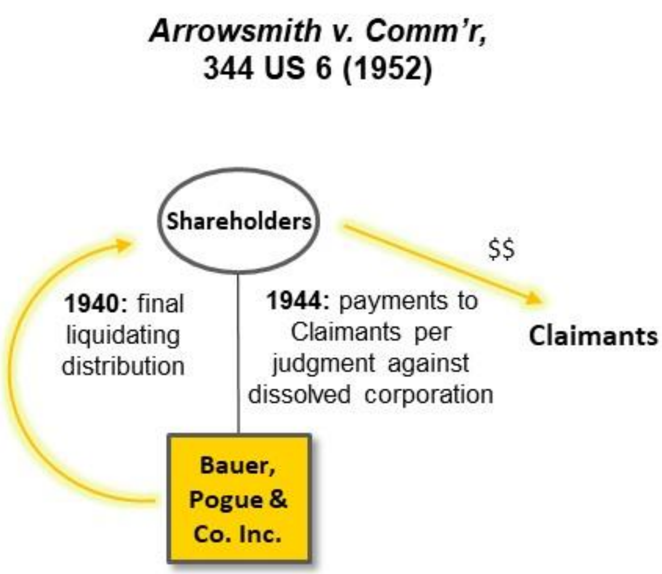
Technical Developments and Musings

***Arrowsmith*: the past is not gone.** Perhaps one of the most cited cases in corporate tax practice is *Arrowsmith v. Comm'r,* a 1952 US Supreme Court opinion in which the Court applied a "relation back" analysis that considered the taxpayers' prior relationship to decide the character of a subsequent payment by the taxpayer. Under *Arrowsmith*, individual taxpayers who reported capital gain on the complete liquidation of a closely held corporation in 1940 could not deduct from ordinary income their 1944 payment to prevailing claimants against the liquidated corporation, as part of a court-ordered judgment. Because payment of these liabilities by the corporation before its liquidation would have reduced the amount of the taxpayers' capital gain, the Court treated the subsequent payment by the shareholders as a capital loss, even though, viewed in isolation, such payment did not involve a capital asset. This "relation back" principle has been applied by the IRS to numerous fact patterns, including in regulations (e.g., Reg. §1.338-7(e)), revenue rulings (e.g., 79-278 and 83-73) and PLRs, especially in the §355 spinoff context, typically addressing the tax treatment of subsequent payments between the distributing and controlled corporation by reference to their pre-spin-off status. (See, e.g., PLR 202449006.) Notably, in recently proposed regulations addressing plan of reorganization requirements applicable to certain spin-offs and other types of reorganizations, the IRS apparently is seeking to narrow the application of *Arrowsmith* principles in such context. For further info on the proposed regs, see Tax Alert 2025-0408.



QSub spin-offs. PLR 202511013 involves a pro rata §355 spin-off, albeit one undertaken by an S corporation with respect to its historically disregarded subsidiary, a qualified subchapter S subsidiary or "QSub." While common, such divisive transactions involve the interplay between generally applicable subchapter C requirements and specialized S corporation requirements, especially where the spun-off entity makes its own S corporation election. That is, a successful §355 spin-off requires, among other things, the distribution of the stock of a subsidiary corporation, an event that terminates the QSub election. And while such termination results, under §1361(b)(3)(C), in a "good" deemed incorporation of a regarded subsidiary for §355 purposes, the IRS ruled that such "momentary ownership" by another corporation will not cause the former QSub to have an ineligible shareholder for purposes of its own S corporation election.

Foreign eligible entity remains eligible following "per se" shareholder investment. In PLR 202511009, the IRS concluded that a foreign entity that had elected disregarded status would remain an "eligible entity" when a new foreign investor, a per se entity for US tax purposes, took back shares in it. Although local country law will treat the foreign entity and the new investor as having the same legal classification for local regulatory purposes, the IRS concluded that this fact would not cause the foreign entity to become ineligible under the US tax entity classification system.

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