

## S Corporation Tax Update

ABA Tax Section – Fall 2008

San Francisco, CA



David Kirk  
Arnold & Porter LLP  
Washington, DC

## S Corporation Tax Update

- Regulations
  - Proposed Regulations on COD
  - Final Regulations for AJCA and GOZA changes
- IRS Guidance
  - Revenue Ruling 2008-42
  - Chief Counsel Memo 20082804F
  - Notable PLRs
  - FOIA Released Email Correspondence
- Congressional Materials
  - Proposed Legislation
  - Hearings & Reports
- New Sub S Articles

### S Corporation Tax Update – Prop. Regs on COD

- Proposed Regulations issued on 8/6/2008
  - REG-102822-08
- The proposed regulations that provide guidance on the manner in which an S corporation reduces its tax attributes under section 108(b) for taxable years in which the S corporation has discharge of indebtedness income that is excluded from gross income under section 108(a).
- The regulations address situations in which the aggregate amount of the shareholders' disallowed section 1366(d) losses and deductions that are treated as a net operating loss tax attribute of the S corporation exceeds the amount of the S corporation's excluded discharge of indebtedness income.

### S Corporation Tax Update – Prop. Regs on COD

- If an S corporation excludes COD income from its gross income under section 108(a), the amount excluded is applied to reduce the S corporation's tax attributes under section 108(b)(2).
- For purposes of the tax attribute reduction rule under section 108(b)(2), any loss or deduction that is disallowed for the taxable year of the discharge under section 1366(d)(1) is treated as a net operating loss of the S corporation under section 108(d)(7)(B) (“Deemed NOL”).

## S Corporation Tax Update – Prop. Regs on COD

- If the amount of the S corporation's deemed NOL exceeds the amount of excluded COD income, the proposed regulations provide that the S corporation's excess deemed NOL is allocated to the shareholder or shareholders of the S corporation as losses and deductions disallowed under section 1366(d)(1) for the taxable year of the discharge.

## S Corporation Tax Update – Prop. Regs on COD

- S Corporations with Multiple Shareholders
  - If an S corporation has more than one shareholder during the taxable year of the discharge, the proposed regulations provide a rule for determining the amount of excess deemed NOL allocated to each shareholder.
  - The IRS and the Treasury Department recognize that shareholders may be disproportionately impacted where the shareholders' respective disallowed losses or deductions are disproportionate to their respective ownership interests.
    - The IRS and the Treasury Department request comments on alternative mechanisms that could address such disproportionate economic effects and on the collateral consequences of such mechanisms.

### **S Corporation Tax Update – Prop. Regs on COD**

- Written and electronic comments must be received by November 4, 2008.
- Public Hearing Schedule for December 8, 2008
- Outlines of topics to be discussed at the public hearing must be received by November 4, 2008.

### **S Corporation Tax Update – Final Regs for Changes made by AJCA of 2004 & GOZA of 2005**

- Final Regulations released on 8/13/2008
  - TD 9422
- On September 28, 2007, a notice of proposed rulemaking and a notice of public hearing (REG-143326-05) were published in the Federal Register (72 FR 55132).
- All revisions in the final regulations are administrative or ministerial and substantively conform to the proposed regulations.
- The final regulations are effective on August 14, 2008.

## S Corporation Tax Update – Final Regs for Changes made by AJCA of 2004 & GOZA of 2005

- The final regulations conformed references in the regulations to the specific numbers of S corporation shareholders permissible under section 1361. For purposes of determining the number of shareholders of an S corporation under Code section 1361(b)(1)(A), the final regulations provided rules relating to stock owned by family members.
- Pursuant to section 1361(c)(2)(A)(vi), the final regulations provided rules regarding limited instances in which individual retirement accounts (including Roth IRAs), qualify as eligible shareholders of banks or depository institution holding companies.
- The final regulations provided that a disposition of the S corporation stock by a QSST shall be treated as a disposition by the income beneficiary for purposes of applying sections 465 and 469 to the income beneficiary of a QSST.
- The final regulations provided that the Commissioner may provide relief for inadvertent invalid elections to be an S corporation or QSub or for inadvertent terminations of valid elections to be an S corporation or QSub and described the requirements to obtain that relief.

## S Corporation Tax Update – Final Regs for Changes made by AJCA of 2004 & GOZA of 2005

- The final regulations described information that is required to be included in the ESBT election statement if the trust includes a power of appointment or other power to make distributions to certain organizations.
  - The final regulations provided rules under which a person that may receive a distribution under a power of appointment will not be treated as a PCB.
  - Also, the final regulations provided rules under which a class of organizations described in section 1361(c)(6) will be treated as one PCB if the fiduciary has a power (other than a power of appointment) to make distributions to one or more members of the class.
  - Also, the final regulations provided rules that any person who first met the definition of a PCB one year before the disposition by an ESBT of all of the stock of the S corporation will not be treated as a PCB or a shareholder of the S corporation.
- Finally, with regard to a transfer of stock under Code section 1041(a), between spouses or incident to a divorce, the final regulations provided for the treatment of losses or deductions with respect to the transferred shares that are subject to the basis limitation under Code section 1366(d)(1).

## IRS Guidance - Revenue Ruling 2008-42

- Issued regarding the increase/decrease in AAA due to employer-owned life insurance.
- Holdings
  - Premiums paid by an S corporation on an employer-owned life insurance contract, of which the S corporation is directly or indirectly a beneficiary, do not reduce the S corporation's AAA.
  - The benefits received by reason of the death of the insured from an employer-owned life insurance contract that meets an exception under §101(j)(2) do not increase the S corporation's AAA.

## IRS Guidance – Chief Counsel Memo 20082804F

- Issued 7/11/2008
- Concerning whether extensions of the statute of limitations should be secured from several grantor trusts that are shareholders in a S Corporation or from the individual grantors and whether potential audit adjustments should be protected via an extension of the statute of limitations on a Form 872 or on a Form 872-I.

## IRS Guidance – Chief Counsel Memo 20082804F

- Conclusions
  - Extensions of the statute of limitations should be secured from each of the individual grantors of the grantor trusts that are shareholders in the S Corporation.
    - In Lardas v. Comm’r, 99 T.C. 490 (1992), the Tax Court held that the relevant return for determining when the statute of limitations is triggered is the return of the grantor, not the grantor trust. Thus, the Court held that “Section 6501(a) refers to the taxpayer’s return and not that of the source entity, where such source entity is a grantor trust.”
  - Such extensions should be secured through Forms 872-I.

## IRS Guidance – Chief Counsel Memo 20082804F

- Conclusions, cont’d
  - Since it is possible that trusts are not wholly-owned and therefore only partly grantor trusts, the Chief Counsel recommended that the field agent also secure extensions of the statutes of limitations from each trust. Each trust’s fiduciary is responsible for making a tax return.
    - In Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984), *nonacq.* Rev. Rul. 85-13, the Second Circuit held that although the grantor must include items of income, deduction, and credit attributable to the trust in computing the grantor’s taxable income and credits, the trust must continue to be viewed as a separate taxpayer for purposes of sales transactions.
    - Conceivably, one could conclude from this decision that the pertinent statute of limitations related to the trust, rather than to the grantors.

## IRS Guidance – Letter Rulings

- Notable S Corporation Rulings (other than Inadvertent Termination and Late Elections)
  - PLR 200821022: S Corporation Company Will Not Recognize Built-In Gain From Sale of Minerals
  - PLR 200827008: S Corp not deemed to have more than one class of stock as the result of adopting a floor price agreement under its employee stock ownership plan

## S Corporation Tax Update – Miscellaneous

- Email correspondence from Matthew S Cooper, IRS Chief Counsel (P&A) dated March 1, 2005
  - Source, Tax Analysts (June 13, 2008) 2008 TNT 115-10
- Issue:
  - Whether an S Corp shareholder may request a refund based on a deduction for tax paid at the entity level for built-in gains (that's treated as a flow-thru loss under IRC 1366(f)(2)) once the general period of limitations on the shareholder's tax year has expired?
- Holding:
  - We are not aware of any support for the shareholder's suggestion that it is implicit from IRC 1366(f)(2) that a shareholder's refund period is open as long as there is an entity-level action. Therefore, it appears that the shareholder should have filed a protective claim for refund. The shareholder would have to provide some authority in order for you to issue a refund.
  - We believe a similar situation arises with IRC 482 adjustments between related entities that transact with each other. In such a case, exam adjustments increasing one entity's tax result in a decrease for the related entity, but there is no provision that keeps open the period of limitations for the related entity to claim a refund. See *Continental Equities, Inc. v Comm.*, 551 F2d. 74, 81 (5th Cir 1977).

## S Corporation Tax Update - Congressional Materials

- Proposed Legislation
  - S Corporation Modernization Act of 2008 (S. 3063)
    - Introduced by Senators Lincoln & Hatch, May 22, 2008
  - Section 2: Reduce BIG to 7yrs
  - Section 3: Repeal of Excessive Passive Inv. Income as a Termination Event
  - Section 4: Modifications to Passive Income Rules
    - Increase passive income from 25% to 60%
  - Section 5: Expansion of Qualifying Beneficiaries of ESBTs
  - Section 6: Allowing IRAs as S Corporation Shareholders
  - Section 7: Allowing Charitable Contribution Deduction for ESBTs

## S Corporation Tax Update - Congressional Materials

### Hearings, Reports, and Comment Letters

- **JCT – Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity**
  - Citation: JCX-48-08, June 4, 2008
- **House Small Business Subcommittee Hearing – June 18, 2008**
  - Comments submitted by:
    - Kevin Andersen, BDO Seidman LLP
    - Cynthia Blankenship, Indp. Comm. Bankers of America
    - Rick Klahsen, S Corp Assn of America
    - Byron Shinn, Shinn & Company
    - Robert Kerr, Nat'l Assn. of Enrolled Agents
- **House Small Business Subcommittee Hearing – July 24, 2008**
  - Testimony and Written Comments Submitted by Arthur R. Connelly, Chairman-Elect of the American Bankers Association (ABA) on S Corporation Changes for Banks.
- **Business Coalition Letter to Congress on BIG Tax Reform**
  - To Speaker of the House Nancy Pelosi & Senate Majority Leader Harry Reid, July 23, 2008

## S Corporation Tax Update – Recent S Corp related Articles

- **Navigating the S Corporation Distribution Rules**
  - Robert Willens, BNA Daily Tax, August 8, 2008
- **Charitable Giving by S Corporations: A Look Back (and Forward)**
  - Paulk Kugler & Jeanne Sullivan, BNA Daily Tax, June 25, 2008
- **Treatment of S Corporation Shareholders and Partners in the Charitable Contribution Context**
  - Susan Kalinka, TAXES – The Tax Magazine, June 2008
- **Practical Estate Planning Strategies for S Corporations**
  - Michael Schlesinger, Estate Planning (May 2008 & June 2008)
- **Tax-Affecting S Corporations**
  - Stephen McMorrow, Valuation Strategies, May/June 2008

## Questions?



David Kirk  
Arnold & Porter LLP  
202-942-5692  
David.Kirk@aporter.com