



**Section of Taxation**

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February 4, 2009

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Proposed Regulations under Section 108 Concerning Reduction of S Corporation Tax Attributes

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations under section 108, regarding the reduction of tax attributes following the exclusion of income from cancellation of indebtedness income realized by S corporations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

A handwritten signature in black ink, appearing to read "William J. Wilkins".

William J. Wilkins  
Chair, Section of Taxation

Enclosure

cc: Clarissa C. Potter, Acting Chief Counsel, Internal Revenue Service  
Michael Mundaca, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury  
Curtis G. Wilson, Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service  
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AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION  
COMMENTS CONCERNING PROPOSED REGULATIONS  
UNDER SECTION 108 REGARDING THE REDUCTION OF TAX  
ATTRIBUTES RESULTING FROM CANCELLATION OF  
INDEBTEDNESS INCOME OF S CORPORATIONS

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Kevin D. Anderson of the Section’s Committee on S Corporations (the “Committee”). Substantive contributions were made by Laura Howell-Smith and Dana Lasley. The Comments were reviewed by Thomas J. Nichols, Chair of the Committee. The Comments were further reviewed by C. Wells Hall III of the Section’s Committee on Government Submissions, and by Leslie E. Grodd, the Section’s Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the Federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: February 4, 2009

## EXECUTIVE SUMMARY

On August 6, 2008, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) published a notice of proposed rulemaking in the Federal Register<sup>1</sup> containing proposed regulations (the “Proposed Regulations”) providing guidance on the manner in which an S corporation reduces its tax attributes for taxable years in which it has discharge of indebtedness income that is excluded from gross income under section 108.<sup>2</sup> The proposed regulations provide helpful guidance clarifying the relationship between sections 108(b)(2) and 108(d)(7)(B) affecting S corporations with income excluded under section 108(a). In view of the current economic circumstances and the expectation of increased bankruptcy filings and workouts by insolvent entities, the guidance is both timely and welcome. Although we do have some suggestions for improvement, the Proposed Regulations already reflect many well-reasoned policy choices on the fundamental issues at stake.

The Proposed Regulations are silent on the application of these rules to S corporations with net operating losses carried forward from C corporation taxable years. We believe that the Regulations, when finalized, should clarify whether such losses are available for attribute reduction under section 108(b)(2), to the extent that the income excluded under section 108(a) exceeds losses suspended under section 1366(d)(1).

The Proposed Regulations provide that, if shareholders have some combination of unused capital losses, section 1231 losses, and other “ordinary” losses, all of which have been limited by section 1366(d)(1), the ordinary losses are used first before the other categories of losses, and the section 1231 losses are used before the capital losses. We do not believe that the statutory provisions require this ordering rule, and we recommend that all such losses be absorbed on a pro rata basis, which treatment is more consistent with the ordering rules for suspended S corporation losses generally.

The Proposed Regulations also provide certain rules requiring the sharing of information between the S corporation and its shareholders. Such information is necessary in order that all taxpayers may comply with the provisions of section 108 applicable to S corporations. The preamble set forth in the notice of proposed rulemaking specifically requested comments on whether special rules are needed if shareholders fail to provide the required information to the S corporation. These comments provide suggestions for additional guidance in two situations, one in which the corporation may have reasonably sufficient information in its records in order to comply with the rules, and the other in which reasonable presumptions may be made in order to permit the S corporation and the shareholders to comply with these rules.

Finally, these comments request clarification in four minor areas not covered by the Proposed Regulations: (1) the application of the Proposed Regulations where a closing-of-the-books election is made to allocate items of income or loss for the taxable year; (2)

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<sup>1</sup> 73 Fed. Reg. 45656 (Aug. 6, 2008).

<sup>2</sup> References to a “section” herein are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

the relevance (if any) of the use of the elective ordering rule for shareholders to reorder and potentially carry forward their nondeductible, noncapital expenses; (3) the application of the Proposed Regulations to a shareholder that is an employee stock ownership plan; and (4) clarification of the application of the rules in those cases where there are different taxable years being used by the S corporation and one or more of its shareholders.

## DISCUSSION

### I. INTRODUCTION

In general, when a taxpayer excludes income from the discharge of indebtedness from the taxpayer's gross income pursuant to section 108(a), the amount of such excluded income must be applied to reduce specified tax attributes. The net operating loss ("NOL") of the taxpayer is the first attribute to be reduced,<sup>3</sup> unless the taxpayer elects to reduce the basis of depreciable property before reducing any other tax attribute.<sup>4</sup> When a taxpayer has both an NOL for the taxable year of the discharge and an NOL carryover to the taxable year, the NOL for the taxable year of the discharge is reduced first. If the excluded income exceeds the amount of the NOL for the taxable year of the discharge, the NOL carryovers from prior taxable years are reduced in the order in which they were created.<sup>5</sup> In other words, after the current-year NOL is eliminated under section 108(b), the oldest NOLs are reduced or eliminated.

In the case of an S corporation, however, the Code provides certain special rules for the application of section 108(b). Section 108(d)(7)(A) provides that, in the case of an S corporation, the rules for income inclusion and tax attribute reduction are applied at the corporate level. In addition, under section 108(d)(7)(B), a loss or deduction that is disallowed for the taxable year of the discharge under section 1366(d)(1) is treated as an NOL of the S corporation for such taxable year.

Section 1366(d)(1) applies to a shareholder of an S corporation when the losses and deductions allocated by the S corporation to the shareholder for a taxable year exceed the shareholder's adjusted tax basis, determined at the end of the year, in the stock of the corporation and in any loans made by the shareholder to the corporation. Excess losses and deductions are treated as incurred in the succeeding taxable year of the shareholder, and thus, in effect, are carried forward for potential deduction in the subsequent year, subject to available adjusted tax basis in the carryover year.

In applying these two rules together, an S corporation may have an amount of income excluded under section 108(a) for a taxable year that either exceeds, or is less than, the amount of its shareholders' losses and deductions suspended under section 1366(d)(1) for such taxable year. (The Proposed Regulations refer to the amount of such suspended losses and deductions as the "deemed NOL" of the corporation.) If the amount of an S corporation's income excluded under section 108(a) exceeds its deemed NOL, the corporation must reduce other attributes in the manner provided in section 108(b), and the shareholders will have no suspended section 1366(d) losses to carry over from that taxable year. If an S corporation's deemed NOL exceeds the amount of income excluded under section 108(a), the corporation has an "excess deemed NOL," and the shareholders' suspended losses from that taxable year will be only partially reduced. The statute does not provide any rules for the allocation of an excess deemed NOL to its

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<sup>3</sup> I.R.C. § 108(b)(2)(A).

<sup>4</sup> I.R.C. § 108(b)(5).

<sup>5</sup> I.R.C. § 108(b)(4)(B).

shareholders, or to put it another way, the statute does not provide any rules as to how the partial reduction of suspended losses will be allocated among the shareholders.

The Proposed Regulations provide guidance in three principal areas: (a) the allocation of an excess deemed NOL to shareholders in the event that the amount of available losses exceeds the amount of the excluded income; (b) the determination of the character of such allocations back to each shareholder; and (c) information-sharing requirements affecting the corporation and its shareholders.

## II. ANALYSIS AND COMMENTS

We believe that the Proposed Regulations provide helpful and necessary guidance on the issues presented under section 108(d)(7). The statutory structure itself is somewhat inflexible, and may lead to unintended or inappropriate results. For example, although losses and deductions are allocated to S corporation shareholders in accordance with their stock interests during the taxable year of the allocation, the amount of available basis for any shareholder is not necessarily proportionate to that shareholder's stock ownership. Some shareholders may have relatively higher tax basis in their stock, while other shareholders may have made loans to the corporation to permit them to deduct the allocated losses and deductions. Thus, the amount of suspended, or excess, losses available to a shareholder will not necessarily be proportionate to the shareholder's ownership of stock in the corporation, or to the amount of excluded income that would be allocated to the shareholder.

Nevertheless, we believe that these anomalies are the result of the straightforward application of the statute. We believe that the formula set forth in the Proposed Regulations for the allocation of the excess deemed NOL back to each shareholder is appropriate. Further, we commend the Service and Treasury for providing that a former shareholder of an S corporation whose interest was completely terminated during the taxable year of the discharge (other than in a transaction subject to section 1041) may be allocated a portion of the tax attribute reduction. This approach is consistent with the statutory language of section 108(d)(7)(B), which refers to "any loss or deduction which is disallowed for the taxable year of the discharge" irrespective of shareholder ownership at year end, and has the effect of increasing the amount of section 1366(d)(1) suspended losses and deductions otherwise allocated to the continuing shareholders.

### A. S Corporations With C Corporation NOLs

The Proposed Regulations do not provide any guidance regarding the application of section 108(b) to an S corporation that has NOLs carried forward from one or more C corporation taxable years. We request that the Service and Treasury provide more specific guidance on this issue, by clarifying that such NOLs are also tax attributes available to an S corporation in applying section 108(b).

An S corporation does not lose its NOLs from C corporation taxable years when it elects to be taxed as an S corporation. Although, in general, an S corporation cannot deduct C

corporation NOLs in determining its taxable income,<sup>6</sup> it is permitted to do so for purposes of determining its liability for the tax on net recognized built-in gains.<sup>7</sup> Moreover, such C corporation NOLs may be taken into account if and when the S corporation election is terminated and the corporation becomes a C corporation again, although for purposes of determining the number of taxable years to which an NOL may be carried forward, any taxable year in which an S corporation election is in effect is included.<sup>8</sup> In sum, these NOLs remain as tax attributes of the S corporation while the election is in effect.<sup>9</sup>

Although we believe that such NOLs continue to be a tax attribute of an S corporation, and thus are available for reduction under section 108(b),<sup>10</sup> we also believe that the statute compels them to be used only after any losses suspended under section 1366(d)(1) have been fully utilized. Section 1366(d)(2) provides that allocated losses and deductions in excess of the available basis of a shareholder are treated as having been incurred by the corporation in the next succeeding taxable year with respect to that shareholder. This provision may be applied successively from one year to the next if the shareholder does not obtain any basis in the stock of, or loans made to, the S corporation. Thus, such losses may be carried forward indefinitely by that shareholder, but are always considered losses of the current taxable year.

Section 108(d)(7)(B) provides that, for purposes of applying the attribute reduction rules of section 108(b)(2), “any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss *for such taxable year*” (emphasis added). Section 108(b)(4)(B) provides that, among available NOLs of the taxpayer, the NOL “for the taxable year of the discharge” must be used first. Only after the current NOL is used, the NOLs carried forward from prior taxable years may be used.

Accordingly, the Regulations, when finalized, should clarify whether an actual NOL of an S corporation, carried forward from one or more C corporation taxable years (in contrast to a deemed NOL under the Regulations), continues to be an attribute available for reduction under section 108(b)(2). If actual NOLs are available for reduction, we

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<sup>6</sup> I.R.C. § 1371(b)(1).

<sup>7</sup> I.R.C. § 1374(b)(2).

<sup>8</sup> I.R.C. § 1371(b)(3).

<sup>9</sup> Similar rules apply with respect to capital losses and general business credits carried forward from a C corporation taxable year. I.R.C. §§ 1374(b)(2) and (3)(B).

<sup>10</sup> See, however, PLR 9541001 (Nov. 30, 1994), which held that net operating loss carryforwards from periods when an S corporation was a C corporation are not subject to attribute reduction under section 108(b)(2)(A), referring to section 1371(b)(1) (“No carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation.”). We do not believe that the conclusion reached in PLR 9541001 is required by the language of section 1371(b)(1). The C corporation NOLs that would be affected by attribute reduction in these circumstances would be carryovers from prior C corporation years otherwise allowable as a deduction against net unrealized built-in gains for a subsequent S corporation year, as expressly permitted by section 1374(b)(2). The rule proposed in these Comments could produce better or worse tax consequences for a particular taxpayer, depending upon the circumstances, but we feel it is more consistent with the policies underlying section 108.

believe they should only be reduced after the deemed NOLs of the S corporation (losses suspended under section 1366(d)(1) at the shareholder level) have been eliminated by operation of section 108(d)(7)(B).<sup>11</sup>

Finally, the Regulations, when finalized, also should clarify that other attributes carried forward from taxable years in which the corporation was a C corporation are available for reduction under section 108(b). Thus, if an S corporation has unused general business credits, minimum tax credits, or capital loss carryovers from C corporation taxable years, these items should be available to offset income excluded under section 108(a) before the S corporation is required to reduce the basis of its property under section 108(b)(2)(E).<sup>12</sup>

## B. Character of Reallocated Losses and Deductions

The Proposed Regulations recognize that a shareholder of an S corporation may have two or more different types of loss and deduction subject to the section 1366(d) limitation. For example, a shareholder may have unused deductions for charitable contributions, section 163(d) investment interest, capital losses, and section 1231 losses,<sup>13</sup> in addition to an unused nonseparately computed loss. The current Regulations provide that, in determining the character of the deduction used or suspended in a given taxable year of a shareholder, where the basis that is available is less than the aggregate losses and deductions allocated to the shareholder, each category of losses is considered to be used and suspended on a pro rata basis.<sup>14</sup> Stated differently, there is no priority among categories of losses regarding their absorption and carryforward.

However, the Proposed Regulations provide an entirely new three-tier priority system for applying income excluded under section 108(a) to the suspended losses of the shareholders. First, the excluded income would be applied to all of the deemed NOL other than section 1231 losses and capital losses. Second, the excluded income would be applied to that portion of the deemed NOL which consists of section 1231 losses. Finally, the excluded income would be applied to that portion of the deemed NOL which consists of capital losses.<sup>15</sup> The preamble indicates that this rule was adopted “to be

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<sup>11</sup> If this recommendation is adopted, the Regulations, when finalized, also should clarify that the earnings and profits of the corporation are not adjusted by the amount of income excluded under section 108(a) and applied to reduce the amount of NOLs carried forward from prior C corporation taxable years. Section 1371(c) provides that, with limited exceptions, no adjustment shall be made to the earnings and profits of an S corporation. Neither exception implicates any provision of section 108(b). Thus, we do not believe that the earnings and profits of an S corporation are required to be increased under these circumstances.

<sup>12</sup> Of course, if the corporation makes the election under section 108(b)(5) to reduce the basis of depreciable property before any other attribute, the other C corporation attributes would be absorbed, if at all, only after the reductions are applied to depreciable property, the deemed NOL, and the C corporation NOLs of the corporation, in that order.

<sup>13</sup> If a shareholder has made an election under Reg. § 1.1367-1(g), the shareholder may also have adjusted basis reduction carryovers for noncapital, nondeductible expenses and oil and gas depletion. However, those adjustments relate to basis only. Neither involves a deduction that is disallowed and therefore potentially subject to section 108(d)(7)(B).

<sup>14</sup> Reg. § 1.1366-2(a)(4).

<sup>15</sup> Prop. Reg. § 1.108-7(d)(3).

consistent with the ordering rule in section 108(b)(2),” pursuant to which an NOL of a C corporation is absorbed before its net capital loss is absorbed.<sup>16</sup>

We do not believe that either the language or the policy of the statute compels the use of the other categories of suspended losses before the suspended capital loss of a shareholder may be used. The ordering rules contained in section 108(d) appear to have been designed with C corporations in mind. Thus, they only purport to disallow three types of deduction carryovers, namely net operating loss under section 108(b)(2)(A), capital loss carryovers under section 108(b)(2)(D), and passive activity loss carryovers under section 108(b)(2)(F). However, the rules contained in section 108(d)(7)(B) for integrating S corporation suspended losses into this attribution reduction system specifically provide that all S corporation suspended losses “shall be treated as a net operating loss.” This language clearly suggests that all such suspended losses, regardless of character, should have first priority in terms of attribute reduction.

Moreover, attempting to apply the C corporation-based policy behind the section 108(b)(2) ordering system could produce some unintended results. The Proposed Regulations already deviate from the ordering system contained in section 108(b)(2) by creating a new separate middle category for section 1231 losses, a category not even contained in the section 108(b)(2) ordering system. Moreover, that attribution reduction scheme also does not contain any attribute reduction rules for other types of carryovers, such as charitable deductions and section 163(d) investment interest carryovers, that are often available for individual taxpayers who are also subject to the section 108(b)(2) ordering rules. If all of these suspended losses are not treated as contained within the first priority NOL category as we suggest above, it would appear that the more “consistent” way to apply the section 108(b)(2) ordering rules in the S corporation setting would be to treat nonseparately computed losses, capital losses, and passive losses as being subject to attribute reduction on a first, fourth, and sixth priority basis, respectively, under sections 108(b)(2)(A), (D), and (F), respectively, and to not allow attribute reduction for charitable contributions, investment interest, and other carryovers. This is what happens to individuals under section 108(b)(2), and, under section 1363(b), the “taxable income of an S corporation shall be computed in the same manner as in the case of an individual.”

We are not advocating for such a policy result. Rather, because the application of section 108(d)(7)(B) to the suspended losses of a shareholder is logically related to the application and suspension of losses under section 1366(d), we believe that a pro rata approach is also appropriate here. We recommend that the Regulations, when finalized, provide that each category of suspended losses be reduced on a pro rata basis.<sup>17</sup>

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<sup>16</sup> I.R.C. §§ 108(b)(2)(A) and (D).

<sup>17</sup> If the Regulations are to be fully consistent with the rules applicable to C corporations, the NOLs of an S corporation from C corporation taxable years should be used before any suspended net capital loss of a shareholder is used. Our recommended pro-rata approach makes it unnecessary to provide such a rule.

### C. Certain Information-Sharing Provisions

The Proposed Regulations also recognize that all of the information that an S corporation needs in order to comply with section 108(d)(7)(B) may not be in the possession of the corporation. Thus, the Proposed Regulations provide that the shareholders of the corporation must provide information to the corporation regarding the amount (if any) and character of their section 1366(d) suspended losses.<sup>18</sup> In turn, the corporation must provide information to the shareholders regarding the amount (if any) and character of any section 1366(d) suspended losses remaining after application of section 108(d)(7)(B).

The preamble specifically requested comments on appropriate means of dealing with shareholders who fail to provide the S corporation with the required information. Presumably, there may also be situations in which an S corporation fails to advise its shareholders of the amount (if any) and character of any remaining suspended losses. In our experience, we believe that the former circumstance is more likely to be the case. Accordingly, we confine our comments to suggested alternatives where one or more of the shareholders fail to provide the S corporation with the required information.

As a technical matter, the determination of the adjusted tax basis in the shares of stock owned by a shareholder is the responsibility of that shareholder. Among other considerations, this information is necessary in order to determine whether the shareholder is subject to a limitation on the use of allocated losses and deductions under section 1366(d)(1). In addition, this information is necessary in order to determine the shareholder-level tax consequences of a distribution made from the accumulated adjustments account (“AAA”) or made after all AAA and earnings and profits have been exhausted.<sup>19</sup>

As a practical matter, however, the S corporation often maintains such records for the shareholder and provides advice to the shareholder on the treatment of distributions and any applicable loss limitations. The S corporation may possess all requisite information because, for example, the corporation had accurate and reliable information regarding the original tax basis of the stock and has kept stock basis and related information updated. We believe it is appropriate for the Service and Treasury to permit the S corporation to rely on stock-basis and suspended-loss information set forth in its own records, provided that the corporation has no reason to believe that such information is inaccurate.

For example, if a shareholder has acquired newly-issued stock from the corporation itself, the corporation is likely to have reliable information regarding the original tax basis of such stock. This should be the case even if the shareholder has acquired the stock upon the exercise of an option to purchase the stock. The corporation should know whether the option was compensatory, and whether the shareholder was required to recognize any compensation income upon exercise. In the vast majority of cases involving the acquisition of stock from the corporation, the corporation will be able to reliably determine the amount of any suspended shareholder losses with respect to the

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<sup>18</sup> Prop. Reg. § 1.108-7(d)(4).

<sup>19</sup> I.R.C. §§ 1368(b) and (c).

corporation.<sup>20</sup> The corporation normally also should be aware of basis adjustments attributable to capital contributions to the corporation.

Similarly, the corporation will know the amount of any loan that the shareholder has made to the corporation. Such loans will also be taken into account in determining the amount (if any) of the losses of the shareholder suspended under section 1366(d)(1).

Even in cases where the shareholder has acquired some or all of the stock from an existing shareholder, whether by purchase, gift, inheritance, or otherwise, the corporation may have accurate and reliable information in its records regarding the shareholder's initial tax basis in those shares. In that case, and in the cases set forth above, by applying all of the relevant rules of sections 1366, 1367, and 1368, the corporation should be able to determine the amount (if any) and character of any losses and deductions suspended under section 1366(d)(1).<sup>21</sup>

Finally, we believe that the Regulations, when finalized, should set forth other presumptions to be applied when one or more shareholders of an S corporation simply fail to provide the information required by the Proposed Regulations. In those cases where such a shareholder failure exists, the Regulations, when finalized, could provide that the corporation and the noncompliant shareholder must treat the noncompliant shareholder as having no unused losses and deductions subject to section 1366(d) and therefore no suspended loss carryovers available for the next taxable year. The application of the formula set forth in the Proposed Regulations could have an adverse impact on those shareholders who properly comply with the information reporting requirements of the Proposed Regulations. However, we believe that this may provide an incentive for all of the shareholders to provide the required information. Similarly, the Regulations, when finalized, could provide that a shareholder who has received a complete calculation from the corporation of the allocation of the excess deemed loss attributable to that shareholder shall not be entitled to deduct any suspended losses in excess of those allocated to that shareholder by the corporation in that calculation to the extent that any inaccuracy in such calculation is based on such shareholder's failure to provide the corporation with the required information.

#### D. Other Suggestions for Clarification

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<sup>20</sup> In such a case, the only likely adjustments to tax basis of which the corporation may not be aware would be transaction costs and title costs of the shareholder capitalized under Reg. §§ 1.263(a)-5 and 1.212-1(k). The corporation should be entitled to presume that the shareholder did not incur any such capitalized costs except to the extent of any information actually provided by the shareholder to the corporation.

<sup>21</sup> In any of these cases, we believe it is appropriate to permit the corporation to presume that the shareholder has properly applied all of the relevant provisions of subchapter S, for example, by limiting flow-through deductions to the amount of any available basis, by treating distributions in accordance with section 1368, and by carrying forward only those losses and deductions as are permitted by section 1366(d). It may also be appropriate to permit the S corporation to presume that no other adjustments to the tax basis of the stock of, or loans to, the corporation have been made. For example, if a shareholder were to claim a worthless stock deduction under section 165(g) or a bad debt deduction under section 166, the basis in the affected stock or loans would be eliminated. The corporation should be permitted to presume that no such deductions have been taken in the absence of information to the contrary.

In addition to our three principal comments, we believe that several areas could be clarified, as set forth below. We do not view these matters to be significant or controversial, but clarification would be helpful.

1. Coordination With Closing-of-the-Books Election

Under the Proposed Regulations, one of the steps required in order to determine the amount of any excess deemed NOL to be allocated to a shareholder is to calculate the amount of cancellation of indebtedness income that would be allocated to each shareholder if it had not been excluded under section 108(a).<sup>22</sup> In one of the examples,<sup>23</sup> involving a change in stock ownership of the S corporation during the taxable year, the analysis suggests that the income is allocated to each of the affected shareholders using an approximate per-share, per-day allocation.<sup>24</sup> The selling shareholder, who owned 50% of the stock of the corporation, sold all of her stock on June 30, 2008, to another person in a transaction not subject to section 1041(a). The purchasing shareholder and the selling shareholder were allocated equal amounts of the excluded income attributable to the stock that was sold.

The Code and existing Regulations permit the corporation to make a “closing-of-the-books” election in order to allocate income, deduction, or other tax items, in the case of a complete termination of a shareholder’s interest<sup>25</sup> or a qualifying disposition.<sup>26</sup> If the election is made, the taxable year is treated as if it consisted of two separate taxable years for purposes of allocating such tax items.

The Regulations, when finalized, should clarify that, if a closing-of-the-books election is properly made, the amount of any income excluded under section 108(a) should be allocated among the shareholders consistently with the manner in which other items of income or loss are allocated. However, in addition, it would be helpful if the final Regulations confirmed that the elections under section 1377(a)(2) and Regulation section 1.1368-1(g) would not cause the bifurcated taxable year of the corporation to be treated as two separate taxable years for purposes of applying section 108(d)(7)(B). Section 1377(a)(2)(A) provides that the effect of the section 1377(a)(2) election is that “paragraph (1) [of section 1377(a)] shall be applied to the affected shareholder *as if* the taxable year consisted of 2 taxable years” (emphasis added); this language clearly suggests that a section 1377(a)(2) election should not prevent the S corporation’s entire taxable year from being considered “the taxable year of the discharge” under section 108(d)(7)(B). Thus, for example, the suspended loss of the terminated shareholder should be taken into account in the excess deemed NOL calculation, even if the discharge occurred in the portion of the taxable year after the effective date of the section 1377(a)(2) election.

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<sup>22</sup> Prop. Reg. § 1.108-7(d)(2)(ii)(A).

<sup>23</sup> Prop. Reg. § 1.108-7(e), Ex. 6.

<sup>24</sup> I.R.C. § 1377(a)(1).

<sup>25</sup> I.R.C. § 1377(a)(2). In this case, the election must be consented to by all of the affected shareholders of the corporation.

<sup>26</sup> Reg. § 1.1368-1(g). In this case, the election must be consented to by all of the shareholders of the corporation during the taxable year in which the event occurs.

## 2. Coordination With Elective Ordering Rule

The basis of a shareholder of an S corporation in the shareholder's stock in, or loans made to, the corporation may be affected by any nondeductible, noncapital expenses allocated by the S corporation to the shareholder.<sup>27</sup> Likewise, the amount of any losses of the shareholder disallowed by section 1366(d)(1) may also be affected by the amount of such expenses allocated by the S corporation to the shareholder. The existing Regulations require the shareholder to reduce available basis for the amount of nondeductible, noncapital expenses before reducing such basis for the amount of all other items of deduction or loss allocated to the shareholder.<sup>28</sup>

A shareholder may elect to reverse the order of these basis reductions.<sup>29</sup> Thus, if the election is made, the shareholder will reduce stock and debt basis for nondeductible, noncapital expenses after basis is reduced for amounts attributable to all other items of deduction or loss allocated to the shareholder. If the election is made, the shareholder must agree to carry forward any nondeductible, noncapital expenses allocated for one taxable year in excess of available basis to the following taxable year. The amounts so carried over must be applied to reduce basis in the following taxable year, and are generally treated as if they were subject to all of the provisions of section 1366(d). However, the election appears to apply "solely for purposes of" the section of the regulations dealing with the computation of basis. It does not appear to trigger the disallowance of any losses, or as a consequence, the creation of any suspended losses. Therefore, we do not believe that nondeductible, noncapital expenses should be treated as being subject to section 1366(d)(1) for purposes of section 108(d)(7)(B).

## 3. Treatment of Suspended Losses of ESOP Shareholders

As the result of amendments to subchapter S made by the Small Business Job Protection Act of 1996,<sup>30</sup> certain tax-exempt organizations were first permitted to be shareholders of an S corporation.<sup>31</sup> In exchange for permitting such organizations to be shareholders, the provisions of the unrelated business income tax ("UBIT") were made applicable to the entities' allocated share of S corporation income, loss, and deduction.<sup>32</sup> However, in the case of an employee stock ownership plan ("ESOP"), as defined in section 4975(e)(7), the UBIT does not apply to the extent that the allocations are made with respect to employer securities.<sup>33</sup>

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<sup>27</sup> I.R.C. § 1367(a)(2)(D).

<sup>28</sup> Reg. § 1.1367-1(f). These Regulations place the basis reduction described in section 1367(a)(2)(E) (relating to certain oil and gas depletion deductions) in the same category as the reduction for nondeductible, noncapital expenses.

<sup>29</sup> Reg. § 1.1367-1(g). If the election is made, the oil and gas depletion deductions are treated in the same manner as the nondeductible, noncapital expenses.

<sup>30</sup> Pub. L. No. 104-188, 110 Stat. 1838 (1996).

<sup>31</sup> I.R.C. § 1361(c)(6).

<sup>32</sup> I.R.C. § 512(e).

<sup>33</sup> I.R.C. § 512(e)(3).

Because the UBIT does not apply to the ESOP's share of S corporation income or loss, the amount of any suspended losses would not appear to be relevant to the ESOP. However, in Rev. Rul. 2003-27, 2003-1 C.B. 597, the Service concluded that an ESOP must adjust its basis in any S corporation stock that it holds for its share of items described in section 1367(a). Although its basis in the stock of an S corporation is not directly relevant to an ESOP shareholder, the basis of that stock is relevant for purposes of determining the amount of a lump sum distribution includible in the gross income of its participants.<sup>34</sup> Rev. Rul. 2003-27 observed that “[s]tock of an S corporation held by an ESOP is subject to the same basis adjustments under § 1367(a) as stock held by any other S corporation shareholder.” Presumably, if all of the basis adjustments apply to stock of an S corporation held by an ESOP, that ESOP is also subject to the provisions of section 1366(d). To the extent that any loss is disallowed by reason of section 1366(d)(1), that loss is treated as a loss incurred in the succeeding taxable year under section 1366(d)(2), and may reduce any available stock basis in such year for an ESOP shareholder in the same manner as any other shareholder.

We believe that any losses that would otherwise be suspended under section 1366(d)(1) for an ESOP holding stock in an S corporation should be treated as part of the S corporation's deemed NOL. Clarification of this point in the Regulations, when they are finalized, would be helpful.

#### 4. Applicable Taxable Years

Unlike a cancellation of indebtedness situation involving, for example, a C corporation or an individual, analysis of cancellation of indebtedness income for S corporations unavoidably requires reference to both the corporation's taxable year and the taxable years of its respective shareholders. In most cases, the taxable years of all parties will be the calendar year. However, there are some common situations where this might not be true, such as an estate of a minority shareholder using a fiscal year as its taxable year or an S corporation making an election under section 444 to use a taxable year other than a required taxable year.

It would be helpful if the Regulations, when finalized, confirmed that the analysis under section 108(d)(7) is based on the taxable year of the S corporation, except that the suspended loss of a taxpayer with a non-conforming year should be made with reference to the taxable year in which the income/loss of the corporation's taxable year is reflected, and only in respect of income/loss passed through for that corporation taxable year.

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<sup>34</sup> I.R.C. §§ 402(a) and 402(e)(4). In calculating the gross income from lump-sum distributions from qualified plans, including ESOPs, net unrealized appreciation (“NUA”) on employer securities is excluded by the participant in the year of receipt under section 402(e)(4)(B). NUA is determined based on the ESOP's adjusted basis in the distributed stock. The remaining appreciation (or depreciation) in the distributed stock will be taxed as long term capital gain (or loss) in the year the stock is sold by the participant.