Section of Taxation
10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670

April 6, 2010

The Honorable Sander M. Levin
Chairman
United States House of Representatives
Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Max S. Baucus
Chairman
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Dave Camp
Ranking Member
United House of Representatives
Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles E. Grassley
Ranking Member
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: H.R. 4169- Technical Correction to ARRA Change in Section 1374 Built-In Gain Tax

Dear Chairmen and Ranking Members:

These comments are submitted on behalf of the American Bar Association Section of Taxation 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.

Our comments relate to a proposed technical correction to the American Recovery and Reinvestment Act of 2009[1] ("ARRA"), that is included in H.R. 4169, the *Tax Technical Corrections Act of 2009,* introduced on December 2, 2009 (the "Technical Corrections Bill"). We believe that, as drafted, section 2(h) of the Technical Corrections Bill constitutes a substantive retroactive change in law that would adversely affect taxpayers who reasonably acted in reliance on ARRA as originally enacted.

As background, ARRA amended section 1374(d)(7)(B)[2] to provide, in relevant part:

> Special rule for 2009 and 2010. In the case of any taxable year beginning in 2009 or 2010, no tax shall be imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year.

Given that this amendment was part of economic stimulus legislation, presumably it was intended to stimulate economic activity by removing barriers to sales transactions.

The President signed ARRA into law on February 17, 2009. As a consequence, under current law, for taxable years beginning in 2009 and 2010, no corporate-level tax is imposed on the net unrecognized built in gains of an S corporation if the seventh taxable year in the recognition period preceded the relevant taxable year (2009 or 2010, as the case may be).

[1] Pub. L. No. 111–5, 123 Stat. 115.
[2] ARRA § 1251. References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

Section 2(h) of the Technical Corrections Bill would strike the phrase "7th taxable year" and insert "7th year" in section 1374(d)(7)(B). Pursuant to section 2(n) of the Technical Corrections Bill, this change would be effective retroactively as if it had been included in ARRA. A description of the Technical Corrections Bill prepared by the staff of the Joint Committee on Taxation states that this provision "clarifies that seven calendar years (not seven taxable years) in the 10-year recognition period must have elapsed prior to any taxable year beginning in 2009 or 2010 for an S corporation to be eligible for the built-in gains tax relief under the Act."[3]

The meaning of the term "taxable year" for U.S. federal income tax purposes is well established. A "taxable year" is not necessarily the same as a calendar year or a "year." Instead, in some circumstances, a taxable year is a period of less than 12 months, as is clearly contemplated by the statutory definition of "taxable year" set forth in 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.*

Short taxable years were taken into consideration under the pre-1986 version of section 1374 ("pre-1986 section 1374"), which imposed a corporate-level tax on capital gains recognized by a converted C corporation within three (3) *taxable years* of the corporation's conversion to S status. A series of private letter rulings confirmed that short taxable years arising as a result of conformity with the S corporation "permitted taxable year" rules counted as taxable years for purposes of pre-1986 section 1374.[4] Section 1374(a) currently imposes a corporate level tax on the net recognized built-in gain of an S corporation within a recognition period, which is defined as "the *10-year period* beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation."[5] Neither the statutory language of ARRA nor its legislative history, however, suggested that *short* taxable years were to be disregarded in counting taxable years for purposes of ARRA's provisions generally governing converted C corporations.

Moreover, the Conference Committee Report that accompanied ARRA highlighted the distinction between the use of the term "*taxable* year" and "year" in addressing distinctions between the treatment of (i) converted C corporations generally and (ii) assets acquired in carryover basis transactions covered by section 1374(d)(8), as amended. In respect of the former, the report stated:

> Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax will be imposed under Code Section 1374 after the seventh [7th] *taxable year* that the S corporation election is in effect.[6]

And as to the latter:

> In the case of built-in gain attributable to an asset received by an S corporation or a C corporation in a carryover basis transaction, no tax will be imposed under

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[3] Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2009* (JCX-56-09), December 2, 2009, p. 2.
[4] *See, e.g.*, PLR 8651019 (Sept. 19, 1986); PLR 8901033 (Oct. 16, 1988); PLR 8911049 (Dec. 20, 1988).
[5] I.R.C. § 1374(d)(7)(A).
[6] H.R. Rep. No. 111-16, at 570 (2009) (Conf. Rep.) (Emphasis added).

section 1374 if such gain is recognized after the date that is *seven [7] years* following the date on which such asset was acquired.[7]

Because section 2(h) of the Technical Corrections Bill, if enacted, would be effective retroactively, we are concerned that it could unfairly affect taxpayers who relied on the plain language Congress used in ARRA. For example, assume that a corporation that used a fiscal year ending September 30 converted to S corporation status effective October 1, 2002. Consistent with the S corporation rules, the corporation began to use a calendar year following the conversion. Hence, the corporation had a short taxable year from October 1, 2002, to December 31, 2002. By January 1, 2009, seven taxable years had passed since the corporation converted to S corporation status. In reliance on the ARRA provision, the S corporation negotiated a sale of its assets based on the understanding that the built-in gain tax would not apply to gain recognized on such sale. The sale was consummated in July of 2009. If enacted, section 2(h) of the Technical Corrections Bill would cause gain recognized on the sale to be subject to corporate-level tax. This is because, even though 7 *taxable years* had passed before the beginning of the S corporation's 2009 taxable year, 7 *calendar years* had not passed. If the S corporation had been aware that the built-in gains tax would apply to the sale, the S corporation might not have sold the assets or it might have sought to negotiate different terms for the sale. Based on the statutory language and the distinctions drawn in the Committee Reports, we believe taxpayers were entirely justified in concluding that Congress used the term "taxable years" intentionally, and that the term "taxable years" was purposefully chosen to increase the number of corporations qualifying for relief under ARRA, and thereby to promote ARRA's purpose of encouraging potentially stimulative asset sales.

The ability of taxpayers to rely on the tax law is a cornerstone of our federal tax system. Therefore, if Congress decides that it is appropriate to modify section 1374(d)(7)(B) to refer to "years" rather than "taxable years," we respectfully submit that, as a matter of sound tax policy, such a change ought to be prospective in application. As such, we encourage you to consider either not making the change proposed in section 2(h) of the Technical Corrections Bill or making such change prospective.

Thank you for your consideration of this matter. Representatives of the Section would be pleased to provide any further information you may need regarding this matter. Please contact, Helen Hubbard, the Section's Vice Chair for Government Relations, at (202) 452-7005 if that would be helpful.

Sincerely,

Stuart M. Lewis
Chair, Section of Taxation

cc: Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Harold E. Hirsch, Senior Legislation Counsel, Joint Committee on Taxation
Cecily W. Rock, Senior Legislation Counsel, Joint Committee on Taxation

[7] H.R. Rep. No. 111-16, at 571 (2009) (Conf. Rep.) (Emphasis added).

John Buckley, Majority Chief Tax Counsel, House Ways and Means Committee
Cathy Koch, Majority Chief Tax Counsel, Senate Finance Committee
Dave Olander, Minority Chief Tax Counsel, House Ways and Means Committee
Mark Prater, Minority Chief Tax Counsel, Senate Finance Committee