October 30, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on the Application of Section 165(g)(3) to S Corporations

Dear Commissioner Koskinen:

Enclosed please find comments on the application of section 165(g)(3) to S corporations (“Comments”). 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 the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

cc: William J. Wilkins, Chief Counsel, Internal Revenue Service
    Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
    Curtis Wilson, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
    Donna M. Young, Deputy Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
    Brad Poston, Senior Technician Reviewer (Passthroughs & Special Industries), Internal Revenue Service
    Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
These comments (‘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.

Principal responsibility for preparing these Comments was exercised by the following members of the S Corporations Committee (the “Committee”): Jerald D. August, Dana A. Lasley, Laura E. Krebs Al-Shathir and Thomas J. Phillips. Other members of the Committee also provided comments. The Comments were reviewed by Laura D. Howell-Smith, Chair of the Committee, by Kevin D. Anderson of the Committee on Government Submissions, by John O. Tannenbaum, Council Director for the Committee and by Peter H. Blessing, Vice Chair (Government Relations).

Although members of the Section of Taxation who participated in preparing the Comments have clients who would be affected by the federal income tax principles addressed by the Comments, or have advised clients on the application of such rules, 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 the Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

Contact:
Laura D. Howell-Smith
Phone (202) 220-2076
lhowellsmith@deloitte.com

Date: October 30, 2015
I. Executive Summary

The Internal Revenue Service (“Service”) Office of Associate Chief Counsel Passthroughs & Special Industries requested the Committee to comment on item 1 under the Subchapter S Corporation Section of the Treasury Department (the “Treasury”) 2015-2016 Priority Guidance Plan (July 31, 2015). This item is listed as “[g]uidance regarding worthless stock deductions under §165(g)(1) for S corporations.” The specific issue on which the comments were requested is whether an S corporation is entitled to an ordinary loss under section 165(g)(3), when any security in a corporation affiliated with the S corporation becomes worthless. The Service gave the Committee a list of authorities to consider in providing comments on this issue. We appreciate the opportunity to comment on this issue and recommend that the Service and the Treasury issue guidance providing that an S corporation is entitled to an ordinary loss under section 165(g)(3) when any security in a corporation affiliated with an S corporation becomes worthless.

II. Statutory Background

Section 165(g)(1) provides that, if any security which is a capital asset becomes worthless during the taxable year, the loss therefrom shall be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. Section 165(g)(2) provides that, for purposes of section 165(g), the term “security” means a share of stock in a corporation, or right to subscribe for or to receive such a share, or a bond, debenture, note or other evidence of indebtedness issued by a corporation or a government (or political subdivision thereof) with interest coupons or in registered form. Under section 165(g)(3), for purposes of section 165(g)(1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset.

Under section 165(g)(3)(A)-(B), a corporation is treated as “affiliated” with the taxpayer only if the taxpayer owns directly stock in such corporation meeting the requirements of section 1504(a)(2) and more than 90% of the corporation’s gross receipts for all taxable years has been from sources other than royalties, rents, dividends, interest, annuities and gains from sales or exchanges of stocks and securities, with certain exceptions. The requirements under section 1504(a)(2) are met if the taxpayer owns stock of a corporation that possesses at least 80 percent of the total voting power of the stock of such corporation and has a value equal to at least 80% of the total value of the stock of such corporation.

Thus, if stock or any other security in a corporation that is affiliated with a domestic corporation becomes worthless, section 165(g)(1) does not apply and the loss is an ordinary loss. As a result, focusing solely on the language of section 165(g)(3), if stock in a corporation that is affiliated with an S corporation becomes worthless, that stock is not a capital asset and section 165(g)(1) does not apply because the S corporation is a “taxpayer which is a domestic corporation.”

1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
III. Analysis and Comment

Our Comments below first examine the technical requirements of section 165(g)(3) in the context of an S corporation. Thereafter the Comments consider the effect of the S corporation regime, specifically, sections 1363(b) and 1366(b), on these requirements and the issue at hand.

We recognize that the similarity of the pass-through provisions of the S corporation regime to the partnership regime raises a policy question concerning the appropriateness of the application of section 165(g)(3) in the context of an S corporation. The legislative history of section 23(g)(4) of the Internal Revenue Code of 1939 as amended, the predecessor to section 165(g)(3), states:

Such a parent and subsidiary may file consolidated returns and to this extent the corporate entity is ignored. Thus, the losses of the one may be offset against the income of the other. It is deemed desirable and equitable, therefore, to allow the parent corporation to take in full the losses attributable to the complete worthlessness of the investment in the subsidiary.\(^2\)

An S corporation and its subsidiaries may not file a consolidated return.\(^3\) However, even though a domestic C corporation may not include a foreign subsidiary in a consolidated return, it is permitted to claim (assuming the section 165(g)(3) requirements are otherwise met) a worthless security deduction in respect of a directly held foreign subsidiary. Moreover, the S corporation regime did not exist when section 23(g)(4) of the Internal Revenue Code of 1939 as amended was adopted.

Unlike in the case of a C corporation, the worthless security deduction claimed by an S corporation passes through to shareholders of the corporation. Nevertheless, an S corporation meets the statutory requirements under section 165(g)(3) of a “taxpayer which is a domestic corporation,” as described below. Further, an S corporation may elect to have its wholly owned subsidiary treated as a qualified subchapter S subsidiary (“QSSS”), in which event the subsidiary entity is disregarded and the income, expenses and loss of the QSSS are treated as the income, expenses and loss of the S corporation.\(^4\) The effect of the QSSS regime is that, in the case of a wholly owned subsidiary (though not an affiliated but less than wholly owned subsidiary), the ordinary deductions available to the shareholders by reason of a worthless stock deduction may be in lieu of ordinary deductions that could have been available to the shareholders had a QSSS election been made. A similar election is not available to a partnership, which distinguishes the partnership regime and has relevance in considering the application of section 1363(b).

\(^2\) S. REP. No. 77-1631, at 46 (1942).
\(^3\) I.R.C. §1504(b).
\(^4\) See I.R.C. §1361(b)(3).
A. An S corporation is a “taxpayer which is a domestic corporation” under section 165(g)(3).

Under section 7701(a)(14), the term “taxpayer” means any person subject to any internal revenue tax. S corporations are subject to the built in gains tax under section 1374 and the tax on passive income under section 1375. S corporations may also be subject to various excise and other taxes under the Code. As a result an S corporation is a “taxpayer” within the meaning of section 7701(a)(14). In this regard, S corporations are distinguishable from partnerships.

An S corporation also is a domestic corporation. Indeed, section 1361(a) defines a C corporation as “a corporation which is not an S corporation,” and an S corporation as a “small business corporation” for which an election under section 1362 has been made. Under section 1361(b)(1), a “small business corporation” means a “domestic corporation” which is not an ineligible corporation. Thus, there are two types of corporations – C corporations and S corporations – and S corporations, by definition, must be domestic.

There is no indication that Congress has ever intended to treat an S corporation as other than a “taxpayer which is a domestic corporation” for purposes of section 165(g)(3). We have found no legislative history indicating such an intention. Therefore, the word “corporation” in section 165(g)(3) should be given its plain and clear meaning as including both S corporations and C corporations.

Case law also supports interpreting the term “corporation” in section 165(g)(3) as including both C corporations and S corporations. For example, in Rath v. Commissioner,⁵ an S corporation owned stock in a corporation which qualified as section 1244 stock as defined in section 1244(c). The S corporation sold the stock of the subsidiary corporation and incurred a loss on the sale. The shareholders of the S corporation claimed the loss incurred by the S corporation as an ordinary loss on their income tax returns. The Service determined that section 1244 loss treatment did not apply to the S corporation shareholders because the S corporation was not an individual or a partnership as required by section 1244(a).⁶

The Tax Court in Rath held that the S corporation shareholders were not entitled to section 1244 loss treatment because the S corporation incurred the loss on the stock and was not considered an individual or a partnership, despite its pass-through nature. The Tax Court reasoned that the plain language of section 1244(a) directs that ordinary loss treatment is limited to individuals and partnerships and that, where a statute is clear on its face, there must be unequivocal evidence of legislative intent before construing the statute so as to override the plain meaning of the words therein. The Tax Court found that there was no indication in the legislative history that section 1244(a) was intended to apply to S corporations.

---

⁶ Section 1244(a) provides that “[i]n the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership” is treated as an ordinary loss rather than a capital loss.
Further support is provided by United States v. BDO Seidman, which addressed, among other issues, the question of whether an S corporation was considered a “corporation” for purposes of a prior version of section 7525(b). In its opinion, the Seventh Circuit Court of Appeals stated:

The Interveners provide no support for their argument that the term “corporation” as used in §7525(b) only means “C corporation.” The IRC itself defines an S corporation as a “small business corporation for which an election under section 1362(a) is in effect,” id. §1361(c)(1); it defines a C corporation as “a corporation which is not an S corporation,” id. §1361(a)(2). This usage alone suggests that, when a particular section of the IRC is intended to apply only to C corporations, Congress will use that term rather than the generic “corporation.” Additionally, the IRC and implementing Treasury Regulations define “corporation” for federal tax purposes as “a business entity organized under a Federal or State statute . . . if the statute describes or refers to the entity as incorporated or as a corporation.” 26 C.F.R. §301.7701-2(b)(1).

Other cases support the conclusion that a reference in the Code to “corporation” includes an S corporation unless otherwise expressly provided.

Further, by analogy, case law applying section 166 in the case of a partnership is relevant. Section 166 allows taxpayers a bad debt deduction for a debt that is not evidenced by a security and becomes worthless within the tax year. But under section 166(d), a “taxpayer other than a corporation” is entitled to such a deduction only if the debt is not a “nonbusiness debt.” Section 166(d)(2)(A) provides in pertinent part that “nonbusiness debt” means a debt other than a debt created or acquired in connection with a trade or business of the taxpayer.

Section 166(d) should not apply to a debt held by an S corporation because, as discussed above, an S corporation is not a “taxpayer other than a corporation.” In Cole v. Commissioner, the Tax Court held that certain bad debt losses incurred by a partnership were nonbusiness bad debts within the meaning of section 166(d), and, accordingly, the partners should treat such nonbusiness bad debts as short-term capital losses. In doing so, the court considered the “taxpayer” to be the partnership, and not the partners, for purposes of section 166(d), as evidenced by the court’s rationale that the debts had no proximate relationship to the partnership’s business of appraising real estate.

Differences in tax treatment between partnerships and S corporations are found throughout the Code. Although both S corporations and partnerships are flow-through
entities, there are a host of differences between the subchapter S and subchapter K rules (e.g., technical termination rules, section 754 elections, disguised sale rules, anti-mixing bowl rules, etc), with subchapter S borrowing heavily from the subchapter C rules. Indeed, section 1371 provides that S corporations are subject to the rules of subchapter C except to the extent subchapter S explicitly provides otherwise, or to the extent inconsistent with subchapter S.

B. Character is determined at the S corporation level.

Section 165(g)(3) governs whether certain kinds of securities are capital assets for purposes of section 165(g)(1). The determination of whether a security is (or is not) a capital asset under section 165(g)(3) in turn determines the character of the loss if such security becomes worthless.

Under section 1366(b), the character of any item of income, loss, deduction or credit included in a shareholder’s pro rata share shall be determined as if such item were realized directly from the source from which realized by the corporation or incurred in the same manner as incurred by the corporation. Regulation section 1.1366-1(b)(1) interprets section 1366(b) to mean that the character of any such item is “determined for the S corporation and retains that character in the hands of the shareholder.” The regulation provides by way of example that, if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder’s pro rata share of that gain will also be characterized as capital gain, regardless of whether the shareholder otherwise is a dealer. Thus, character is determined at the corporate level, notwithstanding that the character of the item might be different if the item were directly realized by the shareholder.

The legislative history to section 1366(b) provides that:

A “conduit” rule for determining the character of items realized by the corporation and included in the shareholder’s pro rata share will be the same as the partnership rule (sec. 702(b)). Under the partnership rules, this has generally resulted in an entity level characterization.\(^\text{11}\)

In addition, as explained above, in Rath, the Tax Court determined that section 1366(a) and (b) require the character of a loss to be determined from the viewpoint of the S corporation rather than from the viewpoint of its individual shareholders. Other authorities also support the characterization of an item at the S corporation level.\(^\text{12}\) As a result, the applicable authorities dictate that, when an S corporation holds stock in an affiliated corporation that becomes worthless, the determination of whether the worthless stock is a capital asset or a noncapital asset and the character of the loss is made at the S corporation level.

\(^{11}\) S. REP. No. 97-640, at 17 (1982).
\(^{12}\) See Rev. Rul. 87-121, 1987-2 C.B. 213 (under section 1366(c), an individual shareholder’s pro rata share of an S corporation’s gross income from farming is treated as the individual’s gross income from farming for purposes of the estimated tax provisions of section 6654(i)); PLR 9130003 (March 25, 1991) (shareholders of an S corporation were not entitled to section 1244 ordinary loss on section 1244 stock owned and sold by the S corporation because the S corporation was treated as a corporation and a corporation does not qualify for a section 1244 loss).
As discussed in part III.A above, focusing on section 165(g)(3), if the stock is stock of a corporation that is affiliated with the S corporation, it is not a capital asset under section 165(g)(3) and the loss is ordinary in character, even though it flows through to non-corporate shareholders. The question remains whether other provisions of the S corporation regime, in particular section 1363(b), change the character of the loss for purposes of its determination at the S corporation level.

C. Section 1363(b) does not make section 165(g)(3) inapplicable or otherwise change the character of the loss.

Section 1363(b) provides that the taxable income of an S corporation is computed in the same manner as in the case of an individual, with certain specified exceptions. In addition, the legislative history of section 1363(b) indicates an intention to generally tax S corporation shareholders like partners. Thus, the issue arises as to whether treating stock in an affiliated corporation owned by an S corporation as a noncapital asset could be viewed as part of the computation of taxable income. In the case of an S corporation, the treatment of the stock affects the character of the loss incurred by the corporation and the type of income the loss may be claimed against. It also affects the character of the items that flow through to the shareholders and the type of income any net loss item may be claimed against at that level.

Section 1363(b) sets forth the rule for computing an S corporation’s taxable income. Section 1366(b), on the other hand, sets forth the rule for determining the character of gain or loss included in an S corporation shareholder’s pro rata share. It would be reasonable to conclude that the determination of character, dealt with in a separate provision, was viewed by Congress as separate from the computation of taxable income. Moreover, section 165(g)(3) is a definitional provision that applies before reaching the actual computation. Accordingly, although the matter is not entirely clear, we believe that the better reading of the statutory language and related authorities is that section 165(g)(3) applies to S corporations.

The Service has requested that we consider certain authorities in our analysis of this issue. These authorities include Rev. Rul. 93-36, Rev. Rul. 2000-43, comments previously received from this Committee, GCM 34706 (Dec. 3, 1971) and Estate of Minnie Miller v. Commissioner. As indicated below, we do not believe that any of these authorities change the fact that, as currently written, section 165(g)(3) applies to S corporations.

15 1993-1 C.B. 187.
17 27 T.C.M. (CCH) 1140, 1968 T.C.M. (RIA) ¶ 68,230, aff’d per curiam, 421 F.2d 1405 (4th Cir. 1970) (“Miller”).
Rev. Rul. 93-36 concluded that, because section 1363(b) requires an S corporation’s taxable income to be computed in the same manner as an individual, the S corporation’s loss was a nonbusiness bad debt described in section 166(d)(2). It reasoned that section 166 is not explicitly excepted from section 1363(b) and in effect treated section 166 as within the scope of section 1363(b). However, section 166(d), like section 165(g)(3), addresses character, and hence may be considered more properly within the scope of section 1366(b), rather than section 1363(b). Further, Rev. Rul. 93-36 reached its conclusion without explicitly addressing whether an S corporation is a “corporation” under section 166(d). Under section 166(d), the nonbusiness debt rule only applies to a taxpayer other than a “corporation”. In sum, Rev. Rul. 93-36 appears to be inconsistent with the authorities discussed above under Part III A, and we do not believe that it reaches the correct result under the existing statutory language or Regulation section 1.1366-1(b)(1).

Rev. Rul. 2000-43 does not support a conclusion that section 1363(b) affects the application of section 165(g)(3) in the case of an S corporation. Rev. Rul. 2000-43 addresses the ability of an S corporation to make an election under section 170(a)(2) and the resulting effect on the computation of an S corporation’s taxable income. Section 170(a)(2) provides that an accrual-basis corporation may elect to deduct a charitable contribution in the year in which the board of directors authorizes the contribution if the payment is made by the 15th day of the third month following the close of the taxable year. Rev. Rul. 2000-43 concluded that an accrual-basis S corporation may not elect under section 170(a)(2) to treat a charitable contribution as paid in the year authorized by the S corporation’s board of directors if the contribution is paid by the S corporation after the close of the taxable year. In its analysis in Rev. Rul. 2000-43, the Service noted that the rationale behind section 170(a)(2), namely, a corporation’s difficulty in determining its charitable contribution limit under section 170(b)(2), does not apply to S corporations because S corporations are not subject to the same charitable contribution limits under section 170(b)(2). This rationale is specific to section 170 and is not applicable in the context of section 165(g)(3). The Service also looked to section 1363(b) for the rule that an S corporation computes its taxable income in the same manner as an individual and stated that the election under section 170(a)(2) is not available to an individual. Section 1363(b) expressly refers to section 703(a)(2), which provides that deductions under section 170 are not allowed in computing the taxable income of an S corporation. In contrast, section 1363(b) does not include any reference to section 165(g)(3). Accordingly, the rationales of Rev. Rul. 2000-43 are not persuasive for purposes of analyzing section 165(g)(3) in the context of S corporations.

---

18 1993-1 C.B. 187
19 In addition, it may be that section 1371(a) as in effect in 1993 impacted the conclusion in Rev. Rul. 93-36. Section 1371(a) as then in effect, provided that for purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual. In 1996, section 1371(a) was amended to provide only that subchapter C shall apply to an S corporation and its shareholders except to the extent inconsistent with subchapter S or as otherwise provided in the Code.
GCM 34706 (Dec. 3, 1971) considered the issue of whether section 165(c) is applicable by its terms only to individuals and not to estates. The whole of its analysis with respect to this issue is:

Section 641(b) provides that for an estate taxable income is generally computed in the same manner as for an individual with exceptions not relevant herein. Thus, for purposes of section 165 an estate is treated as an individual and the requirements of section 165(c) are applicable to estates.

In support of this conclusion, the GCM cites Miller, but acknowledges that the issue was not raised by the taxpayer in that case. In Miller, the issue presented was whether the sale of the decedent’s partnership interest to her son was a “transaction entered into for profit” within the meaning of section 165(c)(2). This section provides “[i]n the case of an individual, the deduction under subsection (a) shall be limited to losses incurred in any transaction entered into for profit, though not connected with a trade or business.” The Tax Court applied section 165(c)(2) and thus by implication, without any discussion, treating the estate as an individual. This holding was affirmed by the appellate court on a per curiam basis. In neither Miller nor the GCM, however, did the issue considered relate to the character of an item.

In a letter dated November 30, 2006, the Committee submitted comments on Proposed Regulations under section 1363(b) concerning S corporation banks and addressed one of the exceptions to computing taxable income in the same manner as an individual. The letter stated in part:

The Proposed Regulations would apply the 20-percent proportionate disallowance provisions of section 291(a)(3) and (e)(1)(B) relating to financial institution preference items to a bank that is an S corporation. These Proposed Regulations would apply to an S corporation that has never been a C corporation, as well as to an S corporation that has passed the three-year period specified in section 1363(b)(4). They would presumably also apply to determine the income of a bank that is a qualified subchapter S subsidiary.

It was the Committee’s position that the Proposed Regulations were inconsistent with section 1363(b)(4), which states that section 291 applies to an S corporation if the corporation has been a C corporation during any of the preceding three taxable years. After the expiration of the three-year period for an S corporation, that corporation is no longer subject to any of the provisions of section 291, including the provision that reduces the allowable deduction for interest expense incurred by a bank.

In the October 26, 2011 issue of the Federal Register, the Treasury Department and the Service published the decision to withdraw these Proposed Regulations. Their reason for the withdrawal was not disclosed. It should be noted, however, that on December 27, 2010, the Service announced in an action on decision (AOD 2010-06) that it acquiesced in the result only of Vainisi v. Commissioner. In Vainisi, the Seventh Circuit found that section 1363(b)(4) precluded application of section 291 to the Vainisis’ S corporation.

20 599 F.3d 567 (7th Cir. 2010) rev’g 132 T.C. 1 (2009) (“Vainisi”).
holding company, which wholly-owned a bank that had elected tax treatment as a QSSS, because the holding company had not been a C corporation for any of the three preceding years. In its action on decision, the Service said it would not apply section 291(a)(3) and (e)(1)(B) to a QSSS bank or an S corporation bank unless the bank, or any predecessor, was a C corporation for any of the three immediately preceding tax years.

Both the Seventh Circuit’s decision in Vainisi and the Committee’s comments were based on the express language of section 1363(b)(4). They do not support the position that section 165(g)(3) does not apply to an S corporation with respect to a worthless securities deduction.

D. Ownership by S corporation of affiliated corporation

Congress defined an affiliated corporation under section 165(g)(3) as a corporation that meets the stock ownership requirements of section 1504(a)(2). The reference to section 1504(a)(2) in section 165(g)(3) only goes to stock ownership and value. Section 165(g)(3) does not reference section 1504(a)(1). There is no requirement under section 165(g)(3) that the affiliated corporation must also be an includible corporation under section 1504(b). Therefore, the fact that, under section 1504(b)(8), an S corporation is not an includible corporation for purposes of section 1504(a)(1) should be of no relevance under section 165(g)(3).

This is supported by the analysis in CCA 201030024 (April 26, 2010). One of the issues presented therein was whether the controlled foreign corporations owned by an S corporation were “C corporations” for purposes of section 1362(d)(3)(C)(iv). This section applies only to dividends that an S corporation receives from a C corporation in which the S corporation owns stock that meets the ownership requirements of section 1504(a)(2). The CCA stated that “[b]ased on the facts presented, S Corp holds the requisite stock ownership with respect to its directly wholly-owned CFCs and thus is eligible for the exclusion set forth in section 1362(d)(3)(C)(iv) . . . .” A foreign corporation, however, is not an includible corporation under 1504(b). So it can be concluded that a reference to section 1504(a)(2), whether under section 1362 or section 165(g)(3), is only for purposes of addressing requisite ownership, and is not a requirement that the corporation be eligible to be a part of a consolidated group.

E. Recommendation

In view of the above analysis and comment, we recommend that the Service and Treasury provide guidance that section 165(g)(3) applies to S corporations as well as C corporations. If there are serious concerns with this result from a policy perspective, we believe that a statutory change is the best approach.