Current Developments

In

Federal Taxation of S Corporations

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BY

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Table of Contents

I. REGULATIONS

A. Proposed Regulations for S Corporation Attribute Reduction under Section 108

REG-102882-08, August 6, 2008

Written and electronic comments must be received by November 4, 2008.

Outlines of topics to be discussed at the public hearing scheduled for December 8, 2008, must be received by November 4, 2008.

<u>Allocation of Excess Losses and Deductions After Section 108(b) Tax Attribute Reduction</u>

Section 108 provides special rules for an S Corporation that has COD income. Section 108(d)(7)(A), as amended by the Job Creation and Worker Assistance Act of 2002, Public Law 107-147, provides, in part, that the rules under Section 108(a) for the exclusion of COD income and under Section 108(b) for the reduction of tax attributes are applied at the corporate level, including by not taking into account under Section 1366(a) any amount excluded under Section 108(a). Therefore, 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). Under Section 108(b)(4)(A), the reduction of tax attributes occurs after the S Corporation's items of income, loss, deduction and credit for the taxable year of the discharge pass through to its shareholders under Section 1366(a). Under Section 1366(d)(1), the aggregate amount of losses and deductions a shareholder can take into account under Section 1366(a) cannot exceed the shareholder's adjusted basis in the shareholder's stock in the S Corporation and the shareholder's adjusted basis of any indebtedness of the S Corporation to the shareholder. 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). The proposed regulations clarify that the S Corporation's deemed NOL includes all losses and deductions disallowed under Section 1366(d)(1) for the taxable year of the discharge, including disallowed losses and deductions of a shareholder that had transferred all of the shareholder's stock in the S Corporation during such year.

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. 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 allocation rule in the proposed regulations takes into account the amount of each shareholder's disallowed losses or deductions under Section 1366(d)(1) (before the tax attribute reduction under Section 108(b)(2)) and the amount of excluded COD income that would have been taken into account by each shareholder under Section 1366(a) had the COD income not been excluded under Section 108(a). This allocation method alleviates, within the parameters of Section 108(d)(7)(B), the disparate treatment that could occur where the shareholders' respective disallowed losses or deductions under Section 1366(d)(1) that are treated as the S Corporation's deemed NOL are disproportionate to the shareholders' respective ownership interests. 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.**

The proposed regulations also provide that any amount of the S Corporation's excess deemed NOL that is allocated under this allocation method to a shareholder that had transferred all of the shareholder's stock in the S Corporation during the year of the discharge is treated as a disallowed loss or deduction that is permanently disallowed under Section 1.1366-2(a)(5) of the Income Tax Regulations, unless the transfer is described in Section 1041(a).

<u>Character of Excess Deemed NOL Allocated to a Shareholder</u>

A shareholder's losses or deductions disallowed under Section 1366(d)(1) consist of a pro rata share of the total losses and deductions allocated to the shareholder under Section 1366(a) during the corporation's taxable year (including losses and deductions disallowed under Section 1366(d)(1) for prior years that are treated as current year losses and deductions with respect to the shareholder under Section 1366(d)(2)). The character of any item included in a shareholder's pro rata share under Section 1366(a) is determined as if such item were realized directly from the source from which it was realized by the S Corporation, or incurred in the same manner as incurred by the corporation. The items of income, loss, or deduction that pass through to a shareholder, and that comprise a shareholder's suspended loss or deduction under Section 1366(d)(1), retain their character (for example, ordinary deduction, long-term capital loss).

Section 108(d)(7)(B) does not address potential character differences that may exist in a shareholder's disallowed losses or deductions under Section 1366(d)(1) that are included in the S Corporation's deemed NOL. Under the general rules of Section 108(b)(2), a taxpayer's net operating loss is reduced before any other tax attributes, such as capital loss carryovers. Therefore, to be consistent with the ordering rule in Section 108(b)(2), the proposed regulations provide that in determining the character of the amount of the S Corporation's excess deemed NOL that is allocated to a shareholder, any ordinary loss or deduction that was disallowed under Section 1366(d)(1) and that was included in the S Corporation's deemed NOL is treated as reduced before any capital loss that was disallowed under Section 1366(d)(1) and that was included in the S Corporation's deemed NOL. With respect to Section 1231 losses, where it is uncertain whether the loss ultimately will be characterized as ordinary or capital, the proposed regulations provide that any Section 1231 loss or deduction that was disallowed under Section 1366(d)(1) and that was included in the S Corporation's deemed NOL is treated as reduced after any ordinary loss and before any capital loss.

The examples in the Regulations provide a good explanation of the mechanics of this rule.

<u>Information Sharing Requirements</u>

An S Corporation shareholder determines the amount of any suspended loss or deduction under Section 1366(d)(1) for a taxable year. If the shareholder has a suspended loss or deduction under Section 1366(d)(1), the shareholder maintains a record of the carryover loss or deduction amount. Because any suspended loss or deduction under Section 1366(d)(1) is treated as a net operating loss of the S Corporation for purposes of the tax attribute reduction rule under Section 108(b)(2), the S Corporation will need to know the amount of each shareholder's suspended loss or deduction under Section 1366(d)(1). The proposed regulations require shareholders of an S Corporation that excludes COD income from its gross income in a taxable year to provide this information to the S Corporation. In addition, because each shareholder will need to know the amount of the shareholder's disallowed losses or deductions remaining after the tax attribute reduction, the proposed regulations require the S Corporation to provide to its shareholders the amount of any excess deemed NOL that is allocated to a shareholder after the tax attribute reduction, even if such amount is zero. The IRS and the Treasury Department request comments on whether the information sharing requirements in the proposed regulations are necessary or overly burdensome and on whether special rules are needed if shareholders fail to provide the required information to the S Corporation.

B. Final Regulations for S Corporation Changes made by AJCA of 2004 and GOZA of 2005

T.D. 9422, August 13, 2008

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).

In the final regulations, all revisions are administrative or ministerial and substantively conform to the proposed regulations.

The final regulations are effective on August 14, 2008.

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 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

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.

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).

II. IRS GUIDANCE

A. Revenue Ruling 2008-42 (AAA Adjustments for S Corp Owned Life Insurance)

<u>Facts:</u>

An S Corporation purchases an employer-owned life insurance contract on the life of one of its employees in order to cover expenses the company would incur as a result of the death of the employee (also known as a key-man policy). The employee is a highly compensated employee of the S Corporation. The S Corporation pays all of the premiums for the policy. The S Corporation is a beneficiary of the policy. At the end of the taxable year, the S Corporation has subchapter C accumulated earnings and profits (E&P).

Issues:

(1) Do premiums paid by an S Corporation on an employer-owned life insurance contract, of which the S Corporation is directly or indirectly a beneficiary, reduce the S Corporation's accumulated adjustments account (AAA)?

(2) Do the benefits received by reason of the death of the insured from an employer-owned life insurance contract that meets an exception under Section101(j)(2) increase an S Corporation's AAA?

Holdings:

(1) 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.

(2) The benefits received by reason of the death of the insured from an employer-owned life insurance contract that meets an exception under Section 101(j)(2) do not increase the S Corporation's AAA.

Analysis:

Section 1.264-1(a) provides that the premiums paid for life insurance on the life of any officer, employee, or person financially interested in a business carried on by the taxpayer are not deductible where the taxpayer is directly or indirectly a beneficiary of the policy.

Section 1.1366-1(a)(2)(viii) provides that for the purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Code applies, and provides as an example that income that is excludible from gross income under Section 101 (certain death benefits) is tax-exempt income.

Section 1.1368-2 provides for the calculation and maintenance of the AAA. The AAA is an account of the S Corporation and is not apportioned among shareholders. The AAA is generally increased by the items of income described in Section 1366(a)(1)(A), other than income that is exempt from tax, and any nonseparately computed income determined under Section 1366(a)(1)(B). The AAA is generally decreased by the items of loss or deduction described in Section 1366(a)(1)(A), any nonseparately computed loss determined under Section 1366(a)(1)(B), and any nondeductible expense not properly chargeable to a capital account other than expenses related to tax-exempt income.

B. Chief Counsel Memo 20082804F (July 11, 2008)

Advice was requested from Associate Area Counsel of LMSB on 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.

Issue:

Whether it is necessary to secure extensions of the statute of limitations from S Corporation shareholders that are grantor trusts or should extensions be obtained from the individual grantors, and whether such extensions should be secured on Forms 872 or Forms 872-I.

Holdings:

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 addition, since it is possible that these trusts are not wholly-owned and therefore only partly grantor trusts, we recommend that you secure extensions of the statutes of limitations from each trust. Each trust's fiduciary is responsible for making a tax return. Such extensions should be secured through Forms 872-I.

Analysis:

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 [in the case, husbands and wives], and not that of the source entity, where such source entity is a grantor trust." The Tax Court has consistently maintained this position without regard to the source entity involved; *see* cases cited in Olson v. Comm'r, T.C. Memo. 1992-711.

Given the addresses of the taxpayers involved, should any litigation of this issue occur, any such decision would be appealable to the Court of Appeals, Second Circuit. That Circuit, in Rothstein v. United States, 735 F.2d 704, 709 (2d Cir. 1984), 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. In response to this decision, the Service issued Rev. Rul. 85-13, which states that the Service will not follow Rothstein. Conceivably, one could conclude from this decision that the pertinent statute of limitations related to the trust, rather than to the grantors.

Thus, if it is the individual grantors against whom you seek to assess tax, it is the individual grantors that should extend their individual statute of limitations. To the extent that you propose to adjust items reported on each of the Forms 1041 filed by any of the subject grantor trusts, if any, the fiduciary for each trust should extend the statute of limitations. However, the safest approach is to get all the individual grantors and the fiduciaries for each of the grantor trusts to extend their respective statutes of limitations.

C. PLR 200821022: S Corporation Company Will Not Recognize Built-In Gain From Sale of Minerals

Issued: December 21, 2007

Facts:

Company's primary business consists of mining and processing of minerals from quarries and making such minerals ready for commercial use. Company mines Mineral A and Mineral B. Company also manufactures construction material such as Product D, Product E and Product F. Company is not in the business of selling its unexploited property for buyers to extract and process the minerals. Company owns two properties that contain reserves of Mineral A that can be mined by Company to produce crushed Mineral A. The total available tonage of Mineral A at the first of these two locations is estimated to be approximately X tons. Company has currently mined approximately M percent of those reserves. The other location is not currently being mined. There are estimated to be approximately Y tons at that location.

Ruling Request:

Company requests a ruling that any income from the disposition of Mineral A and Mineral B which had been mined and processed after the effective S conversion date, yet properly recognized during the 10-year "recognition period," will not constitute recognized built-in gain within the meaning of Section 1374(d)(3).

Holding:

Based solely on the information submitted and on the authority set forth above, we rule that income from dispositions by Company of Mineral A and Mineral B that are mined and processed after the effective S conversion date, during the 10-year recognition period will not constitute recognized built-in gain within the meaning of Section 1374(d)(3).

Analysis:

In Example 1 of Section 1.1374-4(a)(3), X is a C Corporation that converts to an S Corporation as effective on January 1, 1996. On the conversion date, X owns a working interest in an oil and gas property, but on which production of oil and gas has not yet begun, and the fair market value of the working interest exceeds X's adjusted basis in the working interest by $200,000. During the recognition period, X produces and sells oil from the working interest, and includes $75,000 in income from the sale. X's $75,000 of income is not recognized built-in gain, because as of the beginning of its "recognition period" X held only a working interest in the oil and gas property and not the oil itself since the oil had not yet been extracted from the ground.

Rev. Rul. 2001-50 provides that if an S Corporation that holds timber property on the conversion date cuts the timber and sells the resulting wood products during the recognition period, in a transaction to which Section 631 does not apply, the tax consequences to the S Corporation under Section 1374 are determined using the same analysis contained in Example 1 of Section 1.1374-4(a)(3). Under Rev. Rul. 2001-50, such wood products sold as inventory during the recognition period do not constitute separate assets held by an S Corporation on the conversion date and thus their production and sale do not constitute a partial disposition of the timber property. Accordingly, the S Corporation's income on the sale of the resulting wood products during the recognition period is not recognized built-in gain within the meaning of Section 1374(d)(3).

D. 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

Issued: February 14, 2008

Facts:

While it was still taxed as a C corporation, Company adopted an employee stock ownership plan, ESOP. Prior to Date 1, ESOP owned a% of the shares of Company's common stock (the "Pre-Transaction ESOP Shares"). Company has one class of common stock outstanding, and all shares of Company stock have identical rights to operating and liquidating distributions.

On Date 1, Company undertook a series of transactions that resulted in ESOP becoming the sole owner of Company's outstanding stock. (1) Company obtained a line of credit in the amount of $b; (2) Company then made a loan, to be secured by Company stock, of $c to ESOP (the "ESOP Loan"); (3) ESOP used the ESOP Loan proceeds to purchase all of the remaining outstanding stock of Company, pursuant to stock purchase agreements (the "Stock Purchase Agreements"). As a result of these transactions, ESOP became the owner of 100 percent of the outstanding stock of Company.

Among its provisions, ESOP provides that it shall distribute benefits to participants at stated periods of time following their termination of employment due to retirement, disability, death, or other reason. ESOP further provides that the distribution of a participant's benefit may be made in cash, in Company stock, or in both. As a result of the transactions described above, and in particular the loan made by Company to ESOP (the "ESOP Loan Debt"), the net worth, under generally accepted accounting principles ("GAAP") of Company, immediately after the transactions was $d less than the net worth, under GAAP, of the Company immediately before the transactions. The value of Company's stock has similarly declined to reflect the reduction in the Company's net worth under GAAP.

Consequently, Company entered into a Floor Price Agreement (the "Floor Price Agreement") on Date 2. This Floor Price Agreement provides that Company, under certain conditions, will repurchase, for a minimum price (the "Floor Price"), the Pre-Transaction ESOP Shares that are, or have been, distributed to ESOP participants. Thus, all valuations of the Pre-Transaction ESOP Shares are to reflect the value of shares, as determined by an independent appraiser, without taking into account the ESOP Loan Debt.

Ruling Request:

Company requested the following ruling: Company will not be considered to have a second class of stock in violation of Section 1361(b)(1)(D) solely as a result of the existence of the Floor Price Agreement.

Holding:

Based on the facts submitted and representations made, we conclude that the Floor Price Agreement will be disregarded in determining whether the outstanding shares of Company stock confer identical rights. Therefore, for purposes of Section 1361(b)(1)(D) Company will not be considered as having more than one class of stock as a result of adopting the Floor Price Agreement.

Analysis:

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of Section 1361(b)(1)(D) and Section 1.1361-1(l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of Section 1.83-3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

Under ESOP's distribution provisions, Company's agreement to redeem stock is activated by the termination of a participant's employment due to death, disability, or retirement.

Under Section 1.1361-1(l)(2)(iii)(B), agreements to redeem stock upon termination of employment are disregarded. In disregarding agreements that provide for redemptions upon termination of employment, Section 1.1361-1(l)(2)(iii)(B), in effect, distinguishes between redemption agreements for stock of employee shareholders and redemption agreements for stock of investor shareholders. In this case, the shareholders whose stock is to be redeemed are employee shareholders or their trust, rather than investor shareholders. Though specifically referencing redemptions upon termination of employment, as well as death, divorce, and disability, Section 1.1361-1(l)(2)(iii)(B) also anticipates that other types of bona fide agreements to redeem stock may be disregarded by the Service. In addition, a redemption agreement is disregarded under Section 1.1361-1(l)(2)(iii)(A) where the principal purpose of an agreement is not to avoid the one class of stock requirement or the agreement sets a purchase price that does not greatly vary from the fair market value of the stock.

E. Email Correspondence re: Statute of Limitations

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

<u>Issue</u>:

The question posed was 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 Section 1366(f)(2)) once the general period of limitations on the shareholder's tax year has expired?

<u>Answer</u>:

We are not aware of any support for the shareholder's suggestion that it is implicit from Section 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 Section 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. <u>See</u> <u>Continental Equities, Inc. v Comm'r</u>, 551 F2d. 74, 81 (5th Cir 1977).

Finally, we note that equitable tolling and equitable recoupment are slightly different theories and that <u>United States v. Brockamp</u>, 519 U.S. 347 (1997), would not be controlling. While equitable recoupment can be a defense to a pending action, the Supreme Court in <u>United States v. Dalm</u>, 494 U.S. 596 (1990), held that a claim of equitable recoupment does not rise to an independent cause of action. Therefore, the taxpayer's alternative argument regarding equitable recoupment is also likely without merit.

III. CONGRESSIONAL MATERIALS

A. Proposed Legislation: S Corporation Modernization Act of 2008 (S. 3063)

Introduced by Senators Blanche Lincoln (D-AR) & Orrin Hatch (D-UT), May 22, 2008 (Tax Analysts: 2008 TNT 105-26)

1. Introductory Statement by Senator Blanche Lincoln (D-AR)
(Tax Analysts: 2008 TNT 105-27)

Excerpt: "Because Congress has not updated many of the rules governing S Corporations -- such as allowing better access to capital -- I am concerned that these privately-held businesses are not in the best position to deal with the current downturn in the economy. We must modify our outdated rules so that these businesses that are starved for capital have the means to expand and create jobs. Current law -- particularly the punitive built-in gains tax penalty -- not only limits the ability of S Corporations to attract new equity investors, but also effectively forces businesses to sit on 'locked-up' capital that they cannot access and put to use to grow their business.

The S Corporation Modernization Act would update and simplify our S Corporation tax rules. It increases access to capital, encourages family-owned businesses to stay in the family, eliminates tax traps that penalize unwary but well-meaning business owners, and encourages charitable giving."

2. Summary of Bill Provisions

Bill Section 2: Reduce BIG to 7yrs

Bill Section 3: Repeal of Excessive Passive Inv. Income as a Termination Event

Bill Section 4: Modifications to Passive Income Rules which would increase passive income from 25% to 60%

Bill Section 5: Expansion of Qualifying Beneficiaries of ESBTs

Bill Section 6: Allowing IRAs as S Corporation Shareholders

Bill Section 7: Allowing Charitable Contribution Deduction for ESBTs

B. Hearings, Reports and Comment Letters

1. JCT – Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity

JCX-48-08, June 4, 2008 (Tax Analysts: 2008 TNT 109-10)

Excerpts from the Report specifically relating to S Corporations:

Conversion from C Corporation to S Corporation

Proposals to reduce built in gain holding period

Some have suggested shortening the 10-year period after conversion from C Corporation to S Corporation status, during which the built-in gains tax is imposed. For example, several bills have been introduced that would shorten the time period to 7 years following a conversion to S Corporation status.

The present-law 10-year period was intended to provide a sufficiently long holding period that conversion to S Corporation form would not be an immediate escape from corporate level tax on asset sales. The same ten-year period currently applies (by reference to the S Corporation rules of Section 1374) under Treasury regulations for situations in which a C Corporation merges with or otherwise becomes a REIT or RIC, special entity types that are required to make certain types of investments and that are not subject to corporate level tax provided they distribute or make deemed distributions of taxable income each year to their shareholders. In cases involving S Corporations that are owned by ESOPs, any sales of built in gain property after the 10 years may be subject to no tax at all at the time of sale (rather than one level of tax at the time of sale).

Proposals to change the passive investment income rules

Other proposals would (i) eliminate the rule that causes loss of S Corporation status if certain passive income exceeds 25 percent of gross income for three consecutive years and if the S Corporation had C Corporation earnings and profits, and (ii) increase the amount of passive investment income that could be received in any year without corporate level tax.

Prior to the early 1980's, the corporate tax rates historically had been substantially lower than the maximum individual tax rate, so that earnings that had been accumulated by a C Corporation had not been subject to tax at the higher individual rates. The excess passive income rules were generally intended to prevent a C Corporation that had accumulated earnings at low corporate rates from electing S status and thereafter allowing distributions of current earnings with only one level of tax, (rather than becoming subject to the personal holding company tax, or liquidating and incurring capital gains tax for shareholders). Since 1981, however, the corporate tax rates and the maximum individual tax rate have become much closer, and the capital gains tax rate on individuals has been reduced, thereby lessening the need for these rules.

Conversion from S Corporation to partnership or LLC status

Some have suggested that an S Corporation should be permitted to convert to partnership or LLC status without immediate tax consequences. Such a tax-free conversion would permit greater flexibility to provide different types of interests to different investors or employees (since an S Corporation may only have one class of stock and may have no more than 100 shareholders). It would also permit the subsequent distribution of built-in-gain property to investors without the immediate tax required by the corporate rules, and could provide additional flexibility for certain estate planning structures that depend on creating different classes of interests in an entity: for example, interests with different participations in future appreciation. Such proposals raise a number of policy issues.

First, even if an S Corporation has never been a C Corporation, the change of form will occur at a time when it is likely that certain elements of the partnership rules cannot be implemented directly and certain presumptions would have to be substituted. As one example, the partnership rules generally attribute any built-in gain in property, at the time of a property contribution to a partnership, to the contributing partner when that gain is later realized by the partnership. The partnership rules also treat certain contributions and distributions of property as constructive sales of property among the partners. S Corporation rules do not have comparable provisions. It might be necessary to adopt certain tracing rules to prevent the use of S Corporation status, followed by a partnership election, from circumventing the partnership rules.

Some have suggested allowing a conversion election to be made only by S Corporations that have been in existence for at least 10 years, possibly on the theory that this time period might deter certain types of planning. Moreover, it has been argued that State LLC entity forms and the “check the box” Treasury regulations first become effective in the 1990's, so that more recently electing entities would presumably have chosen S status because of their preference for that form, rather than because they were otherwise prevented by State law and Treasury regulations from choosing pass-through form with limited liability at their inception. This type of limitation has been criticized on grounds of fairness and lack of direct relationship to the timing of either the “check the box” regulations or of the increased commercial acceptance of doing business in non-corporate form. Furthermore, whether before or after the “check the box” Treasury regulations, there has been significant flexibility in choice of form, and there may have been advantages to S Corporation status (for example, the ability to engage in a tax free reorganization a later date, or to dispose of entity stock without any potential for ordinary income treatment under the partnership rules, or to offer corporate incentive stock options to employees) that motivated the taxpayer's original choice of form.

The case of an S Corporation that was previously a C Corporation presents additional issues. The ability of a partnership to distribute appreciated property to owners without current tax is a significant shift from corporate tax principles. Some argue that if the 10-year holding period of Section 1374 has been satisfied then there is no inconsistency with the C Corporation rules. However, even the S Corporation rules impose a single level of tax on distributions of gain property, which would not occur in a partnership. Further issues include tracking previous C Corporation earnings and profits, and imposing shareholder level tax on distributions of such earnings and profits with some appropriate interface with the partnership rules that generally permit tax-free distributions.

<u>Payroll Taxes & S Corporation shareholders</u>

An S Corporation is treated as a pass-through entity for Federal income tax purposes, and its income generally is taxed to the shareholders. A shareholder of an S Corporation who performs services as an employee of the S Corporation is subject to FICA tax on his or her wages, but generally is not subject to FICA tax on amounts that are not wages (such as distributions to shareholders). Nevertheless, an S Corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized as other than wages. A significant body of case law has addressed the issue of whether amounts paid to shareholder-employees of S Corporations constitute reasonable compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.

In cases addressing whether payments to an S Corporation shareholder-employee were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages. In recent cases involving whether reasonable compensation was paid (not exclusively in the S Corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms. The Seventh Circuit, however, has adopted an “independent investor” analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.

<u>Payroll tax issues relating to S Corporation shareholders</u>

There has been very substantial growth in the number of S Corporations in recent years, which some attribute to the widespread use of S Corporations to avoid self-employment tax. The 2005 TIGTA report stated that “the S Corporation form of ownership has become a multibillion dollar employment tax shelter for single-owner businesses.”

Individuals who perform services in businesses that they own commonly choose the S Corporation form to seek to reduce their FICA taxes. S Corporation shareholders may pay themselves wages below the wage cap, while treating the rest of their compensation as a distribution by the S Corporation in their capacity as shareholders. They may take the position that no part of the S Corporation distribution to them as shareholders is subject to FICA tax. Because the HI component of the tax has no wage cap, this S Corporation approach may be viewed as a tax planning opportunity with respect to HI tax at high income levels as well as below the cap.

The entire amount of an S Corporation shareholder's reasonable compensation is subject to FICA tax in this situation, under present law. However, enforcement of the “reasonable compensation” standard by the government may be difficult because it involves factual determinations on a case-by-case basis, requiring taxpayer audits and potentially involving costly, resource-consuming litigation.

The 2005 and 2006 proposals aim to reduce the use of S Corporations to avoid the employment tax by recharacterizing wages from service businesses as some other type of S Corporation distribution. Under these proposals, an S Corporation is treated as a partnership and its shareholders as general partners, for self-employment tax purposes (under the 2006 proposal, this applies only to S Corporation service businesses). Either the 2005 or the 2006 proposal would achieve greater uniformity of employment tax treatment as between partnerships and S Corporations than does present law, reducing tax-motivated choice-of-entity decisions and improving the neutrality of the tax law.

The narrower TIGTA proposal applies only to shareholders of S Corporations who, directly or through relatives, have a 50 percent or greater interest in the S Corporation. By contrast to the 2005 and 2006 proposals, the TIGTA proposal would be less effective in improving tax neutrality as between partnerships and S Corporations, though it would serve to reduce the relative attractiveness of S Corporations as employment tax planning vehicles.

By treating the S Corporation shareholders similarly to partners of a partnership (taking into account the modifications made by the partnership portion of the proposals), the 2005 and 2006 proposals reduce the need to apply the cumbersome, difficult-to-administer "reasonable compensation" standard. Although the TIGTA proposal does not cover partners, it could be said that a proposal addressing only S Corporation shareholders' attempts to avoid the reasonable compensation standard is likely to be more enforceable and efficient than continuing to apply the reasonable compensation standard to those shareholders.

The 2005 proposal has the effect of applying the self-employment tax collection system to S Corporation shareholder-employees, rather than the withholding regime that applies to them (along with other employees) under the present-law FICA tax rules. There are both drawbacks and advantages to this approach. One drawback is that withholding may be a more effective and faster collection mechanism than self-assessment as under the self-employment rules. Another is that the income tax deduction for wages or compensation paid by an S Corporation would have to be added back or disallowed for purposes of calculating self-employment tax of the S Corporation shareholder.

Other disadvantages would arise from retaining the FICA withholding system from some compensation while imposing the self-effecting SECA rules on other compensation of the same individual. For example, preserving a withholding regime on S Corporation shareholder wages, and imposing self-employment tax only on the portion of the shareholder's distributive share that exceeds previously taxed wages, would require a mechanism to prevent double-counting from one taxable year to the next, which could impose additional administrative and recordkeeping burdens on the S Corporation. Imposing two separate employment tax regimes on S Corporation compensation payments to one individual could be criticized as complex.

2005 Joint Committee on Taxation staff proposal ("2005 proposal")

Under the proposal, for purposes of employment tax, an S Corporation is treated as a partnership and any shareholders of the S Corporation are treated as general partners. Thus, S Corporation shareholders are subject to self-employment tax on their shares of S Corporation net income (whether or not distributed) or loss. As under the present-law self-employment tax rules, specified types of income or loss are excluded from net earnings from self-employment of a shareholder, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service business, all of the shareholder's net income from the S Corporation is treated as net earnings from self-employment. A service S Corporation is an S Corporation, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)).

If a shareholder does not materially participate in the trade or business activity of the S Corporation, a special rule provides that only reasonable compensation from the S Corporation is treated as net earnings from self-employment.

The 2005 proposal is effective for taxable years of partners or S Corporation shareholders (as the case may be) beginning after the date of enactment.

One commentator has suggested that the 2005 proposal be expanded to closely held C Corporations (in addition to partnerships and S Corporations), in order to achieve parity in the way that the employment tax rules apply to all individuals who perform services in a business conducted through a business entity, particularly in light of the 2003 reduction to 15 percent in the top rate applicable to qualified dividends paid by a C Corporation.

2. House Small Business Committee Hearing – June 18, 2008

a. Tax Analysts Summary, 2008 TNT 119-7 ((June 19, 2008)

Witnesses at a June 18 hearing of the House Small Business Finance and Tax Subcommittee made several recommendations for reforming and modernizing subchapter S Corporations, including providing relief from the built-in gains tax, a change in the shareholder limitations for S Corporations, and modifications to rules regarding passive investment income.

Subcommittee Chair Melissa L. Bean, D-Ill., said a review of the laws related to S Corporations is necessary because the number of S Corporations has grown significantly over the past two decades -- from 500,000 in 1985 to 4 million currently -- but the code's provisions have not been updated.

"Despite the growth in the number of S corps, there are concerns that certain requirements are either unnecessarily burdensome or create obstacles to expansion," Bean said. “Many of these provisions were written almost 60 years ago, and it's important that Congress revisit these measures to see that they are still best serving our nation's economic objectives.”

b. Witnesses to the Hearing and written comments

Kevin Andersen, BDO Seidman LLP,
Source: Tax Analysts, 2008 TNT 119-36 (June 19, 2008)

Andersen noted that while some proposed changes would bring S Corporations more in line with C Corporations, others would bring them closer to partnerships. Lawmakers looking to reform the treatment of S Corporations to provide parity with other types of businesses should determine which type is most appropriate. “Do we seek parity with the tax treatment of business income generally? Parity with partnerships? Parity with C Corporations? Parity with the taxation of individuals?”

Cynthia Blankenship, Indp. Comm. Bankers of America
Source: Tax Analysts, 2008 TNT 119-37 (June 19, 2008)

“ICBA believes forcing S Corporations to hold on to often unproductive and inefficient assets for 10 years limits cash flow and the use of available resources … Therefore, allowing S Corporations to liquidate assets if they choose after seven years -- a more realistic business cycle -- would free up capital to be used to grow the small business and create new jobs.”

Rick Klahsen, S Corp Assn of America
Source: Tax Analysts, 2008 TNT 119-39 (June 19, 2008)

“Relief from the built-in gains tax should also be considered by Congress for inclusion in a possible second economic stimulus bill.”

Byron Shinn, Shinn & Company
Source: Tax Analysts, 2008 TNT 119-40 (June 19, 2008)

S Corporation rules should be converged with those for partnerships.

Robert Kerr, Nat’l Assn. of Enrolled Agents
Source: Tax Analysts, 2008 TNT 119-38 (June 19, 2008)

One issue facing enrolled agents is the definition of reasonable compensation and suggested that practitioners and S Corporations “could be helped by practical IRS guidance -- perhaps in the form of an audit technique guide -- in determining what is reasonable compensation.”

3. House Small Business Committee 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.

Source: Tax Analysts, 2008 TNT 119-38 (July 25, 2008)

Relevant Excerpt: "One way to encourage new capital in the banking system is to allow banks to have alternative business structures. One of these is Subchapter S, which allows pass-through income tax treatment and limited corporate liability. Congress made Subchapter S available to insured depository institutions for the first time in 1996. However, at that time many existing banking institutions were unable to make the election because a corporation was not eligible if it had more than 75 shareholders. Legislative changes in 2004, 2005, and 2007 made significant improvements to Subchapter S, enhancing the viability of the structure for banking institutions. ABA supports further improvements that will: (1) increase the number of eligible shareholders to at least 150; (2) clarify that a current law reduction in the amount of deductions a regular corporation can claim with respect to tax-exempt obligations will not apply to a bank after it has been a Subchapter S Corporation for three years; and (3) permit IRAs to make new investments in Subchapter S Corporations. ABA supports H.R. 4840, which would modernize the Subchapter S structure, and we encourage Congress to enact it."

4. Business Coalition Letter to Congress on BIG Tax Reform

Source: Tax Analysts, 2008 TNT 145-57 (July 28, 2008)

Comments Submitted on behalf of:

The Associated General Contractors of America; The Association For Manufacturing Technology; Independent Community Bankers of America; National Association of Convenience Stores; National Association of Manufacturers; National Beer Wholesalers Association; National Federation of Independent Business; National Funeral Directors Association; National Small Business Association; Plumbing-Heating-Cooling Contractors-National Association; Printing Industries of America; S Corporation Association; Tire Industry Association; U.S. Chamber of Commerce.

Relevant Excerpt: As Congress considers a package of provisions to help employers through the economic slowdown, we ask that provisions assisting small and closely-held businesses be made an integral part of the bill. Specifically, we ask that you consider providing relief from the built-in gains tax (BIG) as a means of freeing up much needed capital in our flagging economy.

BIG applies to any appreciated assets that are held by a firm that has converted to S Corporation tax status. Under BIG, these firms are required to hold these assets for at least ten years or be subject to a punitive level of tax -- first the BIG corporate tax rate of 35 percent and then all other applicable federal, state and local tax rates.

Every year, tens of thousands of small businesses elect S Corporation status for the first time, which means that hundreds of thousands of S Corporations nationwide likely are sitting on billions of dollars in locked-up capital that could be used to grow the business and hire new employees.

The inability to access this capital is particularly harmful to S Corporations. As closely-held businesses with limited access to the public markets, they have fewer options for raising capital than many of their competitors.

In an economy where a one or two percent change can mean the difference between a recession and moderate growth, eliminating the lock-in effect of the BIG tax and allowing these valuable assets to become fully productive again could be significant.

On behalf of America's small business community, we respectfully ask that you consider including built-in gains tax relief in any additional stimulus package crafted this year.