Proposed S Corporation Regulations Close to Final

By Michael L. Griffin*

The American Jobs Creation Act of 2004 (the "2004 Act") and the Gulf Opportunity Zone Act of 2005 (the "2005 Act") made several changes to sections 1361, 1362, and 1366. To implement and interpret these provisions of the 2004 Act and 2005 Act, the Service published proposed S corporation regulations on September 28, 2007. 72 Fed. Reg. 55132. According to a Service representative associated with the proposed regulations (and whom this author contacted), the Service received no written comments on these proposed regulations. Because there were no requests to speak at the public hearing scheduled for January 16, 2008, the Service cancelled the public hearing. 73 Fed. Reg. 1131 (2008).

Given this sequence of events, it seems unlikely that any significant changes will be made before publication in final form. And given that these regulations are listed on the Service's business plan for the period ending June 30, 2008, we might soon expect to see these proposed regulations published in final form. Therefore, this is an appropriate time to discuss what the proposed regulations provide.

Members of a Family

The 2004 Act and the 2005 Act both addressed issues related to "members of a family." The 2004 Act amended section 1361(c) to provide for counting a "common ancestor" and lineal descendants as one shareholder for purposes of the new 100-shareholder limit under section 1361(b)(1)(A). The 2005 Act made aggregation automatic by eliminating a requirement of the 2004 Act to make an election to be treated as "members of a family." In making this change, the 2005 Act provided an "applicable date" on which treatment as a "common ancestor" would be determined. Identification as a "common ancestor" depends upon being no more than six generations removed from the youngest generation of shareholders who would be included as "members of a family." I.R.C. § 1361(c)(1)(B)(ii). The statute does not require the "common ancestor" to have owned stock or even be alive on the "applicable date." No chain of ownership is required.

Because of the six-generation test, on the "applicable date" treatment as "members of a family" is limited to the identified "common ancestor" and the six lineal generations descending from that common ancestor (as well as spouses or former spouses of the common ancestor and lineal descendents, adopted children, and certain foster children). I.R.C. §§ 1361(c)(1)(B)(ii) and 1361(c)(1)(C). Under section 1361(c)(1)(B)(iii), the "applicable date" is the latest of (I) the date the S election is made, (II) the earliest date an individual who is a "member of a family" holds stock in the S corporation, or (III) October 22, 2004.

Proposed section 1.1361-1(e) incorporates the "members of a family" provisions presented in section 1361(c)(1). Of critical importance to S corporations with large numbers of family shareholders, the proposed regulation makes clear that the six-generation test applies only at the "applicable date" and does not later limit treatment as "members of a family" for future generations: "The test is only applied as of the applicable date, and lineal descendents (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date." Prop. Reg. § 1.1361-1(e)(3)(i).

Proposed section 1.1361-1(e) further provides that "members of a family" treatment applies to each person who individually would qualify as a "member of a family" and who also is either a "potential current beneficiary" under an electing small business trust ("ESBT"), the income beneficiary of a qualified subchapter S trust ("QSST"), a beneficiary of a voting trust, a deemed owner of a grantor trust, or an owner of a disregarded entity. Additionally, an estate of a deceased "member of a family" will be considered a "member of a family" during the period in which the estate holds stock in the S corporation.

Further, trusts described in section 1361(c)(2)(A)(ii) and (iii) will be considered "members of a family" during the period in which such trusts hold stock in the S corporation.

It is also worth noting that proposed section 1.1361-1(e)(3)(i) states: "Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of the other family) will be treated as one shareholder."

Proposed section 1.1361-1(h)(1)(vii), regarding individual retirement account owners of stock in S corporation bank and depository institution holding companies, incorporates the requirements of section 1361(c)(2)(A)(vi).

ESBTS and Powers of Appointment

The 2004 Act amended section 1361(e)(2) to state that unexercised powers of appointment will be disregarded in determining an ESBT's potential current beneficiaries for any period.

In its current form, section 1.1361-1(m)(4)(vi) conflicts with section

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1361(e)(2) as amended. Under current section 1.1361-1(m)(4)(vi), each potential recipient under a power of appointment is treated as a "potential current beneficiary." This means that a general power of appointment, or even a broad special power of appointment, can result in a number of "potential current beneficiaries" exceeding the 100-shareholder limit.

Under proposed section 1.1361-1(m)(4)(vi)(A), a person is not treated as a "potential current beneficiary" under a power of appointment unless the power is exercised in favor of that person during the period under consideration. Under proposed section 1.1361-1(m)(4)(vi)(B), a class of charitable organizations permitted to own S corporation stock under section 1361(c)(6) is counted as a single "potential current beneficiary" under a power of distribution other than a power of appointment. However, when specific charities are named in the instrument as beneficiaries of a power of distribution other than a power of appointment, each such charity is counted as a "potential current beneficiary." Examples illustrating application of these rules are found at proposed section 1.1361-1(m)(8).

The 2004 Act also extended, to a full year from what had formerly been 60 days, the period during which an ESBT may dispose of S corporation stock after an ineligible shareholder becomes a "potential current beneficiary." I.R.C. § 1361(e)(2). Proposed section 1.1361-1(m)(4)(iii) incorporates this statutory amendment.

Stock Transfers Between Spouses or Incident to Divorce

The 2004 Act amended section 1366(d) to allow transfer of losses or deductions limited by the basis limitation of section 1366(d)(1) to be treated as incurred by the corporation in the succeeding tax year with regard to a transferee spouse, including a divorcing spouse to whom section 1041(a) applies. Proposed section 1.1366-2(a)(5) incorporates this statutory amendment and provides detailed examples.

At Risk and Passive Activity Loss Limitations

The 2004 Act amended section 1361(d)(1) to treat S corporation stock disposed of by a QSST as, instead, disposed of by the QSST beneficiary for purposes of sections 465 and 469. Proposed section 1.1361-1(j)(8) incorporates this statutory amendment.

QSSS Relief for Inadvertent Invalid Elections or Terminations

The 2004 Act amended section 1362(f) to provide that a qualified subchapter S subsidiary ("QSSS") is eligible for relief from inadvertent invalid elections or terminations on the same basis as such relief is available to S corporations. Proposed section 1.1362-4 incorporates this statutory amendment.

Increasing Number of Permitted Shareholders

The 2004 Act increased the number of permitted shareholders of an S corporation from 75 to 100. Proposed section 1.1361-1(b)(1)(i) would eliminate reference to 75 as the maximum number of permitted shareholders and would replace it with a simple reference to the statute imposing the limit. This is a wise move in light of this limit's history of periodic increases.

Effective Date

The proposed regulations would be effective on the date of publication in the Federal Register of the Treasury Decision adopting the regulations as final.

Conclusion

While several matters addressed in these proposed regulations merely incorporate statutory amendments made by the 2004 Act and the 2005 Act, the proposed regulations go further. Important additions include clarification on application of the six-generation rule, entity ownership, and membership in multiple families, all under the "members of a family" provision. Of importance to practitioners working with ESBTs and providing estate planning services, the proposed regulations give specific guidance on treatment of powers of appointment and offer detailed examples.

Because the Service received no comments regarding the proposed regulations, practitioners should expect to see these regulations finalized soon. ■