SELECTED 2007 TAX DEVELOPMENTS

FOR PARTNERSHIPS,

LIMITED LIABILITY COMPANIES

AND S CORPORATIONS

BY

BRANDON LAGARDE

Jones, Walker, Waechter, Poitevent, Carrère & Denègre, L.L.P

Baton Rouge, Louisiana

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I. PARTNERSHIPS, LIMITED LIABILITY COMPANIES AND DISREGARDED ENTITIES.

A. Regulations

1. Final Regulations Regarding Sharing Partnership Liabilities Where Partner's Interest Held Through Disregarded Entity.

On October 11, 2006, the IRS issued final regulations on the allocation of partnership liabilities where a partner's interest in the partnership is held through a disregarded entity.

Generally, a partner's share of recourse partnership liability equals the portion of the liability for which a partner or a person related to the partner bears the economic risk of loss. Reg. §1.752-2(a). For this purpose, Reg. §1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that any partner or any person related to a partner bears the economic risk of loss set forth in Reg. §1.752-2. A partner is deemed to bear the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or a person related to the partner would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or the related person would not be entitled to reimbursement from another partner or a person related to another partner. Significantly, under Reg. §1.752-2(b)(6), for purposes of these determinations, it is assumed that partners (or related persons), who have obligations to make these payments, actually perform these obligations regardless of their actual net worth unless the facts and circumstances indicate a plan to circumvent such obligation.

Notwithstanding the foregoing rule, the final regulations alter the described scheme where a partner holds his partnership interest through a disregarded entity. Under Reg. §1.752-2(k)(1), where the partnership interest is held by a disregarded entity, in determining the partner's economic risk of loss for the partnership liability, the payment obligation of the disregarded entity is taken into account only to the extent of the net value of the disregarded entity as of a specified allocation date.

The allocation date is the earlier of (i) the first date occurring on or after the date on which the requirement to determine the net value arises under Reg. §1.752-2(k)(2)(ii)(A) or (B) relating to an event requiring a determination of the partner's basis under Reg. §1.705-1(a) or §1.752-4(d), or (ii) the end of the partnership's tax year in which the requirement to determine net value of a disregarded entity arises under Reg. §1.752-2(k)(2)(ii)(A) or (B). In this respect, Reg. §1.752-2(k)(2)(ii)(A) requires that the net value of the disregarded entity be determined if a partnership interest is held by a disregarded entity and the partnership has or incurs a liability, all or a portion of which may be allocated to the owner of the disregarded entity under Reg. §1.752-2(k). The regulations provide other significant events requiring a net value determination.

The net value of the disregarded entity is the fair market value of all of its assets subject creditors' claims (including enforceable rights to contributions from its owner and the fair market value of an interest in any partnership other than the partnership for which net value is being determined), less all obligations of the disregarded entity that do not constitute Reg. 1.752-2(b)(1) payment obligations. The regulations adopt a very favorable rule that provides that the net value is reported by the owner to each partnership

for which the disregarded entity may have one or more payment obligations. Thus, each partnership independently takes the disregarded entity's net value into account.

Under Reg. §1.752-2(k)(5), the owner of a disregarded entity is required to provide, on a timely basis, information to the partnership as to the entity's tax classification and the net value of the disregarded entity that is allocable to the partnership's liabilities. The preamble to the regulations states that the partnership is responsible for obtaining the necessary information to enable it to correctly allocate partnership liabilities among the partners and that the partnership agreement should require that partners comply with the reporting requirements in the regulations.

The final regulations apply to liabilities incurred or assumed by a partnership on or after 10/11/06, less the liabilities were incurred or assumed pursuant to a written binding contract in effect prior to that date.

2. Proposed Regulations for Distributions of Property in "Assets-Over" Merger.

On August 21, 2007, the IRS issued proposed regulations for distributions of property after two partnerships engage in an assets-over merger. The proposed regulations implement the principles articulated in Rev. Rul. 2004-43, which addressed the application of §§ 704(c)(1)(B) and 737 in this type of merger.

The proposed regulations provide that in an assets-over merger, sections 704(c)(1)(B) and 737 do not apply to the transfer by a partnership (the transferor partnership) of all of its assets and liabilities to another partnership (the transferee partnership), followed by a distribution of the interests in the transferee partnership in

liquidation of the transferor partnership as part of the same plan or arrangements. However, the proposed regulations do provide that §§ 704(c)(1)(B) and 737 will apply to a subsequent distribution by the partnership receiving property.

For the property contributed originally, the amount of the original §704(c) gain or loss is the difference between the property's fair market value and the contributing partner's adjusted basis at the time of contribution.

In the case of property contributed with original §704(c) loss, section 704(c)(1)(C), which was added by the American Jobs Creation Act of 2004, gives special rules for determining the basis of the property contributed. The proposed regulations said that the Treasury Department and IRS are currently developing guidance that will implement the provisions of §704(c)(1)(C), so the proposed regulations do not address the impact of that section in applying the rules.

The proposed regulations provide that the seven year period referenced in §737 for recognizing gain from contributed property will not restart with respect to the original §704(c) gain or loss as a result of the merger. Therefore, a subsequent distribution by the partnership receiving property with original §704(c) gain or loss is subject to §§704(c)(1)(B) and 737 if the distribution occurs within seven years of the contribution.

However, with respect to new §704(c) gain or loss, the regulations provide that the seven-year period begins on the date of the merger. Thus, a subsequent distribution by the transferee partnership of property with new §704(c) gain or loss is subject to §§704(c)(1)(B) and 737 if the distribution occurs within seven years.

The regulations further provide that no original §704(c) gain or loss will be recognized under §§704(c)(1)(B) or 737 if property that was originally contributed to the transferring partnership is distributed to the original contributor.

If property has new §704(c) gain or loss, a subsequent distribution of such property within seven years of the merger to one of the former partners of the transferring partnership is subject to §704(c)(1)(B) only to the extent of the other former partners' shares of such gain or loss.

In addition, the proposed regulations further provide an identical ownership and a de minimis change in ownership exception to §§704(c)(1)(B) and 737 with regard to assets-over partnership mergers. Under the identical ownership exception, section 704(c)(1)(B) will not apply to new §704(c) gain or loss in any property contributed in an assets-over partnership merger where the ownership of both partnerships is identical. For purposes of the de minimis exception, a difference in ownership is de minimis if 97% of the ownership is the same.

The proposed regulations would be effective for any distributions of property after Jan. 19, 2005, if the property was contributed in an assets-over merger after May 3, 2004. Changes relating to the change from the previous five-year rule to the seven-year rule will be effective Aug. 22, 2007.

B. Other IRS Pronouncements

1. Transfer of Appreciated Property to a Partner in Satisfaction of Guaranteed Payment Obligation Treated as a Sale or Exchange.

In Rev. Rul. 2007-40, 2007-25 IRB 1426, a partnership transfers appreciated property (Blackacre - $500; FMV - $800) to partner A, in satisfaction of A's right to a guaranteed payment in the amount of $800. The issue was whether the transfer of property is treated as a distribution under §731 or is a sale or exchange for purposes of §1001.

Under §731(a), no gain or loss is recognized by a partnership on a distribution of property to a partner. Nevertheless, the ruling cites several cases providing that if the taxpayer conveys appreciated property or depreciated property in satisfaction of an obligation, or in exchange for the performance of services, the taxpayer recognizes gain or loss equal to the difference between his or her basis in the distributed property and the property's fair market value.

Rev. Rul. 2007-40 holds that a transfer of partnership property to a partner in satisfaction of the partnership's obligation to make a guaranteed payment under §707(c) is a sale or exchange under §1001 and is not a distribution under §731. Therefore, Partnership will have to recognize $300 gain on the transfer of Blackacre to A.

2. IRS Addresses Worthlessness of Partnership Interests.

In Field Service Advice 2006-4601F, 2/16/06, the IRS addresses deductions for the worthlessness of partnership interest and loans.

First the IRS addressed whether partners were entitled to take ordinary loss deductions under §165 for the worthlessness of their partnership interests, or a bad debt deduction under §166(a) for the worthlessness of subordinated notes issued by the partnership. The IRS concluded that the partners could not take the deductions because

the partnership interests and subordinated loans had value and the partners had not established that the subordinated loans and partnership interests were abandoned or worthless. The partners did not establish an identifiable event that would demonstrate that a loss had been sustained, and there was no overt act indicating that the partners had abandoned their right to the amounts due under the subordinated loans. Additionally, the Forms K-1 issued to the partners showed "significant income and positive cash flow," and a mere diminution in value of an asset is not sufficient to establish worthlessness. The IRS also reasoned that the partnership would not have continued collection efforts if the partnership interests and subordinated loans were truly worthless.

Second, the IRS addressed whether partners were entitled to take a capital or §1231 loss deduction under either §165 or §166(a) for the worthlessness of their partnership interests. The IRS noted that a loss claimed to result from the worthlessness or abandonment of a partnership interest may be treated as a sale or exchange under §741(a), and thus result in a capital loss, if the taxpayer is relieved of partnership liabilities. Here, the IRS ruled that the partners had not demonstrated that such a loss was realized; specifically, they did not establish that there was a sale or exchange of their partnership interests. They continued to receive Forms K-1, and the partnership still considered them partners. Thus, the partners were not entitled to a capital loss deduction. Similarly, the partners had not demonstrated that their partnership interests were involuntarily converted.

Finally, the IRS addressed whether partners could reduce their net earnings from self-employment tax by their ordinary loss deduction for the worthlessness of their partnership interests. The IRS noted that a disposition of a partnership interest is a

disposition of property and is therefore excluded from the computation of earnings from self-employment tax under §1402(a)(3). The partners' self-employment tax liability should have been based only on their distributive share of earnings or loss, their distributive share from any other partnerships of which they were partners for the tax year, and any other trade or business income. Therefore, the partners could not reduce earnings from self-employment by the amount of the loss.

3. IRS Does Not Apply Sections 731 and 732 in a Tax-Motivated Transaction.

In IRS Legal Memorandum 200650014, 9/7/06, the IRS concluded that the non-recognition rules of §§731 and 732(b) do not apply when a partnership acquires residential real estate solely for the purpose of immediately making a distribution of the real estate in liquidation of a taxpayer's partnership interest.

Due to ongoing disagreements among partners, the taxpayer and most of the other partners liquidated their interests in the partnership. Under the terms of a redemption agreement, the partnership purchased a house and distributed it to the taxpayer, whose outside basis in the partnership was zero. A significant portion of the purchase price of the house was provided by funds borrowed from the taxpayer's relative, and the taxpayer immediately repaid this loan. The house was unrelated to the partnership's business. The taxpayer claimed that the distribution of the house was a tax-free distribution of property under §731(a)(1).

The IRS noted that, under §731, a partner recognizes gain on a distribution only to the extent that it receives a distribution of money in excess of the partner's outside basis immediately before the distribution. Under §732(b), the basis of non-money property

distributed in liquidation of a partner's interest is equal to the partner's outside basis, reduced by any money distributed in the same transaction.

Applying the legislative history, the IRS concluded that the nonrecognition rule of §731(a)(1) was intended to facilitate moving property in and out of partnerships for business reasons. Because the acquisition and distribution of the house was not accomplished for business reasons, the IRS concluded that nonrecognition treatment was inappropriate.

Moreover, the IRS concluded that the partnership never owned the house for federal tax purposes. Noting that the house was acquired with borrowed funds from the taxpayer and that the taxpayer repaid the loan, the IRS found that the house became the property of the taxpayer as soon as it was acquired by the partnership. Thus, for tax purposes, the partnership distributed cash to the taxpayer, which the taxpayer then used to acquire the house. Because the distribution was in substance a distribution of cash, section 731 did not apply.

In the alternative, the IRS ruled that, even if the partnership was considered the owner of the house, the transaction would be recast under the partnership anti-abuse rules of Reg. §1.701-2. The IRS noted that all the partners were related to one another, and that if the taxpayer's proposed treatment of the transaction were allowed to stand, the taxpayer's tax liability would be substantially less than had the taxpayer purchased the property directly. Taking into account the factors provided in Reg. §1.701-2(c), the IRS concluded that the taxpayer and the partnership had used the rules of Subchapter K inappropriately in an attempt to eliminate the taxpayer's gain on a liquidating distribution

of cash. Thus, the transaction should be recast as a distribution of cash to the taxpayer, who then used the distributed funds to purchase the house.

Finally, the IRS ruled that the transaction was also subject to re-characterization under the step transaction and economic substance doctrines.

4. IRS Extends Relief Under Section 470.

In Notice 2007-4, 12/13/06, the IRS extended by one year the transition relief provided to partnerships and other pass-thru entities that are treated as holding tax-exempt use property under §470 solely as a result of §168(h)(6). This relief is designed to limit the effects of the overly broad language of §470.

Section 470 limits the deductibility of losses resulting from "tax-exempt use property," defined to include property described in §168(h)(6), if a partnership has both tax-exempt and non-tax exempt partners, and any allocation to a tax-exempt entity is not a "qualified allocation," an amount equal to the tax-exempt entity's proportionate share of the property is generally treated as tax-exempt use property. Similar rules apply to other tax-exempt entities. A "qualified allocation" is generally any allocation to a tax-exempt entity that (i) is consistent with such entity's being allocated the same distributive share of each item of income and loss and (ii) has substantial economic effect.

In Notice 2007-4, the IRS announced that, for tax years beginning before 1/1/07, it would not apply §470 to disallow losses associated with property that is treated as tax-exempt use property as a result of the application of §168(h)(6). However, abusive transactions will remain subject to challenge by the IRS.

5. Partnership Allocations of State Tax Credits Recast.

In IRS Internal Legal Memorandum (ILM) 200704028, the IRS recast certain partnership allocations of state tax credits as sales of partnership property.

The state where the partnerships at issue were located allowed state tax credits for certain eligible rehabilitation expenses; it also allowed the allocation of such credits by partnerships. The transactions at issue involved investors contributing cash to a partnership that would join certain developers' partnerships in exchange for an allocation of state tax credits earned by the developer for rehabbing certain properties. The investors would hold the partnership interests for only a few months and then the partnerships would buy back the interests at a fraction of the investors' bases. As a result, the investors also claimed large capital losses on their returns.

The IRS made the following conclusions with respect to these transactions:

a. The investors were not partners in the partnership under the substance over form doctrine. The IRS noted that the critical inquiry into whether a partnership exists for federal tax purposes is the parties' intent to join together in a business activity and the sharing of profits. The IRS stated that under this inquiry, it was clear that because the investors lacked a joint profit motive, they would receive no material cash distribution, no net proceeds from a sale of the projects or operating partnerships, and no partnership items of income, gain, loss or deduction. The investors entered into the transaction knowing that the only benefits were the state tax credits and federal losses. Therefore, the investors were not partners in the partnerships.

b. The transactions should be recharacterized as a disguised sale of partnership property under §707(a)(2)(B). The IRS found that the contribution of cash by the investors in exchange for the simultaneous allocation of credits should be treated as a sale of the credits by the partnership to the investors.

c. The transaction should be recast as a sale of the credits under the partnership anti-abuse rules. The IRS found that the partnerships formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate tax liability in a manner that is inconsistent with the intent of Subchapter K because (i) the partnerships were used for the specific purpose of allocating the credits to the investors, (ii) the use of the partnership form enabled the promoters of the transactions to effect the sale of a large number of credits at a profit without incurring a gain, and (iii) the investors claimed large amounts of capital losses from the sale of their purported "partnership interests." The IRS stated that this use of the partnership form was inconsistent with the intent of Subchapter K, which is to permit taxpayers to conduct joint business activities through a flexible economic arrangement without incurring an entity-level tax. Thus, the IRS concluded that the partnerships should be disregarded under the partnership anti-abuse rules.

Based on these conclusions, the IRS recast the transactions as a sale of the credits. Thus, the partnerships generating the credits were required to report gains from the sale of the credits, with the credits having a zero basis in the hands of the partnership. When the investors used the credits to reduce their state tax liability, the IRS concluded that they should be treated as having satisfied their state tax liability with property, resulting in a disposition of the credits for purposes of §1001 and payments of state tax for purposes of §164(a). Further, the losses claimed by the investors upon the sale of the purported "partnership interests" were disallowed.

6. Installment Method Unavailable on Sale of Partnership Interest to the Extent it Represents Income Attributable to Unrealized Receivables.

In CCA 200722027, the taxpayer was a partner in a partnership that held unrealized receivables attributable to services rendered. A corporation purchased the taxpayer's partnership interest in exchange for a promissory note in a principal amount

exceeding $250,000. The note had a term of five years, with principal payable on the fifth anniversary and interest payable semiannually at the semi-annual mid-term AFR.

One of the issues addressed by the IRS in the CCA is whether income attributable to the partnership's unrealized receivables taxable as ordinary income on a sale of the partnership interest under §751(a)(1) and (c)(2) may be reported by the taxpayer on the installment basis.

CCA 200722027 recognizes that the IRS has not issued regulations under either §§453 or 453A that expressly provide that the sale of a partnership interest should be treated as the sale of a proportionate share of the assets of the partnership. Nevertheless, citing Rev. Rul. 89-108, 1989-2 CB 100, the CCA concludes that the same result occurs under §751. In Rev. Rul. 89-108, the taxpayer sold an interest in a partnership holding substantially appreciated inventory. The ruling holds that because §751 effectively treats the partner as if he or she directly sold an interest in the partnership's §751 property, any income from the sale of that property is reportable on the installment method only to the extent that the installment method could be used to report a direct sale of the property.

CCA 200720027 then analyzes whether a direct sale of unrealized receivables attributable to the performance of services is reportable under the installment method. While the CCA recognizes that §453(b)(2)(B) precludes the use of installment method to report the sale of inventory, it finds judicial authority to support its conclusions that unrealized receivables attributable to the performance of services cannot be reported on installment basis. The CCA primarily relied on *Sorenson*, 22 TC 321 (1954), in which the taxpayer, in consideration for his employment, received transferable options to purchase stock of this employer. Prior to expiration of the options, the taxpayer sold

them for cash and notes payable over a number of years. The court held that sale of options resulted in compensation to the taxpayer and that the installment reporting provisions relate only to income resulting from a sale of property and do not cover the reporting of income arising by way of compensation for services. Additionally, the CCA finds that the sole proprietor could not report income realized on the sale of unrealized receivables for services rendered. Accordingly, CCA 200622027 holds that a taxpayer may not report income from the sale of a partnership interest on the installment basis to the extent attributable to §751(c)(2) unrealized receivables arising from the performance of services.

C. Cases

1. Court Upholds Check the Box Regulations.

In *McNamee*, 99 AFTR 2d 2007-2871, __ F. 3d _____ (CA-2, 2007), the Second Circuit upheld the validity of the check-the-box regulations, which allow a single-owner LLC to choose whether to be treated as an association taxable as a corporation or be disregarded as a separate entity.

The taxpayer had formed a single-member LLC under Connecticut law. The LLC had unpaid payroll taxes for 2000 and 2001, which the IRS assessed against the taxpayer personally since the LLC was a disregarded entity for tax purposes. The taxpayer did not elect to treat the LLC as an association taxable as a corporation, and as such, it was disregarded as a separate entity and treated as a sole proprietorship under the default rule.

The taxpayer argued that the check-the-box regulations directly contradict the relevant statutory provisions of the Code, violate federal policy, and ignore the limited

liability laws created by local legislation. Additionally, the taxpayer argued that an IRS proposal in 2005 to amend the check-the-box regulations and relieve the owner of a single-member LLC from any possibility of personal liability for the LLC's payroll tax liability shows that the current check-the-box regulations are invalid.

The court, after examining the history of the entity classification regulations, concluded that the regulations in issue provided a flexible response to a novel business form, and were not arbitrary, capricious or unreasonable, and in fact, were eminently reasonable. Additionally, the court concluded that the taxpayer's contention that the proposed new regulation does not mean that the current regulations are wrong, and does not result in a finding that the existing regulations are unreasonable.

Finally, the court concluded that the regulations are not invalid on the theory that they ignore the Connecticut law provisions that accord an LLC member limited liability. Specifically, the court noted that the federal government has historically disregarded state classifications of businesses for some federal tax purposes, and as such, even though single-member LLCs are entitled to whatever advantages state law may extend to them, state law cannot abrogate their owner's federal tax liability.

Based on the foregoing, the Second Circuit upheld the validity of the check-the-box regulations, consistent with the recent decision of the Sixth Circuit in *Littriello*, 484 F. 3d 372 (CA-6, 2007).

2. Partners Required to Report Distributive Share of Income Even Though Partnership Funds Frozen.

In *Burke*, 485 F. 3d 171 (CA-1, 2007), the First Circuit, affirming the Tax Court, found that the taxpayer was required to report his distributive share of the partnership's income in the year the partnership received its earnings, even though he never received an actual distribution of the earnings of the partnership since such amounts were being held in escrow and were essentially "frozen."

Under the facts of *Burke*, the taxpayer, Burke, formed a partnership with Jeffrey Cohen named Cohen & Burke. A dispute arose between the two partners when Cohen allegedly refused to comply with a superseding partnership agreement that linked the distribution of the partnership's proceeds more tightly to each partner's individual efforts and allegedly stole money received by the partnership. Burke filed suit against Cohen and the parties agreed to keep the partnership's proceeds in an escrow account pending the outcome of the litigation. Cohen filed the partnership tax return for the year in issues, which reported $242,000 of ordinary income, with $121,000 reflected as each partner's distributive share. Burke reported zero as his distributive share of partnership income and filed a notice of inconsistent determination stating that Cohen's partnership tax filing was factually and legally correct.

Burke's position was that his distributive share of income from the partnership for 1998 should not have been taxed to him because it was being held in escrow and therefore he had no access to it. The IRS filed a motion for summary judgment arguing that, as a matter of law, a partner's distributive share of partnership income is taxable to

the partner regardless of whether the partner actually receives a distribution. The Tax Court granted summary judgment in favor of the IRS.

Citing §703 and cases decided under the "claim of right doctrine," Burke argued that the partnership did not earn taxable income in 1998 because the restrictions on those funds defer the recognition of income at the partnership level, as it does for individuals, until the restriction is removed. The court disagreed, holding that a self-imposed restriction on the availability of income cannot legally defer the recognition of that income. The partnership received the money free and clear in 1998 according to the court, and it was the individual partners who chose to place the funds in escrow. Consequently, the court concluded that Burke was required to report his distributive share of partnership's income in 1998, even though such funds were being held in escrow and not distributed to him.

3. Partnership Audit Procedures.

There was an unusual number of decisions during the past year concerning the application of the statute of limitations to partnerships and partners under the Uniform Partnership Audit Procedures of the Tax Equity and Fiscal Responsibility Act of 1982 (§§6221-6234). Under §6221, the tax treatment of any partnership item is determined at the partnership level. The IRS may challenge the reporting of any partnership item on the partnership tax return by issuing a final partnership administrative adjustment (FPAA), which serves as a predicate to making tax assessments on the individual partners.

Section 6501(a) sets forth the general statute of limitations for assessing taxes and penalties and provide in pertinent part, that "except as otherwise provided in this section,

the amount of any tax imposed by this title shall be assessed within three years after the return was filed…" Additionally, section 6229(a) provides the following:

> Except as otherwise provided in this section, the period for assessing any tax imposed by Subtitle A with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is three years after the later of (1) the date on which the partnership return for such taxable year was filed, or (2) the last day for filing such return for such year (determined without regard to extensions).

Recently, the Federal Circuit of Appeals held in *AD Global Fund, LLC*, 99 AFTR 2d 2007-1259 (Fed. Cir. 2007), that §6229(a) is not a statute of limitations, but rather, provides a minimum period for assessing taxes related to partnership items that sometimes operates to extend the time for assessments otherwise provided by §6501(a).

II. S CORPORATIONS.

A. Legislature

1. Small Business and Work Opportunity Act of 2007 ("Act"), enacted on May 25, 2007.

This act contains a number of tax incentives for small businesses, including the following S corporation provisions.

a. **Passive Investment Income**. The Act eliminates gains from sales or exchanges of stock or securities as an item of passive investment income, effective for taxable years beginning after 5/25/07. This provision will be useful to some S corporations with C corporation earnings and profits that wrestle yearly with ensuring that the amounts of their passive investment income do not exceed specified levels.

b. **Treatment of Sales of QSUB Interest**. Effective for tax years beginning after 12/31/06, the Act makes the rules applicable to the sale of stock of a qualified Subchapter S subsidiary (QSub) more like the rules applicable to the sale of interests in a single member limited liability company, the separate existence of which is disregarded for federal tax purposes. Specifically, the Act provides that, where the sale of stock of a QSub results in the termination of the QSub election, the sale will be treated as a sale of an undivided interest in the assets of the subsidiary, followed by a deemed acquisition by the subsidiary of its assets in a transaction to which Section 351 applied. Thus, for example, under the Act, if an S corporation sells 21% of the stock of a QSub, the S corporation will recognize gain as if it had sold a 21% undivided interest in the assets of the QSub. Under prior law, the S corporation had to merge the QSub into an SMLLC prior to the sale of the QSub in order to secure that result.

c. **Elimination of All Subchapter S E & P Attributable to Years before 1983**. The Act provides that, in the case of any corporation that was not an S corporation for its first

tax year beginning after 12/31/96, the accumulated E&P of the corporation as of the beginning of the first tax year beginning after the date of enactment will be reduced by the E&P accumulated in a tax year beginning before 1/1/83, for which the corporation was an electing small business corporation under Subchapter S. A provision in the 1996 legislation allowed a corporation that was an S corporation for its first tax year beginning after 12/31/96 to eliminate this old E&P; the provision in the new Act extends the ability to eliminate the old E&P to corporations that have converted back to S corporation status more recently.

d. **ESBT's Allowed to Deduct Interest Expense**. Effective taxable beginning after December 31, 2006, the Act allows electing small business trusts a deduction for interest expenses incurred to purchase S corporation stock. Under the current regulations, interest paid by an ESBT to purchase stock in an S corporation is allocated to the S portion of the ESBT but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

e. **S Corporation Bank Rules**. The Act clarifies that certain bank director shares are not a second class of stock. In addition, the Act allows a bank that changes from the reserve method of accounting for bad debts for its first tax year for which it is an S corporation to elect to take into account all adjustments under Section 481 by reason of the change in the last tax year it was a C corporation. In certain situations, this election will be of benefit from a built-in gain perspective (i.e. given that Section 481(a) adjustments taken into account as recognized built-in gain following conversion to S corporation status can be subject to an immediate double-level tax, while income taken into account during a C corporation year is taken into account at the corporate level immediately, but is not taken into account at the shareholder level until earnings are distributed.)

B. Regulations

1. Proposed Regulations under IRC 1367 Regarding Open Account Debt.

On April 11, 2007, proposed regulations were issued relating to an open account debt between S corporations and their shareholders. These regulations provide rules concerning the definition of open account debt and adjustments in debt basis to a shareholder for shareholder advances and adjustments in debt basis to a shareholder for shareholder advances and repayment of advances of open account debt.

To understand the proposed regulations, some background regarding the current rules may be helpful. Section 1367(a)(2) generally provides that the basis of each shareholder's stock is reduced by certain items, such as distributions and losses. Nonetheless, the basis of the stock cannot be reduced below zero. If the amount of these items exceeds the shareholder's basis in his or her stock, section 1367(b)(2) generally provides that the excess is applied to reduce the shareholder's basis in any debt of the S corporation to the shareholder (but not below zero). Section 1367(b)(2)(B) generally provides that "net increases" in subsequent years are applied to restore debt basis before stock basis.

The current regulations generally provide that, when there has been a reduction in debt basis for a year, any "net increase" in a subsequent year is applied to restore that reduction. Reg. §1.1367-2(c) generally defines "net increase" with respect to a shareholder as the amount by which the shareholder's share of certain items that increase basis (e.g., income items) exceeds his or her share of certain items that decrease basis (e.g. items of loss and deduction). As a general matter, Reg. §1.1367-2(d)(1) provides

that the adjustments to debt basis are determined as of the close of the corporation's tax year and are effective as of the close of such year.

The current regulations contain rules for applying the reduction in basis to multiple indebtedness, as well as rules for restoring reduction in such cases. Reg. 1.1367-2(a), however, provides that open account debt is treated as a single indebtedness. For this purpose, the regulations refer to "open account debt" as "shareholder advances not evidenced by separate written instruments and repayments on the advances."

The proposed regulations were issued in response to *Brooks v. Commissioner*, T.C. Memo 2005-204. In *Brooks*, the taxpayer borrowed money from a bank and advanced those funds as open account debt to his S corporation in one taxable year and reduced basis in that open account debt for losses passed through to the taxpayer at the end of the same year. In the first few weeks of the subsequent taxable year, the S corporation repaid the open account debt (the taxpayer then repaid his debt to the bank). Late in that same year, the taxpayer advanced additional money (again, funds borrowed from a bank) in an amount that offset the repayment of advances to avoid the recognition of gain from repayment of indebtedness. Also, the taxpayer's advances increased the shareholder's basis in the indebtedness and allowed losses for that year to pass through to the taxpayer shareholder. Taxpayer and the S corporation made these repayments and advances for several taxable years and deferred indefinitely the recognition of income on any repayment of his open account debt. The court in *Brooks* held "that the basis of the open account indebtedness is properly computed by netting at the close of the year advances of open account debt during the year and repayments of open account debt during the year."

The proposed regulations provide that the IRS believed that the concept of "open account debt" as defined in §1.1367-2(a) was intended to provide administrative simplicity for S corporations but was not intended to permit the deferred allowed in *Brooks*. Accordingly, the proposed regulations define open account debts as shareholder advances not evidenced by separate written instruments for which the payment of the aggregate advances (net of repayments on the advances) does not exceed $10,000 at the close of any day during the S corporation's taxable year. Also included as open account debts are separate advances under a line of credit agreement if the advances are not evidenced by a separate written instrument. Open account debt is treated as a single indebtedness.

In order to determine whether shareholder advances and repayments on the advances exceed the $10,000 aggregate principal threshold on any day during the S corporation's taxable year for open account debt, the shareholder is required to maintain a "running balance" of those advances and repayments and the outstanding principal amount of open account debt. If the resulting aggregate principal of the running balance does not exceed $10,000 at the close of any day during the S corporation's taxable year, the advances and repayments on advances would constitute open account debt, would be treated as a single indebtedness, and would be accounted for at the close of the taxable year. However, if the resulting aggregate principal of the running balance exceeds $10,000 at the close of any day during the S corporation's taxable year, the entire principal amount of that indebtedness would no longer constitute open account debt effective at the close of the day on the date the amount of the running account balance exceeds $10,000. This principal amount would be treated as indebtedness evidenced by a

written instrument for that taxable year, and would be accounted for according to the timing rules in §1.1367-2(d) for that taxable year and subsequent years. Any new shareholder advances not evidenced by a written instrument and repayments on those advances within the $10,000 aggregate principal threshold amount during the taxable year would constitute new open account debt.

The proposed regulations also modify the manner in which repayments on open account debt are accounted for under the existing §1.1367-2 regulations. These rules are separate from the maintenance of a running balance of the advances and repayments to determine if a shareholder has exceeded the $10,000 threshold amount. For purposes of accounting for open account debt, each shareholder, at the end of the S corporation's taxable year, must determine if that shareholder has made a net advance or received a net repayment on open account debt for that taxable year. To determine if a net advance or a net repayment has occurred, each shareholder, at the end of the S corporation's taxable year, must net all advances and repayments made during the year without regard to the outstanding principal amount of the open account debt. If, at the end of the taxable year, a net repayment exists, the net repayment must be taken into account effective at the close of the S corporation's taxable year under the general basis adjustment rules in the existing §1.1367-2 regulations. If, at the end of the taxable year, a net advance exists, the net advance is combined with the outstanding aggregate principal balance of the existing open account debt and that amount is carried forward to the beginning of the subsequent taxable year as the outstanding aggregate principal amount of the open account debt. If at any time during the taxable year the resulting aggregate principal of the running balance exceeds the $10,000 threshold amount so the entire principal amount of the debt no

longer constitutes open account debt, the running balance must be reconciled effective at the close of the day the balance exceeds $10,000 to determine the aggregate principal amount of the debt, and for the remainder of the taxable year that principal amount is treated in the same manner as indebtedness evidenced by a written instrument for purposes of this section.

These regulations will become effective when finalized.

2. Proposed Regulations Provide Guidance Regarding Changes Made to Subchapter S by the American Jobs Creation Act of 2004 and the Gulf Opportunity Zone Act of 2005.

On September 27, 2007, proposed regulations were issued concerning certain changes made to Subchapter S by the American Jobs Creations Act of 2004 and the Gulf Opportunity Zone Act of 2005.

The proposed regulations retain the provisions of Notice 2005-91 describing certain entities other than individuals that will be treated as members of the family. In addition, the regulations discuss how members of a family will be considered one shareholder for purposes of the 100 shareholder limitation. The family members are determined by reference to a common ancestor. The common ancestor test is applied as of the applicable date (i.e. the date the election is made, the earliest date a member of the family holds stock in the corporation, or October 22, 2004.) The proposed regulations make it clear that after the applicable date, transfers can be made to individuals further than six-generations down from that common ancestor without increasing the number of shareholders of the S corporation. The common ancestor test is only applied as of the applicable date, and lineal descendants 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.

The proposed regulations remove or amend several references in the regulations under §1361 that cite a specific number of permissible S corporation shareholders in order to accommodate any future statutory changes in the maximum number of permitted shareholders.

The proposed regulations amend the regulations to provide that potential appointees of a power of appointment will not be considered potential current beneficiaries ("PCB") of an electing small business trust ("ESBT") until the power is exercised. The proposed regulations amend the definition if PCB to provide that all members of a class of unnamed charities permitted to receive distributions under a discretionary distribution power held by a fiduciary that is not a power of appointment, will be considered, collectively, to be a single PCB for purposes of determining the number of permissible shareholders under §1361(b)(1)(A) unless the power is actually exercised, in which case each charity that actually receives distributions will also be a PCB.

The proposed regulations amend the provisions under Reg. §1.1366-2(a)(5) to include the exception that suspended losses may carryover to a spouse or a divorced spouse pursuant to a divorce. Section 235 of the American Jobs Creation Act of 2004 amended §1366(d)(2) to provide that if the stock of an S corporation is transferred between spouses or incident to divorce under §1041(a), any loss or deduction with respect to the transferred stock which cannot be taken into account by the transferring shareholder in the year of the transfer because of the basis limitation in §1366(d)(1) shall

be treated as incurred by the corporation in the succeeding taxable year with regard to the transferee. Prior to this amendment, any losses or deductions disallowed under §1366(d) were personal to the shareholder and did not transfer upon the transfer of the S corporation stock to another person.

The proposed regulations amend the qualified subchapter S ("QSST") regulations to indicate that for purposes of applying §§465 and 469 to the income beneficiary of a QSST, the disposition of S corporation stock by the QSST shall be treated as a disposition by the beneficiary. This creates an exception to the general rule of §1.1361-1(j)(8), which provides that the trust, rather than the beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of a disposition of that stock.

Finally, the proposed regulations amend the inadvertent termination regulations to provide for qualified subchapter S relief for inadvertent elections or terminations.

3. Final Regulations Regarding Employment and Excise Taxes for Disregarded Subchapter S Subsidiaries, Single-Owner Entities.

On August 15, 2007, final regulations were issued that require disregarded entities to collect and remit employment taxes (i.e., income, FICA and FUTA) for their employees and certain excise taxes. The final regulations drastically change the current rules under Notice 99-6 which gave such entities the following choice in collecting and remitting these taxes: (1) the owner of the disregarded entity could collect and remit under its EIN; or (2) the disregarded entity could collect and remit under its EIN. These regulations remove this choice. Under the regulations, the disregarded entity must collect

and remit under its own EIN. The owner of the disregarded entity is no longer able to collect and remit.

The employment tax provisions of these regulations apply to wages paid on or after January 1, 2009. However, the excise tax provisions of these regulations apply to liabilities imposed and actions required or permitted in periods beginning on or after January 1, 2008.

Disregarded entities may continue to use the procedures permitted by Notice 99-6 for wages paid prior to January 1, 2009. Notice 99-6 provides that if the owner calculates and pays all employment taxes and satisfies all other employment tax obligations with respect to employees of the disregarded entity under method (1) of Notice 99-6 for a return period that begins on or after April 20, 1999, then the owner must continue to use that method unless and until otherwise permitted by the Commissioner. However, the regulations modify Notice 99-6 such that the taxpayer may switch to method (2) of Notice 99-6 with respect to wages paid on or after August 16, 2007, and before January 1, 2009, without seeking permission of the Commissioner.

4. Final Regulations Regarding ESOPs Holding Stock of S Corporations

On December 26, 2006, final regulations were issued regarding requirements under §409(p) for employee stock ownership plans holding stock of S corporations. The final regulations modify certain aspects of temporary and proposed regulations that had been issued in December of 2004 and are effective for plan years beginning on or after 1/1/06.

Section 409(p) sets forth an extremely complex set of rules that are aimed largely at ownership structures that concentrate the benefits of the ESOP, directly or indirectly, in the hands of a small number of persons. The final regulations contain guidance regarding prohibited allocations, disqualified persons, nonallocation years, synthetic equity, and standards for determining whether a transaction constitutes avoidance or evasion of §409(p). A detailed discussion of §409(p) and the final regulations is beyond the scope of this presentation.

C. Other IRS Pronouncements

1. Private Letter Ruling 200709004: Distributions & Second Class of Stock.

In this Ruling, the IRS ruled that distributions based on varying ownership interests in an S corporation will not cause the corporation to have a second class of stock. An S corporation, its shareholders, and its option holders entered into a shareholders agreement containing provisions relating to minimum distributions to the shareholders. Under the terms of the agreement, distributions were made based on the shareholders' various interests in the S corporation's income in the current or immediately preceding taxable year. In addition to these distributions, the S corporation declared dividends and made pro rata distributions to its shareholders based on the number of shares as of the record date.

Based upon the Reg. §§1.1361-1(l)(2)(i) and 1.1361-1(l)(2)(iv), the IRS concluded that the S corporation's governing provisions relating to the two types of distributions did not cause it to have more than one class of stock under §1361(b)(1)(D).

2. Private Letter Ruling 200708018: Stock Plan not a Second Class of Stock.

In this Ruling, the IRS ruled that an S corporation's implementation of a plan to issue new stock that is nontransferable and will have no readily ascertainable value at distribution will not cause a second class of stock. An S corporation adopted a nonqualified stock option plan with the intention that the plan not qualify under §422. The plan allowed the granting of stock options to officers of the company as of a given date each year that would expire three years later. The stock options had no readily ascertainable value at the time of issuance and were nontransferable.

Under an agreement between the company and its shareholders, the shares of the company stock were transferable to third parties subject to certain purchase rights of the company and the non-selling shareholders. If the company shares were purchased by third parties within one year of their purchase, the company had the right to purchase them at the purchase price established in the stock option plan. The company had the right to redeem stock shares and a shareholder had a right to sell its stock to the company upon the shareholder's death, disability, termination of employment, or voluntary or involuntary transfer of stock.

3. Private Letter Ruling 200701017: Splitting up Through F Reorganizations

For asset management purposes, the sole shareholder of the taxpayer, an S corporation, formed a new corporation (NewCo) and proposed to transfer all of its stock in the taxpayer to NewCo in exchange for the NewCo's stock. As a result, the shareholder intended to wholly own NewCo, which, in turn, would wholly own the

taxpayer, which would elect QSub treatment, and the protected assets would be transferred to NewCo.

The IRS ruled that if NewCo qualified, it would be treated as an S corp under §1361(b)(1) and the taxpayer would be eligible to be a QSub. The IRS also held that the taxpayer's subsidiaries, originally qualified as QSubs, would retain that status. Interestingly, the ruling does not indicate that NewCo was required to file a Form 2553 in order to be treated as an S corporation; instead, it suggests that NewCo may have become an S corporation simply by virtue of the "F" reorganization. In a situation outlined in the letter ruling, the making of a valid QSub election is essential to the characterization of the transaction as an "F" reorganization. If the transaction constitutes an "F" reorganization, the S corporation election of the historical company can remain in effect. Nonetheless, a parent corporation must be an S corporation in order to file a QSub for an eligible subsidiary. Thus, a question is raised as to whether the transaction can be characterized as an "F" reorganization if the newly formed corporation does not first file an S corporation to enable it to file a QSub election for the historical company.

To avoid this potential concern, some practitioners advise a newly formed holding company in this kind of situation to file a "protective" S election, along with an explanation that the transaction has been structured as an "F" reorganization and that the Form 2553 is being provided merely to facilitate the processing of the QSub election. Further, some practitioners also suggest that consideration be given to securing a new EIN for the holding company to assist the IRS in processing forms.

The IRS also found that the transaction was a reorganization for §368(b) purposes, that no party would recognize gain or loss under §§361(a), 357(a) and 1032(a);

that basis rules in §362(b) and holding period rules in §1223(2) applied; and that the new corporation succeeded to the taxpayer's earnings and profits under §381(a).

4. Private Letter Ruling 200652040: Modification of Trusts & Sub S Eligibility.

A trust settled by a decedent was originally funded with corporate stock. When its issuer became an S corporation, each subtrust chose to be an ESBT. In connection with modifications proposed by the trustee under new state laws, rulings were sought on the income, gift, and generation skipping transfer tax consequences of the changes. Specifically, the IRS was asked whether the proposed modifications would result in: (1) a loss, by the trust or subtrust, of its GST-exempt status; (2) a taxable gift under §2501; (3) a disposition under §1001 or recognition of gain or loss. It also sought a ruling that the modifications satisfied §1361(e)(1).

The IRS ruled that since the trust was irrevocable on September 25, 1985 and since the proposed modifications did not shift a beneficial interest to a lower generation nor defer vesting, its GST-exempt status was preserved and no gift tax liability would be triggered. Nor was there a "disposition" for purposes of §1001. Finally, the modification would not alter or otherwise affect the trusts' ESBT status under §1361(e).

5. Revenue Procedure 2007-62: Simplified Method for Requesting Relief for Late-Filed S Corporation Elections.

In Revenue Procedure 2007-62, the IRS provided an additional simplified method for taxpayers to request relief for late S corporation elections. The procedure also provides a simplified method for taxpayers to request relief for a late S corporation

election and late corporate classification election intended to be effective on the same date.

The methods for requesting relief are provided in lieu of the letter ruling process ordinarily used to obtain relief for late elections.

Generally, the procedure will permit an entity to be granted relief for a late S election if:

- It fails to qualify on the first day that status was desired solely because of the failure to timely file Form 2553 with the applicable IRS office;
- It has reasonable cause for the failure to timely file;
- It has not filed a tax return for the first taxable year in which the election was intended;
- Its application for relief is filed no later than six months after the due date of the tax return, excluding extensions, for the first taxable year in which the election was intended; and
- No taxpayer whose tax liability or return would be affected by the election, including all of its shareholders, has reported inconsistently with the S corporation election on a return for the year in which the election was intended.

Qualifying entities may request relief by filing with the applicable campus a properly completed Form 2553 with a Form 1120S for the first taxable year S corporation status was intended. Similar rules are provided for taxpayers to request relief for a late S

corporation election and late corporate classification election intended to be effective on the same date.

D. Cases

1. *Alpert v. United States*, 2007 U.S. App. LEXIS 6758 (6th Cir. 2007), March 23, 2007.

The Sixth Circuit affirmed a district court's denial of a tax refund to a couple attempting to carry back losses. The taxpayer's failed to establish that, during the bankruptcy period of their S corporation, the S corporation's creditors discharged indebtedness that led to the realization of any COD income that would allow taxpayers to increase stock basis in which to take suspended losses. The taxpayers were the sole shareholders of an S corporation that became insolvent leading to an involuntary petition for bankruptcy and the appointment of a trustee to administer the corporation's estate. During the years at issue, the bankruptcy proceedings were pending and the trustee and receiver administered the estate by filing reports, attempting to satisfy debt, handling claims of the estate, and collecting inventory, receivables and other assets. Once the bankruptcy proceeding was closed, taxpayers filed for a claim for refund as a result of the alleged discharge of indebtedness income. The Sixth Circuit affirmed the District Court's finding that there was no identifiable event that fixed the amount of the discharge of indebtedness before the conclusion of the bankruptcy proceedings. The court held that the taxpayer failed to provide satisfactory evidence that an "identifying event occurred to fix the date of discharge of indebtedness."