ABA Subchapter S News

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Selected Subchapter S 2008 Update/Developments

■ IRS Rulings and Notices

Notice 2008-1 (Health Insurance Cost of 2% Shareholder-Employee): This Notice provides special rules relating to the treatment of health insurance premiums paid by or reimbursed by the S corporation for a 2% shareholder-employee:

- A 2% shareholder-employee may deduct amounts paid for insurance if the insurance plan was established by the S corporation.
- A plan is considered established by the S corporation if:
  - The S corporation makes the premium payments in the current tax year, or
  - The 2% shareholder-employee makes the premium payments in the current tax year and is reimbursed by the S corporation in the current tax year.
- Payments made by the S corporation or reimbursed by the S corporation must be included in the shareholder's wages and reported on IRS Form W-2.

Rev. Rul. 2008-16 (Charitable Contributions): In general, Section 170 allows a taxpayer to take a deduction for charitable contributions made during the taxable year. An S corporation that makes charitable contributions does not itself take deductions under section 170 -- these deductions flow through to the shareholders. Under the general limitations of the Code, a sub S shareholder's share of the corporation's deductions and losses cannot exceed the adjusted basis of his stock and the adjusted basis of any indebtedness of the corporation to the shareholder. This ruling provides guidance on the application of the limitations provisions relating to charitable contributions made by a Subchapter S corporation.

- Applies to charitable contributions of appreciated property made between January 1, 2006 and December 31, 2007.
- Shareholder's charitable contribution deduction equals (i) the shareholder's pro rata share of the fair market value of the contributed property (over the property's adjusted basis) plus (ii) the amount of loss limitation that is allocable to the property's adjusted basis under Treasury regulations.
- Any disallowed portion of the deductions is treated as incurred by the corporation in the subsequent taxable years, with respect to the shareholder.

Rev. Rul. 2008-18 (S Corporation "F" Reorganization): This ruling describes situations where an S corporation undergoes a tax-free F reorganization, and the operating S corporation becomes a QSub of a newly formed holding company. The ruling addresses two questions:

- What is the effect of a section 368(a)(1)(F) reorganization on the S status of an S corporation?
    - The S election does not terminate. When an S corporation merges into a newly formed corporation in a transaction qualifying as a reorganization under §368(a)(1)(F), and the newly formed surviving corporation also meets the requirements of an S corporation, the reorganization does not terminate the S election. Thus, the S election remains in effect for the new corporation.
- The What is the appropriate Federal Employer Identification Numbers (EIN) that should be used by the new S corporation parent and the QSub?
    - The newly formed parent will have to get its own EIN rather than take over the QSub's EIN. This is effective January 1, 2009.
    - For S corporations that have previously gone through an F reorganization (as described in the ruling) where the newly formed parent took the QSub's EIN, the parent should continue to use that EIN and the QSub will have to get a new EIN when it is treated as a separate corporation.

Rev. Proc. 2008-18 (Bad Debt Recapture): As a general rule, banks are allowed to use the reserve method of accounting for bad debt under the code.

- When Congress permitted banks to elect the S status, it required that a bank making the S election must change from the reserve method to the specific charge-off method.
- If a financial institution changes from the reserve method of accounting for bad debts to the specific charge-off method the amount of the institution's reserve for bad debts is generally the amount of its § 481(a) adjustment for the change. This amount (§ 481(a) adjustment) is generally taken into account over four taxable years beginning in the year of change.
- The Small Business and Work Opportunity Act of 2007 created a new section 1361(g), which provides that: a bank which changes from the reserve method for its first S corporation year may elect to take into account any §481 adjustments resulting from the change in its final C corporation year.
- Applies to taxable years beginning after December 31, 2006.
- The Rev. Proc. provides guidance for making the election:
    - For its first S corporation year, the bank must attach an original IRS Form 3115 for accounting change to its tax return. A copy must be sent to the IRS National office.
    - For its last C corporation year, the bank must attach a copy of IRS Form 3115 to its tax return. The bank must also include the full amount of the section 481(a) adjustment in income.
    - Original copy of the Form 3115 must state at the top "Section 1361(g) election Filed Pursuant to Rev. Proc. 2008-18".

Notice 2008-100 (Section 382): Applies to corporations in which the Treasury acquires equity securities under the Capital Purchase Program (CPP). (As of this date, S corporations have not been formally included in the CPP, as no term sheet addressing the terms of participation has been released by the Treasury for S corporations.)

- Section 382 provides limitations on the use of losses following an ownership change.
- The notice allows the Treasury to acquire equity securities in a corporation (including an S corporation) without triggering the ownership change rules or the loss limitation rules of section 382.

■ **Proposed Regulations**

Reduction of Tax Attributes For S Corporations: Generally, if an S corporation excludes COD income from its gross income, the amount excluded is applied to reduce the S corporation's tax attributes. The proposed regulations provide guidance on:

- The manner in which an S corporation reduces its tax attributes under the Code for taxable years in which the S corporation has income from cancellation of debt (COD) that is excluded from gross income under the Code.
- Situations in which the aggregate amount of the shareholders' disallowed losses and deductions that are treated as a net operating loss tax attribute of the S corporation exceeds the amount of the S corporation's excluded COD income.
  - The S corporation's deemed NOL also includes 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 S corporation's excess deemed NOL is allocated to the shareholders as excess losses and deductions that are disallowed under the S corporation rules.
  - 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.

■ Final Regulations

T.D. 9422 (Final regulations implementing provisions of the AJCA of 2004): Final regulations providing guidance on certain Sub S provisions contained in the American Jobs Creation Act of 2004 (the 2004 Act) and the Gulf Opportunity Zone Act of 2005 (the 2005 Act). According to the IRS, these final regulations, which contain only a few (non substantive) changes to proposed regulations issued in September 2007, "replace obsolete references in the current regulations and allow taxpayers to make proper use of the [new] provisions that made changes" to the Subchapter S rules. Under the final regulations:

- Section 1361-1(e) (which references the number of shareholders an S corporation may have) is made to conform to the language of the Code (which reflects the change made by the 2004 Act).
- For purposes of stock held by an IRA (including a Roth IRA), the "individual for whose benefit the trust was created shall be treated as the shareholder."
- Guidance is provided on: (1) rules regarding stock owned by family members for purposes of determining the number of shareholders of an S corporation; (2) rules relating to the treatment of losses and deductions resulting from either transfers of stock between spouses or transfers of stock incident to divorce; (3) definition of "powers of appointment" and potential current beneficiaries" for ESBTs; and (4) the applicable rules relating to a situation where the IRS exercises its authority to grant a taxpayer relief from inadvertent S corporation termination or inadvertent invalid S election. Click here to view the text of the final regulations.

TD 9428 (S Corporation Open Account Debt): These regulations address:

- The definition of open account debt - shareholder advances not evidenced by separate written instruments for which the principal amount of the aggregate advances (net of repayments on advances) did not exceed $25,000 per shareholder at the close of any day during the S corporation's taxable year. Shareholders are required to determine for open account debt purposes whether shareholder advances and repayments on the

advances exceed the $25,000 aggregate principal threshold on any day during the S corporation's taxable year. For example, an S corporation with ten shareholders could receive up to $250,000 of open account debt as long as no single shareholder advanced more than $25,000.

- Adjustments in basis of indebtedness for shareholder advances and repayments on advances of open account debt. Treasury regulations provide specific rules for required adjustments (reductions and restorations) to basis in any indebtedness of an S corporation to a shareholder. The basis adjustment rules under the regulations apply to all indebtedness of an S corporation to a shareholder, whether the indebtedness is evidenced by a written instrument or is open account debt.
- All advances to an S corporation by a shareholder are subject to the general tax principles for debt, whether evidenced by a written instrument or not.

The regulations apply to any and all shareholder advances to the S corporation made on or after October 20, 2008, and repayments on those advances by the S corporation.

■ Accounting

FIN 48 (Accounting for Uncertainty in Income Taxes):

- Requires analysis of all tax positions taken on tax returns and a possible accrual of tax liability or asset for uncertain tax positions.
- All tax positions taken on the return must meet the "more likely than not" standard.
- More likely than not standard is a greater than 50% test.
- Effective for tax years beginning after December 15, 2007.
- Applies to S corporations with entity-level federal or state income tax.
- On Nov, 3, 2008, FASB issued FSP) FIN 48-c, which defers the effective date of the application of FIN 48 for certain nonpublic companies for one year. (Effective for fiscal years beginning after December 15, 2008) The deferral does not apply to:
    - nonpublic consolidated entities of public enterprises that apply U.S. GAAP, and
    - nonpublic enterprises that have applied the recognition, measurement, and disclosure provisions of FIN 48 in a full set of annual financial statements issued prior to the issuance of this FSP.
- The deferred effective date would give FASB time to amend the disclosure requirements under FIN 48 for nonpublic enterprises and to develop guidance on the application of FIN 48 by pass-through entities and not-for-profit organizations.
- An entity is required to disclose the fact that it is deferring for each set of financial statements where the deferral applies, and also explain how it dealt with tax uncertainties. This disclosure is necessary to help financial users that may be analyzing multiple entities, some of which have applied the guidance and others that have not.

■ Others

TEFRA Interest Disallowance:

- The TEFRA interest disallowance rule under section 291 provides a 20% limitation on the deductibility of interest expense that is allocable to a bank's qualified tax-exempt obligations (QTEOs).
- S corporations are required to compute their taxable income in the same manner as an individual. Exception – The TEFRA interest disallowance rule (under section 291) will apply for the first three years of S status.

- The IRS contends that the 20% limitation rule continues to apply to S corporation banks after the first three years of S status.
- This issue is currently being litigated in the U.S. Tax Court (the Vainisi case). The case has been fully briefed by the IRS and taxpayer. Briefs were submitted in November 2007.
- The court's decision is expected any day now. (The Tax Court has no deadline by which it must render its decision, thus, there is no way of predicting when the decision will be rendered.)
- In August of 2006, the IRS issued proposed regulations addressing this issue. The proposed regulations provide that the TEFRA interest disallowance continues to apply to S corporation banks and QSub banks after the third year.
- The IRS received many comments, most of which state that the IRS does not have authority to override the code provision via regulation. The comments requested that the proposed regulations be withdrawn.
- The proposed regulations (with an effective date of August 2006) have not been made final.

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