

S CORPORATION UPDATE 2008

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1. News Flash from the JCT

- For 2005 S corporations were 11.6% of all business entities in the U.S. (up from 3.7% in 1985, before the Tax Reform Act of 1986). Sole props were 67.3%.²

2. Tax Basis in Shares

- Treasury issued final regulations regarding the treatment of open account debt between S corporations and their shareholders.³ The principal threshold was raised from \$10,000 to \$25,000, but the rules are still horribly complex and a trap for the very unwary business owner or accountant.⁴
- The basis adjustment to the stock of S corporations that make charitable contributions was extended from December 31, 2007 to December 31, 2009.⁵

² Joint Committee on Taxation, as reported in Daily Tax Report (BNA), 100 DTR G-14, June 5, 2008 and JCT, Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity, Id., TaxCore. S corps and partnerships (including LLCs) are increasing. The number of C corporations and farms are about equal and have neither increased nor decreased much recently.

³ Treas. Reg. § 1.1367-2, T.D. 9458, October 20, 2008; Daily Tax Report (BNA) 202 DTR G-1. October 20, 2008.

⁴ A Treasury attorney called the Brooks v. Commissioner case (90 T.C.M. 172 (2005)) an extreme abuse of the open account rule. *Treasury Working to Alleviate Burdens of Proposed Open Account Debt Regulations*, Daily Tax Report (BNA) 92 DTR G-7, May 13, 2008.

⁵ Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008, Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (H.R. 1424) Section. 307, amending I.R.C. § 1367(a)(2). The Senate Finance Committee explained:

(footnote continued on next page)

- Proposed regulations were issued on how an S corporation reduces its tax attributes under section 108(b) for taxable years in which the S corporation has discharge of indebtedness income that is excluded from gross income under section 108(a). In particular, when the aggregate amount of the shareholders' disallowed section 1366(d) 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 discharge of indebtedness income.⁶

3. Distributions – AAA Account

- S corp with AAA is owner and beneficiary of key-person life insurance policy.
 - ⇒ 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.⁷

(footnote continued from prior page)

Prior to the PPA, if an S corporation made a contribution to a charity, shareholders reduced the basis in their stock by their pro rata share of the fair market value of the contribution. The PPA provided the amount of a shareholder's basis reduction in the S corporation stock will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property. The provision expired December 31, 2007. The proposal would extend the provision to the end of 2009. The proposal would also make a technical correction clarifying the application of this provision. The proposal is effective for tax years beginning after December 31, 2007. The estimated cost of this proposal is \$132 million over ten years.

Senate Finance Committee Detailed Summary of Energy, Disaster Relief, AMT, and Other Tax Extender Provisions in Emergency Economic Stabilization Act of 2008, Daily Tax Report (BNA) TaxCore, October 2, 2008.

⁶ August 5, 2008, proposing changes to Treas. Reg. § 1.108-7. The Service requested comments on several specific issues. Comments were due by November 4, 2008. Hearings are scheduled for December 8, 2008.

⁷ Rev. Rul. 2008-42, I.R.B. 2008-30 (July 1, 2008).

⇒ 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.⁸

4. Other Developments

4.1. Small Business and Work Opportunity Act of 2007 (May 25, 2007)

- Allows an ESBuT an interest deduction for interest paid or accrued on indebtedness incurred to acquire stock in an S corporation.⁹

⇒ No interest in an ESBuT can be acquired by purchase.¹⁰

⇒ But the ESBuT can acquire the S corporation stock by purchase.

4.2. Final regs issued on Pension Protection Act of 2006 issues¹¹

- Counting families as shareholders¹²
- Definitions for powers of appointment and potential income beneficiaries for ESBuTs¹³
- Transferring suspended losses to former spouses¹⁴

⁸ Id.

⁹ I.R.C. § 641(c)(2)(C)(iv).

¹⁰ I.R.C. § 1361(e)(1)(A)(ii).

¹¹ These follow up proposed regs issued on September 27, 2007.

¹² T.D. 9422, August 14, 2008, amending Treas. Reg. § 1.1361-1.

¹³ Id.

- QSub election relief¹⁵

4.3. **Definition of Farming Syndicate**

- An S corporation was held to be treated as a limited partner for purposes of the definition of a farming syndicate in IRC Section 464(c).¹⁶

4.4. **Current IRS/Treasury Priority Guidance Plan¹⁷**

- Final regulations under section 1363 providing guidance for S corporation banks regarding separately stated items. (Proposed regulations were issued on August 24, 2006.)
- Guidance under sections 1366 and 1367(a)(2) regarding the amount of deduction, and adjustments to basis of S corporation stock, for charitable contributions of property by S corporations made after the Pension Protection Act of 2006 amendments.
- Guidance under section 1367 regarding S corporations and back-to-back loans.

(footnote continued from prior page)

¹⁴ T.D. 9422, August 14, 2008, amending Treas. Reg. § 1.1366-2.

¹⁵ T.D. 9422, August 14, 2008, amending Treas. Reg. §§ 1.1361-4, 1.1362-4.

¹⁶ Chief Counsel Advice 2008-40-042, October 3, 2008.

¹⁷ Office of Tax Policy and Internal Revenue Service, Update to 2007-2008 Priority Guidance Plan, August 29, 2008, Daily Tax Report (BNA), TaxCore, September 11, 2008.

4.5. Proposed “S Corporation Modernization Act of 2007” (H.R. 4840, December 19, 2007)¹⁸

- Reduce built-in gain period from ten to seven years.
- Qualifying beneficiaries of an ESBuT determined without looking through the ESBuT.
- ESBuT could take a charitable contribution deduction for corporation-level contributions.
- Excess passive receipt problems would never terminate the S corporation election.
- Passive receipts would not be excessive unless they exceeded 60% (not just 25%) of total receipts.
- IRAs could hold S corporation shares.

4.6. Lead Trust as S Corporation Shareholder

- A grantor charitable lead trust was held to be an eligible shareholder of an S corporation.¹⁹

[End of outline.]

¹⁸ The similar S corporation Modernization Act of 2008 (S. 3063) was introduced by Senators Lincoln and Hatch on May 22, 2008. Daily Tax Report (BNA) 103 DTR G-3, May 29, 2008.

¹⁹ PLR 2007-47-001, August 3, 2007.