

REG-102822-08. Section 108 Reduction of Tax Attributes for S Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing

SUMMARY: This document contains proposed regulations that provide guidance on the manner in which 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, the regulations address situations in which 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. The proposed regulations will affect S corporations and their shareholders. This document also provides notice of a public hearing on these proposed regulations.

DATES: 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.

ADDRESSES: Send submissions to CC:PA:LPD:PR (), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov/ (IRS). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jennifer N. Keeney, (202) 622-3060; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Funmi Taylor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by November 4, 2008. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in these proposed regulations is in §1.108-7(d)(4). This information must be provided by both the S corporations that exclude discharge of indebtedness income from gross income under section 108(a) and the shareholders of those S corporations. The information will be used by the S corporation to properly reduce its tax attributes under section 108(b), and the information will be used by the shareholders of S corporations to calculate their taxable income in succeeding taxable years. The respondents will be S corporations and their shareholders.

Estimated total annual reporting burden: 1,000 hours.

Estimated average annual burden hours per respondent: 1 hour.

Estimated number of respondents: 1,000.

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by .

Background

This document contains proposed amendments to under (Code). Section 61(a) provides that gross income means all income from whatever source derived, including (but not limited to) income from discharge of indebtedness, also known as cancellation of debt (COD income). Section 108(a) provides an exclusion from gross income for COD income if the discharge occurs while the taxpayer is bankrupt or insolvent, or if the indebtedness discharged is qualified farm indebtedness, certain qualified real property business indebtedness, or certain qualified principal residence indebtedness. In the case of a discharge of indebtedness during insolvency, the exclusion from income is limited to the amount by which the taxpayer is insolvent. Section 108(b) provides that the taxpayer must reduce certain specified tax attributes to the extent COD income is excluded under section 108(a)(1)(A), (B), or (C). Section 108(b) also provides the order in which these

tax attributes must be reduced. Unless the taxpayer makes an election under section 108(b)(5) to first reduce the basis of depreciable property, section 108(b)(2)(A) provides that the first tax attribute to be reduced is any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

Explanation of Provisions

A. Allocation of Excess Losses and Deductions After Section 108(b) Tax Attribute Reduction

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 §1.1366-2(a)(5) of the Income Tax Regulations, unless the transfer is described in section 1041(a).

B. Character of Excess Deemed NOL Allocated to a Shareholder

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.

C. Information Sharing Requirements

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.

Proposed Effective Date

These regulations are proposed to apply to discharges of indebtedness occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information contained in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the collection burden imposed on S corporations and their shareholders is minimal in that it requires S corporations and their shareholder(s) to share information that shareholders already maintain to determine their respective tax liability. Moreover, it should take an S corporation or a shareholder no more than one hour to satisfy the information sharing requirements in these regulations. Finally, the collection burden imposed applies only to S corporations that are required to reduce their tax attributes under - a group estimated to be less than 1 percent of all existing S corporations. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to , this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 8, 2008, beginning at 10 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by November 4, 2008, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 4, 2008. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Jennifer N. Keeney, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations Accordingly, is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: ***

Par. 2. Section 1.108-7 is amended by:

1. Redesignating paragraphs (d) and (e) as paragraphs (e) and (f), respectively.
2. Adding new paragraph (d).
3. Adding paragraph (e) Example 5 and Example 6 to newly-redesignated paragraph (e).
4. Revising newly-redesignated paragraph (f).

The additions and revision read as follows:

Proposed Amendment 1.108-7.

§1.108-7 Reduction of attributes.

(d) Special rules for S corporations—(1) In general. If an S corporation excludes COD income from gross income under section 108(a)(1)(A), (B), or (C), the amount excluded shall be applied to reduce the S corporation's tax attributes under paragraph (a)(1) of this section. For purposes of paragraph (a)(1)(i) of this section, the aggregate amount of the shareholders' losses or deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1), including disallowed losses or deductions of a shareholder that transfers all of the shareholder's stock in the S corporation during the taxable year of the discharge, is treated as the net operating loss tax attribute (deemed NOL) of the S corporation for the taxable year of the discharge.

(2) Allocation of excess losses or deductions—(i) In general. If the amount of an S corporation's deemed NOL exceeds the amount of the S corporation's COD income that is excluded from gross income under section 108(a)(1)(A), (B), or (C), the excess deemed

NOL shall be allocated to the shareholder or shareholders of the S corporation as a loss or deduction that is disallowed under section 1366(d) for the taxable year of the discharge.

(ii) Multiple shareholders—(A) In general. If an S corporation has multiple shareholders, to determine the amount of the S corporation's excess deemed NOL to be allocated to each shareholder under paragraph (d)(2)(i) of this section, calculate with respect to each shareholder the shareholder's excess amount. The shareholder's excess amount is the amount (if any) by which the shareholder's losses or deductions disallowed under section 1366(d)(1) (before any reduction under paragraph (a)(1) of this section) exceed the amount of COD income that would have been taken into account by that shareholder under section 1366(a) had the COD income not been excluded under section 108(a).

(B) Shareholders with a shareholder's excess amount. Each shareholder that has a shareholder's excess amount, as determined under paragraph (d)(2)(ii)(A) of this section, is allocated an amount equal to the S corporation's excess deemed NOL multiplied by a fraction, the numerator of which is the shareholder's excess amount and the denominator of which is the sum of all shareholders' excess amounts.

(C) Shareholders with no shareholder's excess amount. If a shareholder does not have a shareholder's excess amount as determined in paragraph (d)(2)(ii)(A) of this section, none of the S corporation's excess deemed NOL shall be allocated to that shareholder.

(iii) Terminating shareholder. Any amount of the S corporation's excess deemed NOL allocated under paragraph (d)(2) of this section to a shareholder that had transferred all of the shareholder's stock in the corporation during the taxable year of the discharge is permanently disallowed under §1.1366-2(a)(5), unless the transfer of stock is described in section 1041(a). If the transfer of stock is described in section 1041(a), the amount of the S corporation's excess deemed NOL allocated to the transferor under paragraph (d)(2) of this section shall be treated as a loss or deduction incurred by the corporation in the succeeding taxable year with respect to the transferee. See section 1366(d)(2)(B).

(3) Character of excess losses or deductions allocated to a shareholder. In determining the character of the amount of the S corporation's excess deemed NOL allocated to a shareholder under paragraph (d)(2) of this section, any ordinary loss or deduction that was included in the shareholder's aggregate amount of disallowed losses or deductions under section 1366(d)(1) is treated as reduced under section 108(b) before any section 1231 loss that was included in the shareholder's aggregate amount of disallowed losses or deductions under section 1366(d)(1), and any section 1231 loss is treated as reduced under section 108(b) before any capital loss that was included in the shareholder's aggregate amount of disallowed losses or deductions under section 1366(d)(1).

(4) Information requirements. If an S corporation excludes COD income from gross income under section 108(a) for a taxable year, each shareholder of the S corporation during the taxable year of the discharge must provide to the S corporation the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1). The S corporation must provide to each shareholder the amount of any of the S corporation's excess deemed NOL that is allocated to that shareholder under paragraph (d)(2) of this section, even if that amount is zero.

(e) ***

Example 5. (i) Facts. During the entire calendar year 2008, A, B, and C each own equal shares of stock in X, a calendar year S corporation. As of December 31, 2008, A, B, and C each have a zero stock basis and X does not have any indebtedness to A, B, or C. For

the 2008 taxable year, X excludes from gross income \$30,000 of COD income under section 108(a)(1)(A). The COD income (had it not been excluded) would have been allocated \$10,000 to A, \$10,000 to B, and \$10,000 to C under section 1366(a). For the 2008 taxable year, X has \$30,000 of losses and deductions that X passes through pro-rata to A, B, and C in the amount of \$10,000 each. The losses and deductions that pass through to A, B, and C are disallowed under section 1366(d)(1). In addition, B has \$10,000 of section 1366(d) losses from prior years and C has \$20,000 from prior years. A's (\$10,000), B's (\$20,000) and C's (\$30,000) combined \$60,000 of disallowed losses and deductions for the taxable year of the discharge are treated as a current year net operating loss tax attribute for X under section 108(d)(7)(B) (deemed NOL) for purposes of the section 108(b) reduction of tax attributes.

(ii) Allocation. Under section 108(b)(2)(A), X's \$30,000 of excluded COD income reduces this \$60,000 deemed NOL to \$30,000. Therefore, X has a \$30,000 excess net operating loss (excess deemed NOL) to allocate to the shareholders. Under paragraph (d)(2)(ii)(C) of this section, none of the \$30,000 excess deemed NOL is allocated to A because A's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction (\$10,000) do not exceed A's share of the excluded COD income for 2008 (\$10,000). Thus, A has no shareholder's excess amount. Each of B's and C's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of B's and C's respective shares of the excluded COD income for 2008. B's excess amount is \$10,000 (\$20,000 - \$10,000) and C's excess amount is \$20,000 (\$30,000 - \$10,000). Therefore, the total of all shareholders' excess amounts is \$30,000. Under paragraph (d)(2) of this section, X will allocate \$10,000 of the \$30,000 excess deemed NOL to B ($\$30,000 \times \$10,000 / \$30,000$) and \$20,000 of the \$30,000 excess deemed NOL to C ($\$30,000 \times \$20,000 / \$30,000$). These amounts are treated as losses and deductions disallowed under section 1366(d)(1) for the taxable year of the discharge. Accordingly, at the beginning of 2009, A has no section 1366(d)(2) carryovers, B has \$10,000 of carryovers, and C has \$20,000 of carryovers.

(iii) Character. Immediately prior to the section 108(b)(2)(A) reduction, B's \$20,000 of section 1366(d) losses and deductions consisted of \$8,000 of long-term capital losses, \$7,000 of section 1231 losses, and \$5,000 of ordinary losses. After the section 108(b)(2)(A) tax attribute reduction, X will allocate \$10,000 of the excess deemed NOL to B. Under paragraph (d)(3) of this section, the \$5,000 of ordinary losses are treated as reduced first, followed by \$5,000 of section 1231 losses. Accordingly, the \$10,000 of losses allocated to B consist of the remaining \$2,000 of section 1231 losses and \$8,000 of long-term capital losses. As a result, at the beginning of 2009, B's \$10,000 of section 1366(d)(2) carryovers include \$2,000 of section 1231 losses and \$8,000 of long-term capital losses.

Example 6. (i) A and B each own 50 percent of the shares of stock in X, a calendar year S corporation. On June 30, 2008, A sells all of her shares of stock in X to C in a transfer not described in section 1041(a). For the 2008 taxable year, X excludes from gross income \$12,000 of COD income under section 108(a)(1)(A). The COD income (had it not been excluded) would have been allocated \$3,000 to A, \$6,000 to B, and \$3,000 to C under section 1366(a). Prior to the section 108(b)(2)(A) reduction, for the taxable year of the discharge the shareholders have disallowed losses and deductions under section 1366(d) (including disallowed losses carried over to the current year under section 1366(d)(2)) in the following amounts: A- \$9,000, B- \$9,000, and C- \$2,000. These combined \$20,000 of disallowed losses and deductions for the taxable year of the discharge are treated as a current year net operating loss tax attribute for X under section 108(d)(7)(B) (deemed NOL).

(ii) Under section 108(b)(2)(A), X's \$12,000 of excluded COD income reduces the \$20,000 deemed NOL to \$8,000. Therefore, X has an \$8,000 excess net operating loss (excess deemed NOL) to allocate to the shareholders. Under paragraph (d)(2)(ii)(C) of this section, none of the \$8,000 excess deemed NOL is allocated to C because C's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction (\$2,000) do not exceed C's share of the excluded COD income for 2008 (\$3,000). However, each of A's and B's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of A's and B's respective shares of the excluded COD income for 2008. A's excess amount is \$6,000 (\$9,000 - \$3,000) and B's excess amount is \$3,000 (\$9,000 - \$6,000). Therefore, the total of all shareholders' excess amounts is \$9,000. Under paragraph (d)(2) of this section, X will allocate \$5,333 of the \$8,000 excess deemed NOL to A ($\$8,000 \times \$6,000 / \$9,000$) and \$2,667 of the \$8,000 excess deemed NOL to B ($\$8,000 \times \$3,000 / \$9,000$). However, because A transferred all of her shares of stock in X in a transaction not described in section 1041(a), A's \$5,333 of section 1366(d) losses and deductions are permanently disallowed under paragraph (d)(2)(iii) of this section. Accordingly, at the beginning of 2009, B has \$2,667 of section 1366(d)(2) carryovers and C has no section 1366(d)(2) carryovers.

(f) Effective/applicability date—(1) Paragraphs (a), (b), (c), and Examples 1, 2, 3, and 4 of paragraph (e) of this section apply to discharges of indebtedness occurring on or after May 10, 2004.

(2) Paragraph (d) and Examples 5 and 6 of paragraph (e) of this section apply to discharges of indebtedness occurring on or after the date that these regulations are published as final regulations in the **Federal Register**.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

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