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S Corporation Committee

Important Developments in the Federal Income Taxation of S Corporations

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Current Developments in the Federal
Income Taxation of S Corporations

I. Cases

A. *Meruelo v. Comm'r*, TC Memo 2018-16 (2/5/2018)

At issue in *Meruelo v. Comm'r* was whether petitioner had sufficient basis in his S corporation stock to absorb the entirety of a net operating loss incurred in 2008. Petitioner was a real estate developer who held interests in numerous S corporations, partnerships, and LLCs. One of these entities was Merco of the Palm Beaches, Inc. ("Merco"), an S corporation in which petitioner held a 49% interest. Petitioner also held a 50% interest in Merco Group at Akoya ("Akoya"), an S corporation.

During 2004, Petitioner obtained a personal loan and transferred $4,985,035 of the loan proceeds to Akoya. Akoya transferred those funds to Merco in order to cover half of the deposit for a condominium purchase. During the years 2004-2008, Merco entered into hundreds of transactions with various flow-through entities (the "Affiliates") in which Petitioner owned an interest. The Affiliates regularly paid expenses on behalf of Merco or on each other's behalf to simplify accounting or enhance liquidity. These payments were documented on the books as accounts payable and accounts receivable. However, an accountant for the Petitioner, Merco, Akoya, and the Affiliates would net these amounts at the end of each year, and if Merco had net accounts payable at the end of a given year, the accountant would report that amount as a "shareholder loan." Petitioner was allocated a percentage of this purported indebtedness. Additionally, the accountant drafted a promissory note in 2004, whereby Petitioner made available to Merco a $10 million unsecured line of credit at a 6% rate. No evidence was presented at trial that an adjustment was ever made to the credit balance or that interest was accrued or paid to Petitioner.

On his 2008 individual income tax return, Petitioner reported a flow-through loss from Merco and sought to carryback the loss to an earlier year. The IRS disallowed a portion of the loss on audit, determining that Petitioner had insufficient basis in his S corporation stock.

The Tax Court concluded that the IRS had properly disallowed a portion of the loss. In so holding, the Court rejected the Petitioner's "back-to-back loan" theory because (i) no loan transactions were contemporaneously documented, (ii) any indebtedness was between Merco and its Affiliates, and (iii) the notional line of credit between Petitioner and Merco was not respected as such by the parties. Additionally, the Court rejected Petitioner's "incorporated pocketbook" theory, whereby he claimed that the Affiliates were used to pay Merco's expenses on his behalf. In rejecting this argument, the Court noted that Petitioner was not the sole shareholder of Merco or the Affiliates and there was no evidence that the Affiliates "habitually" paid his expenses.

B. *Stephens v. U.S.*, 884 F.3d 1151 (Fed. Cir. 2018) (3/9/2018)

Stephens v. U.S. involved a husband and wife's refund complaint whereby they sought to utilize certain passive activity losses and credits that flowed through from the husband's S corporation. The Court of Federal Claims reconsidered and vacated its earlier orders

dismissing the taxpayers' refund claims on the grounds that the claims were barred because the taxpayers filed late or no administrative claim for the subject years.

The taxpayers also attempted to raise mitigation relief under section 1311, et seq. However, the Court held that relief was not available because neither the S corporation's closing agreement nor the IRS's denial of the taxpayers' carryover claim constituted a "determination" of their individual liabilities under mitigation authorities. The taxpayers' arguments regarding equitable recoupment were likewise rejected. The Court of Appeals for the Federal Circuit affirmed the lower court's decision.

C. *Povolny Group, Inc., et al. v. Comm'r*, TC Memo 2018-37 (4/2/2018)

The Tax Court considered several issues relating to Mr. Povolny's real estate business and a consulting business conducted by an S corporation owned by Mr. Povolny and his wife. First, the Tax Court determined that payments that Petitioner's brokerage corporation made to creditors of other financially-strapped entities which the couple owned, including the S corporation consulting business, comprised capital contributions, not loans, to those entities and constructive dividends to the couple. Second, the couple was not entitled to bad debt deductions from the S corporation consulting business for payments the business made to or incurred on behalf of Mr. Povolny's LLC, as there was no evidence of bona fide debt. Third, a payment from Mr. Povolny's brokerage corporation to Mr. Povolny, in a year in which the corporation elected S corporation status, was not a loan or a distribution, but rather was a wage payment includible in his income and for which the corporation owed employment tax. Finally, the court did not uphold accuracy-related penalties against the couple, but did uphold penalties against the brokerage corporation.

D. *Taha, et. al v. U.S.*, No. 17-1174, ___ Fed. Cl. __, 121 AFTR 2d 2018-1405 (4/10/2018)

Shareholders of Atek Construction, Inc., an S corporation, paid taxes on shareholder income that, by virtue of the S corporation becoming insolvent, they never received. The shareholders claimed a refund with respect to such taxes, which the IRS denied. Shareholders reported income as a result of their ownership interests in Atek in 2002 and 2003, but by 2004, Atek was insolvent, and it became fixed and determinable that the shareholders would not receive the amounts they had reported as income. The shareholders filed amended returns for 2002 and 2003 on November 9, 2007. The IRS does not have record of the amended 2003 return. The IRS denied the refund request for 2002 on December 20, 2007. The shareholders corresponded with the IRS regarding the 2002 refund through November 2009, claiming the amount constituted a bad debt. The shareholders filed amended returns for 2004 on November 1, 2009, claiming that the timing was proper because Atek became insolvent that year, and so the loss became fixed and determinable. Extensive correspondence regarding the refund request between the shareholders and the IRS ran from March 2010 through April 2017. While the court acknowledged the potential applicability of the business bad debt provisions given the shareholders' claim that the refunds were claimed with respect to business income, the shareholders were required to file a claim for refund within 2 years of the denial by the

IRS. Because the claim was not filed with the court until May 2017, the court ruled that it did not have jurisdiction to hear the case.

E. *Rogers v. Comm'r*, TC Memo 2018-53 (4/17/2018)

The Tax Court considered a litany of issues related to Mr. and Mrs. Rogers (the "Petitioners"). The issues were (i) whether Petitioners had unreported income from the following sources: trustee fees relating to Mr. Rogers' implementation of distressed debt transactions, unreported income from another of Mr. Rogers' businesses, and unreported income relating to the tax consequences of Mrs. Rogers transfer of real property to her wholly owned S corporation, (ii) whether Petitioners and their wholly owned entities were entitled to the following deductions: a charitable deduction for the transfer of real property, a worthless debt deduction or a worthless stock deduction, certain business expenses, certain itemized deductions, and a long-term capital loss deduction, (iii) whether Mrs. Rogers was entitled to relief from joint and several liability under the innocent spouse relief provisions of section 6015, and (iv) whether Petitioners were liable for penalties and addition to tax.

As it relates to the Petitioners' S corporations, the Tax Court made several determinations. First, the Court upheld the IRS's determination that Petitioners had unreported income from Mr. Rogers' wholly owned S corporation. Petitioners argued that a payment, which Mrs. Rogers' S corporation deducted as a business expense, was a nontaxable loan repayment; however, the Court found this contention to be meritless. Second, the Court determined that a transfer of real estate to Mrs. Rogers' newly created S corporation in exchange for a multimillion dollar loan with a nominal deposit was a capital contribution and not a sale, with a carryover basis that did not include the loan. Third, the Court disallowed a charitable contribution deduction for Mrs. Rogers' S corporation's transfer of undeveloped real property to municipality because it lacked donative intent. Fourth, the Court disallowed a business deduction for charges that Mrs. Rogers' S corporation incurred in connection with a letter of credit that was required by a municipality as part of a development project, finding that such expenses were costs of construction and thus capital expenditures. Fifth, the Court disallowed numerous other flow-through deductions from the Petitioners' S corporations.

The Court disallowed Mrs. Rogers' claim for innocent spouse relief, finding that for earlier years the doctrine of res judicata had barred the claims and that she did not meet the burden of proof for a claim relating to later years. Finally, the Court did not impose fraud or failure to timely file returns penalties.

F. *Petersen v. Comm'r*, Nos. 17-9003 & 17-9004 (10th Cir.) (timely appeal of Tax Court decision filed in the 10th Circuit)

In Petersen v. Comm'r, 148 T.C. No. 22 (2017), the Tax Court held that an S corporation and the employees that participated in its ESOP were related persons under section 267(b). As a result, unpaid payroll expenses were not deductible until received and includable in the gross income of the employees. The Appellants filed a timely appeal

with the Tenth Circuit and submitted their brief on February 9, 2018. The Appellee Commissioner of Internal Revenue filed its brief on April 20, 2018.

The Appellants assert that an ESOP is not a trust under section 267, arguing that other uses of the term "trust" in the Internal Revenue Code do not apply to ESOPs and that many other trusts and trust relationships are not covered by or subject to section 267. The government argued that the language of section 267(c)(1) is intentionally broad and is meant to cover ESOP trusts.

Taxpayers and their tax counsel are watching how the Petersen appeal plays out, as it may have tax planning implications for S corporations with ESOPs. At issue in the case is whether an S corporation can deduct accrued wages from employees who were ESOP participants before the wages were paid.

G. *Quiroz v. United States (In re Quiroz)*, 121 AFTR 2d 2018-1421, (Bankr. N.D. Okla) (04/10/2018)

Juventino Gayton Quiroz claimed his federal income tax liabilities for 2005, 2006 and 2009 were discharged through bankruptcy. The IRS contended that after learning his 2005 and 2006 tax returns were to be audited, Quiroz willfully attempted to evade or defeat payment of taxes. Quiroz ran a painting business in the construction industry, initially as a sole proprietorship and later as an S corporation. Quiroz hired two different accountants to prepare his tax returns, the one for tax years 1998-2007 and 2010-2014, and another for 2008-2009. In the course of its audit of the 2005 and 2006 tax returns, the IRS informed Quiroz that his tax liability could not be determined because he had not kept adequate books and records. While Quiroz included some incorrect information in his responses to the IRS in the course of the audit, the court found that Quiroz did not understand the questions, and his interpretation of the questions led to consistency in his responses. Thus, the court ruled that there was no willful attempt to evade the payment of taxes because there was not willfulness.

II. Private Letter Rulings

A. PLR 201807002 (2/16/2018)- Shareholders - QSST and ESBT elections - Revocations - Extensions (similar facts and rulings in PLR 201807003 and PLR 201807004)

Trust was a shareholder of X, an S corporation, and Trust made an election to be treated as a qualified Subchapter S trust ("QSST") election effective Date 1. Trust was treated as a QSST for tax years beginning Year 1 and ending Year 2. Effective Date 2, the trustee of Trust filed an election to convert Trust from a QSST to an electing small business trust ("ESBT"). The trustee requested that the IRS consent to revoke Trust's ESBT election as of Date 2 and grant Trust an extension of time to re-elect to be treated as a QSST effective Date 2.

The IRS ruled that Trust could revoke its ESBT election effective Date 2. The IRS also granted Trust an extension of 120 days from the date of the ruling letter to file a QSST election for Trust effective Date 2.

B. PLR 201807006 (2/16/2018) – Late S Corp Election to Be Treated as Timely

X was incorporated on Date 1 and intended to be treated as an S corporation effective Date 2 but did not timely file the proper election. The IRS determined that X established reasonable cause for failing to make the timely election and was therefore entitled to relief under Code Section 1362(b)(5). Accordingly, the IRS determined that X would be recognized as an S corporation effective Date 2, provided that X submits a properly completed Form 2553 within 120 days of the date of the letter.

C. PLR 201808008 (2/23/2018) - Gain or loss recognized on property distributed in complete liquidation - Qualified stock dispositions - Asset dispositions - Elections - Extensions

Shareholder A, Shareholder B, Purchaser A, Purchaser B, and S Corporation Target submitted a request for an extension of time under Treas. Reg. § 301.9100-3 to file the election statement under Treas. Reg. § 1.336-2(h)(3)(iii) (the "Election Statement") with respect to Purchaser A and Purchaser B's acquisition of the stock of S Corporation Target.

Purchaser A and Purchaser B acquired shares of stock of S Corporation Target from Shareholder A and Shareholder B in a series of transactions that qualified as a "qualified stock disposition" under Treas. Reg. § 1.336-1(b)(6). The parties intended for the stock sale to be treated as a deemed asset sale, but for various reasons, a timely section 336(e) election was not made. As a result, the parties submitted the ruling request for an extension of time to file the Election Statement.

The IRS ruled that the parties acted reasonably and in good faith, that the requirements of Treas. Regs. §§ 301.9100-1 and 301.9100-3 were satisfied, and that granting relief would not prejudice the interests of the government. As a result, the IRS granted an extension of 45 days from the date of the ruling letter to file the Election Statement with respect to the disposition of S Corporation Target.

D. PLR 201808011 (2/23/2018) - Gain or loss recognized on property distributed in complete liquidation - Qualified stock dispositions - Asset dispositions - Elections - Extensions

Purchaser, S Corporation, and Shareholder submitted a request for an extension of time under Treas. Reg. § 301.9100-3 to file the election statement under Treas. Reg. § 1.336-2(h)(3)(iii) (the "Election Statement") with respect to Purchaser's acquisition, through a disregarded entity, of all of the stock of S Corporation from Shareholder.

Purchaser acquired all of the shares of stock of S Corporation from Shareholder in exchange for cash (the "Disposition"). The parties represented that the Disposition qualified as a "qualified stock disposition" under Treas. Reg. § 1.336-1(b)(6). The parties intended for the stock sale to be treated as a deemed asset sale, but for various reasons, a timely section 336(e) election was not made. As a result, the parties submitted the ruling request for an extension of time to file the Election Statement.

The IRS ruled that the parties acted reasonably and in good faith, that the requirements of Treas. Regs. §§ 301.9100-1 and 301.9100-3 were satisfied, and that granting relief would not prejudice the interests of the government. As a result, the IRS granted an extension of 45 days from the date of the ruling letter to file the Election Statement with respect to the Disposition.

E. PLR 201809001 (3/2/2018) – Extension Granted to File IC-DISC Election

X is a domestic corporation wholly owned by a partnership; two partners in the partnership are S corporations. X formed on Date 1, and X's law firm submitted Form 4876-A to the IRS on Date 3 to elect for X to be classified as an IC-DISC as of Date 2, which was January 1 of the same year as Date 3 and the first full year of X's existence. The IRS notified X that the election was not timely because the deadline for the election of an existing corporation differed from the deadline for an initial election. X intended to be classified as an IC-DISC as of Date 1. The IRS found that X satisfied the requirements of Treasury Regulation Section 301.9100-3(a) and granted X a 60-day extension to elect to be treated as an IC-DISC for X's first taxable year.

F. PLR 201809002 (3/2/2018) – Extension Granted to File IC-DISC Election

X is a domestic corporation and the wholly-owned subsidiary of an S corporation. X filed an election to be classified as an IC-DISC as of its formation, and such election was received by the IRS 92 days after the formation date. X had no proof of the date such election was mailed. The IRS found that X satisfied the requirements of Treasury Regulation Section 301.9100-3(a) and granted X a 60-day extension to elect to be treated as an IC-DISC for X's first taxable year.

G. PLR 201810003 (3/9/2018) - Election to treat sub. as QSub - Extensions

X was formed on Date 1 and elected to be an S corporation effective on Date 2. X wholly owned Sub. X represented that it intended to elect to treat Sub as a QSub effective Date 3; however, X failed to timely file the election form used to make a QSub election for Sub. X represented that it had filed its tax returns for all relevant tax years consistent with Sub being a QSub since Date 3.

The IRS ruled that the requirements of Treas. Reg. § 301.9100-3 were satisfied. Accordingly, X was granted 120 days from the date of the ruling letter to elect to treat Sub as a QSub, effective Date 3.

H. PLR 201810006 (3/9/2018) - Inadvertent terminations - Improper issuance of stock certificate

X was formed on Date 1 and elected to be an S corporation effective on Date 2. As of Year 1, A was a shareholder of X. Also as of Year 1, A and A's spouse were the sole owners of LLC, a limited liability company treated as a disregarded entity for federal tax purposes. A, A's spouse, and LLC were the owners of Partnership, a limited partnership.

During Year 1, A requested that his shares in X be transferred to Partnership. X issued a stock certificate in the name of Partnership on Date 3, despite having restrictions against such a transfer in its articles of incorporation and bylaws. During Year 2, X discovered the inadvertent transfer, immediately rescinded it, and restored ownership of the transferred shares to A.

X represented that X and its shareholders intended for X to remain an S corporation effective Date 3 and that X filed all returns consistent with such treatment. Further, X represented that during all years at issue all income of LLC and Partnership attributable to X was allocated to the individual partners as though the individual partners owned the X stock directly.

The IRS ruled that X's S election may have terminated on Date 3, but that such termination was inadvertent within the meaning of section 1362(f). As a result, X will be treated as continuing to be an S corporation from Date 2 and thereafter, provided X's S election was otherwise valid and had not otherwise terminated.

I. PLR 201811001 (3/16/2018) – Ineffective S Corp Election Was Inadvertent

X timely filed an election to be treated as an S corporation as of Date 1. However, Trust, a shareholder of X, did not timely file an election to be treated as an ESBT as of Date 1, causing X's S election to be invalid. The IRS determined that X's S election was inadvertently ineffective, and X will be treated as an S corporation from Date 1 and thereafter so long as (1) an election to treat Trust as an ESBT effective as of Date 1 is filed within 120 days and (2) X and its shareholders file any original and amended returns consistent with the treatment of X as an S corporation and Trust as an ESBT within 120 days.

J. PLR 201811005 (3/16/2018) – Termination of S Corp Election Inadvertent

X was a valid S corporation until Date 1, when shares of X were transferred to Y, an ineligible shareholder. Y discovered the terminating event on Date 2 and transferred the shares to A, an eligible shareholder, and Trust. A, the beneficiary of Trust, made a timely election to treat Trust as a QSST as of Date 2. The IRS determined that X's S election terminated as of Date 1, but such termination was inadvertent, so X will be treated as an S corporation as of Date 1 and thereafter.

K. PLR 201812003 (3/23/2018) - Passive investment income - Rental income - Qualification of ESBT

X, an S corporation, requested two rulings: (1) that the rental income derived by X was not passive investment income within the meaning of section 1362(d)(3)(C) and (2) that Trust qualified as an electing small business trust ("ESBT") under section 1361(e). Trust, a shareholder of X, was created as a grantor trust. The grantor and owner of Trust died and the beneficiaries of Trust were two distributing trusts and two tax exempt organizations described in section 170(c)(2). The beneficiaries of the distributing trusts were U.S. individuals. None of the beneficiaries of Trust (or of the distributing trusts)

acquired their interests by purchase and the bases of their interests were determined by section 1014 and not by section 1012.

X was involved in the business of farming and managing real property. X entered into certain Leases of real property. Certain of the Leases provided that X was a full participant in the management of the farm, including that X was responsible for determining the crop plan and which the tenants would not deviate from. Certain of the Leases also provided that X would participate in some of the associated costs of farming the property. Tenants furnished labor, equipment, and other expenses for the operation of the farm, except that expenses for fertilizer, insecticide, fungicides, and grain drying were divided between X and the tenant in the same proportion as the crop was divided. X exerted control and management over several other facets of the operations conducted on the leased property.

X had a share, in varying percentages, of all crops produced on the property subject to the Leases. X's return for Year showed farm rental income and expenses, including officer compensation, salaries and wages, repairs and maintenance, fertilizer, insurance, and utilities.

The IRS ruled that the rental income attributable to the Leases was not passive investment income as described in section 1362(d)(3)(C). In addition, the IRS ruled that Trust qualified as an ESBT because the beneficiaries of Trust were qualified beneficiaries and no interest in Trust was acquired by purchase.

L. PLR 201813001 (3/30/2018) (identical rulings issued as PLR 201813002 and PLR 201813003)

X, an S corporation, granted equity to I that was not entitled to the same rights to distribution and liquidation proceeds as X's shareholders because I would only receive proceeds upon sale of X's assets, thus creating a second class of stock. Once X learned about the second class of stock, X and I terminated the equity grant. X intended to be treated as an S corporation at all times and filed all tax returns consistent with treatment as an S corporation. The IRS determined that the termination was inadvertent and X will be treated as continuing to be an S corporation through the date of inadvertent termination.

M. PLR 201813007 (3/30/2018) (identical rulings issued as PLR 201813008, PLR 201813009, PLR 201813010, PLR 201813011, PLR 201813012, PLR 201813013, PLR 201813014, and PLR 201813015

A, B, C, D, and E formed a partnership, Y, in order to purchase interests in entities including X, an S corporation. Y acquired an interest in X on Date 1, causing X's S election to be terminated because of an interest held by an ineligible shareholder. X and its shareholders have filed all tax returns consistent with treating X as an S corporation. X, Y, and X's shareholders have taken appropriate measures to remedy the situation, including Y distributing its X stock to its members. The IRS determined that the

termination of X's S election was inadvertent, so X would be treated as an S corporation continuing through Date 1 unless some other terminating event occurred.

N. PLR 201815003 (4/13/2018) - Ineffective S Corp, QSub Elections Inadvertent

A, B, C and D filed an election for X, an LLC, to be treated as an S corporation as of Date 1. However, B was not an eligible S corporation shareholder as of Date 1. The members intended that the interests held by B would be transferred to E, an eligible S corporation shareholder, prior to Date 1. As of the formation of X, prior to the X election, the shareholders entered into an operating agreement that described treatment of X as a partnership for tax purposes and created a second class of stock. These provisions applied until Date 2, when X and its members replaced the agreement with an agreement that provided for the prevention of a second class of stock. Y, a corporation, was formed on Date 3, and on Date 4. X purchased all of the stock of Y in a transaction in which a Section 338(h)(10) election was in effect. X elected for Y to be treated as a QSub effective as of Date 4. On Date 6, X contributed the stock of Y to a wholly-owned disregarded entity. In addition to relief for inadvertent terminations, X requests that the QSub election be effective as of Date 5 instead of Date 4. The IRS determined that the ineffectiveness of the elections was inadvertent, and X would be treated as an S corporation as of Date 1, and Y would be treated as a QSub as of Date 5, to the extent the applicable elections are filed within 120 days after the issuance of the letter.

O. PLR 201815004 (4/13/2018) - Termination of S Corp, QSub Elections Inadvertent

All of the shares of X, an S corporation as of formation, were transferred to Partnership on Date 1, terminating X's S election. On Date 2, X learned of the termination, and on Date 3, X took remedial action by having Partnership transfer all of its shares of X stock to A and B, eligible S corporation shareholders. X also elected for its 8 subsidiaries to be QSubs as of the date of X's formation. The IRS determined that the termination was inadvertent, and X would continue to be treated as an S corporation, and its subsidiaries treated as QSubs, through Date 1 to the extent no other terminating event occurred.

P. PLR 201815006 (4/13/2018) - Termination of S Corp Election Inadvertent

X elected to be treated as an S corporation as of Date 1. One of its shareholders as of Date 1 was a grantor trust ("Trust"). On Date 2, the grantor died, and Trust began the 2-year period that it would continue to qualify as an S corporation shareholder. Trust continued as a shareholder and became an ineligible shareholder on Date 3. At all times, Trust qualified to elect to be a QSST. The IRS determined that the termination and failure to elect QSST status were inadvertent. Thus, X will be treated as continuing as an S corporation through Date 3, and Trust will be treated as a QSST as of Date 3 to the extent Trust files an election to be treated as a QSST within 120 days of the issuance of the letter.

Q. PLR 201817015 (4/27/2018) - Termination of S Corp Election Inadvertent

X, an S corporation, transferred shares of X stock to IRAs on Date 1. Because IRAs are not valid S corporation shareholders, X's S election was terminated. Upon learning of the termination of its S corporation status, X redeemed all of the X stock owned by IRAs. The IRS determined that the termination was inadvertent, and S will continue to be an S corporation from Date 1 and thereafter, provided the S corporation status is not otherwise terminated.

III. Regulations

A. [N/A]

IV. Other

A. IR 2018-37 (3/1/2018)

The IRS announced that it had released Notice 2018-18 (summarized below), which states that the IRS will be issuing regulations to clarify that taxpayers will not be able to circumvent the three-year holding period rule with respect to certain carried interests by using S corporations.

B. Notice 2018-18, 2018-12 IRB 443 (3/1/2018)

The IRS will issue regulations under Section 1061 to provide that Section 1061(c)(4)(A) does not include S corporations. Section 1061 provides that a taxpayer's capital gains that are related to a partnership interest transferred to or held by a taxpayer in connection with substantial services and for which the taxpayer has a holding period of less than 3 years will be treated as short term capital gains. There is an exception in Section 1061(c)(4)(A) for partnership interests held by corporations. This notice clarifies that such exception does not apply to interests held by S corporations.

C. Notice 2018-26, 2016-16 IRB (4/2/2018)

On April 2, 2018, the IRS released Notice 2018-26, which described forthcoming regulations to be issued in connection section 965, as amended by the Tax Cuts and Jobs Act of 2017. The IRS intends to issue regulations providing that if an S corporation is, directly or indirectly, a partner, beneficiary, or owner of a domestic pass-through entity and takes into account a share of the section 965(a) inclusion amount of a domestic pass-through entity with respect to a deferred foreign income corporation, and the S corporation is a US shareholder of the deferred foreign income corporation, the shareholders of the S corporation will be permitted to make the election under section 965(i) to defer the shareholder's net tax liability under section 965 with respect to the S corporation. However, if the S corporation is not a US shareholder of the deferred foreign income corporation, the net tax liability under section 965 of the shareholder for purposes of the section 965(i) election will not include the shareholder's share of the domestic pass-through entity's section 965(a) inclusion amount.

D. Notice 2018-28, 2018-16 IRB (4/2/2018)

On April 2, 2018, the IRS released Notice 2018-28, which described proposed forthcoming regulations to address section 163(j). The Notice provides that all interest paid accrued by a C corporation on indebtedness of the corporation will be business interest within the meaning of section 163(j)(5), and all interest on indebtedness held by the C corporation includible in gross income of such C corporation will be business interest income within the meaning of section 163(j)(6). However, the foregoing sentence will not apply to a corporation that is an S corporation.

Additionally, the Notice provides that regulations will be issued providing that, for purposes of calculating a partner's annual deduction for business interest under section 163(j)(1), a partner cannot include the partner's share of the partnership's business interest income for the taxable year except to the extent of the partner's share of the excess of (i) the partnership's business interest income over (ii) the partnership's business interest expense. Additionally, regulations will be issued providing that a partner cannot include such partner's share of the partnership's floor plan financing interest in determining the annual business interest expense deduction limitation under section 163(j). These regulations are intended to prevent the double counting of business interest income and floor plan financing interest for purposes of the deduction afforded by section 163(j). These regulations are intended to apply in a similar fashion to any S corporation and its shareholders.

E. LB&I Concept Unit: Adjustment to Debt Basis – DCN SCO/C/53_4_2_2-05(2016)

The practice unit, released on February 5, 2018 with an update as of January 18, 2018, focused on guidance related to how stock and debt bases are reduced and restored. The guidance states that losses reduce stock basis first, then debt basis, but debt basis is restored prior to stock basis. Current year earnings and losses may be distributed prior to the restoration of debt basis, but only a net increase in basis restores a shareholder's basis in debt. If a shareholder makes multiple loans to the S corporation, then any reduction in debt basis reduces the basis of all outstanding notes pro rata. These principles are illustrated in a series of examples included in the practice unit guidance.

F. LB&I Concept Unit: Valid Shareholder Debt Owed by S Corporation – DCN SCO/C/53_04_02_01-04(2016)

The practice unit, released on March 9, 2018 with an update as of January 19, 2018, focused on guidance related to validity of shareholder debt owed by an S corporation. The guidance first noted that a shareholder may only take basis in S corporation debt owed to the shareholder, so for a loan to increase shareholder debt basis, (1) the shareholder must be the creditor, and (2) the loan must be bona fide debt.

The guidance names 7 factors to utilize in determining whether a loan is bona fide debt: whether (1) there is a written instrument; (2) there is a stated interest rate; (3) there is a maturity date; (4) the debt is enforceable under state law; (5) the expectation of repayment is reasonable; (6) the creditor has remedies upon default, whether by security

interest or position with respect to other creditors; and (7) repayments were made or the parties complied with the terms of the agreement. The guidance also directs to Notice 94-47 and applicable case law for additional factors regarding whether an instrument is bona fide debt.

In determining whether debt is owed directly to the shareholder, the guidance calls for consideration of (1) whether the proceeds came from the shareholder or a third party, and (2) the intent of the S corporation related to repayment to the shareholder. Debt basis is only created if the shareholder loaned funds to the S corporation; thus a guarantee, co-borrowing, or a judgment of default by the S corporation do not create or increase debt basis unless there is a repayment by the shareholder, at which point debt basis increases to the extent of the repayment by subrogation. The guidance notes, however, that back-to-back loans give rise to debt basis, though one must consider how such loans are booked. In addition, installment obligations from a sale from a shareholder to an S corporation create notes that give rise to debt basis. These principles are illustrated in a series of examples included in the practice unit guidance.

G. LB&I Process Unit: Losses Claimed in Excess of Basis – DCN SCO/P/53_05_01_03-06(2016)

The practice unit, released on May 1, 2018 with an update as of April 9, 2018, focused on guidance related to how to process and audit losses claimed by S corporation shareholders in excess of basis. The guidance notes that losses and deductions that are disallowed because of basis limitation are carried forward indefinitely. There are several criteria named to determine and validate calculations to determine whether losses and deductions do, in fact, exceed basis. Agents are to confirm the calculations of losses and shareholder stock and debt basis. If a shareholder claims a loss in excess of basis, the shareholder must suspend tax-free distributions and losses until the losses that were claimed but not allowed are recaptured. These losses are held in a "suspense account." Agents are to use tax return information to calculate basis and losses starting with the most recent and going through the date the shareholder first held shares in the S corporation as an S corporation. The guidance notes that sometimes, when there are multiple items to include in such calculation to reduce basis, the amount to be passed through must be prorated among the items to the extent of basis. These criteria are illustrated in a series of examples included in the practice unit guidance.

H. IR News Release 2018-50 (3/13/2018)

The IRS granted additional time to business taxpayers, including S corporations, affected by Winter Storms Quinn and Skylar to file Form 7004 for an automatic 6-month extension. Affected partnerships and corporations must file Form 7004 on or before March 20, 2018 instead of March 15, 2018.

V. Legislative Developments

A. [N/A]