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BY US MAIL AND FACSIMILE

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RE: IRS Interpretation of Regulations on Basis of S Corporation Stock

Dear Messrs. Wilkins, Wilson and Haglund:

I am pleased to submit and attach The Florida Bar Tax Section's comments with respect to the Internal Revenue Service's interpretation of Internal Revenue Code ("Code") §1366(d)(2)(A) and Treasury Regulation §1.1366-2(a)(2).

Principal responsibility for these comments was exercised by Sydney S. Traum. The comments were reviewed by Richard Comiter and Stephen Looney. Although the members of The Florida Bar Tax Section (the "Tax Section") who participated in preparing these comments may have clients who would be affected by the relevant Code and Treasury Regulation sections, no such member has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

These materials were prepared by the Comment Projects Subcommittee of the Tax Section.

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The Tax Section is comprised of approximately 2,000 members of The Florida Bar. The membership of the Tax Section engages in a broad spectrum of the practice of tax law, including (but not necessarily limited to) federal, individual, corporate and partnership income tax; federal estate and gift tax, international tax, state and local tax, as well as employee benefits law.

As always, we will be pleased to provide additional commentary as requested. If the Internal Revenue Service has any questions regarding our comments, please do not hesitate to contact us.

Sincerely,

Guy Whitesman, Chair

cc: Paul Hill, Esq. The Florida Bar
Sydney Traum, Esq.
Richard Comiter, Esq.
Stephen Looney, Esq.
D. Michael O'Leary, Esq.
Micah G. Fogarty, Esq.

COMMENTS OF THE FLORIDA BAR TAX SECTION ON INTERPRETATION OF REGULATIONS RELATING TO BASIS IN S CORPORATION STOCK

We appreciate the opportunity to provide written comments on the interpretation of the Code and Treasury Regulations with respect to the effect of suspended losses in calculating a shareholder's basis in S corporation stock for the current year.

Issue:

The issue relates to the treatment of losses that were not deductible because of the basis limitation on deductibility of losses under Code §1366(d)(2) ("suspended losses"), in calculating a shareholder's basis in S corporation stock for the current year, and in particular, with respect to the basis ordering rules. Under the general basis ordering rules of Subchapter S, a shareholder's basis is first increased for income items, then reduced for distributions made by the S corporation to the shareholder (but not below zero), and finally decreased (but not below zero) by items of loss and deduction. We believe that suspended losses should not be segregated (unless otherwise required to be separately stated due to the nature of the suspended loss or deduction), but should be treated as if they arose in the next year with respect to that shareholder. This interpretation is consistent with Code §1366(d)(2)(A), which states that a loss suspended under the basis limitation rules is treated as incurred by the corporation in the succeeding tax year with respect to that shareholder. Additionally, Regulation §1.1366-2(a)(2) states that any suspended loss or deduction retains its character and is treated as incurred by the corporation in its next succeeding tax year with respect to that shareholder. In discussions with Susan L. Kerrick and Mark Pierce, both S corporation technical advisors for the Internal Revenue Service's Chief Counsel Office (Passthroughs and Special Industries), they have indicated that the IRS position is that any suspended loss (regardless of its nature) is a "separately stated item" which does not reduce basis until after distributions reduce basis.

The issue is best illustrated by two examples, one in which all losses and deductions occur in the same tax year and the second in which there are suspended losses from the prior year.

Example 1: An S corporation has one shareholder whose basis in his stock is zero and who has made no loans to the corporation. In 2009, the corporation has business income of $50,000 and business deductions of $60,000, resulting in a non-separately stated loss of $10,000. In addition, distributions of $6,000 were made to the shareholder during 2009. Under these circumstances, we and the IRS agree that the business expenses are netted against the business income to result in a non-separately stated loss of $10,000. Since distributions are taken into account before losses, the $6,000 distribution would be taxed as a capital gain and the $10,000 net loss would be suspended and carried forward to the next tax year with respect to that shareholder.

Example 2: In calendar year 2010, the same corporation has business income of $90,000 and business expenses of $60,000. It also makes a distribution of $35,000 to its sole shareholder.

Under these circumstances, the IRS position is that the $30,000 net income of the corporation increases the basis of the stock to $30,000, and that the $35,000 distribution would result in a capital gain of $5,000 (the excess of the $35,000 distribution over the shareholder's $30,000 basis). The $10,000 suspended loss carried over from 2009 would continue to be suspended because it is treated as a separately stated item of loss that is taken into account only after the reduction in basis caused by the distribution.

We believe this result to be incorrect because it fails to give effect to the Code and Regulation provisions which expressly provide that any losses suspended under the basis limitation rules are to be treated as if they had been incurred in the current year. If the 2009 $10,000 non-separately stated loss is treated as if it was incurred in 2010, then the 2010 taxable income of the corporation would be $20,000 ($90,000 - $60,000 - $10,000). Thus, a distribution of $35,000 would result in capital gain income of $15,000 to the shareholder and there would be no further carryover of the suspended $10,000 non-separately stated loss from 2009.

Authority for Each of the Two Positions:

Authority for our position is based upon the express language of Code §1366(d)(2)(A) and Regulation §1.1366-2(a)(2). Code §1366(d)(2)(A) states that any loss that is not deductible because of the basis limitation rules is treated as incurred by the corporation in the next succeeding year with respect to that shareholder. Reg. §1.1366-2(a)(2) provides that any suspended loss or deduction retains its character and is treated as incurred by the corporation in its next succeeding year with respect to that shareholder.

The IRS bases its authority on Reg. §1.1366-2(a)(3)(i). The language upon which they base their authority is as follows: "In so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2)(B) and (C) (for losses and deductions, *including losses and deductions previously disallowed*) for the taxable year." Emphasis added.

The IRS interprets this regulation as requiring losses and deductions previously disallowed to be treated as separately stated items in the current year. We believe that this is a misreading of the regulation. The parenthetical material relating to losses and deductions previously disallowed merely indicates that those losses and deductions previously disallowed are also to be considered together with losses and deductions for the current taxable year. Simply put, if the suspended loss is an item of non-separately stated loss under Code §1366(a)(1)(B), it should be combined with any non-separately stated items of income or loss for the current year.

Deference Given to Regulations:

The courts in many cases give deference to IRS regulations where they are interpreting an ambiguous Code provision. However, IRS regulations may not contradict a Code section. There are two possible ways of interpreting the regulation cited by the IRS Technical Advisors. The interpretation suggested by the IRS Technical Advisors would contradict the statute and the other part of the Regulation. Thus, if the IRS Technical Advisors are correct in their interpretation of the regulation, the regulation would be held invalid since it would contradict the Code.

Where there are two possible interpretations, and only one of them is consistent with the Code, that interpretation should be followed. We believe that our position is the one consistent with the language of the Code and is, thus, the correct interpretation. Our position is that any losses suspended under the basis limitation rules which are carried over into the current year should be treated as if they were incurred in the current year. Thus, suspended losses would be combined with similar items of income and loss (including non-separately stated income or loss) for the current year before determining their effect on a shareholder's stock basis.

Conclusion:

In summary, we believe that any suspended losses disallowed from a prior year due to the basis limitation rules that are carried over to the current year should be netted with similar types of income and losses before determining their effect on basis calculations. This gives effect to the express language of the Code requiring the suspended losses to be treated as having been incurred in the current year with respect to that shareholder.

We thank the Internal Revenue Service for its consideration of the comments contained in this letter.