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May 23, 2011

Mr. Douglas H. Shulman
Commissioner of Internal Revenue
Internal Revenue Service
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Washington, D.C. 20024

Mr. Curtis G. Wilson
Associate Chief Counsel for
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Ms. Donna Young
Deputy Associate Chief Counsel for
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By e-mail: notice.comments@IRScounsel.treas.gov

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

The New York State Society of Certified Public Accountants, representing 28,000 CPAs in public practice, industry, government and education, wishes to provide comment on the above captioned topic.

The NYSSCPA's Closely Held & S Corporations Committee deliberated the IRS Interpretation of Regulations on Basis of S Corporation Stock and prepared the attached comments. If you would like additional discussion with us, please contact Edwin B. Morris, Chair of the Closely Held & S Corporations Committee at (212) 330-6000, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

A handwritten signature in cursive script that reads "Margaret Ann Wood". The signature is written in black ink and is positioned above the printed name and title.

Margaret A. Wood
President

Attachment

**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS ON
IRS INTERPRETATION OF REGULATIONS ON BASIS OF
S CORPORATION STOCK**

May 23, 2011

**Principal Drafter
Sydney S. Traum**

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New York State Society of Certified Public Accountants
Closely Held & S Corporations Committee

Comments on
IRS Interpretation of Regulations on Basis of S Corporation Stock

Issue and Current Practice

The issue on which we are commenting relates to the effect on an S corporation shareholder's stock basis of prior year losses that were not deductible because of the basis limitation on deductibility of losses. We believe that the carryover losses should not be segregated. They should be treated as if they arose in the next year with respect to that shareholder. This interpretation is in accordance with Code section 1366(d)(2)(A) which states that a basis limitation carryover loss is treated as incurred by the corporation in the succeeding tax year with respect to that shareholder.

Further, Regulation section 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 two S corporation Technical Advisors for the Internal Revenue Service, we have been advised and given every indication that the IRS position is that such carryover losses are treated separately and will not affect basis until after distributions reduce basis.

The controversy 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 carryover losses from the prior year.

Example 1: An S corporation has one shareholder whose basis in his stock is \$0 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 net loss of \$10,000. In addition, distributions of \$6,000 were made to the shareholder. In this case, we and IRS agree that the business expenses are netted against the business income to result in the net loss. Because 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 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. In this case, 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 be taxable as capital gain to the extent of \$5,000. The \$10,000 loss carried over from 2009 would continue to be carried over because it comes 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 that the prior year basis disallowed losses are to be treated as if they had occurred in the current year. If the 2009 year \$10,000 business expense loss is treated as if it was incurred in the 2010 year, the 2010 taxable income of the corporation with respect to its shareholder would be only \$20,000. Thus, a distribution of \$35,000 would result in capital gain income of \$15,000 to the shareholder, and no further carryover of the prior year \$10,000 business expense loss would result.

Authority for Each of the Two Positions:

Authority for our position rests in Code section 1366(d)(2)(A) and Regulation section 1.1366-2(a)(2). Code section 1366(d)(2)(A) states that any loss that is not deductible because of the basis limitation is treated as incurred by the corporation in the next succeeding year with respect to that shareholder. Reg. Sec. 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 that year with respect to that shareholder.

The IRS bases its authority on Reg. Sec. 1.1366-2(a)(3)(i). The language upon which it bases its 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 Service interprets this regulation as requiring losses and deductions previously disallowed to be treated separately from items in the current year. 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. They fail to realize that once the prior year deductions and losses and the current year losses and deductions are combined, the next step is to see if there are similar items of income that should be combined with that number to determine if there is a positive or a net negative adjustment.

Deference Given To Regulations

The courts in many cases give deference to IRS regulations where they are interpreting a Code provision. However, the IRS regulations may not contradict a Code section. There are two possible ways of interpreting this 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, even if they are correct in their interpretation, the Regulation would have to be held invalid as being in violation of 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 and deductions that were disallowed by the basis limitation for a prior year and are carried into the current year should be treated as if they were incurred in the current year. Prior year losses would be combined with current year similar types of income and losses before determining their effect on basis of stock.

Conclusion

In summary, we believe that any losses disallowed from a prior year due to the basis limitation that are carried over to the current year should be netted with similar types of income and losses **before** they are inserted in the basis calculation. This gives effect to the Code provision requiring the prior year losses to be treated as having been incurred in the current year with respect to that shareholder.