

S CORPORATION CURRENT DEVELOPMENTS

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SECTION: ACCOUNTANTS LIABILITY
ACCOUNTANT WHO FAILED TO DISCLOSE PROPER AMOUNT OF TAX
ON 7004 FOUND LIABLE TO CLIENTS FOR TREBLE DAMAGES AND
ATTORNEY FEES

Citation: Haddad Motor Group v. Karp, Ackerman, CA1 Nos. 06-2206, 09-1479, 4/20/10

An accounting firm found that even though it was found not liable for the major claim of damages against it, its actions were enough to trigger an award of treble damages under Massachusetts law and, as well, a complete award of attorney fees and costs incurred by the plaintiffs—amounts that were far in excess of the actual damages found.

The CPA firm in question acquired a client in December of 1997 that was already a party to a “margin-against-the-box” transaction that gave the corporation access to the funds represented by appreciated stock it held, but delayed the payment of tax on that transaction until the position was closed out. The corporation continued with the accountant, and in December of 1998 met to discuss whether to close out the “margin-against-the-box” transaction (which incurred fees each year it was kept open) and whether the corporation should make an S election.

On February 11, 1999 the corporation closed out the transaction, triggering the gain. On March 15, 1999 the corporation filed an S election retroactive to the beginning of the year—and causing the February transaction to be subject to built-in gains tax. In December of 1999 the accounting firm informed the corporation it was subject to the built in gains tax, and suggested the corporation file an extension at March 15 due to the ongoing audit of the corporation’s 1997 return.

An extension was prepared, but no amount was shown as being due with the extension. When the return was filed on the extended due date, the tax due, plus penalties for underpayment of estimated taxes, late payment of taxes and interest were imposed. The client sued the CPA firm asking for damages from the BIG tax and the penalties and interest. The trial court found no damages from the BIG tax itself, but did find that the penalties and interest were related to the CPA firm’s failure to advise the client to make payment earlier.

More troubling, the court found that the firm acted willfully, rather than merely negligently, based on the fact that the Form 7004 the firm prepared showed a very small tax liability when the firm at that point knew a substantial liability for the built in gain tax on this transaction was due. The willful action triggered an automatic trebling of the \$12,345 of damages to \$37,035. But that wasn't the worst of it—the finding also triggered an award of attorney's fees and costs in the case that amounted to over \$250,000, which included costs incurred on the portion of the claim for which the plaintiffs did not prevail (in fact, that appears to have made up the vast majority of such costs).

On appeal the First Circuit Court of Appeals sustained the result. The Court found it plausible that the accounting firm had failed to discuss the payments due largely to avoid having to admit the large amount of tax due that they had failed to warn the client about, and found very damaging the preparation of the Form 7004 that failed to include taxes the firm knew were due.

**SECTION: GAO
GAO REPORTS MOST S CORPORATION RETURNS CONTAIN ERRORS,
RECOMMENDS CORRECTIVE ACTIONS**

Citation: Tax Gap: Actions Needed to Address Noncompliance with S Corporation Rules, GAO-10-195, 12/15/09

In a report to the Senate Finance Committee, the GAO discussed the results of the IRS's National Research Project on S Corporations. The GAO found that, per the NRP, 68 percent of S corporation returns filed for tax years 2003 and 2004 had at least one item misreported that affected net income, resulting in a net underreporting of income of \$85 billion. The GAO also found that returns prepared by paid preparers actually had a higher error rate of 71 percent.

The GAO also noted significant problems for taxpayers in the computation of basis in their S corporation shares, resulting in taxpayers claiming losses beyond those allowed under the law. The GAO suggests that S Corporations be required to prepare a computation of basis to be given to each shareholder.

The largest median adjustment was for shareholder compensation, amounting to \$20,127. The GAO noted that the largest adjustments in total for compensation took place on S corporations with a single shareholder, decreasing as the number of shareholders increased—and for S corporations with 4 or more shareholder there was actually a negative adjustment.

The GAO also recommended the IRS take action to improve preparer compliance in this area. The recommendations include licensing of paid preparers, including consideration of special licensing for S corporation preparers and increased penalties imposed on paid preparers.

SECTION: AICPA

AICPA ISSUES REVISIONS TO SSTSS EFFECTIVE JANUARY 1, 2010

Citation: Statements on Standards for Tax Services, November 2009

The AICPA Tax Executive Committee issued revisions to the Statements on Standards for Tax Services effective on January 1, 2010. These standards govern the conduct of CPAs when performing tax services and are considered enforceable standards under Rule 202 of the Code of Professional Conduct. The new standards revise and replace the prior standards.

Changes include combining what used to be standards 6 and 7 into the new SSTS No. 7 and renumbering No. 8 to the new No. 7. Some of the more significant substantive changes include revising the standards for a tax return position found in SSTS No. 1. Under the new SSTS No. 1 a CPA must comply with the more restrictive of the reporting standards under the rules of the taxing agency with jurisdiction over the item or the minimum AICPA standard.

The AICPA minimum standard requires that a CPA determine a position has a realistic possibility of success (that is, a 1 in 3 chance of success on its merits) positions without additional disclosure or that a disclosed position has a reasonable basis under the law. However, federal law generally imposes the “substantial authority” standard for return positions without disclosure, so CPAs will have to meet that higher standard for federal filings.

SSTS No. 7 (formerly SSTS No. 8) also had notable changes, adding that when written advice is provided it should comply with the standards of any applicable taxing agency in addition to the AICPA standard, a member should consider tax return reporting, disclosure and potential penalty issues when giving advice and adds to the list of factors to be considered when advice is given.

SECTION: FIN48

FASB GIVES GO AHEAD TO PRIVATE COMPANY REPORTING UNDER FIN48

Citation: ASU 2009-06, Income Taxes, 9/2/09

After a couple of delays, the Financial Accounting Standards Board gave the go ahead for the implementation of the measurement and disclosure requirements of FIN48 to private companies (or “nonissuers” in the current parlance) and passthrough entities, effective for annual statements with an ending date after December 31, 2009. The FASB did make some modifications found in Accounting Standards Update 2009-06 in the final requirements.

The ASU did remove some disclosure requirements for nonpublic entities. Such entities will not be required to disclose a tabular reconciliation of uncertain return positions, nor would they prepare a summary of exposures that would change the effective tax rates. However the other measurement and disclosure requirements of FIN48 will apply to such entities.

Firms should be readying procedures to handle FIN48 compliance for clients that require GAAP compliant statements. Firms should also consider the potential impact on their independence of any assistance tax practitioners render to the client’s accounting staff in assembling the information necessary to comply with FIN48, specifically considering issues related to nonattest work covered by Ethics Interpretation 101-3.

SECTION: 108

TREATMENT OF §108(I) DEBT ISSUES FOR S CORPORATIONS AND PARTNERSHIP ISSUED BY IRS

Citation: TD 9498, 8/11/10

The IRS issued temporary and proposed regulations outlining the application of the §108(i) cancellation of debt income deferral provisions as they apply to partnerships and S corporations.

Unlike C corporations where the rules apply to all debt, for a partnership or S corporation the rule only applies to what is referred to as an “applicable debt instrument.” An “applicable debt instrument” generally is a debt instrument issued by the partnership or S corporation in connection with the conduct of a trade or business. While the regulations hold that this determination is based on all facts and circumstances, five safe harbor tests are provided where the debt will be treated as issued in connection with the conduct of a trade or business. Meeting any of the five tests will cause the debt to be treated as an “applicable debt instrument.”

1. At the date of issuance of the debt instrument, the gross fair value of the trade or business assets of the entity represented at least 80% of the gross fair value of the entity's total assets;
2. For the taxable year of issuance, the trade or business expenditures of the entity represented at least 80% of the entity's total expenditures for the year in question;
3. For the year of issuance at least 95% of the proceeds of debt instruments are traceable to trade or business assets under the interest tracing rules of §1.163-8T;
4. At least 95% of the proceeds from the debt instrument were used by the entity to acquire one or more trades or businesses within 6 months of the date the debt was issued; or
5. The entity issued the debt instrument to a seller of the trade or business to acquire the trade or business. [Reg. §1.108(i)-2T(d)(1)]

While COD income must be allocated in accordance with the standard §704 rules for a partnership, after the amount has been allocated among the partners, the partnership can designate what portion of each partner's COD income is subject to the election and which portion is not. [Reg. §1.108-2T(b)(1)] For an S corporation, the COD income is shared prorata among the shareholders that are shareholders immediately before the reacquisition of the debt. [Reg. §1.108-2T(c)(1)]

Basis generally is not adjusted for either a partner nor an S corporation shareholder on the deferred COD income until the income is taken into income by either the partner or shareholder. However, for purposes of §752 special rules apply, and for purposes of capital account maintenance deferred items are treated as if no §108(i) election had been made.

There are rules in the regulation to prevent the election under §108(i) from triggering recapture of losses under §465(e). The decrease in amount at risk is not taken into account until such time as the amount is recognized in income by the partner or shareholder.

Acceleration events are addressed in the regulations. These are events that trigger the early recognition of the COD income. There are separate triggers that can apply to the entity as a whole, or those that apply to individual partners or shareholders.

The following events at the entity level would trigger an acceleration event for all direct and indirect interest holders: 1) liquidation of the entity, 2) sale, exchange, transfers or gifts of substantially all of the entity's assets, 3) cessation of business by the entity or 4) filing a petition in a bankruptcy or similar case. As well, for an S corporation the termination of the S election is an acceleration event under the regulations.

Substantially all of the entity's assets is defined to mean assets representing at least 90% of the fair value of the entity's net assets and at least 70% of the fair value of the entity's gross assets. Special rules are provided for partnership transfers subject to §721 where subsequent transactions result in dispositions.

At the individual partner level, the following items will be treated as acceleration events: 1) death or liquidation of the partner, 2) sale, exchange, transfer or gift of all or a portion of the partners' interest, 3) redemption of the partner's interest or 4) abandonment of the partner's interest. Events 1, 2 or 4 in the context of an S corporation will cause an S corporation shareholder to have an acceleration event.

If only a portion of an interest is sold, exchanged, transfers or gifted, only a proportionate amount of the COD deferral is triggered.

Certain events are not treated as acceleration events. Transfers under §721 (tax free contributions to a partnership) are generally excluded, as are like kind exchanges under §1031 though for the latter the receipt of boot will be considered in determining what proportion of assets were sold. Technical terminations of a partnership under §708(b) are also not treated as acceleration events.

The regulations apply to applicable debt instruments reacquired in taxable years ending after December 31, 2008.

SECTION: 108
DEBT SECURED BY SINGLE MEMBER LLC HOLDING ONLY REAL
ESTATE CAN QUALIFY FOR QUALIFIED REAL PROPERTY BUSINESS
INDEBTEDNESS

Citation: PLR 200953005, 12/31/09

The taxpayers had a loan that was secured by their interest in a single member LLC, an LLC formed solely to hold a piece of real estate and which is treated for tax purposes as a disregarded entity. The taxpayers are negotiating to refinance that indebtedness. The real estate securing that debt has declined in value and the taxpayers believe that some of the debt will end up being cancelled as part of the refinancing operation. They sought a ruling from the IRS that even though the debt is secured by the LLC interest rather than directly by the real estate, the reduction in indebtedness would still be able to qualify as qualified real property business indebtedness under §108(c)(3)(A).

The IRS ruled that the existence of the LLC as a disregarded entity means that the property is treated as being owned directly by the taxpayer. The ruling notes that it would “incongruent” to pay attention to the LLCs for purposes of determining whether the debt is secured by real property when that LLC is otherwise disregarded for federal tax purposes. The IRS therefore held that merely having the property titled in the name of the LLC, and then having the interests pledged against the debt, did not remove the ability for such a debt to qualify for treatment as qualified real property business indebtedness under §108(c)(3)(A).

Therefore, if the debt otherwise meets the requirements, the debt cancellation could be excluded from income and the basis of the property reduced. Since, for environmental liability concerns, a number of property acquisitions have been structured in this form (many times at the behest of the lender), this ruling gives comfort that this technicality will not remove such real estate related debt from the potential relief provisions of §108(c)(3)(A).

SECTION: 108
IRS FINALIZES S CORPORATION REDUCTION OF ATTRIBUTES
REGULATIONS WHEN DEBT DISCHARGE EXCLUDED FROM INCOME
UNDER §108

Citation: TD 9127, Reg. §1.108-7(d), 10/30/09

The IRS has finalized the revisions of the regulations found at §1.108-7(d) dealing with how an “NOL” is to be reduced when income from debt discharge is excluded in the S corporation context under IRC §108. The tests under IRC §108(a) for exclusion from discharge of debt from income are tested at the S corporation level, pursuant to IRC §108(d)(7). However, if debt discharge is excluded from income various tax attributes are reduced, one of the first being any net operating loss of the taxpayer. S corporations obviously don’t have such an item, so IRC §108(d)(7)(B) provides that losses disallowed under IRC §1366(d)(1) at the shareholder level are treated as the NOL for these purposes.

The regulations outline how this net operating loss is to be handled by the S corporation. The overall disallowed losses of all shareholders are treated as the “deemed NOL” and the S corporation reduces those losses. The reduction is allocated among the shareholders under the methods contained in these regulations and then reported back to the shareholders. Reduction is prorated based on the various types of losses or deduction that each shareholder has.

Shareholders are required to report their disallowed losses to the corporation to enable this calculation. However, if a shareholder either fails to provide this information after reasonable attempts are made to obtain it by the corporation, or the corporation determines that the information provided to it is in error, the corporation can make its own calculation of a shareholder's disallowed loss and use that. The regulations contain comprehensive examples of how to calculate the amount of disallowed loss and allocate it among the shareholders.

SECTION: 162
S CORPORATION SHAREHOLDER HEALTH INSURANCE REPORTING
AND INDIVIDUAL PLAN REIMBURSEMENT RULES ISSUED BY IRS

Citation: Notice 2008-1, 12/13/07

The IRS solved a problem of its own creation with Notice 2008-1, but it created a potential compliance problem for certain S corporation shareholders with its guidance. The IRS had previously informally indicated in a "headliner" on its website that while a proprietor could claim a deduction for self-employed medical insurance for a policy in the individual's name, that same individual, if he/she incorporated the business and elected S status, could not claim the same self-employed health insurance deduction. The headliner implied, but did not directly say, that the only solution in that case would be for the policies to be reissued as group policies in the name of the S corporation—although the author noted that the IRS understood that some states did not allow for one person group policies to be issued.

Some commentators wondered why the IRS had not looked to Revenue Ruling 61-146 that dealt with a similar problem in the context of employee health insurance. That ruling allowed an employer to reimburse the employee's individual policy payments and treat that as paid under a medical plan of the employer, being excludable from income. In Notice 2008-1 the IRS, while not directly citing that ruling, nevertheless essentially adopted its terms in the context of an S corporation shareholder with an individual policy.

So long as the S corporation either actually pays the premiums for the shareholder or reimburses the shareholder for the premium in the year the premium is paid, the self-employed health insurance deduction can be claimed if the amount is properly reported in W-2 of the shareholder as taxable wages not subject to social security or Medicare taxes. Note, however, that that ruling seems to extent that "must be reported in the W-2" rule to all shareholder health insurance. The implication is that if it is reported in any other form (such as on the K-1) the self-employed deduction will not be allowed.

SECTION: 183
IRS PUBLISHES AUDIT TECHNIQUE GUIDE ON NOT-FOR-PROFIT
ACTIVITIES

Citation: IRS Audit Technique Guide, 6/19/09

The IRS released an Audit Technique Guide on Not-for-Profit Activities to be used by agents examining taxpayers who have activities for which the question of profit motive may be open. The guide is a good review for professionals of the issues that are considered when the matter of whether or not the limitations found in §183 will apply to the activity are potentially open to question. As well, the fact that the IRS has recently revised this guide suggests the IRS has an increased interest in this area that you may find in upcoming audits.

Finally, quite often clients who cannot be convinced by our warnings regarding items that may place them at risk on exam will find an official IRS document to be much more convincing. The document can be used to persuade such clients about the need to pay attention to factors that may place their activity at risk for a deficiency assessment based on an assertion that the taxpayer lacked the proper profit motive.

SECTION: 197
DESIGNATION OF VINEYARD AS AN AMERICAN VITICULTURAL AREA
CAN GIVE RISE TO A §197 INTANGIBLE

Citation: Chief Counsel Memorandum 201040004, 10/8/10

The taxpayer in the matter in question purchased a vineyard in two “American viticultural areas” as designated by the Alcohol and Tobacco Tax and Trade Bureau of the United States Treasury. The taxpayer argued that it should be able to allocate a portion of the purchase price of the land to the right to use the “AVA” designation and treat it as a Section 197 intangible which may be amortized. The Chief Counsel’s office was consulted on whether such a treatment was appropriate.

The memorandum looks at the details of how an area is designated as an AVA and the right to use that designation for wines that come from the regions in question. The memorandum concludes that the right to use the AVA designation is not a right that attaches to a particular piece of land and therefore not an interest in land under §197(e)(2), but rather a right granted by a governmental unit governed by §197.

However the memorandum cautions that valuing this right could prove to be a problem, since it will be difficult in many cases to find comparable land that does not have the right to the designation that would be necessary to determine the incremental value of that right. As well, the memo notes that the taxpayer would need to show a clear premium, such as a marketable and recognizable tradename to a taxpayer's vineyard, to be able to recognize the intangible asset.

SECTION: 304

IRS FINALIZES RULES ALLOWED IT TO IGNORE CORPORATIONS FORMED TO AVOID APPLICATION OF §304

Citation: TD 9477, 12/29/09

Final regulation §1.304-4 modified what had been a discretionary look through rule in Reg. §1.304-4T when the formation of a corporation avoided the application of §304 to a transaction. Generally, IRC §304 generally applies to transactions that attempt to effect what would otherwise be treated as a redemption (or attempted redemption) into a transfer of assets for the stock of the corporation. In such transactions, a portion of the property received is treated as a dividend to the extent of the earnings and profits of the two corporations.

Temporary Regulation §1.304-4T had been issued to address transactions where a new corporation or corporations were formed to avoid the application of this section. The IRS gives an example where Corporation A owns two foreign corporations that it labels F1 and F2. The basis and fair market value of F1 is \$100,000, it has at least \$100,000 worth of cash but has no earnings and profits. The basis and fair market value of F2 is \$100,000 and it has more than that amount of earnings and profits. Corporation A forms a new foreign corporation F3 and contributes F2's stock to that corporation in exchange for F3 stock. Corporation A then transfers F3 stock to F1 in exchange for \$100,000 of cash. Since neither F1 nor F3 has earnings and profits, Corporation A reported the transaction as a return of basis.

The temporary regulations allowed the IRS to unwind this transaction at the District Director's discretion, treating it as an acquisition by F2 (and getting access to F2's earnings and profits). The final regulations removes the discretionary standard and instead has the rule apply if a principal purpose for creating, organizing, or funding the acquiring or issuing corporation was to avoid the application of §304. The new regulations are effective on December 29, 2009

SECTION: 316**AUTO TITLED IN SHAREHOLDER NAME TREATED AS CORPORATE ASSET, AND DATE OF CHECK DETERMINED BY DATE ON CHECK NOT DATE DEPOSITED BY SHAREHOLDER**

Citation: Rosser v. Commissioner, TC Memo 2010-6, 1/6/10

In general the taxpayers in Rosser v. Commissioner and Rosser Enterprises, Inc. v. Commissioner, TC Memo 2010-6 failed to gain deductions for which they had not provided supported, and were charged with a number of constructive dividends. But the IRS failed on two issues that may be of interest to practitioners.

The IRS failed in its claim that payments the corporation made on a loan for the purchase of a Ford van were constructive dividends. The van was titled in the name of the individual, and the loan was also in the individual shareholder's name. Nevertheless, the Tax Court found that the actual use of the van was for the business of the corporation. The Court held that the loan was in the shareholder's name for financing purposes, and the shareholder held the van as a nominee for the corporation.

The IRS also attempted to assess the shareholder a constructive dividend for 2004 on a check that was dated December 31, 2003 for \$20,200, but which was deposited in the shareholder's bank account on January 6, 2004. The IRS claimed that the deposit six days into 2004 indicated that the taxpayer had backdated the checks and therefore it was available for assessment in 2004. However, the Court did not agree—it held that the date on the checks, in the absence of any evidence that the checks had been backdated, controlled in this case.

SECTION: 368**REVISED REGULATIONS PROVIDE FOR ISSUANCE OF DEEMED SHARE OF STOCK IN D REORGANIZATION WHERE NO STOCK IS ISSUED**

Citation: TD 9475, 12/17/09

The IRS released regulations dealing with the case of an acquisitive Type-D reorganization where no stock is actually issued. The regulations, effective for transactions occurring on or after December 17, 2009 provide for the deemed issuance of a share of stock from the transferee to the transferor, followed by a distribution of that stock to the shareholders of the transferor.

The regulations apply if the same person owns, directly or indirectly, all of the stock of both corporations in equal proportions and there is only a de minimus variation in shareholder identity or proportionality of ownership in the two corporations. The shareholder is allowed to designate which share he/she already holds in the transferor will receive the carryover basis.

The IRS has modified Reg. §§1.358-2(a)(2)(iii), 1.368-2(l) and 1.1502-13(f)(7).

SECTION: 469
REQUIRED DISCLOSURES UNDER §469 FOR GROUPING OF ACTIVITIES
OUTLINED BY THE IRS

Citation: Revenue Procedure 2010-13, 1/6/10

The IRS in Revenue Procedure 2010-13 outlined required disclosures to be made when a taxpayer groups activities under Reg. §1.469-4 for purposes of the passive loss rules. The new disclosures will apply to taxable years beginning on or after January 25, 2010—or, for calendar year taxpayers, calendar year 2011.

In the first year a taxpayer groups two or more business activities as one, the taxpayer must attach a statement to the return disclosing the names, addresses and, if applicable, employer identification numbers of the trade or business activities or rental activities that are being grouped as a single activity. As well, the statement must contain a declaration that the grouping constitutes an appropriate economic unit for purposes of measuring gain or loss under §469. The taxpayer must also file a similar statement with the return for any year where a new activity is added to the group.

If the taxpayer regroups activities under Reg. §1.469-4(e)(2) because it is determined the taxpayer's original grouping was clearly inappropriate or a material change has occurred that makes the original grouping clearly inappropriate, the taxpayer makes a disclosure of the same items noted above plus an explanation of why the regrouping was determined to be inappropriate or the nature of the material change that made the grouping inappropriate.

A taxpayer will not need to make a disclosure compliant with this ruling for groupings that existed before the effective date of the ruling unless a change occurs in the grouping.

Partnerships and S corporations don't comply with the above rules, but must comply with the disclosure requirements for reporting activities separately to interest holders via the holders' K-1s.

If a taxpayer fails to report, the taxpayer can make the report with the return for the year the taxpayer discovers the omission. However, if the failure is discovered by the IRS on examination, the taxpayer must show reasonable cause for failure to make the proper disclosure.

SECTION: 565
IRS ALLOWS CORPORATION TO MAKE LATE CONSENT DIVIDEND ELECTION FOR PHC WHEN FINALLY ADVISED OF THE OPTION TWO YEARS LATER

Citation: PLR 201035002, 9/3/10

While, in general, ignorance of the law is not an excuse, in some cases it may get sympathy from the IRS Chief Counsel's office to allow for a late election. In the case in question the Company's president was a CPA, but apparently one not well versed in corporate taxation. He was the son-in-law of the couple that owned the corporation, and apparently was relied upon for tax decisions. One of his decisions was not to make a Subchapter S election when the corporation was formed. The CPA felt there was no need to do this, as the return would be simple as the only income of the corporation was interest income.

Of course, having only investment generated interest income meant that the corporation was subject to the personal holding company tax, something the CPA discovered when he prepared the return with unspecified tax preparation software. Being unaware of the option to have the couple take a consent dividend under §565, the CPA simply had the corporation pay the personal holding company tax. He then elected S status for the second year of the corporation's existence.

In late October of the third year, the President met with outside tax advisors to plan for year 3. The outside advisors informed him of the existence of the option to have taken a consent dividend back in the first year.

While not stated in the ruling request, it seems likely a problem the advisors noticed was that the corporation would have accumulated earnings and profits from that first year, thus triggering the application of the §1374 excess passive income tax and, more ominously, the potential loss of the S status under §1362(d)(3) after the third successive year of excess passive income. The imposition of that tax can be avoided if the accumulated earnings and profits are distributed to the shareholders, but if that was done in this case the taxpayers would now be paying tax on a dividend on top of the PHC tax paid for Year 1. An election under §565 would have avoided that double tax issue.

The IRS granted the corporation's request to make a late election for the shareholders to take a consent dividend for year one, finding that the taxpayers had acted reasonably and with good faith and granting the election would not prejudice the interests of the government.

SECTION: 1361
STOCKHOLDER AGREEMENT PROVIDING FOR DISTRIBUTIONS TO PAY TAX IN ACCORDANCE WITH INTEREST FOR YEAR TAX ARISES DOES NOT CREATE SECOND CLASS OF STOCK

Citation: PLR 201017019, 4/30/10

The IRS dealt with a taxpayer's request to rule on whether the following arrangement would create a second class of stock, invalidating the corporation's S election. The corporation has a provision in its Shareholder Agreement that requires that it make a distribution based on its taxable income passed out on shareholder's K-1s in sufficient amounts to enable shareholders to pay their taxes by December 31 following the year in which the income arises. The Agreement also provides that if a later adjustment is made to items reported on the K-1, the agreement allows a discretionary payment to be made to handle the increased taxes resulting from the adjustment.

The corporation proposes to change the Agreement so that if an adjustment is made and it makes a discretionary payment, the payment would be made in accordance with the taxpayer's interest in the corporation during the taxable year the adjustment applies to, rather than the interests at the date the distributions are made.

The IRS issued the letter ruling requested, holding that this arrangement would not create a second class of stock, nor will actual distributions under the arrangement create a second class of stock.

SECTION: 1361
MERGER OF PARENT INTO QSUB WAS AN F REORGANIZATION, S ELECTION NOT TERMINATED

Citation: PLR 201007043, 2/19/10

The taxpayers wished to combine the operations of a parent corporation and its subsidiary. The parent corporation had an S election in place, while the subsidiary had a valid QSUB election in place. Due to certain legal agreements, the subsidiary could not be merged upstream into the parent, but rather had to be the surviving entity following the merger. Adding another wrinkle to the transaction, the parent also owned another subsidiary that had a valid S election.

The subsidiary would be merged with the parent, with the shareholders of the parents receiving subsidiary stock in exchange for their old parent stock. The subsidiary would receive all assets of the parent, including the stock in the other subsidiary.

The IRS ruled that this transaction was properly treated an F reorganization of the parent under § 368(a)(1)(F), with no gain or loss recognized on the transaction. As well, the S election remained intact, effectively being transferred to the surviving subsidiary that had previously been a QSUB. The QSUB election of the other subsidiary also survived the transaction.

SECTION: 1361
ROTH IRA ACCOUNT IS NOT AN ELIGIBLE S CORPORATION
SHAREHOLDER

Citation: Taproot Administrative Services, Inc. v. Commissioner, 133 TC No. 9, 9/29/09

A Nevada corporation was formed with a single shareholder—a Roth IRA. The corporation had elected S status, having its income flow through to Roth IRA. The IRS contended that a Roth IRA was not an eligible S corporation shareholder and took the position that the corporation instead was now a C corporation. In a split decision the Tax Court agreed with the IRS.

The majority noted that there was no direct authority on whether a Roth IRA could be a shareholder. However the court found the situation analogous to the situation for a regular IRA that was covered in Rev. Ruling 92-73 where the IRS ruled that a regular IRA was not an eligible S corporation shareholder. The court found that ruling persuasive. As well, the court felt that there was no evidence the Congress intended for Roth IRAs to be eligible S corporation shareholders, noting that in 2004 the Congress passed a provision that allowed IRAs as shareholders in S corporation banks—a provision that would be unnecessary if, in fact, IRAs had all along been allowed to be S corporation shareholders.

Once it was determined the Roth IRA was not an eligible shareholder, the S status issue is quickly resolved. If there is an ineligible shareholder, the corporation ceases to be an S corporation and instead is taxed as a C corporation.

SECTION: 1362
CORPORATION ACQUIRED BY PARENT ADOPTION ESOP ALLOWED EARLY RE-ELECTION OF S STATUS AND QSUB ELECTION, SUBJECT TO CONDITIONS

Citation: PLR 201047007, 11/26/10

The IRS dealt with the question of granting permission for a corporation to re-elect S status and make a Qualifying S Corporation Subsidiary election in the following situation. In order, the following events took place:

Corporation Y (eventually the parent corporation) adopted an employee stock ownership plan (ESOP).

Corporation X (to be the subsidiary) terminated its S election.

Corporation Y acquired 100% of the shares of Corporation X.

The ESOP acquired 100% of the shares of Corporation Y.

Corporation Y filed an election to be an S corporation.

Corporation X now wishes to elect S status and make a QSUB election. The problem is that less than five years have elapsed since the original S election was revoked, thus the corporation is still within the five year waiting period before a new S election can be made without IRS consent under §1362(g). So the corporation asked for permission to make that election.

The IRS granted permission to make the election, but the former shareholders of Y (the parent) had to represent that no election to defer gain on the sale of the stock to the ESOP under §1042 would be made, and Corporation Y represented that it would not consent to any such election under §§4978 or 4979A.

SECTION: 1362
S CORPORATION GRANTED RELIEF FROM INADVERTANT TERMINATION DUE TO IRA SHAREHOLDER, BUT MUST TREAT IRA AS SHAREHOLDER PRIOR TO REDEMPTION FOR ANY LOSS YEAR

Citation: PLR 201046005, 11/19/10

In the case in question an S corporation had taken on an S corporation shareholder, a shareholder the IRS sees as an ineligible shareholder (see Revenue Ruling 92-73). The corporation, upon becoming aware of this view, asked the IRS for relief from an inadvertent termination after redeeming the shares from the IRA shareholder.

The IRS granted relief, but with a unique condition. The IRA would continue to be treated as a shareholder for any tax period in which the corporation reported a net loss, but for any other years only the eligible shareholders would be treated as shareholders who would receive an allocation of the passthrough items.

SECTION: 1362
CORPORATION REMOVAL OF GUARANTEE OF RETURN OF PRINCIPAL TO SINGLE SHAREHOLDER WAS TREATED BY IRS AS REASON TO TREAT TERMINATION AS INADVERTANT

Citation: PLR 201042014, 10/22/10

The IRS allowed an S corporation to reinstate its S election after it, in the words of the IRS, “may” have been terminated by the following transaction. The corporation sold its shares to an eligible trust, but the purchase agreement had a clause that guaranteed that the shareholder would receive its initial investment back if there were a sale of the corporation that resulted in the loss. As the corporation was the entity giving that guarantee, there was concern that the clause may have created a second class of stock, something not allowable for an S corporation under §1361(b)(1)(D).

The corporation had never paid out any funds based on that portion of the purchase agreement, and it had now amended the agreement to remove the clause. The corporation asked for and received an IRS ruling that the termination (if it had occurred) was inadvertent and that relief was granted to treat the election as if it were not terminated, pursuant to §1362(d).

SECTION: 1362
IRS ALLOWS LATE ELECTION WHEN INDIVIDUALS WHO SIGNED S ELECTION ONLY BELIEVED THEY WERE SHAREHOLDERS

Citation: PLR 201030002, 7/30/10

A corporation looked to make an S election, but there turned out to be some confusion about who were the shareholders at the date of the election. The plan was for an estate to sell its shares to one individual. An agreement was drawn up to transfer the estate's shares to the individual for a set price. The agreement, with a blank check for the amount of the purchase, were delivered to the individual. However, the attorney directed the individual not to execute the agreement pending further instruction.

The individual buying shares from the estate and another individual executed a Form 2553. The agreement noted above was dated prior to the date of the Form 2553, but was not yet executed at the date of the S election. The Form 2553 was signed only by the two individuals and not by the executor of the estate.

After the date of the Form 2553 the check was delivered and the agreement was executed transferring the shares. The taxpayers later became concerned the S election was invalid, as the estate appears to have been a shareholder at the date the election was executed.

The IRS agreed that the election was not valid, but that it was inadvertent and late election relief was granted.

SECTION: 1362
IRS RULES THAT TERMINATION OF S ELECTION DUE TO EXCESS
PASSIVE INCOME WAS INADVERTENT

Citation: PLR 201030018, 7/30/10

While §1375(d) allows a waiver of the excess passive income tax if a taxpayer in good faith believed it did not have earnings and profits and it distributed the earnings and profits within a reasonable time after it was discovered, that exception does not serve to undo the termination of S status under §1362(d)(3)(A)(i) if there have been three years of excess passive income.

However a taxpayer that has such a termination can have that termination waived by the IRS if the IRS determines the termination was inadvertent pursuant to §1362(f). In the case at hand, the taxpayer requested the IRS find the termination was inadvertent.

The IRS granted the request, so long as a payment of the tax now was timely made.

SECTION: 1362
S CORPORATION SHAREHOLDER AGREEMENT SERVED TO PRESERVE
S STATUS DESPITE ATTEMPT TO TRANSFER SHARES TO INELIGIBLE
SHAREHOLDER

Citation: PLR 201026006, 7/2/10

A restriction on the transfer of S corporation stock to impermissible shareholders that was upheld by a state court served to preserve the corporation's S corporation status in this letter ruling. The Shareholders' Agreement of the Corporation, which was executed by the founding shareholders of the corporation, stated that a shareholder desiring to transfer shares of stock to another party had to 1) obtain the consent of the other shareholders prior to the transfer, 2) the new shareholder must become a party to the Shareholders' Agreement and 3) any transfer that would result in the termination of the corporation's S status would not be valid.

Eventually a shareholder attempted to transfer shares to an ineligible shareholder. Court proceedings followed, and an order was entered that held this transfer was null and void, and that the original shareholder remained the legal owner of all shares that he had attempted to transfer to an ineligible shareholder.

The IRS ruled that because the transfer was held to be null and void, the S election was held not to terminate. However the IRS conditioned the ruling on having all shareholders file amended returns within 60 days, if necessary, to have the original owner treated as the owner of all shares.

Because it is a letter ruling where we see only the IRS response, we don't know whether this was likely to be an issue with the shareholders, though it's easy to imagine a circumstance where the person whose sale was voided might not be in a very cooperative mood. However it's easy to imagine cases where that cooperation might not be easy to come by, or where such cooperation would need to be mandated by the court action voiding the transfer.

SECTION: 1362

TRUST THAT ERRONEOUSLY ELECTED QSST RATHER THAN ESBT STATUS ALLOWED TO CORRECT ERROR AND CORPORATION REMAINED AN S CORPORATION

Citation: PLR 200952037, 12/24/09

The taxpayers requesting a ruling in PLR 200952037 appear to have somehow gotten confused over the difference between a QSST and an ESBT. The facts indicate that a trust that qualified as an ESBT but not a QSST was a shareholder of the S corporation at the time of its election. The trust made a timely election to be treated as a QSST—which it wasn't eligible to be. The “wannabe” S corporation also had two wholly owned subsidiaries for which it filed a QSUB election to be effective upon election.

Due to the trust having made the wrong election, the parent corporation was not eligible to elect S status and so would revert to a C corporation. As well, the QSUB election was also an invalid one, since the corporation holding the potential QSUB's stock was not an S corporation. The taxpayer was asking that the IRS grant the trust the right make a late ESBT election and to treat the subsidiaries as QSUBs.

The IRS granted relief, subject to the receipt of an actual election and the filing of amended tax returns on behalf of the trust that recognize that the trust was an ESBT.

SECTION: 1363

SECTION 291 DOES NOT APPLY TO LIMIT DEDUCTION FOR INTEREST PAID ON DEBT TO ACQUIRE QUALIFIED TAX EXEMPT SECURITIES FOR QSUB WITH S STATUS MORE THAN 3 YEARS

Citation: *Vainisi v. Commissioner*, No. 09-3314, 3/17/10

Reversing the holding of the Tax Court, the Seventh Circuit Court of Appeals held that §1363(b)(4) explicitly makes the limitations on the deduction of interest to purchase qualified tax exempt securities inapplicable to a QSUB bank that had been in S status for more than three years.

The parent S corporation in this case had been an S corporation for six years prior to the year in question. The IRS argued that regulations issued under the authority found at IRC §1361(b)(3)(A) allowed it to apply the general financial institution rules to this QSUB, thus applying Section 291 to limit the deduction of interest. The taxpayers argued that Section 291 did not apply to them based on the explicit language of the statute and that they should be able to deduct all of the interest.

The Seventh Circuit panel noted that the explicit language of §1363(b)(4) held that §291 would only apply to an S corporation that had been a C corporation during the prior three years. The Court rejected the IRS's view that since this provision had been enacted prior to when banks could be S corporations or subsidiary it was inapplicable, and found that neither the plain wording of the statute nor the Treasury's own regulations supported the IRS's interpretation.

The Court commented that if this result is not what is intended, Congress should change law or, possibly, the Treasury should revise its regulation. On the latter point the Court noted that the IRS had issued proposed regulations to do just that—but those regulations had never been made final and many commentators suggested the regulations if made final would go beyond what the IRS could do via regulation. The Court specifically reserved judgment on whether the IRS could, in fact, accomplish this goal by regulation.

SECTION: 1363
LIFO RECAPTURE TAX DOES NOT APPLY TO PROPRIETORSHIP
ELECTING S STATUS IMMEDIATELY FOLLOWING §351 INCORPORATION

Citation: PLR 201010026, 3/12/10

In response to a taxpayer request for a private letter ruling, the IRS reaffirmed that the LIFO recapture tax of §1363(d) does not apply when a sole proprietorship incorporates under §351, makes a timely LIFO election for its first year of existence and makes a valid S election for its first year as a corporation. The IRS notes that the literal language of §1363(d) requires that the S corporation be a C corporation at some point before the effective date of its S election.

The IRS also goes on to analyze the rationale behind the LIFO recapture tax, noting that it serves as a backstop to the built in gains tax of §1374. The IRS reasons that Congress enacted the LIFO recapture tax as otherwise an S corporation that did not experience a decrease in inventory during its first ten years would escape the built in gain on its inventory that existed when it made the S election.

What we need to remember from this ruling is that there is a danger that still lurks for sole proprietorships that incorporate. If the S election does not take effect that first year, then the LIFO recapture tax would come into play if the entity elects its S status in a later year. Certainly the issue of the later imposition of a LIFO recapture tax if the entity later elects S status should be discussed when a sole proprietor on the LIFO basis is deciding to convert to a C corporation. As well, this issue also needs to be kept in mind when we discover an S election that was intended to be made was not made—failing to go through procedures to obtain relief for a late election may be much more costly than we might first expect.

SECTION: 1366
TAXPAYER'S INABILITY TO SHOW BASIS, COMBINED WITH FACT THAT
DEBT GUARANTEE DOESN'T CREATE BASIS, MEANS NO S
CORPORATION LOSS DEDUCTION

Citation: Weisberg and Peterson v. Commissioner, TC Memo 2010-55

Robert Weisberg's K-1 from his law firm's S corporation for 2003 showed a loss of \$199,141, a loss claimed on his personal return by the accounting firm that prepared his return. Robert had guaranteed the firm's line of credit and, in 2004, ended up borrowing money personally that he then used to pay off the corporation's credit line.

However, Robert did not present any evidence to show his basis in the S corporation. The Tax Court noted that a guarantee of debt did not create any basis in the S corporation, and his actual payment on that guarantee in a later year was not relevant to his ability to claim a deduction in 2003.

The Court also imposed a negligence penalty on Robert. Although he used an accounting firm to prepare his return, he presented no evidence on the information he had provided to that firm, in particular any information about basis in his S corporation. As such, the Court found he did not qualify for an exception to the penalty for having reasonably relied on a professional—such reliance requires a showing that the taxpayer had provided the preparer with all information the taxpayer believed relevant and actually relied on the advice provided.

SECTION: 1366
GUARANTEED DEBTS, DEBTS FROM RELATED PARTNERSHIP AND
COSIGNED DEBTS DID NOT CREATE BASIS IN S CORPORATION

Citation: Russell v. Commissioner, TC Memo 2008-246, 10/30/08

The taxpayers had loans they had guaranteed and cosigned with their S corporation and attempted to deduct losses from the S corporation against such loans. However, as the Tax Court pointed out, while it is possible that they might have to pay on the loans, such is not sufficient to create shareholder basis under the rules of IRC §1366(d)(1)(B). Only if such payments are actually made would a shareholder end up with basis, largely because the shareholder would now be owed money by the S corporation to reimburse for the payment on the guarantee.

Similarly a loan from a related partnership that the shareholders claimed was actually from the partnership to them followed by a loan to the S corporation failed to create basis. The Tax Court did not find that the loans actually flowed as the shareholders claimed, rather finding they appeared to actually flow directly from the partnerships to the S corporation—again, not a valid type of loan that would create shareholder basis.

SECTION: 1367

CONTRIBUTION OF CAPITAL NOT TREATED AS EITHER TAX EXEMPT INCOME FOR S CORPORATION DEBT BASIS OR LOSS UNDER §165

Citation: Nathel v. Commissioner, CA2 No. 09-1955-ag, 6/2/10

The taxpayers in this case had loaned money to their S corporation and also guaranteed debts the corporation had to the bank. Losses had wiped out their stock basis, and the basis in their debt (which appears to have an open account balance not evidenced by a note) had been reduced in order to take losses in prior years. The taxpayers, readying to sell off the operations, contributed capital to the corporation, a step that was necessary to have the bank remove the shareholders from the guarantee. The corporation repaid the shareholder loans and redeemed their stock.

The taxpayers initially claimed that the contribution of capital should be treated as tax exempt income. The taxpayers argued that §118, which excludes such contributions from income, would only be needed if the item were one of income and, therefore, under the logic the Supreme Court had originally laid out in the Gitlitz case for cancellation of indebtedness income excluded under §108, it would add to basis. In their case this is important because basis is first restored to debt by income. If it wasn't income, it would create stock basis and the repayment of their debt whose face value would be less than its basis would create ordinary income.

The IRS argued that was exactly the result and the Tax Court agreed. The taxpayers appealed to Second Circuit Court of Appeals which sustained the Tax Court. The Second Circuit held that capital contributions from shareholders had never been an item of item. §118 was enacted primarily to codify case law regarding contributions to capital by nonshareholders and did not serve to convert contributions by shareholders into an item of income.

The taxpayers argued in the alternative that they should be able to treat the contribution of capital as an ordinary loss under §165, as they argued they made the contribution to be released from their guarantees. The Tax Court had ruled that such a loss could be claimed only if the taxpayers could show that was the sole reason for the contribution, and the Tax Court found there were significant other reasons in the transaction.

The Second Circuit agreed in result, but held that in its view the taxpayers would have prevailed if they could have shown the primary purpose of their contribution had been to secure the release. The panel noted that there is a bit of diversity in the holdings of the various courts in this matter, some holding to the sole purpose test the Tax Court applied, while others (the Tenth Circuit in the 1964 Condit decision) had appeared to allow the deduction even when there was no primary purpose. But this panel came down for the primary purpose test and held that the taxpayers in this case had failed to show their payment was made for the primary purpose of securing a release from the guaranties.

SECTION: 1367

IRS ISSUES REVISED REGULATIONS LIMITING USE OF OPEN ACCOUNT DEBT RULES FOR S CORPORATIONS

Citation: TD 9248, Reg. §1.1367-2, 10/20/08

In response to a loss in the Brooks case (TC Memo 2005-204), the IRS decided the time had come to revise the open account debt rules for S corporations. Reg. §1.1367-2 provided two sets of rules for shareholder loans to the S corporation. Debts evidenced by a note were accounted for on a transaction basis—so if a payment was made on the loan and basis was less than face, a gain would be recognized. However, for debts not evidenced by notes (open account debt), the taxpayer nets advances and repayments during the year, so if there is a net advance for the year no gain would be recognized.

The new regulations impose an additional condition on open account debt aside from the “no note” rule. Now any open account debt that, at the end of a tax year, shows a balance of greater than \$25,000 will cease to be treated as open account debt. That means that if a repayment is made on that debt in the following year, the debt started the year with a face value greater than its basis, and that basis is not restored through income items at year end, there will be a gain on the repayment.

This regulatory change means clients can no longer have a floating open account debt item which the taxpayer merely assures at year end has a running balance at least equal to the prior year’s ending balance. Clients who are used to using such “due to/from accounts” run the risk of accidentally triggering a taxable gain.

SECTION: 1374

LINKED PREPAID VARIABLE FORWARD CONTRACT AND SHARE LENDING AGREEMENT TRIGGERED IMMEDIATE GAIN RECOGNITION IN BUILT IN GAIN MEASUREMENT PERIOD

Citation: *Anschutz Company v. Commissioner*, 135 TC No. 9, 7/22/10

Having acquired the Staples Center in Los Angeles and two professional sports team, Philip Anschutz needed some cash. His wholly owned S corporation's, which has elected its status only a year before, held a number of highly appreciated securities in a subsidiary it owned that had elected QSUB status. A sale of the shares would trigger the built-in gain tax of §1374 along with individual income taxes at the shareholder level, so Mr. Anschutz looked to avoid that result.

To accomplish that goal, he entered into a pair of transactions, one where the corporation entered into a prepaid variable forward contract (PVFC) involving various appreciated shares he held, and another that required him to lend those same shares to the investment bank with which he entered into the agreements with under a share-lending agreement (SLA). The transactions would ultimately finish up after the 10 year built-in gain period at which time, in the taxpayer's view, any gain or loss would be recognized.

The agreements limited the QSUB's ability to participate in appreciation of the underlying shares to no more than 50% of the value when the contract was entered into—all additional appreciation accrued to the benefit of the investment bank. Similarly, because the PVFC could be settled by delivering the initial number of shares, the QSUB had locked in the lowest price it would receive for the shares, that being the initial 75% value received.

The taxpayer contended that the two transactions had to be evaluated separately citing the Tax Court's decision in *Samueli v. Commissioner*, 132 TC 37, while the IRS contended that rather they were an integrated whole. The Tax Court sided with the IRS, finding that the taxpayer had misinterpreted the holding in *Samueli* which involved an arrangement the taxpayers argued they could have (but did not) enter into. The Court found that, viewed as a whole, the QSUB transferred all risk of loss and most of the opportunity for gain when it executed this pair of transactions.

The Court also refused to consider that the QSUB had the right to recall the lent shares and, in fact, did so twice after the examination commenced. The Court pointed out the recalls were not done for any valid economic reason, but rather solely to try and influence the result in the case. The taxpayers, being insulated from loss by the overall arrangement, could not obtain the protection of §1058 for the lending transactions, as the loss protection violated the requirements of §1058(b)(3).

However the Court did not agree with the IRS that the QSUB should be taxed on the full fair value of the shares transferred. The IRS argued that, effectively, the QSUB had received 75% in cash and the remainder in equity options. The Tax Court rejected that view, holding that the amount to be received cannot be determined until the contract is settled, so only payments received by the QSUB would be taxable.

SECTION: 1374
PRICE PAID NINE MONTHS AFTER S ELECTION WAS A FACTOR, BUT DID NOT BY ITSELF, ESTABLISH VALUE AT S ELECTION DATE FOR BUILT IN GAIN TAX

Citation: The Ringgold Telephone Company v. Commissioner, TC Memo 2010-103, 5/10/10

Ringold Telephone Company had been a C corporation, but effective January 1, 2000 the corporation elected S status. At the time it held a minority interest in a telecommunications company, the majority interest of which was held by BellSouth in various forms. In September of 2000, BellSouth acquired the interest for over \$5,000,000.

The built in gain tax under §1374 applied in this case, but the question became how much of the gain was subject to that tax. The IRS contended that since the sale took place a few months after the S election that the sales price was the value at the date of the S election. The taxpayer argued that the true value at the date of conversion was less than that amount, not because the entity had suddenly become more valuable in those few months, but rather because BellSouth had its own reasons for paying a higher than market price.

The Tax Court found that the September price paid by BellSouth was an indicator of the value. The court agreed with the IRS that BellSouth did not pay extra to get a controlling interest, since it already had one and this purchase did not add to its control, a position the S corporation had argued. However, the court found that the S corporation's valuation expert, who had significant experience in valuing telecommunications organizations, was able to show that BellSouth had a history of "doing whatever it takes" to be sure to complete a deal once it decided it wished to acquire an interest.

In this case, there existed a right of first refusal for the other minority partners to buy the interest that Ringold was selling to BellSouth. The Court found that BellSouth likely did pay more than the market price to some extent to insure the right of first refusal options would not be exercised. The Court therefore factored in other valuation methods in arriving at its own value at the date of the S election.

SECTION: 1374

SECTION 481(A) ADJUSTMENT FROM C YEARS IS BUILT IN GAIN FOR S CORPORATION

Citation: MMC Corp v. Commissioner, No. 08-9002, CA10, 1/13/09

The Tenth Circuit affirmed the Tax Court's holding that a §481(a) adjustment that arose from a change of accounting method undertaken while a corporation was a C corporation represented built in gain for purposes of the built in gain tax on S corporations under IRC §1374. The court held that the amounts are attributable to the periods before the S election, and that IRC §1374's tax will therefore apply to such payments.

The taxpayer had attempted to argue that Reg. §1.1374-4(d) would prevent this result, since, by virtue of the four year spread, an accrual basis taxpayer could not have included that amount in income. The Court ruled this was an incorrect interpretation of that provision and cites Example 2 of Reg. §1.1374-4(d) to demonstrate what it feels is the proper interplay between Reg. §1.1374-4(d) and §1.1374-4(b).

SECTION: 1402
IRS PROTECTIVE ASSERTION OF FICA TAX DUE FROM S
CORPORATION DID NOT PROHIBIT IRS FROM LATER ARGUMENTS
PAYMENTS WERE PERSONAL SELF-EMPLOYMENT INCOME

Citation: Daniel v. Commissioner, TC Summary Opinion 2010-61, 5/13/10

The mere fact that the IRS had assessed the taxpayer's S Corporation alleging an underpayment of payroll taxes did not prevent the IRS from taking the alternative position that the taxpayer owed self-employment taxes on the income.

The taxpayer received real estate commissions from Holland Realty as a real estate agent. The taxpayer had reported such items not on Schedule C, but rather treated them as assigned to his S corporation. The S corporation claimed various expenses and then issued a W-2 for the remaining income.

The IRS examined the taxpayer and issued a notice to the S Corporation finding that Daniel was an employee and assessing payroll taxes on the entire amount of commissions paid. The IRS, after a petition in Tax Court was filed, decided that assessment was in error as the return had treated Daniel as an employee and asked that the case be dismissed. The Tax Court dismissed that case.

The IRS assessed the taxpayer personally at the same time for self-employment tax due on the commissions. The taxpayer argued that the IRS had conceded he was an employee of the S Corporation in the prior case and could not claim an inconsistent position here.

The Tax Court did not agree. The Court found, first, that the question of whether Daniel was or was not an employee was never decided in the first case so there was no prior ruling. The Court also held that the IRS was allowed to take inconsistent position as a protective measure—in this case, to capture an underpayment regardless of whether the assignment of income was or was not effective.

SECTION: 1402
S CORPORATION FORMED SOLELY AS A SELF-EMPLOYMENT TAX
DODGE IGNORED

Citation: Pate v. Commissioner, TC Memo 2008-272, 12/9/08

The Pates had created what may have been two entities (they weren't real clear on the concept) through which passed the income paid to Mr. Pate as an independent contractor and reported on his Schedule C. Payments to these entities fully offset Mr. Pate's Schedule C income, resulting in zero Schedule Cs. When the amounts later passed through these entities (one of which was an S corporation and the other apparently a partnership), the amount of income had dropped from \$98,200 to \$49,820 and none of that net was subjected to self-employment. The "shrinkage" occurred by the offset of personal expenses against that income.

The taxpayers admitted those two entities were formed solely for tax benefits—to remove the income from self employment tax and disguise the nature of expenses being claimed. The Tax Court found the entities lacked economic substance, disallowed the deductions and imposed the self-employment tax on the entire amount of the income. Despite the fact that a CPA had advised them to take these steps, they did not present evidence of what information they had provided that CPA in preparing their returns, nor exactly what advice was given to them by this CPA. Thus, the 20% penalty under §6662(a) was imposed.

SECTION: 3101
IRS NOT LIMITED TO ASSESSING PAYROLL TAXES ONLY AGAINST
DESIGNATED AS COMPENSATION IN CORPORATE MINUTES FOR S
CORPORATION

Citation: David E Watson, P.C. v. United States, US District Court for the Southern District of Iowa, 5/27/10

A CPA whose S corporation was a partner in an accounting firm with no other activities, basing his arguments on IRS wins in cases involving attempts by taxpayers at trial to recharacterize payments as compensation, argued that since his S corporation had only designated \$24,000 of payments to him as compensation, the IRS was barred from reclassifying additional payments made to him in the form of dividends as wages. In those cases, taxpayers were blocked by trying to claim payments were truly wages when, at the time the payments were made, the corporation had shown no intention to treat these payments as compensation.

However, the Court noted that in those cases it was the corporation trying to argue after the fact that payments it had labeled as one thing were truly another—and the corporation was, of course, the party that had full control of what it decided to label them when they were paid.

The Court cited a number of S corporation cases where the opinions had supported IRS efforts to recharacterize the payments as wages, noting that S corporations had an incentive under the tax law to understate wages to avoid payroll taxes. Thus, the Court held, the mere recitation of salary in the corporate minutes did not serve to fix the amount that the IRS could argue was compensation.

SECTION: 6011 IRS UPDATES LIST OF "TRANSACTIONS OF INTEREST" AND "LISTED TRANSACTIONS"

Citation: Notice 2009-55 and Notice 2009-59, 7/15/09

The IRS has updated its list of transactions of interest in Notice 2009-55. Such transactions are ones that fall short of the IRS's listed transaction threshold, but for which disclosure is still required by taxpayers for transactions entered into after November 1, 2006.

The IRS also updated its list of listed transactions in Notice 2009-59. These transactions carry more significant consequences for failure to disclose including, for the moment, the potential of an automatic \$100,000 per year affected penalty for failure to disclose even if no tax deficiency ends up being shown by the IRS. While some relief in this area is being considered by Congress, it's unlikely the entire disclosure and penalty regime will go away once Congress makes its changes.

All tax practitioners should be aware of where to find the most current list of such transactions, since some of the items detailed apply only to individuals or small closely held businesses. No matter what type of client you serve, it's possible for your clients to run afoul of these rules.

SECTION: 6011
LISTED TRANSACTION - PENALTY APPLIED TO SUBSTANTIALLY
SIMILAR TRANSACTIONS

Citation: ILM 200917030, 4/24/09

Internal Legal Memorandum 200917030 deals with a situation in which a couple participated in a listed transaction but failed to properly report that fact in their personal returns. The deal involved using contributions to Roth IRAs that were then used to acquire ownership of a corporation. The corporation operated profitably and made dividend distributions to the Roth IRAs. That's a transaction "substantially similar" to a listed transaction identified in a 2004 Notice. Therefore, it has the same disclosure requirements as the listed transaction.

Notice 2004-8 described such a transaction and concluded it produced tax benefits not contemplated by a reasonable interpretation of the law allowing Roth IRA contributions. Any taxpayer involved in a listed transaction must disclose that fact by filing Form 8886 with it's or their tax return. In the situation discussed in the memo, the corporation filed the Form, but the individuals did not. That means they are subject to significant penalties AND the statute of limitations does not start to run until they file the Forms 8886. These schemes have been promoted for several years. What happens to them now ?

SECTION: 6109
IRS ADDS REQUIREMENT TO LIST NAME AND IDENTIFYING NUMBER OF
RESPONSIBLE PARTY WHEN APPLYING FOR EIN

Citation: Form SS-4, 2/2/10

The IRS revised Form SS-4 on February 2, 2010. The new form added lines 7a and b to the form that request the name and identifying number of the "responsible party" for the entity applying for the number.

For entities traded on a public exchange, the responsible party is the principal officer of a corporation, general partner of a partnership, owner of a disregarded entity and the grantor, owner or trustor of a trust. For other entities, the responsible party is the person who, per the IRS instructions, “has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets.” An identifying number must be provided unless the only reason for applying for an EIN is to make an entity classification election under the check the box regulations and the responsible party is an alien or foreign entity with no effectively connected income from sources within the United States.

The new form also contains an option on line 14 for eligible employers to elect whether or not they wish to file Form 944 annually rather than Form 941 quarterly. The filing of Form 944 is no longer mandatory for qualifying employers so long as they opt out of that program, and this SS-4 allows a new employer to opt out at the time of application for an identification number.

SECTION: 6229
FEES PAID RELATED TO SON OF BOSS PARTNERSHIP TRANSACTION
TRANSACTION BILLED TO S CORPORATION NEVERTHELESS IS AN
AFFECTED ITEM

Citation: Domulewicz v. Commissioner, TC Memo 2010-177, 8/5/10

If over \$1,000,000 of fees related to a partnership transaction are billed to an S corporation that the same taxpayers controlled, are those fees properly treated as an affected item? The question was crucial because only if they were was the statute of limitations still open for the IRS to assess tax related to a disallowance of the expenses.

The Tax Court held that the provisions of §6229 operated in this case to keep the statute open, as the fees were an affected item. The Tax Court noted that the fees were related to the Son of BOSS transaction itself, a factor that was not clear from the original returns in question. As the partnership itself was held to be a sham, the issue of the deductibility of these fees were an affected item, since the transactions required a determination at the partner level and the fees' deductibility related to the partnership transaction.

The taxpayer's claim that because the fees had been billed and paid through their S corporation rendered them not affected items was rejected by the court.

SECTION: 6501
CREDITS CARRIED BACK AFTER RELEASE OF CREDIT FROM NET
OPERATING LOSS CARRYBACK TO LATER YEAR DO OPEN YEAR TO
ASSESSMENT

Citation: CC Email 201008044, 2/26/10

The taxpayer had a net operating loss in year 5 that was carried back to year 3. The loss carryback released foreign tax credits from 3 year, which were then carried back to year 1. Years 3 and 1 were other closed for the assessment of tax. The Chief Counsel's office was asked if year 1 was opened for assessment of tax, which could be used to offset the foreign tax credit being claimed on carryback, or whether that year remained closed for assessment of additional tax.

The Chief Counsel's office held that the refund from year 1 was attributable to a net operating loss carryback and, as such, the year would be open for assessment to offset the claimed refund under §6501(h).

SECTION: 6502
HUSBAND'S FAILURE TO CLAIM SIGNATURE ON STATUTE WAIVER WAS
FORGED UNTIL AFTER STATUTE HAD OTHERWISE EXPIRED
AMOUNTED TO ACCEPTANCE OF WAIVER

Citation: Jordan v. Commissioner, 134 TC No. 1, 1/11/10

The taxpayers argued that while the wife had signed the waiver of the statute of limitations on collection when entering into an installment agreement, the husband's signature was not his. Based on that, they argued, the IRS did not have a valid waiver for either of them and therefore could no longer collect the remaining tax due.

The Tax Court first determined that the party asserting the statute had expired had the burden of proof in the case, citing the *Adler* case (85 TC 535). While *Adler* had been regarding the application of the three year statute on assessments, the court found the same reasoning applied to the ten year statute on collections. The court also found that even if the husband had not signed the waiver, the waiver would still be valid as to the wife who, it was conceded, had signed the form. However, to be enforceable against the husband, he must have signed the form or otherwise was pre-empted from repudiating it.

However, the court found that the taxpayers had not carried their burden of showing the husband had not signed the return. A key factor in the court's decision was the fact that the wife was not called to testify on the issue of whether her husband had signed the return, and the court presumed that was because her testimony would not have been favorable.

But even if the court had determined the husband had not signed the return, he had ratified that signature when he made payments pursuant to the installment agreement, not raising the forgery issue until after the statute had otherwise expired. He accepted the benefit of the IRS not pursuing other collection actions against him while the statute was open, and could not disadvantage the IRS by only bringing up the issue after they could no longer pursue those other options.

SECTION: 6603
INTEREST DUE ON REQUESTS FOR REPAYMENTS OF AMOUNTS THAT REPRESENT EXCESS §6603 DEPOSITS EXPLAINED

Citation: Chief Counsel Notice CC-2010-002, 12/2/09

Taxpayers that end up asking for a refund of the amount of a payment made as a deposit in a tax dispute that turns out to be in excess of the tax actually due may be eligible for interest on that amount, but not based on the standard overpayment interest rules. The Chief Counsel's office explains that if a taxpayer submits an amount no greater than the maximum amount the taxpayer reasonably expects could be due for the items in dispute, interest would be paid under the rules of §6603 rather than the general rules for overpayments under §6611. Such an excess arose from a "disputable tax" as defined by §6603(d)(2)(A).

However, if the taxpayer puts on deposit an amount in excess of the amount that might reasonably be expected to be the maximum tax due on the disputed amounts, no interest is due on any amount that is in excess of that maximum when it is later refunded.

SECTION: 6662

IRS OUTLINES ADEQUATE DISCLOSURE FOR PURPOSES OF §6662 AND §6694

Citation: Revenue Procedure 2010-15, 1/27/10

After not issuing its normally annual revenue procedure regarding disclosures on tax returns in 2009, the IRS returned to issuing the annual document in 2010, applicable for 2009 income tax returns. The document outlines disclosures made on the return that will be deemed to be adequate to escape the penalty for substantial understatement of tax without having to file a Form 8275 or 8275-R for positions that have, at a minimum, a reasonable basis. The requirements are listed generally by form and information type, and describe what items will and will not constitute adequate disclosure.

This year's version of the revenue procedure added description of new schedules required to be filed by Forms 1120 and 1065 filers filing Schedule M-3.

The document outlines what the IRS expects of taxpayers when filling out tax returns forms to properly disclose items and should be reviewed by all individuals who are involved in the *preparation* of tax returns.

SECTION: 6698 & 6699

PENALTIES INCREASED DRAMATICALLY FOR LATE FILED PARTNERSHIP OR S CORPORATION RETURNS

Citation: Worker, Homeowner, and Business Assistance Act of 2009, Sec. 16, 11/6/09

Congress has revisited what has become a recent favorite place to visit to find funds—raising the penalties imposed on late filed partnership and S corporation returns. The penalties for late filed returns for taxable years beginning after December 31, 2009 will be \$195 per partner/shareholder per month or portion of a month. The penalty continues for up to 12 months. This is an increase from the current level of \$89 per month.

SECTION: 6707A
IRS SUSPENDS ENFORCEMENT OF §6707A PENALTIES PENDING
CONGRESSIONAL ACTION TO REVISE PENALTY

Citation: Statement from IRS Commissioner, 3/4/10

The IRS Commissioner, in a statement issued to Congress, has for the fourth time agreed to suspend the imposition of penalties for failure to disclose properly a taxpayer's involvement in either a listed or reportable transaction where the amount of tax savings was less than the penalty prescribed by law. The IRS will suspend such action through June 1, 2010. While measures have been introduced in Congress to modify the penalty so that the penalty would be 75% of the actual or purported tax savings of the transaction, subject to maximum and minimum caps, the bills were stalled in committee when Congress adjourned for the year.

Preparers will need to pay attention to insure that a) the Congress actually enacts revisions to this provision and b) to understand when the revised rules will apply and what penalties will continue to apply. While it seems likely the proposed rules in the bills, the Senate version of which was sponsored by Chairman Baucus and ranking minority member Grassley, will become the law, in the legislative process anything is possible—including finding on June 1 the IRS is being asked yet again to extend their “no action” rule.

SECTION: 6707A
TAX COURT FINDS IT HAS NO JURISDICTION TO REVIEW APPLICATION
OF §6707A PENALTIES

Citation: Smith v. Commissioner, 113 TC No. 18, 12/22/09

The rather significant penalties under §6707A are imposed on a taxpayer that fails to file the appropriate disclosures required by the regulations (generally Form 8886) to report the participation in a reportable or listed transaction. In this case, the Tax Court considers whether it has any jurisdiction to review the imposition of this penalty.

In this particular case, the IRS was asserting the §6707A penalties along with deficiencies of tax related to the years in question. The IRS agreed that the Tax Court had jurisdiction on the taxes, but argued that the Tax Court had no jurisdiction over the §6707A penalties.

Interestingly enough, the Tax Court decided it did not have jurisdiction, but did so not by holding that §6707A(d)(2) (which bars judicial review) was the reason. Rather the Court held that since the penalty did not require a deficiency (it applies based on the lack of disclosure) and did not fit the statutory definition of a deficiency. Because of that fact, the Court found it had no jurisdiction to review the imposition of the penalty.

SECTION: 7216
IRS ISSUES TEMPORARY REGULATIONS ON CERTAIN PERMITTED USES AND DISCLOSURES OF TAX RETURN INFORMATION WITHOUT CLIENT CONSENT

Citation: TD 9478, 12/29/09

The IRS issued temporary regulations modifying the final regulations issued under §7216 that went into affect on January 1, 2009. The IRS looked to modify provisions in Regulation §301.7216-2(n), (o) and (p).

The revisions to §301.7216-2(n) deal with the use of tax return information for the solicitation of tax return business without explicit taxpayer consent. The revised temporary regulation expands the type of information that may be compiled and maintained in a list for solicitation to include individual status and tax return type (such as Form 1040 or Form 1120 clients). The regulations allow the IRS to identify future information that may be included in such a list by publishing guidance in the Internal Revenue Bulletin rather than having to modify the regulation itself.

The regulation expands the definition of tax information that can be provided to taxpayers to specifically include general business or economic information for educational purposes—and that is indicated to specifically cover information explaining current developments in the tax law. As well, the regulations clarify that disclosure of this limited amount of information in conjunction with the sale of the preparer's business includes disclosure in the due diligence phase of a potential acquisition.

The rules allowing disclosures of compilation of taxpayer information for limited purposes under Reg. §301.7216-2(o) are also expanded. Disclosure of such anonymous compilations is allowed in conjunction with bona fide research or public policy discussions concerning taxation. However, the revised regulations specifically prohibit, for marketing or advertising, the disclosure of dollar amounts or percentages of refunds, credit or deductions based on such compilations.

Finally, regulation §301.7216-2(p) is modified to allow the use and disclosure of tax return information to comply with conflict of interest reviews required by governmental agencies or professional association ethics committees, but only to the extent necessary to accomplish the review.

The regulations apply to disclosures or uses of tax return information occurring on or after January 4, 2010. The temporary regulations will expire on or before December 28, 2012.

SECTION: 7701

IRS LIBERALIZES RELIEF FOR LATE ENTITY ELECTIONS UNDER CHECK THE BOX RULES

Citation: Revenue Procedure 2009-41, 9/3/09

The IRS liberalized the rules for automatic late election relief for entity classification elections. For an entity that failed to timely file an election to make or change its entity classification, it can qualify for automatic relief if all returns have been filed consistent with the classification chosen (if any returns have yet been due), the only reason the entity does not have its intended classification is due to the late filing of Form 8832, the entity has reasonable cause for the late filing and the request is filed within 3 years and 75 days of the date the entity intended to have its different classification.

An election under this procedure must be filed on a Form 8832 that includes a declaration that all requirements of the procedure have been met and, until Form 8832 is modified, must have "Filed Pursuant to Rev. Proc. 2009-39" written at the top of the Form 8832. The 8832, the declaration and the reasonable cause statement must be filed with the applicable IRS service center.

SECTION: 7805

FAILURE TO PROPERLY ANSWER QUESTION ABOUT CONTROLLED ENTITIES ALLOWED IRS TO RETROACTIVELY REVOKE PLAN'S DETERMINATION LETTER

Citation: Yarish Consulting Inc. v. Commissioner, TC Memo 2010-174, 8/4/10

A taxpayer established a management S corporation which received management fees from the taxpayer's controlled corporations and a corporation that the taxpayer was selling to a third party. The S corporation sponsored an ESOP that would become the principal owner of the S corporation presumably allowing the income of the S corporation to remain untaxed until the owner took a distribution from the plan.

In its application for a determination that the ESOP was a qualified plan, the taxpayer indicated that the sponsor was not a member of an affiliated service group or a controlled group of corporation, something that was not true. The taxpayer continued to answer similar questions in the same manner on its Form 5500s filed for the plan.

The taxpayer terminated the plan and rolled the value of the ESOP's assets (over \$2.4 million) to an IRA. The 5500 the taxpayer filed for the final year failed to note that the taxpayer had terminated the plan at that time. The IRS eventually examined the plan and, after discovering that the S corporation was a member of an affiliated service group and a controlled group, proposed to disqualify the plan retroactively. As well, the IRS noted that since the S corporation ESOP transaction was a listed transaction, the plan could not take advantage of the EPCRS program to correct its defects.

The taxpayer argued the IRS could not retroactively revoke its determination letter, arguing the errors it committed in answering questions were mere "scrivener's errors" in this case, thus limiting the IRS to only a prospective effect of the revocation of the original determination.

The Tax Court disagreed, holding that there was no mutual mistake of fact between the taxpayer and IRS and rather the taxpayer simply failed to disclose a crucial fact on its initial application, and continued to give that erroneous answer on four straight Forms 5500. Thus, the IRS was not required to limit its action to prospective revocation only, as the taxpayer failed to qualify for relief under §7805(b).