

February 10, 2009

Linda E. Stiff, Deputy Commissioner for Services and Enforcement
Internal Revenue Service
1111 Constitution Avenue, NW
Attention: Jennifer N. Keeney, (202) 622-3060
Washington, DC 20224

By e-mail: jenniferkeeney@irs.counsel.treas.gov

**Re: Comments on Proposed Amendments of Regulations §1.108-7, Reduction of
Attributes**

Dear Ms. Stiff:

The New York State Society of Certified Public Accountants, representing 30,000 CPAs in public practice, industry, government and education, submits the following comments to you regarding the above captioned matter. The NYSSCPA thanks the IRS for the opportunity to comment.

The NYSSCPA's Closely Held and S Corporations Committee deliberated the Proposed Amendments of Regulations §1.108-7, and drafted the attached comments. If you would like additional discussion with us, please contact Stewart Berger, Chair of the Closely Held and S Corporations Committee, at (212) 303-1881, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,


Sharon Sabba Fierstein
President

Attachment



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**COMMENTS ON PROPOSED AMENDMENTS OF REGULATIONS
§1.108-7, *REDUCTION OF ATTRIBUTES***

February 10, 2009

Principal Drafter

David S. Gibson

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New York State Society of Certified Public Accountants

Comments on Proposed Amendments of Regulations §1.108-7

Background

Pursuant to IRC § 1367(a)(1)(A), an S corporation shareholder increases his basis in his S corporation stock by items of income including tax exempt income. In 2001, the Supreme Court ruled that cancellation of indebtedness (“COD”) income which was excluded from income pursuant to IRC § 108 was tax exempt for these purposes and that, accordingly, an S corporation shareholder was allowed to increase his basis in his S corporation stock by the amount of COD income which was excluded from his income (see *Giltitz v. Commr., S. Ct., 2001-1 USTC 50,147*).

Congress reversed this decision as part of the 2002 Jobs Act by amending IRC § 108(d)(7) to effectively conclude that excluded COD income is not an item of income for purposes of IRC §§ 1366 and 1367. Accordingly, excluded COD income is no longer treated as tax exempt and thus does not increase an S corporation shareholder’s stock basis.

COD income which is excluded pursuant to IRC §108(a)(1) must be used to reduce certain tax attributes. Generally speaking, the first attribute which must be reduced is any net operating loss (“NOL”) for the current year and any NOL carryover to such taxable year. To the extent the excluded COD income exceeds the NOLs, other attributes are then reduced according to the ordering rules of IRC § 108(b)(2).

With regard to an S corporation, the rules of IRC § 108 are applied at the corporate level. In addition, any loss or deduction which is disallowed for the taxable year of the debt discharge pursuant to IRC § 1366(d)(1) due to a lack of stock basis is treated as a NOL for such taxable year.

An S corporation may use NOL carryovers from its years as a C corporation in certain instances. For example, an S corporation which has a recognized built-in gain may use NOL carryovers from its C corporation years to offset its recognized built-in gains (IRC § 1374(b)(2)). Proposed regulations have been released in the form of an amendment to current Regulation Section 1.108-7. The purpose of the proposed regulation is to explain how an S corporation reduces its NOL tax attribute under IRC § 108(b) for tax years in which the S corporation has COD income which is excluded from gross income.

The Need for Change

The proposed regulation indicates that, for purposes of reducing the NOL of an S corporation which excludes COD income, the aggregate amount of the shareholders’ losses or deductions that are disallowed for the taxable year of the discharge under IRC § 1366(d)(1), including disallowed losses or deductions of a shareholder that transfers all of the shareholder’s stock in

the S corporation during the taxable year of the discharge, is treated as *the* net operating loss tax attribute (i.e., a “deemed NOL”) of the S corporation for the taxable year of the discharge.

The proposed regulation does not mention anything about NOL carryovers from C corporation years. We believe that the proposed regulation should clarify that a C corporation NOL carryover is also subject to attribute reduction in the case of excluded COD income of an S corporation. We also believe that the proposed regulation should clarify how the attribute reduction is calculated when this situation exists.

Pursuant to IRC § 108(d)(7) and for purposes of determining an S corporation’s NOL attribute which is subject to reduction under IRC §108(b)(2)(A), any loss or deduction which is disallowed for the taxable year of the discharge under IRC §1366(d)(1) shall be treated as a NOL for such taxable year. IRC §108(b)(2)(A) states that any NOL for the taxable year of the discharge and any NOL carryover to such taxable year is an NOL which is subject to attribute reduction. There is no distinction in the IRC between an S corporation NOL carryover and a C corporation NOL carryover. Therefore, it is reasonable to conclude that an S corporation’s NOL carryovers from C corporation years are subject to attribute reduction. However, the statute does not indicate how the reduction is applied in this situation or in what order such reduction would be applied.

Based on the proposed regulations, the IRS appears to ignore the possibility of C corporation NOL carryovers in its analysis. As indicated earlier, the proposed regulations state that the disallowed losses and deductions of the shareholders would be the only NOL of the corporation and, thus, it is not clear what the IRS would do in the case of an S corporation which has NOL carryover from a C corporation taxable year.

Conclusion

Based on IRC §108(b)(2)(A), any NOL of a corporation should be subject to attribute reduction for a corporation which has excluded COD income in a taxable year. The proposed regulations regarding the attribute reduction of NOLs as applied to an S corporation do not deal with the situation of an S corporation with NOL carryovers from a C corporation taxable year. We believe the proposed regulations should include this clarification before the regulations are finalized. We believe that this clarification would prevent many unintended results and would also prevent potential conflicts between taxpayers and IRS agents who might interpret the regulation differently. We believe that it is extremely important to deal with this matter expeditiously in light of the current economic conditions; this issue could be relatively commonplace as more and more businesses seek to restructure debt.