



Section 108 Proposed S Corporation Regulations  
August 11 ,2008



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## **Section 108 and the S Corporation**

The IRS has released proposed regulations to deal with IRC §108(d)(7)(B) and reduction of the S Corporation “deemed net operating” loss when the S corporation as excluded relief of indebtedness income under one of the provisions of Section 108 and is looking to reduce tax attributes. These proposed regulations deal with the quirk that the attribute being reduced (carryover losses under §1366(d)(1)) are an attribute of the individual shareholders and not the corporation itself.

The regulation deals with a provision added by Congress in 2002 in response to the Supreme Court's decision in the *Gitlitz* decision (531 U.S. 206) to reverse the result in that case and not allow S corporation shareholders to “double dip” by getting to exclude indebtedness under one of the exceptions in §108 and then still obtain an increase in basis from the nontaxable income. Part of that provision required S shareholders to reduce their carryover losses as a substitute to the normal reduction of net operating losses under §108(b)(2)(A).

With talk of “short sales” in various real estate ventures as well as simple foreclosures, the subject of Section 108 in general has become a timely topic.

## Section 108 and the S Corporation

IRC §108 deals with income from the forgiveness of debt. In general, a forgiveness of debt is income under IRC §61, but §108 provides for certain cases that income can be excluded from income. §108(a) provides the outline of the exceptions

**108(a)(1) IN GENERAL. --**

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if --

- (A) the discharge occurs in a title 11 case,
- (B) the discharge occurs when the taxpayer is insolvent,
- (C) the indebtedness discharged is qualified farm indebtedness,
- (D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or
- (E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2010.

“Discharge in a title 11 case” refers to debts discharged in bankruptcy. The second option provides the same benefit from an insolvent taxpayer who has debt forgiven outside of a formal bankruptcy case, and the last three deal with more isolated special cases (the last one added at the end of last year).

However, taxpayers who get to exclude amounts from income under one of the first three exceptions have to deal with a side effect—they have to reduce certain tax attributes.

**108(b)(1) IN GENERAL. --**The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

The attributes to be reduced are listed, in order, in §108(b)(2)

**108(b)(2) TAX ATTRIBUTES AFFECTED; ORDER OF REDUCTION. --**  
Except as provided in paragraph (5), the reduction referred to in paragraph (1)

shall be made in the following tax attributes in the following order:

(A) NOL. --Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) GENERAL BUSINESS CREDIT. --Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) MINIMUM TAX CREDIT. --The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) CAPITAL LOSS CARRYOVERS. --Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(E) BASIS REDUCTION. --

(i) IN GENERAL. --The basis of the property of the taxpayer.

(ii) CROSS REFERENCE. --

For provisions for making the reduction described in clause (i), see section 1017.

(F) PASSIVE ACTIVITY LOSS AND CREDIT CARRYOVERS. --Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) FOREIGN TAX CREDIT CARRYOVERS. --Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

S Corporations, of course, present certain problems with that ordering. Many other business taxpayers who have this particular “problem” have been having a number of other financial issues, and generally face a significant net operating loss. But an S corporation presents a different situation in most cases—if the S corporation had significant outside debt, it likely has created losses in excess of the basis the shareholders have in the S corporation, thus triggering suspended losses under §1361 at the

shareholder level.

In light of this fact, Congress decided to use a somewhat different “stand in” for the net operating loss in the case of an S corporation. That rule is found in IRC §108(d)(7) which provides

108(d)(7) SPECIAL RULES FOR S CORPORATION. --

(A) CERTAIN PROVISIONS TO BE APPLIED AT CORPORATE LEVEL. --In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section.

(B) REDUCTION IN CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS. --In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

(C) COORDINATION WITH BASIS ADJUSTMENTS UNDER SECTION 1367(b)(2). --For purposes of subsection (e)(6), a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2).

§108(d)(7)(B) is the provision we're concerned with today. The loss disallowed under §1366(d)(1) would include both excess losses incurred in the current year and prior year losses disallowed under the same section that flowed into the current year. As with the net operating loss, you do get the use of the losses for the year of discharge, but it's the attribute flowing out to the following year that is impacted.

## The Devil is in the Details

While this transfer to the shareholder sounds simple in theory, in reality things may not be so simple. Different shareholder may have very different levels of disallowed losses, and the regulations have to deal with how we handle this multiple shareholder situation.

The first situation that is discussed in the preamble is how we should handle a shareholder that disposed of his/her shares during the year. The preamble notes

The proposed regulations clarify that the S corporation's deemed NOL includes all losses and deductions disallowed under section 1366(d)(1) for the taxable year of the discharge, including disallowed losses and deductions of a shareholder that had transferred all of the shareholder's stock in the S corporation during such year.

Proposed Regulation §1.108-7(d)(1) specifically holds:

*(d) Special rules for S corporations --(1) In general .* If an S corporation excludes COD income from gross income under section 108(a)(1)(A), (B), or (C), the amount excluded shall be applied to reduce the S corporation's tax attributes under paragraph (a)(1) of this section. For purposes of paragraph (a)(1)(i) of this section, the aggregate amount of the shareholders' losses or deductions that are disallowed for the taxable year of the discharge under section 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 (deemed NOL) of the S corporation for the taxable year of the discharge.

Having added up the total deemed NOL and compared it with the cancellation of debt (COD) income, if the deemed NOL is larger than Proposed Regulation §1.108-7(d)(2)(i) governs:

*(2) Allocation of excess losses or deductions --(i) In general .* If the amount of an S corporation's deemed NOL exceeds the amount of the S corporation's COD income that is excluded from gross income under section 108(a)(1)(A), (B), or (C), the excess deemed NOL shall be allocated to the shareholder or shareholders of the S corporation as a loss or deduction that is disallowed under section 1366(d) for the taxable year of the discharge.

What this is stating, in a backdoor way, is that the excess “takes over” for the regular computation under §1366(d), so that the amount that is not in excess essentially “disappears” as a carryover for the taxpayer.

Multiple shareholders add complications, and Proposed Regulation §1.108-7(d)(2)(ii) governs this case:

*(ii) Multiple shareholders --(A) In general .* If an S corporation has multiple shareholders, to determine the amount of the S corporation's excess deemed NOL to be allocated to each shareholder under paragraph (d)(2)(i) of this section, calculate with respect to each shareholder the shareholder's excess amount. The

shareholder's excess amount is the amount (if any) by which the shareholder's losses or deductions disallowed under section 1366(d)(1) (before any reduction under paragraph (a)(1) of this section) exceed the amount of COD income that would have been taken into account by that shareholder under section 1366(a) had the COD income not been excluded under section 108(a).

Now we have to do a shareholder by shareholder computation, looking at the COD income that would have passed to the shareholder and been taxable, and compare that to the shareholders §1366(d) disallowed losses computed under the regular rules. Each shareholder computes his/her own excess amount, and those that end up with an excess next look to Proposed Regulation §1.108-7(d)(2)(ii)(B)

(B) Shareholders with a shareholder's excess amount . Each shareholder that has a shareholder's excess amount, as determined under paragraph (d)(2)(ii)(A) of this section, is allocated an amount equal to the S corporation's excess deemed NOL multiplied by a fraction, the numerator of which is the shareholder's excess amount and the denominator of which is the sum of all shareholders' excess amounts.

Note that this will not necessarily cause a shareholder to end up with amount of his/her computed excess unless *all* shareholders end up with an excess. If any shareholder ends up not having an excess, then the total individual shareholder excesses for those with an excess will exceed the the S Corporation's excess deemed NOL, and thus each shareholder with an excess will end up with a lower amount for the carryover than the simple excess.

As you would expect, shareholders without an excess end up with no carryover. Proposed Regulation §1.108-7(d)(2)(ii)(C) holds

(C) Shareholders with no shareholder's excess amount . If a shareholder does not have a shareholder's excess amount as determined in paragraph (d)(2)(ii)(A) of this section, none of the S corporation's excess deemed NOL shall be allocated to that shareholder.

A terminating shareholder who gets allocated a portion of the excess NOL simply has a permanently disallowed item unless the transfer took place under §1041(a) (transfers between spouses or incident to a divorce).

(iii) Terminating shareholder . Any amount of the S corporation's excess deemed NOL allocated under paragraph (d)(2) of this section to a shareholder that had transferred all of the shareholder's stock in the corporation during the taxable

year of the discharge is permanently disallowed under §1.1366-2(a)(5), unless the transfer of stock is described in section 1041(a). If the transfer of stock is described in section 1041(a), the amount of the S corporation's excess deemed NOL allocated to the transferor under paragraph (d)(2) of this section shall be treated as a loss or deduction incurred by the corporation in the succeeding taxable year with respect to the transferee. See section 1366(d)(2)(B).

Reg. §1.1366-2(a)(5) referred to above holds that, generally, an S corporation's losses are not transferred to a new shareholder.

Proposed Regulation §1.108-7(d)(3) gives us information on the nature of the new loss carryover, establishing an "ordering" for how the losses go away when a portion of them are eliminated under these provisions.

(3) Character of excess losses or deductions allocated to a shareholder . In determining the character of the amount of the S corporation's excess deemed NOL allocated to a shareholder under paragraph (d)(2) of this section, any ordinary loss or deduction that was included in the shareholder's aggregate amount of disallowed losses or deductions under section 1366(d)(1) is treated as reduced under section 108(b) before any section 1231 loss that was included in the shareholder's aggregate amount of disallowed losses or deductions under section 1366(d)(1), and any section 1231 loss is treated as reduced under section 108(b) before any capital loss that was included in the shareholder's aggregate amount of disallowed losses or deductions under section 1366(d)(1).

We first lose any ordinary losses, followed by §1231 losses and finally offset any capital losses. That is, we compute the losses we would have had available without this provision under the standard rules for a §1366(d) loss, and then start reducing the losses in the above order until we are down to the amount of excess NOL allocated to the shareholder.

The proposed regulations provide that when this situation arises, there is mandatory reporting both by the S corporation and the individual shareholders.

(4) Information requirements . If an S corporation excludes COD income from gross income under section 108(a) for a taxable year, each shareholder of the S corporation during the taxable year of the discharge must provide to the S corporation the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under section 1366(d)(1). The S corporation must provide to each shareholder the amount of any of the S corporation's excess deemed NOL that is allocated to that shareholder under paragraph (d)(2) of this section, even if that amount is zero.

This provision may raise a number of practical problems if it is not modified in the final regulations. Quite often this problem will arise in the case of a financially troubled S corporation, and relations between the corporation and the various shareholders, as well as among the various shareholders may be strained—or matters may even be in litigation. If a shareholder refuses to provide the necessary information, it's not clear what would happen, though in the worst case it is possible that no one might end up with an excess.

Similarly, does the S corporation have the right or obligation to investigate each shareholder's claimed amount of §1366(d)(1) loss carryover? Obviously, it's in the shareholders best interests to claim they have more such loss carryover in order to “attract” the NOL to them. Similarly, shareholders may not have kept good records of their basis, and it's possible if the shares were transferred that the corporation has no way to independently calculate the basis. Or, perhaps worse, the corporation may be able to calculate and determine that the shareholder's calculation is in error.

It's also not clear when this reporting would take place—a shareholder would have to know the information generally contained on the K-1 in order to calculate their otherwise disallowed §1366(d)(1) loss. So if that has to go out on the K-1, it would seem the corporation has to essentially create two K-1s.

## IRS Examples

The IRS does give two examples of applying these regulations. The facts for the first example are listed by the IRS as follows:

Example 5 . (i) Facts . During the entire calendar year 2008, A, B, and C each own equal shares of stock in X, a calendar year S corporation. As of December 31, 2008, A, B, and C each have a zero stock basis and X does not have any indebtedness to A, B, or C. For the 2008 taxable year, X excludes from gross income \$30,000 of COD income under section 108(a)(1)(A). The COD income (had it not been excluded) would have been allocated \$10,000 to A, \$10,000 to B, and \$10,000 to C under section 1366(a). For the 2008 taxable year, X has \$30,000 of losses and deductions that X passes through pro-rata to A, B, and C in the amount of \$10,000 each. The losses and deductions that pass through to A, B, and C are disallowed under section 1366(d)(1). In addition, B has \$10,000 of section 1366(d) losses from prior years and C has \$20,000 from prior years. A's (\$10,000), B's (\$20,000) and C's (\$30,000) combined \$60,000 of disallowed losses and deductions for the taxable year of the discharge are treated as a current year net operating loss tax attribute for X under section 108(d)(7)(B) (deemed NOL) for purposes of the section 108(b) reduction of tax attributes.

The allocation is explained as follows:

(ii) Allocation . Under section 108(b)(2)(A), X's \$30,000 of excluded COD income reduces this \$60,000 deemed NOL to \$30,000. Therefore, X has a \$30,000 excess net operating loss (excess deemed NOL) to allocate to the shareholders. Under paragraph (d)(2)(ii)(C) of this section, none of the \$30,000 excess deemed NOL is allocated to A because A's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction (\$10,000) do not exceed A's share of the excluded COD income for 2008 (\$10,000). Thus, A has no shareholder's excess amount. Each of B's and C's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of B's and C's respective shares of the excluded COD income for 2008. B's excess amount is \$10,000 (\$20,000 - \$10,000) and C's excess amount is \$20,000 (\$30,000 - \$10,000). Therefore, the total of all shareholders' excess amounts is \$30,000. Under paragraph (d)(2) of this section, X will allocate \$10,000 of the \$30,000 excess deemed NOL to B ( $\$30,000 \times \$10,000 / \$30,000$ ) and \$20,000 of the \$30,000 excess deemed NOL to C ( $\$30,000 \times \$20,000 / \$30,000$ ). These amounts are treated as losses and deductions disallowed under section 1366(d)(1) for the taxable year of the discharge. Accordingly, at the beginning of 2009, A has no section 1366(d)(2) carryovers, B has \$10,000 of carryovers, and C has \$20,000 of carryovers.

Finally, the IRS addresses the nature of the carryovers

(iii) Character . Immediately prior to the section 108(b)(2)(A) reduction, B's \$20,000 of section 1366(d) losses and deductions consisted of \$8,000 of long-term capital losses, \$7,000 of section 1231 losses, and \$5,000 of ordinary losses. After the section 108(b)(2)(A) tax attribute reduction, X will allocate \$10,000 of the excess deemed NOL to B. Under paragraph (d)(3) of this section, the \$5,000 of ordinary losses are treated as reduced first, followed by \$5,000 of section 1231 losses. Accordingly, the \$10,000 of losses allocated to B consist of the remaining \$2,000 of section 1231 losses and \$8,000 of long-term capital losses. As a result, at the beginning of 2009, B's \$10,000 of section 1366(d)(2) carryovers include \$2,000 of section 1231 losses and \$8,000 of long-term capital losses.

The next example outlines the situation in a year in which a shareholder also transfers her interest. The facts are as follows:

Example 6 . (i) A and B each own 50 percent of the shares of stock in X, a calendar year S corporation. On June 30, 2008, A sells all of her shares of stock

in X to C in a transfer not described in section 1041(a). For the 2008 taxable year, X excludes from gross income \$12,000 of COD income under section 108(a)(1)(A). The COD income (had it not been excluded) would have been allocated \$3,000 to A, \$6,000 to B, and \$3,000 to C under section 1366(a). Prior to the section 108(b)(2)(A) reduction, for the taxable year of the discharge the shareholders have disallowed losses and deductions under section 1366(d) (including disallowed losses carried over to the current year under section 1366(d)(2)) in the following amounts: A- \$9,000, B- \$9,000, and C- \$2,000. These combined \$20,000 of disallowed losses and deductions for the taxable year of the discharge are treated as a current year net operating loss tax attribute for X under section 108(d)(7)(B) (deemed NOL).

(ii) Under section 108(b)(2)(A), X's \$12,000 of excluded COD income reduces the \$20,000 deemed NOL to \$8,000. Therefore, X has an \$8,000 excess net operating loss (excess deemed NOL) to allocate to the shareholders. Under paragraph (d)(2)(ii)(C) of this section, none of the \$8,000 excess deemed NOL is allocated to C because C's section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction (\$2,000) do not exceed C's share of the excluded COD income for 2008 (\$3,000). However, each of A's and B's respective section 1366(d) losses and deductions immediately prior to the section 108(b)(2)(A) reduction exceed each of A's and B's respective shares of the excluded COD income for 2008. A's excess amount is \$6,000 (\$9,000 - \$3,000) and B's excess amount is \$3,000 (\$9,000 - \$6,000). Therefore, the total of all shareholders' excess amounts is \$9,000. Under paragraph (d)(2) of this section, X will allocate \$5,333 of the \$8,000 excess deemed NOL to A ( $\$8,000 \times \$6,000 / \$9,000$ ) and \$2,667 of the \$8,000 excess deemed NOL to B ( $\$8,000 \times \$3,000 / \$9,000$ ). However, because A transferred all of her shares of stock in X in a transaction not described in section 1041(a), A's \$5,333 of section 1366(d) losses and deductions are permanently disallowed under paragraph (d)(2)(iii) of this section. Accordingly, at the beginning of 2009, B has \$2,667 of section 1366(d)(2) carryovers and C has no section 1366(d)(2) carryovers.

It's useful to note that even though A “lost” the carryover, that carryover would have been lost anyway. However, B, even though having \$3,000 of “excess” losses only was allocated \$2,667, effectively “losing” \$333 due to the fact that C had no excess—thus total excess at the shareholder level exceeded the corporation's overall excess NOL.

## Conclusions

Note that this is, at the moment, a proposed regulation and the IRS is asking for comments through November. As well, the IRS did not issue these as temporary

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regulations at the same time, so right now they are prospective only. But considering the number of taxpayers facing §108 issues this year, the topic may be one many of us will end up dealing with.