

TaxClinic

PRACTICAL ADVICE ON CURRENT ISSUES

In This Department

ACCOUNTING METHODS & PERIODS

- IRS issues second directive on gift cards; p. 6.

CORPORATIONS & SHAREHOLDERS

- Final unified loss rule published; p. 8.
- IRS issues guidance on Sec. 382 for corporations in the Capital Purchase Program; p. 11.

CREDITS AGAINST TAX

- Research credit extended; p. 11.

DEPRECIATION

- IRS issues guidance on electing out of 50% additional first-year depreciation; p. 12.

FOREIGN INCOME & TAXPAYERS

- Automatic penalty assertions begin for delinquent Forms 5471; p. 15.

GAINS & LOSSES

- Lenders allowed nonrecognition treatment for certain securities loans terminated due to bankruptcy; p. 15.

INDIVIDUALS

- Effects of Emergency Economic Stabilization Act provisions on individuals; p. 15.

S CORPORATIONS

- Final Sec. 1367 regs. address open account debt between S corps. and their shareholders; p. 18.

ACCOUNTING METHODS & PERIODS

IRS Issues Second Directive on Gift Cards

The IRS has issued a second industry director directive (IDD No. 2) (LMSB 4-0808-042) on gift cards and gift certificates, elevating the use of a separate gift card company (Giftco) to administer a taxpayer's gift card or certificate program to Part A status and providing more information on issues categorized as Part B.

IDD No. 1 (LMSB-04-0507-039), issued on May 23, 2007, classified gift card "variations and problems" into two categories, Part A and Part B. Part A includes compliance with regulations, accounting method changes, and the use of estimates. Part A concerns must be raised on examination, and contact must be made with a Food and Beverage or a Retail technical adviser for coordination of the issue. (For more on IDD No. 1, see Suttora and Mortenson, "Gift Card and Gift Certificate Income Deferral," *Tax Clinic*, 39 *The Tax Adviser* 333 (June 2008).)

Planning and Examination Guidance: Part A

IDD No. 2 states that the question of a taxpayer's use of a separate legal entity to administer its gift card or certificate program is now elevated to Part A status and accorded Part A treatment. The primary concern is whether the entity has goods for sale in the ordinary course of its trade or business and is therefore eligible to elect a deferral method of reporting gift card income under Regs. Sec. 1.451-5 or Rev. Proc. 2004-34.

Contributors are members of or associated with Ernst & Young LLP.

For additional information about these items, contact Mr. Kautter at (202) 327-8878 or david.kautter@ey.com.

The directive refers examiners to field attorney advice (FAA) 20082801F, released on July 11, 2008, which provides a legal analysis of a specific case.

Planning and Examination Guidance: Part B

In addition to elevating the Giftco matter to Part A status, the IRS has also updated the issues under Part B in a question and answer format. Part B covers the following topics:

Gift cards versus gift certificates: The IRS explains that gift cards and gift certificates are the same for purposes of Regs. Sec. 1.451-5. If a taxpayer treats gift cards differently from gift certificates, the IRS advises an examiner to raise the issue with one of the Retail or Food and Beverage technical advisers.

Reloadable gift cards: If a taxpayer's gift cards are reloadable, the IRS tells examiners to verify that the taxpayer's accounting system and software take into account the actual dates when money is added to the card for purposes of income deferral.

Deposits: The IRS takes the position that gift card or certificate income is not a deposit that is excludible from income. If a taxpayer excludes from taxable income gift card or certificate proceeds as deposits, the IRS advises examiners to bring the issue to the attention of one of the Retail or Food and Beverage technical advisers.

Gift cards as refunds: The IRS is still formulating a position on whether a taxpayer may treat the issuance of a gift card for returned merchandise, in lieu of a cash refund, as equivalent to a sale of a gift card but indicates that a Retail or Food and Beverage technical adviser should be contacted in such cases.

Dormancy fees: The IRS's position is that a taxpayer may not report as income dormancy or latency fees that are charged against the gift card or certificate. Examiners will need to verify that the income is properly reported when dormancy, latency, or other administrative fees may be incurred on a taxpayer's gift cards or certificates.

Escheatment to states: Some taxpayers are arguing that they do not have to recognize income on unredeemed gift cards

until the earlier of redeeming the gift card/certificate or turning over the balances to a state. The IRS points out that a technical adviser can help examiners determine whether the taxpayer's position is in accord with the income deferral methodology under Regs. Sec. 1.451-5. (For more on the impact of state escheat laws on gift cards, see Kile and Wall, "States Bite into Broken Gift Cards," 206 *Journal of Accountancy* 76 (December 2008).)

Bulk sales discounts: If sales discounts on gift cards are not expensed in direct relationship to the recognition of income from the cards, the IRS advises examiners to contact a technical adviser, who will help determine whether the taxpayer's treatment of expensing discounts while deferring the income from the related gift cards is an improper acceleration of the deduction under Sec. 461(h).

Promotion gift cards: When gift cards are given away by the taxpayer, the IRS takes the position that the advertising expense is a deferred expense because the credit is to a deferred income account. However, the IRS notes that examiners need to consider whether the deferred advertising expense should be recognized under the provisions of Regs. Sec. 1.446, the clear reflection of income standard, and Sec. 461 in determining when the advertising expense is deductible.

Charitable contribution of gift cards: The IRS indicates that facts would have to be ascertained to establish whether the donated gift card has been redeemed and the item has been released from inventory through cost of goods sold. A technical adviser may aid examiners in determining when liability becomes fixed and economic performance occurs to entitle the taxpayer to a deduction.

Estimated cost of goods sold: Taxpayers using the deferral method of income recognition have asserted that they are entitled to a cost of goods sold deduction for the unredeemed gift cards that they include in income two years after the sale of the gift card. The IRS states, however, that Regs. Sec. 1.451-5(c)(1)(iii) provides that the deduction for cost of sales does not apply if the



goods for which the advance payments are received are not identifiable. Therefore, in a typical situation, a taxpayer is not allowed to reduce its cost of goods sold until the goods are shipped or otherwise identified to the contract because it is not known which products will be ordered.

Other legal entities and franchisor/franchisees: The IRS is currently formulating a position on how its position on Giftco applies to other legal entities, such as partnerships, S corporations, and franchisors and franchisees.

Expiration date: The IRS asserts that if a taxpayer is using the income deferral procedures under Regs. Sec. 1.451-5, gift card income must be recognized on the expiration date if it is earlier than two years after the sale of the gift card.

Rev. Proc. 2004-34: Regs. Sec. 1.451-5 provides income deferral for advance payments of goods for up to two years after the gift card sale, while Rev. Proc. 2004-34, which provides a one-year deferral, covers sales of goods, services, and mixtures of goods and services. The IRS states that taxpayers may be able to defer qualifying advance payments under the regulations or the revenue procedure.

Not-for-profit entities: Some taxpayers have argued that they will use all gift card income to satisfy future redemptions and therefore no profit or loss is recorded. If a gift card company is set up as a not-for-profit entity, all other income will never

be recognized for tax purposes. They cite *Seven-Up Co.*, 14 T.C. 965 (1950), to support the argument that they are only holding gift card sale revenues as a fund to satisfy the liabilities of others. The IRS advises examiners to contact technical advisers for assistance on this topic.

Intermediaries: Technical advisers are uncertain as to the scope of issues involving the use of third-party intermediaries to sell gift cards, but the IRS advises examiners to contact technical advisers if they encounter them.

Implications

This second directive covers a range of concerns related to the broadly defined Tier II gift card/deferral of income issue. Interestingly, the IRS had previously posted to its website a second gift card directive (on September 12, 2008), but shortly thereafter removed it without explanation. It now appears that the September 12 directive was a draft posted in error. The final version, released on October 3, contains a number of substantive revisions. The September 12 draft set forth positions on many of the items noted above, while the final version identifies the potential issue but advises examiners to consult a technical adviser, indicating that the IRS has not fully developed its position for a number of these items.

The directive also confirms the differences in procedural treatment to which the various gift card issues will be subject, depending on whether the topic falls under Part A or Part B. While issues under Part A are mandatory examination items and require coordination with the appropriate technical advisers, taxpayers should nonetheless be aware that examiners auditing any concern related to gift cards will likely contact the appropriate technical advisers for guidance.

From Jane Rohrs, CPA, Washington, DC

CORPORATIONS & SHAREHOLDERS

Final Unified Loss Rule Published

In final regulations (T.D. 9424), the Service has addressed the tax consequences of a member's transfer of loss shares of subsidiary stock. The final regulations adopt the

unified loss rule (ULR) contained in the proposed regulations (REG-157711-02), with modifications, and generally apply to transfers made on or after September 17, 2008.

The portion of the proposed regulations (Prop. Regs. Secs. 1.1502-13(e)(4) and 1.1502-32(c)(1)(ii)) addressing the application of Sec. 362(e)(2) to certain intercompany transactions is withdrawn, and the final regulations instead provide that, subject to an anti-avoidance rule, Sec. 362(e)(2) generally does not apply to transactions between consolidated group members.

The final regulations adopt numerous related and unrelated regulatory amendments, so only the most significant aspects are summarized below.

Timing

The final regulations clarify that the ULR applies when a member transfers a share of subsidiary stock and, after taking the effects of all applicable rules into account (including those that would not apply until after the transfer), the transferred share is a loss share. While the determination of whether a transferred share is a loss share is made as of the transfer, the ULR applies as a whole, and any required adjustments under that rule are given effect, immediately before the transfer.

Deferred Recognition Transfers

The final regulations coordinate application of the ULR with Regs. Sec. 1.1502-13's intercompany transaction provisions. If a member transfers a share of subsidiary stock intercompany under Regs. Sec. 1.1502-13, the ULR applies to the transfer and any subsequent transfer when the intercompany item is taken into account and by treating the buying and selling members as divisions of a single corporation. Thus, appropriate adjustments will be made to intercompany item(s) and any member's basis in the subsidiary's share and/or attributes. Notwithstanding the final regulations' coordination with intercompany transfers, other rules that defer the loss recognized on the sale of subsidiary stock generally do not defer application of the ULR.

Basis in Lower-Tier Stock

The Service considered several suggestions for simplifying application of the

ULR to lower-tier stock, such as applying the rules based solely on the net inside attributes of lower-tier subsidiaries (the look-through approach), but they were rejected because including lower-tier stock basis in the ULR determinations better protects taxpayers' interests while also providing adequate protections against abuse.

Nevertheless, the government is sympathetic to the difficulties. Various proposals remain under consideration and comments are requested.

Adjustments for Sec. 362(e)(2) Transactions

The final regulations provide that Sec. 362(e) generally does not apply to (1) intercompany transactions occurring on and after September 17, 2008, and (2) prior intercompany transactions, if the taxpayer chooses to apply the rules in the final regulations. The ULR retains rules for coordination with basis reductions required by Sec. 362(e)(2).

Transition Period

Consistent with Notice 2008-9, the final regulations provide that the final ULR applies to transfers on or after September 17, 2008, unless the transfer is made under a binding agreement between unrelated parties that was in effect before that date and at all times thereafter. Under the final regulations, the term "related party" has the same meaning as in Sec. 267(b).

Redetermination of Subsidiary Stock Basis

The final ULR does not reallocate positive investment adjustments applied to a subsidiary's preferred shares under Regs. Sec. 1.1502-32 because these adjustments are generally based on economic changes in the shareholder's investment. Reallocation of remaining investment adjustments is designed to reduce or eliminate artificial loss and loss duplication from transferred loss shares.

Two exceptions to the basis redetermination rule significantly limit its applicability. First, no redetermination is required if members' bases in shares of S common stock are equal (that is, there is no disparity) and members' bases in shares of S preferred stock reflect no gain

or loss. Second, no redetermination is required if, in one fully taxable transaction: (1) members dispose of their entire interest in S stock to one or more nonmembers; (2) all members' shares of S stock become worthless; or (3) all members' shares of S stock are either worthless or disposed of to one or more nonmembers. Notwithstanding this latter exception, taxpayers can elect to redetermine basis (e.g., because it reduces gain or avoids the ULR for upper-tier shares).

When it applies, basis is redetermined in a manner that reduces the extent to which there is disparity in members' bases, and "the overall application of the rule must reduce disparity among members' bases in preferred shares of subsidiary stock (as provided in the applicable reallocation provisions) and among members' bases in common shares of subsidiary stock, to the greatest extent possible" (T.D. 9424 preamble, §B(iii)).

Disallowance of Subsidiary Artificial Stock Loss

The final ULR effectively disallows loss on the transfer of a share of subsidiary stock by reducing the share's basis immediately before a transfer, based on the lesser of two factors with respect to the share: (1) its net positive investment adjustment and (2) its disconformity amount. In computing disconformity, the final regulations clarify that the term "loss carryovers" means losses that are attributable to the subsidiary, including any losses that would be apportioned to it under the principles of Regs. Sec. 1.1502-21(b)(2) if it had a separate return year. Because a waiver under Regs. Sec. 1.1502-32(b)(4) affects only the extent to which a loss can be duplicated, the final regulations disregard this waiver for purposes of the disconformity amount (i.e., it is taken into account only "for purposes of applying the attribute reduction rule").

Limitations on Loss Duplication

To simplify the ULR provisions limiting duplication of subsidiary stock loss:

1. No attribute reduction is required if the total attribute reduction amount is less than 5% of the aggregate value of the

subsidiary shares that are transferred by members in the transaction; and

2. Taxpayers can elect not to apply the conforming limitation or the basis restoration provisions that operate to protect them (e.g., if their protections are outweighed by their administrative burden).

Taxpayers may nevertheless elect to apply the attribute reduction rule (i.e., to take advantage of the rule permitting the reattribution of subsidiary loss).

When it is required, the first attributes reduced are losses and deferred deductions in Categories A, B, and C (capital loss carryovers, net operating loss (NOL) carryovers, and deferred deductions, respectively), and the taxpayer may specify the allocation of attribute reduction amount among the attributes in those categories. If no order is specified, a default rule provides the following order of reduction: capital loss carryovers (oldest to newest); NOL carryovers (oldest to newest); and deferred deductions (proportionately).

The next attribute reduced is asset basis in Category D other than Class I assets (cash and general deposit accounts, other than certificates of deposit held in depository institutions), and the reduction applies in the reverse order of asset classes specified in Regs. Sec. 1.338-6(b). But the attribute reduction amount applied to Category D must first be allocated between the subsidiary's basis in any stock of lower-tier subsidiaries (treating all shares of any one lower-tier subsidiary as a deemed single share) and its other assets (treating the nonstock Category D assets as one asset) in the ratio of their basis. Only the portion not allocated to lower-tier subsidiary stock is applied under the reverse residual method.

If the attribute reduction amounts exceed the amount of reducible attributes, the excess is suspended and applied to reduce or eliminate subsequent attributes arising when the subsidiary or any other person takes the liabilities into account.

To promote flexibility, the final regulations allow taxpayers to elect to (or make a protective election to) reduce stock basis or reattribute attributes, or a combination thereof, in any amount that does not exceed the attribute reduction amount.

Attribute Reduction for Certain Dispositions

A special attribute elimination rule applies if:

1. A member transfers subsidiary stock solely by reason of treating the stock as worthless under Sec. 165, the subsidiary remains a member of the group, and the member has a deduction or recognizes a loss on the transfer; or
2. A member transfers subsidiary stock as a result of the subsidiary ceasing to be a member, the subsidiary has no separate return year, and the member recognizes a net deduction or loss on the transfer.

In either scenario, the subsidiary's NOL carryovers, capital loss carryovers, and deferred deductions (including its share of the consolidated tax attributes) that are not otherwise reduced or reattributed, and the subsidiary's credits (including its share of consolidated credits), are eliminated.

A parallel provision in Regs. Sec. 1.1502-19 applies these two principles to excess loss accounts and similarly eliminates the subsidiary's tax attributes. The final regulations also provide that the elimination of attributes is not a noncapital, nondeductible expense under Regs. Sec. 1.1502-32.

Changes to Other Sections

Dispositions before September 17, 2008, that were subject to Regs. Sec. 1.1502-35 remain subject to the loss suspension and anti-loss reimportation rules of that regulation. A clarification provides that, if a loss is suspended under Regs. Sec. 1.1502-35(c) and the member with the suspended loss ceases to be a member, then immediately before it ceases to be a member, the common parent is treated as succeeding to the suspended loss under Sec. 381. Another clarification addresses how the 10-year period under the loss anti-reimportation rule is computed.

Uniform amendments are made to the whole-group exceptions in Regs. Secs. 1.1502-13(j)(5), 1.1502-19(c)(3), and 1.1502-33(e)(2), applying them without regard to whether the acquirer is a consolidated group member before the acquisition. Taxpayers may choose to apply each

of those modified whole-group exceptions retroactively.

An overarching rule to prevent duplicative adjustments, inclusions, and all similar items is added in Regs. Sec. 1.1502-80(a). It provides that, in determining the application of any specific rule, the purposes of the provisions and single-entity principles are taken into account.

Implications

The final regulations adopt the general approach of the proposed regulations, with helpful modifications. For example, taxpayers may make protective elections that will limit the effect of the loss duplication rules on unsuspecting buyers and have greater administrability and flexibility in identifying the attributes to be reduced (e.g., allowing taxpayers to specifically identify the reduced losses).

By making Sec. 362(e)(2) inapplicable, the final regulations generally eliminate the complex rules for Sec. 362(e)(2) that would have required specialized valuation and tracing of investment adjustments. Instead, the final regulations rely on the generally applicable investment adjustment rules and ULR to police loss duplication, and they add only a specific anti-avoidance rule.

Nevertheless, the final regulations remain quite complex, particularly in the context of lower-tier subsidiaries. The government considered simplification approaches (for example, the lookthrough approach) but rejected them because the more detailed approach better protects taxpayers' interests while also providing adequate protections against abuse. To comply with these new rules, however, taxpayers must now engage in a whole new set of complicated asset and stock basis calculations.

From Martin Huck, J.D., LL.M., Washington, DC

IRS Issues Guidance on Sec. 382 for Corporations in the Capital Purchase Program

The IRS has issued guidance (Notice 2008-100) on the application of Sec. 382 to loss corporations whose instruments Treasury acquires pursuant to the Capital Purchase Program (CPP) under the Emergency

Economic Stabilization Act of 2008, P.L. 110-343. The IRS intends to issue regulations on the application of Sec. 382 under the CPP, but taxpayers may rely on the guidance in Notice 2008-100 until further guidance is issued. Any contrary guidance will be prospective only.

Sec. 382 limits the amount of a corporation's taxable income in a postchange year that may be offset by prechange losses. The event separating a prechange year from a postchange year is known as an ownership change. An ownership change occurs for a loss corporation on a testing date if, immediately after the close of the testing date, the percentage of the corporation's stock owned by one or more 5% shareholders has increased by more than 50 percentage points over the lowest percentage of the corporation's stock owned by such shareholder(s) at any time during the testing period (Temp. Regs. Sec. 1.382-2T(a)(1)).

For purposes of the ownership change test, Notice 2008-100 provides that if Treasury acquires shares of a loss corporation's stock under the CPP, the ownership represented by those shares on any date on which they are held by Treasury will not cause any increase in Treasury's ownership in the loss corporation for purposes of Sec. 382.

However, for purposes of determining the percentage of loss corporation stock owned by other 5% shareholders on a testing date, the shares held by Treasury generally are considered outstanding.

A special rule for redemptions provides that when shifts in ownership by a 5% shareholder are measured on a testing date occurring after the loss corporation redeems shares of its stock held by Treasury that were acquired under the CPP, the redeemed shares are treated as if they had never been outstanding.

Preferred stock of a loss corporation acquired by Treasury is treated as stock described in Sec. 1504(a)(4) for all federal income tax purposes.

Warrants to purchase stock of a loss corporation acquired by Treasury under the CPP (whether held by Treasury or another person) are treated as options for all income tax purposes. Options held by Treasury will not be deemed exercised under Reg. Sec. 1.382-4(d)(2). In addition,

Notice 2008-100 provides that capital contributions made by Treasury to a loss corporation under the CPP will not be considered to have been made as part of a plan with a principal purpose of avoiding or increasing any Sec. 382 limitation.

Implications

Notice 2008-100 is the most recent in a series of notices dealing with Sec. 382 consequences for corporations involved in the federal efforts to rescue the economy. The notice provides more detailed rules regarding ownership changes for corporations in the CPP program. The earlier Notice 2008-76 addressed the takeover of Fannie Mae and Freddie Mac with a very simple provision that a "testing date" under Sec. 382 would not include any date on or after which the United States (or any agency or instrumentality thereof) acquired stock or options in those corporations.

Notice 2008-84, issued later in September, provided a similar result aimed at AIG, by providing that the term "testing date" will not include any date as of the close of which the United States directly or indirectly owns a more-than-50% interest in a loss corporation. Notice 2008-83 provided special treatment allowing the recognition of built-in losses and bad debt deductions for assets held by banks, for which the losses might otherwise have been limited by Sec. 382(h).

From Marc D. Levy, CPA, New York, NY

CREDITS AGAINST TAX

Research Credit Extended

The long-awaited extension of the Sec. 41 research credit arrived in the Emergency Economic Stabilization Act of 2008, P.L. 110-343 (EESA), which contains the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. On October 3, 2008, Congress passed the act and President Bush signed it into law.

The research credit had expired for amounts paid or incurred after December 31, 2007; however, EESA retroactively extends the research credit to amounts paid or incurred after December 31, 2007, and before January 1, 2010, with the following changes: EESA increases the credit rate under the alternative simplified credit

(ASC) method from 12% to 14%, but only for tax years ending after December 31, 2008. Also, the alternative incremental research credit (AIRC) is eliminated for tax years beginning after December 31, 2008.

Implications

Given the current economic conditions, this retroactive extension potentially creates both cash benefits and earnings-per-share benefits for taxpayers. As a result of the retroactive extension of the research credit implemented under this law, taxpayers will need to consider the financial statement effect of the research credit's now being avail-

Taxpayers will need to carefully evaluate the bonus depreciation election ordering rules to maximize the deduction and credit.

able for 2008. Taxpayers will also need to consider the effect of the research credit's retroactive extension on their estimated tax payments for the 2008 tax year.

Fiscal-year taxpayers that have already filed their 2007 tax year returns should consider filing amended returns to claim research credits related to the period for which the credit had expired. In light of the increasing scrutiny taxpayers are experiencing at IRS examinations, taxpayers should consider assessing the approaches used and the documentation maintained to support their research credits. This retroactive extension also opens up the opportunity for taxpayers to consider a pre-filing agreement for the research credit for their 2008 tax year.

Taxpayers that are not currently reporting research credits under the ASC method will need to analyze the effect of the ASC rate increase beginning for tax years ending after December 31, 2008. Fiscal-year taxpayers whose 2007 tax year has already closed are currently subject to the new 14% ASC rate. In addition, taxpayers that are currently using the AIRC method will need to evaluate whether to use the regular credit or ASC for tax years beginning after December 31, 2008.

From Anthony J. Mondoro Jr., CPA, Iselin, NJ, and David Hudson, LL.M., Washington, DC

DEPRECIATION

IRS Issues Guidance on Electing Out of 50% Additional First-Year Depreciation

The IRS has issued Rev. Proc. 2008-65, which provides guidance on new Sec. 168(k)(4), added by Section 3081 of the Housing and Economic Recovery Act of 2008, P.L. 110-289. Sec. 168(k)(4) allows corporations to elect out of claiming the 50% additional first-year depreciation for new property acquired after March 31, 2008, and placed in service before January 1, 2009. Under Sec. 168(k)(4), corpo-

rations may elect to increase their business credit limitation under Sec. 38(c) (but only for certain research credits determined under Sec. 41(a)) or their alternative minimum tax (AMT) credit limitation under Sec. 53(c). Rev. Proc. 2008-65 is effective October 10, 2008.

Eligible Qualified Property

Eligible qualified property for purposes of Sec. 168(k)(4) is property that is eligible for bonus depreciation under Sec. 168(k)(2), with certain modifications to reflect the revised dates in Sec. 168(k)(4). Thus, eligible qualified property is tangible property (and certain computer software):

- With a MACRS recovery period of 20 years or less;
- The original use of which begins after March 31, 2008;
- That is acquired after March 31, 2008, and before January 1, 2009, provided no written binding contract was in effect before March 31, 2008 (special rules apply to passenger aircraft and to property with a long production period); and
- That is manufactured, constructed, or produced for the taxpayer's own use and is manufactured, constructed, or produced after March 31, 2008, and before January 1, 2009.

If new property is placed in service after March 31, 2008, and is the subject of a sale-leaseback transaction within three months of the placed-in-service date, the taxpayer-lessor is treated as the original owner and the original placed-in-service date by the taxpayer-lessor is not earlier than the date on which the property is used by the lessee under the leaseback.

Sec. 168(k)(4) Election

Rev. Proc. 2008-65 provides ordering rules for making the elections out of bonus depreciation under Sec. 168(k)—the election under Sec. 168(k)(2)(D)(iii) and the Sec. 168(k)(4) election. Under the procedure, a corporate taxpayer applies the election out of bonus depreciation

under Sec. 168(k)(2)(D)(iii) first. The taxpayer makes that election on an asset-class basis. If an election is made under Sec. 168(k)(2)(D)(iii) for a certain class of property, that class of property is not qualified property under Sec. 168(k)(2) or eligible qualified property under Sec. 168(k)(4).

The corporate taxpayer makes the Sec. 168(k)(4) election for its first tax year ending after March 31, 2008. Once the election is made, it applies to all eligible qualified property placed in service by the taxpayer in the taxpayer's first tax year ending after March 31, 2008, and any subsequent tax year and may be revoked only with the Service's consent. If the taxpayer wants to apply the election to subsequent tax years, it must make the election for its first tax year ending after March 31, 2008, even if the taxpayer does not place in service eligible qualified property in its first tax year. If a Sec. 168(k)(4) election is made, the straight-line depreciation method should be used for all eligible qualified property.

Importantly, under the revenue procedure all corporations that are treated as a single employer under Sec. 52(a) are treated as one taxpayer for purposes of Sec. 168(k)(4) and the election thereunder. Thus, for example, if the common parent

of a consolidated group makes the election under Sec. 168(k)(4) for one member of the affiliated group, then all members of the affiliated group are treated as one taxpayer for purposes of Sec. 168(k)(4) and as having made the election.

The IRS intends to issue separate guidance on the time and manner of making the Sec. 168(k)(4) election.

Bonus Depreciation

The bonus depreciation amount is defined in Sec. 168(k)(4)(C)(i) as an amount for any tax year equal to 20% of the excess (if any) of:

1. The aggregate amount of depreciation allowable under Sec. 168(k)(1) for all eligible qualified property placed in service by the taxpayer during the tax year, over
2. The aggregate amount of depreciation that would be allowable under Sec. 168 without regard to subsection (k)(1) for all eligible qualified property placed in service by the taxpayer during the tax year.

In computing the bonus depreciation amount, Rev. Proc. 2008-65 provides that the applicable convention rules under Sec. 168(d) apply in computing the aggregate amount of depreciation; however, this computation is made without regard to any elections to use the 150% declining balance method, the straight-line method, or the alternative depreciation system (ADS), or the requirement to depreciate eligible qualified property using the straight-line method. In addition, for a corporation that is a partner in a partnership, the corporation's computation of aggregate depreciation does not include depreciation property placed in service by the partnership. Special rules apply for passenger aircraft and long production period property.

Rev. Proc. 2008-65 provides that the bonus depreciation amount must not exceed the maximum increase amount reduced by the sum of the bonus depreciation amounts determined under Sec. 168(k)(4)(C) for all preceding tax years. The maximum increase amount is the lesser of: (1) \$30 million or (2) 6% of the sum of the business credit increase amount and the AMT credit increase

amount. The business credit increase amount is the portion of the credit allowable under Sec. 38 for the first tax year ending after March 31, 2008, that is allocable to business credit carryforwards to such tax year that are from tax years beginning before January 1, 2006, and properly allocable to the research credit determined under Sec. 41(a). A business credit carryforward allocable to the research credit that was from a tax year beginning before January 1, 2006, but has expired before the first tax year ending after March 31, 2008, is not taken into account in calculating the business credit increase amount.

Rev. Proc. 2008-65 defines the AMT credit increase amount as the portion of the minimum tax credit under Sec. 53(b) for the first tax year ending after March 31, 2008, determined by taking into account only the adjusted minimum tax for tax years beginning before January 1, 2006. Minimum tax credits are treated as allowed on a first-in, first-out basis.

Allocation of Bonus Depreciation Amounts

Rev. Proc. 2008-65 allows a taxpayer to specify the portion of the bonus depreciation amount for the tax year that is to be allocated to the business credit limitation under Sec. 38(c) and the AMT credit limitation under Sec. 53(c). However, the bonus depreciation amount allocated to the business credit limitation under Sec. 38(c) must not exceed the excess of the business credit increase amount over the bonus depreciation amount allocated by the taxpayer to the limitation for all preceding tax years. The bonus depreciation amount allocated to the AMT credit limitation under Sec. 53(c) must not exceed the excess of the AMT tax credit increase amount over the bonus depreciation amount allocated by the taxpayer to the limitation for all preceding tax years.

Rev. Proc. 2008-65 sets forth an example of a corporation with \$10 million in business credit carryforward and \$590 million in AMT credit carryforward. The sum of these carryforwards (\$600 million) multiplied by 6% equals \$36 million. Thus, the maximum increase amount is \$30 million. Of this \$30 million, up to

\$10 million (the full amount of the business credit carryforward) may be allocated to the business credit limitation.

Implications

Taxpayers will need to carefully evaluate the bonus depreciation election ordering rules to maximize the depreciation deduction and the refundable credit. By permitting taxpayers to first make the election out of bonus depreciation under Sec. 168(k)(2)(D)(iii), taxpayers may still depreciate such elected classes of property using MACRS. For all other property for which a taxpayer (which for purposes of Sec. 168(k)(4) includes all affiliated group members filing a consolidated return) elects not to claim bonus depreciation, all eligible qualified property placed in service by the taxpayer (which includes all members of a consolidated group) must be depreciated using the straight-line method, regardless of whether such property results in additional refundable credits.

Rev. Proc. 2008-65 states that the IRS intends to publish separate guidance on the time and manner for making the Sec. 168(k)(4) election and for allocating the credit limitation increases allowed by the election.

An October 6, 2008, posting on the IRS website directs taxpayers with fiscal years ending after March 31, 2008, to not make the Sec. 168(k)(4) election and claim the refundable credit on their original 2007 return. Instead, the Service directs these taxpayers to make the election and claim the credit on a subsequently filed amended return. Taxpayers intending to make the election and claim the refundable credit on an amended 2007 return may claim the bonus depreciation deduction on their original 2007 return for all classes of property for which they did not make the Sec. 168(k)(2)(D)(iii) election out of bonus depreciation.

It is important to note that, as stated above, Rev. Proc. 2008-65 requires taxpayers to make the election on their first tax year ending after March 31, 2008, even if they do not place any eligible qualified property in service in its first year. However, because fiscal-year taxpayers must make the Sec. 168(k)(4) election on

amended 2007 tax returns, this will afford fiscal-year taxpayers additional time to make the decision based on their fiscal 2008 activities.

From Jack Donovan, J.D., LL.M., Washington, DC, and Jane Rohrs, CPA, Washington, DC

FOREIGN INCOME & TAXPAYERS

Automatic Penalty Assertions Begin for Delinquent Forms 5471

The IRS posted to its website guidance encouraging taxpayers to submit delinquent Forms 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, before January 1, 2009—the date on which the Service began to automatically assert appropriate penalties under Sec. 6038 on late-filed Forms 1120, U.S. Corporation Income Tax Return, with Forms 5471 attached. In August 2008, the IRS began mailing “soft letters” to corporations that had, during the past two years, filed a late Form 1120 that included at least one Form 5471, to inform them of the new automatic penalty assertion procedures.

Implications

Although the Service has not historically focused on Sec. 6038 penalties for late-filed Forms 1120 with Forms 5471 attached, the increased number of Forms 1120 being filed electronically has enabled the IRS to determine quickly which of these returns are late filed and therefore potentially subject to penalty. The automatic assertion program seems to be one way that the IRS is responding to TIGTA's criticism of the Service's failure to appropriately assess penalties.

It is interesting that this published guidance went beyond late-filed Forms 1120 by encouraging taxpayers to submit before January 1, 2009, all delinquent Forms 5471 for prior years. This could be an indication that the Service will be more lenient regarding reasonable cause for late filing for forms filed before that date. It also could be an indication that the Service will be encouraging its examiners to look for delinquent Forms 5471, as well as other international

forms, and assert relevant penalties during examinations.

For more on this topic, see Keenan and Patel, “IRS Changes Policy for Asserting Penalties for Late-Filed Form 5471,” *Tax Practice & Procedures*, p. 52.

From Linda Gurene, CPA, San Antonio, TX

GAINS & LOSSES

Lenders Allowed Nonrecognition Treatment for Certain Securities Loans Terminated Due to Bankruptcy

Rev. Proc. 2008-63 permits securities lenders continued nonrecognition treatment under Sec. 1058(a) for certain securities loans terminated due to the bankruptcy of the securities borrower, provided the lender applies the collateral to the purchase of identical securities within 30 days of the default. Rev. Proc. 2008-63 is effective for tax years ending on or after January 1, 2008.

Sec. 1058(a) provides nonrecognition treatment for the owner of securities exchanged for an obligation under an agreement that meets the requirements of Sec. 1058(b) or on the exchange of the resulting rights for securities identical to the securities transferred. To meet the requirements of Sec. 1058(b), an agreement must:

1. Provide for the return to the transferor of securities that are identical to those transferred;
2. Require payments to the transferor of amounts equivalent to all interest, dividends, and other distributions that the securities owner is entitled to receive during the period beginning with the transfer of the securities and ending with the transfer of identical securities back to the transferor; and
3. Not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred.

In the current market, a significant number of securities loans have terminated due to borrower default. Often the default is the result of the borrower's bankruptcy (or the bankruptcy of its affiliate). In that situation, if the agreement meets the Sec. 1058(b) requirements and the lender, as soon as commercially

practicable (no more than 30 days after the default), uses collateral provided under the agreement to purchase identical securities, the IRS will treat the purchase as an exchange of rights under the agreement for identical securities to which Sec. 1058(a) applies.

Implications

Prop. Regs. Sec. 1.1058-1(e)(2) will trigger the built-in gain (and built-in loss, subject to deferral under the Sec. 1091 wash sale rules) in securities loaned under a Sec. 1058 agreement if the borrower fails to return the borrowed securities “or otherwise defaults.” A standard-form securities lending agreement treats the bankruptcy filing by the borrower as a default. Thus, the proposed regulations raise the possibility that the bankruptcy of a securities borrower will trigger the built-in gain in securities lent to or through that borrower.

The revenue procedure negated that possibility without analysis. Perhaps the Service viewed the securities lender as the borrower's agent when it applied collateral to obtain identical replacement securities. In any event, the guidance is both welcome and timely.

One unanswered question is what happens if the posted collateral amount is less than the then full value of the loaned security. Perhaps the guidance can be viewed as splitting the loaned securities into two parts, one adequately secured and the other totally unsecured. The unsecured part cannot meet the requirements for continued nonrecognition, but it seems reasonable to claim the protection of Rev. Proc. 2008-63 for the remainder.

From Marc D. Levy, CPA, New York, NY

INDIVIDUALS

Effects of Emergency Economic Stabilization Act Provisions on Individuals

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008, P.L. 110-343. The act provides alternative minimum tax (AMT) relief, energy tax credits, and disaster relief for individuals. It also extends the availability of the exclusion from gross

income of discharges of qualifying mortgage debt and several other provisions affecting individuals that had expired at the end of 2007 or were scheduled to expire at the end of this year. This item discusses the implications of those provisions.

AMT

The act provides individuals with several areas of relief from AMT liability.

Increased individual AMT exemption amounts: The 2008 exemption amounts are increased from:

- \$45,000 to \$69,950 for married couples filing jointly and surviving spouses;
- \$33,750 to \$46,200 for other unmarried individuals; and
- \$22,500 to \$34,975 for married individuals filing separate returns (Sec. 55(d)(1)).

Implications: The increase in the exemption amounts for 2008 is the latest in a series of annual increases. As in past years, this increase is effective for only one year. Under current law, the exemption is phased out at higher levels of alternative minimum taxable income (AMTI). The exemptions are fully phased out at \$429,800 of AMTI for married couples filing jointly and surviving spouses (\$297,300 for other unmarried individuals and \$214,900 for married individuals filing separately) (Sec. 55(d)(3)(A)). This increases the income range in which AMT taxpayers would be subject to a marginal tax rate of as high as 22% on capital gains and qualified dividends (i.e., $15\% + (.25 \times 28\%)$).

AMT relief for personal tax credits: The act extends the ability of individuals to offset their entire regular tax and AMT liabilities with personal nonrefundable tax credits to tax years beginning in 2008 (Sec. 26(a)).

Implications: Eligible nonrefundable personal tax credits include the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child credit, the credit for interest on certain home mortgages, the Hope scholarship and lifetime learning credits, the credit for savers, the credit for certain nonbusiness

energy property, the credit for residential energy-efficient property, and the DC first-time homebuyer credit.

Increase in AMT refundable credit: The act extends and modifies the amount of the refundable AMT credit for long-term unused minimum tax credits (i.e., minimum tax credits attributable to tax years before the third tax year immediately preceding the current tax year). Under the



act, 50% of long-term unused minimum tax credits may be refunded over each of two years, rather than 20% per year over five years as under previous law (Sec. 53(e)(2)). In addition, the adjusted gross income (AGI) phaseout for the refundable credit is eliminated.

The act also provides that any underpayment of outstanding tax on the enactment date of an AMT liability (and any penalty and interest related to such underpayment) attributable to the minimum tax adjustment for incentive stock options (ISOs) is abated (Sec. 56(b)(3)). Finally, the AMT refundable credit amount and the AMT credit for each of the first two tax years beginning after December 31, 2007, are increased by one-half the amount of any interest and penalty paid that would have been abated under the above rules had it not been paid before the enactment date (Sec. 53(f)(2)).

Implications: As a result of these changes, taxpayers can recover their

entire balance of long-term unused minimum tax credits over two years regardless of their AGI. This provision may be particularly beneficial to taxpayers who have large minimum tax credit carryforwards due to the exercise of ISOs shortly before the tech stock crash of 2000–2001. Because the use of a minimum tax credit generated by an ISO adjustment often depends on the profitable sale of the stock received, many taxpayers in this position have been unable to use any significant portion of their available minimum tax credits in subsequent years.

Energy Incentives

The act extends the Sec. 25C credit for purchases of energy-efficient improvements to existing homes for two years through 2009. It also includes energy-efficient biomass fuel stoves as a new class of energy-efficient property eligible for a consumer tax credit of \$300.

The act also provides an eight-year extension of the credit for residential energy-efficient solar property under Sec. 25D (through 2016). In addition, the act eliminates the current \$2,000 cap on the credit for solar electric investments. The legislation also creates tax credits for residential small wind energy property (\$4,000 cap) and geothermal heat pumps (\$2,000 cap).

The act establishes a new credit for plug-in electric drive passenger cars and light trucks ranging from \$2,500 to \$7,500 (Sec. 30D).

The nonrefundable credits are allowed to offset both regular tax and AMT. The depreciable basis of the property acquired is reduced by the amount of the credit claimed.

Implications: The credits are intended to spur investment in these types of alternative energy property by making their use economically viable for a wider range of taxpayers.

Three-Year Extension of Discharged Mortgage Debt Income Exclusion

The act extends (for three years through 2012) the temporary exclusion from gross income of discharges of qualified principal residence indebtedness (Sec. 108(a)(1)(E)). This exclusion was enacted

in the Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142.

Qualified principal residence indebtedness is defined as acquisition indebtedness (within the meaning Sec. 163(h)(3)(B), except that the dollar limitation is \$2 million) with respect to the taxpayer's principal residence. Acquisition indebtedness generally means indebtedness incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

The basis of the individual's principal residence is reduced by the amount excluded from income.

Implications: This provision allows homeowners who are already in a tight financial position due to the decline in the real estate market to avoid a significant current year tax bill due to a mortgage write-off. Although the taxpayer is required to reduce his or her basis in the residence, due to the Sec. 121 exclusion of gain from the sale of a principal residence, the tax relief is likely to be permanent for many taxpayers.

Other Extenders Applicable to Individuals

The act extends the following to the end of 2009:

- The provision allowing a taxpayer to elect to take an itemized deduction for state and local general sales taxes instead of state and local income taxes (Sec. 164(b)(5)).

Implications: The provision continues to benefit residents of states with no state income tax. Because it is available to all taxpayers as an option, however, it may also benefit other taxpayers whose sales tax bill for the year exceeds their state income tax (for example, taxpayers who reside in a jurisdiction with a low income tax rate or who made large taxable expenditures during the tax year).

The sales tax deduction is a preference for AMT purposes and may be of

little or no value to taxpayers exposed to the AMT. In such an instance, if a taxpayer itemizes for state tax purposes and can claim the sales tax deduction, the taxpayer may be better off deducting sales tax on the federal return despite the fact that the deduction results in no federal tax savings.

- The above-the-line tax deduction for qualified higher education expenses (Sec. 222). However, the act modifies the deduction so that it is unavailable for any tax year beginning in 2008 or 2009 if the taxpayer would, in the absence of the AMT, have a lower tax liability for that year if he or she elected the Hope or lifetime learning credit.
- A provision allowing teachers an above-the-line deduction for up to \$250 in educational expenses (Sec. 62(a)(2)(D)).
- The additional standard deduction for real property taxes added by the Housing and Economic Recovery Act of 2008, P.L. 110-289, which would have expired at the end of 2008 (Secs. 63(c)(1)(C) and (c)(7)).
- The exclusion from gross income for distributions from a traditional or Roth IRA directly contributed to charity by individuals over age 70½ (Sec. 408(d)(8)). Distributions eligible for the exclusion may not exceed \$100,000 per taxpayer per tax year. Furthermore, distributions in excess of \$100,000 that otherwise meet the requirements for a qualified charitable distribution cannot be carried over to future years.

Implications: Qualifying IRA owners may recognize significantly greater tax benefits by using this provision to fund charitable donations than they would from making contributions from other accounts or property. Excluding IRA distributions that satisfy the requirements for qualified charitable distributions reduces AGI, which in turn reduces the various percentage limitations based on AGI that apply to itemized deductions and credits. Taxpayers may consider using Roth IRAs for qualified charitable distributions if the distribution would not otherwise be a qualified Roth IRA distribution.

- Adjustment of an S corporation shareholder's stock basis by a pro-rata share of the adjusted basis of appreciated property donated by the corporation to charity (Sec. 1367(a)(2)).

Implications: Prior to the enactment of the Pension Protection Act of 2006, P.L. 109-280 (PPA), when an S corporation donated appreciated property that qualified for a fair market value deduction, the shareholder's basis in his or her S corporation stock was reduced by the shareholder's pro-rata share of the fair market value of the property. Consequently, when the S corporation shareholder ultimately sold shares, the shareholder would effectively pay tax on the appreciated value of the property that the S corporation had contributed to charity. This result differed from what the shareholder would have realized had he or she personally donated that appreciated property. In that case, the shareholder would not recognize the gain attributable to the appreciation. The act extends the change made by the PPA that aligns the tax results.

- The application of the estate tax lookthrough rule for stock held in a regulated investment company (RIC) to estates of nonresident decedents dying before January 1, 2010 (Sec. 2105(d)(3)). Under this rule, RIC stock owned by a nonresident decedent is not deemed to be property within the United States in the proportion that, at the end of the quarter of the RIC's tax year immediately before the decedent's date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate.

Disaster Relief

The act liberalizes the casualty loss rules for individuals who are victims of a federally declared disaster that occurs after December 31, 2007, and before January 1, 2010. The act waives the rule under Sec. 165(h)(2) that a casualty loss is deductible only to the extent it exceeds 10% of the taxpayer's AGI. However, the act also raises the \$100 per casualty

threshold under Sec. 165(h)(1) to \$500. The act also allows nonitemizers to claim casualty losses as a standard deduction.



In addition to revising the casualty loss rules, the act extends the time period when taxpayers can carry back net operating losses attributable to a casualty loss incurred in a federally declared disaster from two to five years.

The act also provides tax relief for those affected by the floods, severe storms, and tornadoes in the Midwest (Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin) declared as disaster areas by FEMA on or after May 20, 2008, and before August 1, 2008 (Sec. 1400N).

Current Inclusion of NQDC Paid by Tax-Indifferent Parties

New Sec. 457A requires individuals who participate in a nonqualified deferred compensation (NQDC) plan of a tax-indifferent party (such as an offshore corporation in a low- or no-tax jurisdiction) to recognize such deferred compensation in gross income currently.

Implications: Such deferred compensation must be included in gross income regardless of whether the taxpayer ever actually or constructively receives the compensation. In essence, an individual is subject to income tax when the right to the compensation accrues, even if subsequent events eliminate the

compensation or significantly reduce its value. While supposedly aimed at hedge fund managers operating in offshore tax havens, this provision actually affects a broader group of U.S. taxpayers who work in foreign countries for foreign companies, including employees of U.S. multinational corporations who earn deferred compensation from foreign entities.

From Gary N. Cohen, J.D., MBA, Atlanta, GA, and Todd A. Richardson, J.D., CPA, Indianapolis, IN

S CORPORATIONS

Final Sec. 1367 Regs. Address Open Account Debt Between S Corps. and Their Shareholders

The Service has issued final regulations (T.D. 9428) amending the definition of open account debt, which may significantly affect when an S corporation shareholder recognizes gain on the repayment of such debt.

Background

Under Sec. 1366(d)(1), the aggregate amount of passthrough losses and deductions that an S corporation shareholder may take into account for any tax year cannot exceed the shareholder's adjusted basis in the corporation's stock and loans made by the shareholder to the corporation.

Under Sec. 1367(a)(2), the basis of each shareholder's stock in an S corporation is decreased (but not below zero) by, among other things, the shareholder's pro-rata share of the corporation's losses, deductions, and nondeductible, non-capital expenses. If these items reducing basis exceed the amount that reduces the shareholder's stock basis to zero, such excess losses and deductions are applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the

S corporation to the shareholder (Sec. 1367(b)(2)).

If an S corporation repays a loan from a shareholder in which the shareholder's basis has been reduced under Sec. 1367(a)(2), the shareholder recognizes gain on the repayment.

Final regulations issued in 1994 (T.D. 8508) provided that shareholder advances not evidenced by separate written instruments and repayments on the advances (open account debt) are treated as a single indebtedness. Under these rules, a shareholder would compare the amount of open account indebtedness outstanding at the beginning of the year with the amount of such indebtedness at the close of the year to determine if there was a net repayment for which gain might be recognized.

In *Brooks*, T.C. Memo. 2005-204, the taxpayer took advantage of these rules by making a large unwritten advance at the end of the tax year (year 1) against which he claimed passthrough losses; the S corporation repaid the loan shortly after the beginning of the following tax year (year 2). Shortly before the close of year 2, the taxpayer made another large unwritten advance. As a result of the advance made at the close of year 2, there was no net repayment of the open account debt for the year; accordingly, the taxpayer avoided recognizing gain on the repayment of the year 1 advance.

The taxpayer continued this pattern of making a loan at the close of one year, repaying the loan at the beginning of the following year, and making another loan just prior to the close of the following year for several years. This allowed the taxpayer to claim losses flowing through from the S corporation without having his cash invested in the S corporation for any real period of time.

The Tax Court sided with the taxpayer, agreeing that under the Sec. 1367 regulations there is a repayment on open account debt to which gain might be recognized only if there is a net decrease in the amount of such indebtedness for the year, determined by comparing the amounts outstanding at the beginning and end of the tax year.

In response to the Tax Court's decision in *Brooks*, in 2007 the IRS issued proposed regulations modifying the definition of open account debt (REG-144859-

04). These proposed regulations defined “open account debt” as shareholder advances not evidenced by separate written instruments for which the principal amount of the aggregate advances (net of repayments on advances) did not exceed \$10,000 per shareholder at the close of any day during the S corporation’s tax year.

Accordingly, under these regulations, shareholders would be required to determine for open account debt purposes whether shareholder advances and repayments on the advances exceeded the \$10,000 aggregate principal threshold on any day during the S corporation’s tax year. This meant that shareholders would be required to maintain a daily “running balance” of shareholder advances and repayment on advances and the outstanding principal amount of the open account debt.

Final Regulation Changes

On October 20, 2008, the IRS issued final regulations on open account debt. The regulations define the term “open account debt” as shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed \$25,000 of S corporation indebtedness to the shareholder at the close of the S corporation’s tax year. The regulations also provide that advances and repayments on open account debt are treated as a single indebtedness.

More significantly, the final regulations eliminate the requirement to maintain a daily running balance; instead, under the final regulations the determination of whether the threshold balance of \$25,000 is exceeded will generally be made at the end of the tax year of the S corporation. However, if all or part of the open account debt is disposed of before then, the final regulations require the determination to be made immediately before the disposition of the debt during that tax year. Similarly, if a shareholder with open account debt is no longer a shareholder at the end of the S corporation’s tax year, the final regulations require the determination to be made immediately before the shareholder’s interest in the S corporation is terminated.

The new regulations are effective October 20, 2008, and apply to shareholder

advances and corresponding repayments made on or after that date. They do not apply to open account debt that is outstanding prior to October 20, 2008, or to corresponding repayments on that debt. To illustrate how the October 20, 2008, effective date affects outstanding open account debt, the preamble includes an example.

Implications

As a result of the modification to the definition of open account debt provided in the final regulations, the tax-planning opportunity that the taxpayer used in *Brooks* is no longer available (other than for amounts of \$25,000 or less). However, the final regulations are a significant improvement over the proposed regulations because they eliminate the requirement to maintain a daily running balance.

The final regulations do not address the character of gain on the repayment of unwritten advances that do not qualify as open account debt under the regulations. However, it appears that the treatment of unwritten advances exceeding \$25,000 as being evidenced by a separate written instrument is only for purposes of determining the timing and amount of gain recognized on repayment. Accordingly, it is likely that gain recognized on the repayment of such debt will be ordinary. Shareholders should consider evidencing all loans made to their S corporations in writing; gain on the repayment of a debt that is evidenced by a written instrument should generally be capital gain.

From Laura MacDonough, CPA, Washington, DC

TTA

EditorNotes

David Kautter is a partner with Ernst & Young LLP in Washington, DC.

Clarification

Randi A. Schuster is with Holtz Rubenstein Reminick LLP in New York, NY; James J. Wienclaw is with Holtz Rubenstein Reminick LLP in Melville, NY. Both were authors of items in the October Tax Clinic.