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November 23, 2004

The Honorable Mark W. Everson  
Commissioner of Internal Revenue  
Internal Revenue Service  
Room 5226  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: Comments on Proposed Regulations on Adjustment to Net Unrealized  
Built-in Gain (REG-131486-03)

Dear Commissioner Everson:

Enclosed are comments on proposed regulations under section 1374,  
regarding an adjustment to net unrealized built-in gain, as prepared by members of the  
Committee on S Corporations. These comments represent the individual views of  
those members who prepared them and do not represent the position of the American  
Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon  
Chair, Section of Taxation

Enclosure

cc: Gregory F. Jenner, Acting Assistant Secretary (Tax Policy),  
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Donald L. Korb, Chief Counsel, IRS  
Eric Solomon, Deputy Assistant Secretary (Regulatory Affairs), Department of  
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COMMENTS CONCERNING PROPOSED REGULATIONS  
UNDER SECTION 1374 OF THE INTERNAL REVENUE CODE  
REGARDING AN ADJUSTMENT TO NET UNREALIZED  
BUILT-IN GAINS AND LOSSES  
ISSUED JUNE 24, 2004

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

The comments were prepared by members of the Committee on S Corporations of the Section of Taxation. Principal responsibility was exercised by Kevin D. Anderson. Substantive contributions were made by Carol A. Kulish and Ronald A. Levitt. The Comments were reviewed by C. Wells Hall III of the Section's Committee on Government Submissions and by Fred T. Witt, Jr., Council Director for the Committee on S Corporations.

Although the members of the Section of Taxation who participated in preparing these Comments may have clients who would be affected by the federal income tax principles addressed by these Comments, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: November 23, 2004

## I. EXECUTIVE SUMMARY

The proposed amendments to the section 1374 regulations represent an important and helpful improvement to the application of the built-in gains tax to S corporations. Changes made by Congress in 1996 to the treatment of S corporations have increased the likelihood that certain transactions by S corporations during the ten-year recognition period would permanently eliminate the possibility that certain of the corporation's built-in gains would ever be recognized. Under the existing regulations, the original determination of the amount of such built-in gains is not adjusted by subsequent events. Under the proposed amendments, however, such transactions would result in a prospective adjustment of the original determination of such built-in gains.

The proposed regulations achieve the proper result for the transactions to which they apply, *i.e.*, the acquisition of assets by an S corporation from a C corporation in a section 1374(d)(8) transaction. However, we believe that the principles of the regulations should be extended to all section 355 distributions by an S corporation, whether or not the distribution is part of a reorganization described in section 368(a)(1)(D).

We agree that the occurrence of a section 1374(d)(8) transaction by an S corporation should affect the computation of that corporation's built-in gains tax only with respect to taxable years ending on or after the date of the transaction. We believe that sound policy reasons justify a prohibition on amending returns to claim refunds for taxable years preceding the year of the section 1374(d)(8) transaction.

Finally, we believe that both modification and clarification of the proposed effective date of the regulations are in order. We do not believe it is necessary to delay the application of the proposed regulations until the first taxable year that *begins* after the date on which the regulations are issued in final form. Furthermore, we recommend that the regulations apply only to transactions occurring after the date of publication of final regulations.

## II. INTRODUCTION

In proposed regulations issued on June 24, 2004 (REG-131486-03, 69 Fed. Reg. 35,544 (June 25, 2004)), the Service and Treasury provided guidance regarding an adjustment to the net unrealized built-in gain of an S corporation under section 1374 of the Internal Revenue Code of 1986, as amended (the "Code").<sup>1</sup> The proposed adjustment applies to limited circumstances in which an S corporation holds the stock of another corporation and acquires assets from that corporation in a transaction to which section 1374(d)(8) applies, and in which the stock of the other corporation is redeemed or cancelled.

### A. Background

Section 1374 was enacted, in its current form, by the Tax Reform Act of 1986, as a part of overall repeal of the *General Utilities* doctrine.<sup>2</sup> It applies to every S corporation that either has

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<sup>1</sup> Unless otherwise indicated, all section references are to the Code.

<sup>2</sup> Pub. L. No. 99-514, Section 632(a).

converted from C corporation status or has acquired assets from a C corporation in certain tax-free transactions. In general, a corporate-level tax is imposed if an S corporation recognizes gain on the sale or exchange of any of the assets, within a ten-year recognition period, that were held on the date of conversion or were acquired in such a transaction.<sup>3</sup>

The tax is imposed on the smallest of three items: (a) the net unrealized built-in gain (“NUBIG”) not subject to tax in prior taxable years; (b) the net recognized built-in gain (“RBIG”) for the taxable year;<sup>4</sup> and (c) the taxable income of the S corporation, determined as if it had been a C corporation (with modifications).<sup>5</sup> In the case of the sale or exchange of any asset with a built-in gain, the RBIG is the lesser of the amount of gain recognized from the disposition of that asset or the amount of such gain which was considered to be “built-in” at the date of the C-to-S conversion or tax-free acquisition, as the case may be.<sup>6</sup>

The section 1374 tax is in addition to the tax imposed at the shareholder level on the shareholder’s proportionate share of all items of income, gain, deduction, and loss of the corporation. In order to replicate (as nearly as possible) the effects of the double taxation of C corporation earnings distributed to shareholders, the corporate-level tax is considered a loss which has the same character as the income or gain giving rise to the tax.<sup>7</sup> The tax is thus deductible by the shareholders, as an ordinary deduction, a capital loss, or a section 1231 loss, as the case may be.

Section 1374(d)(8) provides that the section 1374 tax is applied separately to any asset acquired by an S corporation from a C corporation in a transaction in which the basis of the asset is determined in whole or in part by reference to the basis of such asset in the hands of the C corporation.<sup>8</sup> Among other modifications to the application of section 1374, the date on which the asset is acquired by the S corporation is treated as the first day of the recognition period.

At the time that the existing section 1374 regulations were issued in final form,<sup>9</sup> the NUBIG of an S corporation was expected to remain constant for the entire ten-year recognition period. The formula prescribed by the Service and Treasury to determine the NUBIG of a corporation converting from C corporation to S corporation status was intended to capture the aggregate tax consequences of a hypothetical sale of all of the assets of the corporation and the assumption of all of the liabilities of the corporation, including the recognition of built-in income items and the

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<sup>3</sup> Section 1374(d)(5) also treats certain items of recognized income in the same manner as recognized built-in gain.

<sup>4</sup> Recognized built-in gains and losses for any taxable year in the recognition period are netted together and, in certain circumstances, built-in gains from prior taxable years in the recognition period are carried forward to the current taxable year in order to determine the net RBIG for the year. Treas. Reg. § 1.1374-2(a)(1).

<sup>5</sup> Treas. Reg. § 1.1374-2(a).

<sup>6</sup> Section 1364(d)(3) provides that all recognized gain is presumed to be built-in gain except to the extent that the taxpayer establishes the contrary. In contrast, section 1374(d)(4) provides that no recognized loss is recognized built-in loss except to the extent established by the taxpayer.

<sup>7</sup> Section 1366(f)(2).

<sup>8</sup> The most common types of transactions contemplated by section 1374(d)(8) are reorganizations in which the S corporation acquires assets from a C corporation (such as a statutory merger under section 368(a)(1)(A) or an acquisition of assets under section 368(a)(1)(C) or (D)) and a liquidation of a C corporation subsidiary qualifying under sections 332 and 337.

<sup>9</sup> These regulations were issued as T.D. 8579 (Dec. 23, 1994).

deduction of expenses that had been economically accrued but not yet deducted.<sup>10</sup> The aggregate tax consequences of the hypothetical sale, as so determined, would only give rise to a section 1374 tax to the extent that a recognition event occurred during the recognition period with respect to any component of NUBIG. In other words, every component of NUBIG is ordinarily capable of being recognized during the ten-year period as the result of a sale or exchange (in the case of a gain or loss) or recognized in accordance with the corporation's method of accounting (in the case of an item of built-in income or deduction).<sup>11</sup>

However, other subsequent changes in the law affecting S corporations have made it even more readily apparent that this premise was incorrect. As the result of amendments to subchapter S made by the Small Business Job Protection Act of 1996 (the "1996 Act"),<sup>12</sup> an S corporation can own any amount of the stock of a C corporation. Under prior law, an S corporation could not be a member of an affiliated group of corporations, which meant that it could not own 80 percent or more of the outstanding stock of any other corporation, whether foreign or domestic.<sup>13</sup> Although the 1996 Act amendments permitted an S corporation to own any amount of C corporation stock, the amendments excluded the S corporation from the "affiliated group" otherwise eligible to file a consolidated federal income tax return with the other members of the group.<sup>14</sup> In addition, in the 1996 amendments, Congress also eliminated any uncertainty regarding the application of significant portions of subchapter C to S corporations.<sup>15</sup>

As a result of these two changes, an S corporation could own all of the stock of a C corporation at the time it converted to S corporation status, but liquidate the subsidiary under section 332 during the recognition period.<sup>16</sup> Under these circumstances, the assets of the liquidated C corporation subsidiary would be subjected to a wholly-separate determination of NUBIG under section 1374(d)(8) and the stock itself, which was taken into account in determining the S corporation's NUBIG at the time of its conversion, would never give rise to RBIG.

In another transaction contemplated under the regulations, an S corporation could own less than 80 percent of the stock of a C corporation at the time of its C-to-S conversion. Similarly, the C corporation stock would be taken into account in determining the NUBIG of the S corporation. The S corporation could agree to acquire all of the assets of the C corporation in a transaction qualifying as a reorganization.<sup>17</sup> The assets of the transferor C corporation would be subject to a new ten-year recognition period under section 1374(d)(8). The stock of the transferor C

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<sup>10</sup> Treas. Reg. § 1.1374-3(a).

<sup>11</sup> Section 1374(d)(5); Treas. Reg. § 1.1374-4(b).

<sup>12</sup> Pub. L. No. 104-188.

<sup>13</sup> See section 1361(b)(1) prior to its amendment by the 1996 Act.

<sup>14</sup> Section 1504(b)(8).

<sup>15</sup> Section 1371(a).

<sup>16</sup> The S corporation could acquire the assets of the subsidiary, for federal tax purposes, either pursuant to an actual liquidation, including a merger of the subsidiary into the parent, or pursuant to a deemed liquidation by reason of a qualified subchapter S subsidiary election under section 1361(b)(3)(B)(ii). Because of the flexibility that S corporations have to own either C corporation subsidiaries or qualified subchapter S subsidiaries, it has become increasingly common for an S corporation to make such elections with an effective date that occurs during the recognition period for the S corporation itself.

<sup>17</sup> Depending on the structure of the transaction, the asset acquisition could qualify as either a statutory merger under section 368(a)(1)(A) or an assets-for-stock acquisition under section 368(a)(1)(C).

corporation would also be eliminated in the reorganization, and would never give rise to RBIG in the hands of the S corporation.

## B. General Explanation of Regulations

In recognition of these transactions, the proposed regulations provide for a prospective adjustment to the NUBIG of an S corporation under limited circumstances. In general, the NUBIG adjustment is available to the S corporation when all of the following conditions are present:

1. Section 1374(d)(8) applies to an S corporation's acquisition of assets;
2. Some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of NUBIG for a pool of assets of the S corporation; and
3. Some or all of such stock is redeemed or canceled in the transaction.<sup>18</sup>

The NUBIG adjustment is the amount necessary to eliminate any effect that any built-in gain or built-in loss in the redeemed or canceled stock had on the initial computation of NUBIG. In other words, for example, NUBIG would be reduced by any unrealized gain, or increased by any unrealized loss, in the stock of a C corporation subsidiary if the subsidiary is liquidated in a transaction qualifying for nonrecognition under sections 332 and 337 during the recognition period. The adjustment, however, would be made only prospectively, *i.e.*, for taxable years that end on or after the date of the section 1374(d)(8) acquisition.<sup>19</sup>

## III. COMMENTS

### A. Generally

We commend the Service and Treasury for proposing these changes to the section 1374 regime. The existing section 1374 regulations were finalized before the 1996 Act changes significantly expanded the scope of permissible tax-free transactions involving S corporations, thus making such changes necessary for an increasing number of S corporations. Such regulations at least implicitly assumed that NUBIG would never be adjusted during the ten-year recognition period of an S corporation that had converted from C corporation status or had acquired assets in a section 1374(d)(8) transaction. The possibility of duplication of gain or loss is readily apparent in the examples presented in the proposed regulations. Nevertheless, we believe that there are other transactions involving S corporations where similar relief is appropriate.

### B. Relief Based on Duplication of Elimination of Built-in Gain or Loss

The proposed regulations appear to be based on the principle that an adjustment is necessary only to avoid duplication of gain or loss under section 1374. For example, the proposed rule applies, among other requirements, only where the S corporation has acquired assets from

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<sup>18</sup> Prop. Reg. § 1.1374-3(b)(1).

<sup>19</sup> Prop. Reg. § 1.1374-3(b)(3).

another corporation in a transaction to which section 1374(d)(8) applies. We believe that the articulated standard should be broad enough to encompass other transactions in which gain or loss is eliminated from the S corporation. In one respect, the proposed regulations appear to be broad enough to apply an elimination theory, but in another respect, the proposed regulations do not go far enough.

The regulations are broad enough, as proposed, to address a situation in which an S corporation has an unrealized built-in gain in the stock of a wholly-owned C corporation subsidiary at the time of its (the parent's) conversion from C to S corporation status, but there is no unrealized built-in gain or loss in the assets of the subsidiary. Suppose, for example, that P, an S corporation, owns all of the outstanding stock of T on January 1, 2004, the effective date of its S corporation election. The fair market value of the T stock on that date was \$1,000, but the basis of S in the T stock was \$200. Accordingly, S has an unrealized built-in gain of \$800 in the T stock. Assume further that the NUBIG of S exceeds \$800. However, on the same date, T's assets have an aggregate adjusted basis and fair market value of \$1,000, and that T has no liabilities.<sup>20</sup>

On January 1, 2005, S either liquidates T or makes a qualified subchapter S subsidiary ("QSub") election for T, at a time when there has been no change in either the fair market value or adjusted basis of T's liabilities.<sup>21</sup> Thus, under section 1374(d)(8), the T assets have their own ten-year recognition period and their own separate section 1374 determinations, but there is no NUBIG with respect to those assets. The regulations appear to provide that S may reduce its NUBIG by \$800, because the gain attributable to the T stock has been eliminated through the actual or deemed liquidation of T. This is true even where the gain in the T stock is not duplicated in the assets of T. Although the overall exposure of T and its subsidiaries to section 1374 has been reduced, this result seems entirely appropriate under the theory of elimination. The result is also consistent with an alternative scenario in which S had liquidated T (or made a QSub election for T) effective at the same time as the S corporation election.

### C. Application to Other Transactions

The regulations, however, do not apply to two other situations where an elimination theory would apply. Both involve section 355 distributions, transactions with respect to which the preamble to the proposed regulations requested comments.

In the first transaction, D, an S corporation, owns all of the stock of C, a C corporation. The stock of C has been owned by D for several years before, and at all times since, D converted from C corporation to S corporation status. At the time of conversion, D had an unrealized built-

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<sup>20</sup> This scenario can exist simply where the value of T stock has increased as the result of earnings taxed to T but retained by it and reinvested in other assets which do not appreciate in value. It can also exist where the net assets of T have a relatively high adjusted basis and a relatively low fair market value, but the stock of T in the hands of the S corporation reflects unrealized appreciation.

<sup>21</sup> Assuming that the step-transaction doctrine does not apply to the QSub election, the election should be treated as a complete liquidation of T. Treas. Reg. § 1.1361-4(a)(2)(i). If T is solvent at the effective date of the election, the liquidation should qualify for nonrecognition treatment under sections 332 and 337. Treas. Reg. § 1.1361-4(a)(2)(ii), *Example 1*.

in gain in the C stock, and a NUBIG that exceeded such built-in gain. During the recognition period, D distributes the C stock pro rata to its shareholders in a transaction that qualifies as a tax-free distribution under section 355. Because the C stock is no longer owned by D, it will never be capable of producing a recognized gain or loss in D's hands. Moreover, the basis of the C stock in the hands of the D shareholders will be determined by reference to their pre-distribution basis in the D stock, rather than to any basis that D had in the C stock.<sup>22</sup>

Although no assets were received by D in a section 1374(d)(8) transaction, the gain in the C stock has been permanently eliminated from D. Accordingly, we believe that it is appropriate to expand the scope of the regulations so that they would also apply to a section 355 distribution of stock of a C corporation where such stock had been taken into account in determining the NUBIG of an S corporation.

Another situation not covered by the proposed regulations involves a transfer of built-in gain assets to a controlled subsidiary and the distribution of the stock of that subsidiary in a transaction that qualifies as a reorganization within the meaning of section 368(a)(1)(D) by reason of section 355.

Assume the same facts as the previous example, except that C has been a QSub at all times during the effectiveness of the S corporation election of D. Under the QSub regulations, C is treated as if it had distributed all of its assets to D in a complete liquidation, effective on the day preceding the effective date of the S corporation election.<sup>23</sup> Thus, all of the assets of D and C are treated as owned by D at the beginning of D's recognition period for purposes of determining the amount of D's NUBIG.

The distribution of the C stock results in a termination of C's QSub status, and is treated as if D had transferred all of C's assets to a new C, in exchange for new C stock, immediately prior to the distribution of the new C stock.<sup>24</sup> Assuming all of the other applicable requirements are satisfied, the transaction can qualify as a reorganization under sections 368(a)(1)(D) and 355.<sup>25</sup> The proposed regulations do not apply to this transaction because section 1374(d)(8) does not apply to new C's acquisition of the assets.<sup>26</sup> (See Part III.F., below, for an additional comment related to transactions of this type.) Nevertheless, in a manner similar to the straight section 355 distribution of the stock of a C corporation, the gain inherent in the assets of C has been permanently eliminated from D, and should be removed from D's determination of NUBIG under the same standards as those that currently apply under the proposed regulation.

We note that, in this example, section 1374 would continue to apply to the assets of C, if C makes an S corporation election effective upon completion of the distribution. Thus, no potential section 1374 tax is avoided, and C would be subject to this corporate-level tax if it

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<sup>22</sup> Section 358(a) and (b).

<sup>23</sup> Treas. Reg. § 1.1361-4(a)(2)(i).

<sup>24</sup> The same analysis would apply if, instead of holding the assets in a QSub, D had operated the C business as an unincorporated division, but transferred this business to a newly-formed C as part of the plan of distribution.

<sup>25</sup> Treas. Reg. § 1.1361-5(b)(3), *Example 4*.

<sup>26</sup> Indeed, it is possible that the described transaction meets none of the three requirements set forth in Prop. Reg. § 1.1374-3(b)(1).

should dispose of any of these assets during the remainder of the ten-year recognition period applicable to D. If C does not make an S corporation election, any disposition of C's assets will be subject to tax under section 11, and there is no authority (and no reason) to apply the section 1374 tax to such disposition.

We do not believe that the principles of the regulation should be extended to any other type of transaction carried out by an S corporation. Any other type of nonrecognition transaction would likely be governed by section 1374(d)(6), and the application of that provision will carry out the purposes of section 1374 without a need for further regulatory guidance. The proposed regulation should not be extended to any taxable transaction.

#### D. Prospective Application of Proposed Regulations

As noted above, the regulations provide that any adjustment to the NUBIG only affects computations of the amount subject to tax under section 1374 for taxable years that end on or after the date on which the section 1374(d)(8) acquisition occurs.<sup>27</sup> This provision, if retained in the final regulations, will have the effect of treating two similarly-situated S corporations differently merely because of the order in which two events occur. For example, assume that each of X and Y has an asset A with a \$100 unrealized built-in gain, an asset B with a \$100 unrealized built-in loss, and stock of a C corporation with a \$100 unrealized built-in gain, all at the date of their respective S corporation elections (the beginning of Year 1). In Year 3, each corporation liquidates the C corporation subsidiary in a transaction that qualifies under sections 332 and 337.

X sells asset A in Year 2 for a recognized gain of \$100. The entire amount of gain is built in, and does not exceed X's NUBIG for Year 2. Accordingly, X will incur a section 1374 tax of \$35 on the \$100 RBIG. Although X can adjust its NUBIG in Year 3, it does not affect its computation of any section 1374 tax for Year 2 under the proposed rule. In contrast, Y sells asset A in Year 4 for a recognized gain of \$100. In Year 3, however, Y is permitted under the proposed regulations to adjust its NUBIG to zero, such that it will not incur a section 1374 tax on the \$100 RBIG resulting from the sale of asset A.

We recognize that the proposed rule furthers the goal of administrative simplicity by eliminating the ability of an S corporation to file an amended return to claim an overpayment of section 1374 tax for a taxable year as the result of an unrelated transaction occurring in a subsequent taxable year.<sup>28</sup> However, we also note that a NUBIG adjustment following a section 1374(d)(8) transaction could be positive, in a case where the stock of the C corporation reflects an unrealized built-in loss as of the beginning of the recognition period.<sup>29</sup> Accordingly, mandatory retroactive application of the proposed rule may result in a detriment to some S corporations. Although some may argue that the proposed rule represents a significant trap for the unwary and places a premium on planning such transactions, we believe that, on balance, the proposed rule

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<sup>27</sup> Prop. Reg. § 1.1374-3(b)(3).

<sup>28</sup> The proposed rule also provides similar treatment for two taxpayers, both of whose gain recognition transactions occur in a taxable year prior to the taxable year of the section 1374(d)(8) transaction, but only one of whose prior taxable years is open pursuant to the period of limitations established under section 6511 for seeking a refund of tax.

<sup>29</sup> See Prop. Reg. § 1.1374-3(c), *Example 3*.

precluding adjustments to NUBIG retroactive to prior taxable years should be retained.

E. Proposed Effective Date

The regulations are proposed to apply for taxable years that begin after the date the regulations are published as final regulations in the Federal Register.<sup>30</sup> We have three comments regarding the proposed effective date.

First, we note that one other commentator has requested the Service and Treasury to take steps to make the rules effective sooner than proposed, assuming that they will not become effective, at the earliest, until 2005 in the case of a calendar-year S corporation.<sup>31</sup> Among other suggestions, the commentator recommends the issuance of temporary regulations with an immediate effective date, a modification of the proposed effective date to apply to *transactions* occurring after the regulations have been finalized, or a provision that would permit taxpayers to elect to retroactively apply the regulations, subject to appropriate safeguards to ensure consistency of treatment and other tax administration and policy objectives.

We recognize that the proposed effective date is more prospective than is the case with many other proposed regulations, particularly those that taxpayers will generally find as “friendly” and useful rules.<sup>32</sup> In a worst-case scenario, if the regulations are not issued in final form until January 2005, they would not even apply to reduce the section 1374 tax on a sale of assets by a calendar-year S corporation in December 2005.

We support alternatives that would make the effective date less prospective, although we have concerns with an alternative that would permit taxpayers to elect to apply the regulations retroactively. Among other considerations, such an election would appear to be at odds with the policy decision, reflected in Prop. Reg. § 1.1374-3(b)(3) and discussed above, to the effect that NUBIG is to be adjusted only for taxable years that end on or after the date of the section 1374(d)(8) acquisition. Moreover, other policy considerations not specific to this area could also be cited in support of a determination not to permit elective retroactivity of the proposed regulations.

Second, it is not clear why the proposed effective date was formulated as it was. For example, it might have been possible to propose that the regulations, when finalized, would apply to taxable years *ending* after the date on which final regulations are issued. This approach would provide some modest amount of helpful retroactivity without permitting (or requiring) amended returns to be filed for taxable years that had already ended at the time the regulations had been issued in final form.

Third, the proposed effective date is not a model of clarity. The proposed substantive rule

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<sup>30</sup> Prop. Reg. § 1.1374-10.

<sup>31</sup> See Comments of Steptoe & Johnson LLP, dated July 19, 2004, reprinted in *Tax Notes Today* as 2004 TNT 142-17 (Doc. No. 2004-15129).

<sup>32</sup> As we noted earlier, we recognize that the proposed regulations will, when issued in final form, have an adverse impact on an S corporation with an unrealized built-in loss in its C corporation stock at the beginning of its recognition period.

applies as the result of a section 1374(d)(8) acquisition transaction, but is relevant only to the extent that it might reduce the amount of RBIG in the same or a subsequent taxable year that is subject to the section 1374 tax. Thus, it is not clear whether the section 1374(d)(8) transaction must occur in a taxable year to which the final regulations will apply. It may be possible, for example, to draft the effective date of the regulations so that they apply to section 1374(d)(8) transactions occurring after the date on which the regulations are finalized. An effective date based solely on the date on which the transaction occurs will have the added advantage of avoiding an increase for an S corporation that completed a section 1374(d)(8) transaction in reliance on the provisions of the existing regulations. In addition, the provisions of Prop. Reg. § 1.1374-3(b)(3), if finalized as proposed, would be adequate to prevent retroactive application of the regulations.

#### F. Additional Section 1374(d)(8) Guidance

Although this comment is not directly related to the substance of the proposed regulations, we offer it up because it is closely related to the issues presented in the proposed regulations. The issue is present in the second example, set forth above, involving D and C, where C is a QSub and D is an S corporation subject to the section 1374 tax, and D makes a tax-free distribution of the C stock to its shareholders.

We noted that the C assets deemed to be transferred to new C in the section 368(a)(1)(D) reorganization were subject to a built-in gains tax under section 1374 and could use a recognition period that was “tacked on” to the recognition period of D. In other words, C’s recognition period is shortened to accommodate only the remaining time in D’s original recognition period. Such is the conclusion that the Service provides in a number of private letter rulings,<sup>33</sup> but the authority for the conclusion is less than clear. The rulings typically cite section 1374(d)(8) and Announcement 86-128, 1986-51 I.R.B. 22, as their authority for the conclusion.

Section 1374(d)(8) does not apply to this transaction, because C has acquired the assets from another S corporation, not from a C corporation. It may require a strained reading of section 1374(d)(8) to conclude that it applies to this transaction because the assets are acquired by C from a corporation *which once was* a C corporation. Moreover, merely applying section 1374(d)(8) without modification is inconsistent with the ruling practice of the Service regarding the “tacked” recognition periods, because section 1374(d)(8)(B)(i) provides that the rest of section 1374 must be applied as if the day on which the S corporation acquired the subject assets was the first day of its S corporation period. In other words, among other conclusions, a new recognition period would begin upon acquisition of the assets.

Announcement 86-128 provided a variety of guidance under section 1374 pending the issuance of more comprehensive regulations. Nevertheless, the recognition period component of Ann. 86-128 continues to be cited in private letter rulings because it had never been incorporated into the final section 1374 regulations. With an open section 1374 regulations project at its disposal, we recommend that the Service and Treasury incorporate the recognition period conclusion of the Announcement into the final regulations so that taxpayers and tax practitioners will have clear

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<sup>33</sup> For a recent example, see Priv. Ltr. Rul. 200435002 (May 5, 2004).

and reliable authority on which to base their conclusions.

G. Conclusion

We believe that the proposed regulations represent an important improvement in the application of the section 1374 tax to increasingly complex S corporation structures. The regulations should, with slight modifications, be issued in final form as promptly as possible. Please feel free to contact us if you wish to discuss our comments in more detail.