



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

November 15, 2001

Number: **200207015**
Release Date: 2/15/2002
UILC: 1366.00-00
1377.02-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:NR:PHX:4

FROM: ASSOCIATE CHIEF COUNSEL
CC:PSI

SUBJECT: CARRYOVER OF SUSPENDED LOSSES TO POST-
TERMINATION TRANSITION PERIOD

This Field Service Advice responds to your memorandum dated August 21, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Taxpayers

Company

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Date 1
Date 2
Date 3
Date 4
Date 5
Date 6
Date 7
Date 8
Year 1
Amount 1
Amount 2
Amount 3

ISSUES

1. Whether Taxpayers' basis in Company stock purchased after termination of Company's S status provides basis for purposes of § 1366(d)(3)(B) that might allow deduction of carryover losses treated as incurred by Taxpayers at the close of the last day of a post-termination transition period (PTTP).
2. Whether the loss or deduction allowed to Taxpayers at the close of the last day of a PTTP arising under § 1377(b)(1)(B) is limited to the amount of the adjustment to S corporation items determined in audit.

CONCLUSIONS

1. Based upon the information provided, we conclude that Taxpayers' purchase of Company stock after termination of Company's S status provides basis for purposes of § 1366(d)(3)(B).
2. Based upon the information provided, we conclude that Taxpayers' loss or deduction that, pursuant to § 1366(d)(3), carries over to the last day of a PTTP arising under § 1377(b)(1)(B) is not limited by anything in the Code or the regulations to the amount determined in audit to be an adjustment to subchapter S items.

FACTS

On Date 1, Company terminated its S election by issuing a second class of stock. At this time, Taxpayers, as Company shareholders, had approximately Amount 1 in losses that were suspended due to insufficient stock basis. During the PTTP, which ran from Date 2 to Date 3, Taxpayers were unable to deduct any of these carryover losses because of a lack of stock basis.

On or about Date 4, Taxpayers sold a portion of their Company stock, using the proceeds two days later to exercise options to purchase Company shares from third

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parties.

The Internal Revenue Service examined Company's Forms 1120S for the periods ending Date 5 and Date 1, proposing adjustments to subchapter S items of income and deductions. On Date 6, the Service and Taxpayers agreed to adjustments totaling Amount 2 for both periods. As of the end of the PTTTP to which this determination gave rise, Taxpayers had a total stock basis of Amount 3. This second PTTTP expired on Date 7.

On their Form 1040 for Year 1 and a subsequent Form 1045, Taxpayers claimed carryover losses correlating to the agreed adjustments. In addition, they claimed deductions for the suspended losses they were unable to deduct in the first PTTTP because of a lack of stock basis.

LAW AND ANALYSIS

Issue 1

Section 1366(d)(1) of the Internal Revenue Code provides that the aggregate amount of losses and deductions taken into account by a shareholder under § 1366(a) for any tax year shall not exceed the sum of—

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to § 1367(a)(1) and (2)(A) for the tax year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under § 1367(b)(2) for the tax year).

Section 1366(d)(2) provides that any loss or deduction which is disallowed for any tax year by reason of § 1366(d)(1) shall be treated as incurred by the corporation in the succeeding tax year with respect to that shareholder.

Section 1366(d)(3)(A) provides that, in general, if for the last tax year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of § 1366(d)(1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any PTTTP.

Section 1366(d)(3)(B) provides that the aggregate amount of losses and deductions taken into account by a shareholder under § 1366(d)(3)(A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the PTTTP and without regard to this paragraph). Section 1.1366-2(b)(2) of the Income Tax Regulations provides that any losses and deductions in excess of a shareholder's adjusted stock basis are permanently disallowed.

Section 1366(d)(3)(C) provides that the shareholder's basis in the stock of the

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corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

Section 1.1366-2(a)(3) of the Income Tax Regulations provides that a shareholder generally determines the adjusted basis of stock for purposes of limiting losses and deductions by taking into account only increases in basis under § 1367(a)(1) for the tax year and decreases in basis under § 1367(a)(2)(A), (D) and (E) (relating to distributions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) for the tax year. In so determining this loss limitation amount, the shareholder disregards decreases in basis under § 1367(a)(2)(B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the tax year. However, if the shareholder has in effect for the tax year an election under § 1.1367-1(g) to decrease basis by items of loss and deduction prior to decreasing basis by noncapital, nondeductible expenses and certain oil and gas depletion deductions, the shareholder also disregards decreases in basis under § 1367(a)(2)(D) and (E).

Section 1377(b)(1) provides that, for purposes of subchapter S of chapter 1, the term “post-termination transition period” means—

(A) the period beginning on the day after the last day of the corporation’s last tax year as an S corporation and ending on the later of—

(i) the day which is 1 year after such last day, or

(ii) the due date for filing the return for such last year as an S corporation (including extensions),

(B) the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer which follows the termination of the corporation’s election and which adjusts a subchapter S item of income, loss, or deduction of the corporation arising during the S period (as defined in § 1368(e)(2)), and

(C) the 120-day period beginning on the date of a determination that the corporation’s election under § 1362(a) had terminated for a previous tax year.

Section 1377(b)(2)(A) provides that, for purposes of § 1377(b)(1), the definition of the term “determination” includes a determination as defined in § 1313(a).

On or about Date 8, Taxpayers purchased shares in Company (acquired Company stock), obtaining a cost basis in the shares under § 1012. Taxpayers may include their adjusted basis in acquired Company stock as of the close of the last day of the PTPP in the determination of the amount of Taxpayers’ adjusted basis for purposes of § 1366(d)(3).

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Issue 2

Regarding Taxpayers' loss or deduction that, pursuant to § 1366(d)(3), carries over to the last day of a PTTTP arising under § 1377(b)(1)(B), there is nothing in the Code or the regulations that limits that loss or deduction to the amount determined in audit to be an adjustment to subchapter S items.

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