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September 18, 2015

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Re: Guidance Regarding Worthless Stock Deductions Under Section 165(g) for S Corporations

Dear Messrs. Koskinen, Wilkins, West, and Wilson:

The American Institute of CPAs (AICPA) is pleased to submit comments on the guidance regarding worthless stock deductions under section 165(g) for S corporations. This specific item is listed in the Department of the Treasury 2015-2016 Priority Guidance Plan[1] as the first priority of the S corporations category.

The AICPA is the world's largest member association representing the accounting profession, with more than 412,000 members in 144 countries, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We understand that the central focus of this priority list item, regarding worthless stock deductions, is to provide guidance on whether an S corporation is entitled to an ordinary loss deduction treatment under Internal Revenue Code (IRC or "Code") section 165(g)(3),[2] rather than a capital loss treatment under section 165(g)(1). In response to this issue, the AICPA recommends that the

[1] See the Department of the Treasury "2015-2016 Priority Guidance Plan," released July 31, 2015; http://www.irs.gov/uac/Priority-Guidance-Plan.
[2] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated there under, unless otherwise specified.

Internal Revenue Service (IRS) and the Department of the Treasury ("Treasury") conclude that an S corporation is entitled to the benefits of section 165(g)(3) to the same extent as a C corporation. We believe our proposed approach offers equity and fairness, which is a principle of good tax policy[3] that advocates for similarly situated taxpayers to have similar taxation.

Our comments set forth a background of this issue as well as an analysis of the principal authorities relevant to the question at hand. The recommendation included in this letter was developed by the AICPA S Corporation Taxation Technical Resource Panel (TRP) and approved by the AICPA Tax Executive Committee.

I. BACKGROUD

Many of the current provisions of subchapter S are, with minor modifications, substantially the same as the provisions enacted by the Subchapter S Revision Act of 1982.[4] However, since 1982, there have been other important modifications to subchapter S, some of which are relevant to the relationship between the taxation of S corporations and the application of section 165(g)(3).

Until 1996, an S corporation could not have owned a sufficient amount of the stock of another corporation in order to have eligibility to claim a worthless stock deduction qualifying under section 165(g)(3). With the changes enacted by the Small Business Job Protection Act of 1996 (the "1996 Act"),[5] an S corporation can now own any percentage of the stock of another corporation.[6] If the S corporation owns all of the stock of another corporation, and if certain other requirements are met, the S corporation can make an election to treat the subsidiary as a disregarded qualified subchapter S subsidiary.[7] If such an election is not in effect, or if one of the requirements for such status is not met, the subsidiary corporation is treated as a C corporation.

II. ANALYSIS

In support of equity in tax rules, we encourage the IRS and Treasury to provide guidance that an S corporation is entitled to the benefits of section 165(g)(3) to the same extent as a C corporation. The following is an analysis of our recommendation.

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[3] AICPA's Tax Policy Concept Statement No. 1: Guiding Principles for Good Tax Policy: Framework for Evaluating Tax Proposals, issued March 2001.
[4] Pub. L. No. 97-354.
[5] Pub. L. No. 104-188.
[6] The 1996 Act accomplished this change by modifying two provisions of the Code. Section 1308(a) of the 1996 Act amended section 1361(b)(2) by removing from the list of ineligible corporations "a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof)". Section 1308(d)(2) of the 1996 Act amended section 1504(b) by adding a new section 1504(b)(8) in order that an S corporation is not treated as an includible corporation. Thus, while an S corporation could own all of the stock of another corporation, the S corporation is not an includible corporation within an affiliated group. These changes were effective for taxable years beginning after December 31, 1996.
[7] Section 1361(b)(3).

A. <u>Loss from Worthless Securities</u>

Section 165(a) provides that a deduction is allowed for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(g)(1) provides that, if any security that is a capital asset becomes worthless during the taxable year, the loss from worthlessness is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.[8]

Section 165(g)(2) provides that, for purposes of section 165(g), the term "security" includes a share of stock in a corporation. Thus, under section 1222, a loss from the worthlessness of a share of stock is treated as a short-term capital loss or a long-term capital loss, depending on the holding period of such stock as of the end of the taxable year.

However, section 165(g)(3) allows an important exception to the capital loss treatment that is included in section 165(g)(1). If the requirements of this exception are satisfied, the security is not treated as a capital asset for purposes of section 165(g)(1). Since a qualifying security is not treated as a capital asset for this purpose, no part of section 165(g)(1) applies. Even though the qualifying security is likely a capital asset as defined in section 1221, there is no sale or exchange in the event that the security is merely deemed worthless or is abandoned. In the absence of a sale or exchange, the loss is not treated as a capital loss under section 1222.[9]

Section 165(g)(3) applies to any security in a corporation affiliated with a taxpayer that is a domestic corporation. The affiliation requirement is met if the taxpayer owns stock directly in the other corporation meeting the requirements of section 1504(a)(2) and the other corporation satisfies a gross receipts test. The stock ownership requirement is satisfied if the taxpayer owns stock possessing at least 80 percent of the total voting power of all classes of stock entitled to vote and at least 80 percent of the total value of all of the outstanding stock. These dual voting power and value tests are occasionally referred to as the "80/80" test. The gross receipts test is satisfied if more than 90 percent of the aggregate of the gross receipts of the corporation, for all taxable years, is from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stocks and securities.[10]

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[8] The fact pattern that involves this issue is always one in which an S corporation owns the requisite percentage of the stock of a subsidiary corporation and has sustained a loss from the complete worthlessness of such stock. In every case, the subsidiary stock is ordinarily treated as a capital asset under section 1221 and is not described in section 1221(a)(1) (stock in trade, property held for sale to customers in the ordinary course of a trade or business, etc.).

[9] The IRS and Treasury precluded ordinary loss treatment for certain stock and other securities where these assets have been abandoned prior to becoming worthless. Some taxpayers had taken the position that, because there was not a sale or exchange, the abandonment of these capital assets did not give rise to a capital loss. However, Treas. Reg. § 1.165-5(i) provides that worthlessness and abandonment should produce the same tax results, effective for any abandonment of stock after March 12, 2008. Thus, while abandonment of a section 165(g) "security" is generally treated as a sale or exchange, this rule does not apply to a security meeting the requirements of section 165(g)(3).

[10] Certain exceptions apply in the case of rents and interest, but these exceptions are not relevant to the question addressed by the guidance plan project.

B. Overview of Relevant Authorities

Sections 1363(b) and 1371(a)

We believe that two provisions of subchapter S are relevant in determining whether an S corporation may avail itself of the benefits of section 165(g)(3), (*i.e.*, sections 1363(b) and 1371(a)). However, the two provisions, when considered in light of this issue, may lead to different results. Accordingly, our comment letter explores both of these provisions in some detail as follows:

1. Section 1363(b)
   This section provides that, with four exceptions not relevant to this issue, the taxable income of an S corporation is computed in the same manner as in the case of an individual. Although the precise scope of this provision is not entirely clear,[11] a few applications of section 1363(b) are clear and well established. For example, an S corporation is not entitled to a dividends received deduction (DRD) under section 243. The IRS has ruled that an S corporation is subject to the limitations on deduction for nonbusiness bad debts under section 166(d).[12] Several years later, the IRS also ruled that an accrual basis S corporation may not elect, under section 170(a)(2), to treat a charitable contribution as paid in the year authorized by the corporation's board of directors if the contribution is paid by the S corporation after the close of the tax year.[13]

2. Section 1371(a)
   This section provides that, except as otherwise provided in the Code, and except to the extent inconsistent with subchapter S, subchapter C shall apply to an S corporation and its shareholders. As originally enacted in 1982, this provision was section 1371(a)(1). Section 1371(a)(2) had provided that, for purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation is treated as an individual. However, section 1310 of the 1996 Act effectively removed former section 1371(a)(2) and left former section 1371(a)(1) as the sole remaining provision governing the interaction between subchapters C and S.

   The original (1982) version of section 1371(a) created some confusion and, arguably, some inappropriate results. In 1988, the IRS took the position that an S corporation could not make a section 338 election with respect to the purchase of the stock of a C corporation, because an individual could not have made a qualified stock purchase within the meaning

[11] See K. Hill and K. Anderson, "Computing S Corporation Taxable Income: Unraveling the Mysteries of Section 1363(b)," 11(4) *Business Entities* 32, 39-41 (2009).
[12] Rev. Rul. 93-36, 1993-1 C.B. 187.
[13] Rev. Rul. 2000-43, 2000-41 I.R.B. 333.

of section 338(d)(1).[14] By the same logic, an S corporation could not have liquidated a C corporation on a tax-free basis under section 332 because an individual sole shareholder of a C corporation could not do such a liquidation. However, in 1992, the IRS reversed its position and held that former section 1371(a)(2) did not prevent an S corporation from being treated as a corporation for purposes of sections 332 and 338.[15]

This brief history was cited in the "Blue Book"[16] accompanying the 1996 Act, in which Congress sought to clarify that the position taken by the IRS in 1992 represented the proper policy. The purpose of the 1996 amendments to section 1371(a) was to clarify the relationship between subchapters C and S. The "Blue Book" explanation also stated that the repeal of former section 1371(a)(2) did not change the general rule governing the computation of the income of an S corporation.

Rath v. Commissioner and *Trugman v. Commissioner*

The relationship between the two Code provisions detailed above, as well as their potential application to other Code provisions, was considered in the following tax court opinions.

1. *Rath v. Commissioner*
   Specifically, this issue was discussed at length in *Rath v. Commissioner*, 101 T.C. 196 (1993). The taxpayer in the court opinion was a shareholder in an S corporation, which in turn owned some of the stock of another corporation. The S corporation sustained a loss in 1986 on the sale of the stock of the other corporation, and the shareholder sought to claim the benefits of section 1244 with respect to his share of the loss sustained by the corporation.

   Section 1244(a) provides that a loss on section 1244 stock is treated as an ordinary loss if it is issued to an individual or to a partnership (but for section 1244) that is treated as a loss from the sale or exchange of a capital asset to the extent provided in the section. The IRS acknowledged that the stock was section 1244 stock but asserted that an S corporation, in its capacity as the holder of such stock, was not entitled to the ordinary loss treatment conferred by section 1244(a).

   In *Rath*, the taxpayer advanced arguments under sections 1363(b) and 1366(b). The Tax Court devoted most of its analysis to the potential relevance of section 1366(b) but dispatched the section 1363(b) argument with only a cursory analysis. The court merely noted that, while section 1363(b) provides that the taxable income of an S corporation is

[14] Priv. Ltr. Rul. 8818049 (Feb. 10, 1988).
[15] Tech. Adv. Mem. 9245004 (July 28, 1992).
[16] See JCS-12-96, "Staff of Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress*," submitted on December 18, 1996;
https://www.jct.gov/publications.html?func=startdown&id=2346.

computed in the same manner as an individual, an S corporation is not included within the definition of the term "individual" set forth in section 1244(d)(4). Thus, it appears that the court focused on the actual form of ownership of the section 1244 stock, inasmuch as the statute required that the stock is "issued to [the] individual or to a partnership." The court was apparently unwilling to apply the principles of section 1363(b) to treat the S corporation as if it were an individual to whom the section 1244 stock was issued.

Noted authors made the following observation about the potential significance of the decision in the *Rath case*:

> This case may have broad significance regarding the relationship between (1) the ambiguous words of IRC §§ 1363(b) and 1366(b) and (2) other Code sections in which Congress used the word "corporation" or "individual" with no specific intent about S corporations.[17]

Elsewhere, after describing the holding of *Rath*, these authors identify Rev. Rul. 93-36[18] as "what may be a different view" of section 1363(b), also noting that the court expressed "no opinion regarding the revenue ruling."[19]

2. <u>*Trugman v. Commissioner*</u>
   Other cases also suggest that the principles of section 1363(b) should apply in the context of the specific other Code provision at stake. For example, in *Trugman v. Commissioner*, 138 T.C. 390 (2012), the Tax Court held that an S corporation that owned a residence occupied by its two shareholders was not entitled to claim the first-time homebuyer credit under section 36. The relevant statute defines a first-time homebuyer as "any individual if such individual . . . had no present ownership interest in a principal residence during the 3-year period ending on the date of the purchase of the principal residence." Although the court did not cite section 1363(b) in its opinion, it provided the following analysis in support of its conclusion:

> We hold that S corporations are not individuals for purposes of section 36. A corporation, at its core, is a business entity organized under State or Federal law, whether an association, a company, or another recognized form. *See* sec. 301.7701-2(b), Proced. & Admin. Regs. A corporation that satisfies certain criteria may elect small business status for Federal income tax purposes. Sec. 1361. An S election does not alter the corporation's corporate status; it merely alters the corporation's Federal tax implications. *See*

[17] J. Eustice and J. Kuntz, *Federal Income Taxation of S Corporations* ¶ 7.02[1], fn. 38 (WG&L).
[18] *Supra*, fn. 11.
[19] Eustice and Kuntz, *supra*, at ¶ 7.04[2], fn. 141.

> *generally* secs. 1361, 1363(a); sec. 1.1363-1(a), Income Tax Regs. Items of income, deduction, loss and credit generally pass through to the shareholders. Sec. 1366; *cf. Knott v. Commissioner*, T.C. Memo. 1991-352. S corporations remain freestanding entities "independently recognizable" from their shareholders. *Carlson v. Commissioner*, 112 T.C. 240, 244 (1999) (citing *United States v. Basye*, 410 U.S. 441, 448 (1973)).

We recognize that *Trugman* did not directly implicate section 1363(b), inasmuch as it considered a taxpayer's entitlement to a tax credit rather than the computation of its taxable income. Nevertheless, the analyses in *Rath* and *Trugman* suggest a basis for distinguishing Rev. Rul. 93-36 from a conclusion that an S corporation is entitled to an ordinary loss under section 165(g)(3).

Rev. Rul. 93-36 addresses the treatment of a nonbusiness bad debt loss incurred by an S corporation. This ruling concludes that section 1363(b) requires that an S corporation is treated as a "taxpayer other than a corporation" for this purpose and is thus subject to the less-favorable tax treatment of a nonbusiness bad debt applicable to individuals. However, we believe that the rather narrow scope of Rev. Rul. 93-36 is not determinative of the proper treatment of S corporations for purposes of section 165(g)(3). Rev. Rul. 93-36 does not deal with business bad debts or equity securities. In contrast, section 165(g)(3) is confined to dispositions of securities where the holder is the parent corporation of a wholly-owned, or nearly wholly-owned, subsidiary corporation. Just as *Trugman* held that an S corporation's ownership of a residence precluded the application of section 36 because the owner was not an individual, an S corporation should have the ability to apply section 165(g)(3) because it is a corporate owner of the requisite amount of the stock of another corporation. Accordingly, we believe that there is no conflict between ordinary loss treatment under section 165(g)(3) and the IRS's position in Rev. Rul. 93-36. If the forthcoming guidance is issued in the form of a revenue ruling, it should characterize Rev. Rul. 93-36 as having been distinguished.

C. Analysis of Relevant Authorities

Ordinary Loss Treatment

Having identified the potentially relevant authorities above, we return to the analysis of section 165(g)(3). To the extent that an unqualified application of the principles of section 1363(b) to this area is the proper approach, an S corporation is not eligible for ordinary loss treatment. If an individual were to directly own the stock of a corporation otherwise meeting the requirements of section 165(g)(3), the taxpayer could not claim the benefits of this provision. In contrast, if the right approach is to cast aside section 1363(b) in favor of other relevant principles, as the *Rath* court did, the focus is on the identity of the owner of the subsidiary stock. The language of section

165(g)(3) is not limited to stock owned by a C corporation. Nor does the statute provide that the benefits of section 165(g)(3) are not available to S corporations.[20] Thus, provided that an S corporation otherwise meets the requirements of section 165(g)(3) with respect to its subsidiary corporation, it is entitled to ordinary loss treatment.

We acknowledge that the authorities thus far do not conclusively establish whether an S corporation is entitled to ordinary loss treatment under section 165(g)(3). While the original purpose of section 165(g)(3) is not entirely clear, the stock ownership and gross receipts requirements of the 80/80 test demonstrate that Congress intended for qualified worthless stock deductions to demonstrate substantially similar characteristics as the realized losses obtained by a subsidiary with respect to a sale, exchange, or other disposition of all of its assets. Conversely, the legislative history of predecessor provisions suggests that the ordinary loss deduction is available only for an operating company and not for an investment or holding company.[21] This policy is reflected in Rev. Rul. 88-65,[22] where the IRS held that amounts received under leases of automobiles and trucks were not "rents" for purposes of section 165(g)(3), where significant services were also rendered by the corporation. This policy was also applied in a few private letter rulings in which the IRS permitted the use of section 165(g)(3) for subsidiaries engaged in the

[20] There are many instances elsewhere in the Code in which Congress limited a particular benefit to C corporations, precluded a benefit to an S corporation, or otherwise made a careful distinction between C corporations and S corporations. *See*, *e.g.*, section 56(g)(6) (exempting S corporations from the adjustment for adjusted current earnings under the alternative minimum tax); section 108(a)(1)(D) (permitting favorable tax benefits for income from the discharge of qualified real property business indebtedness in the case of a taxpayer other than a C corporation); section 163(e)(5)(D) (providing an exception for S corporations from the limitations otherwise imposed on an applicable high-yield debt obligation); section 170(e)(3)(A) (defining a qualified contribution as one made by a corporation other than an S corporation); section 170(e)(3)(C)(ii) (limiting certain charitable contribution deductions in the case of a taxpayer other than a C corporation); section 170(e)(4)(D) (specifically excluding an S corporation from the definition of the term "corporation" for purposes of section 170(e)(4)); section 170(f)(11)(B) (exempting certain C corporations from specified disclosure requirements with respect to charitable contributions of property); section 172(b)(1)(D)(iii) (effectively limiting the rules for corporate equity reduction transactions to C corporations); section 183(a) (applying the "hobby loss" limitations to an activity engaged in by an S corporation); section 280A(a) (applying the vacation home rules to individuals and S corporations); section 404(a)(9) (precluding an S corporation from deducting contributions to an employee stock ownership plan in excess of otherwise applicable limitations to the extent such contributions are applied to the payment of principal or interest on certain loans); section 404(k)(1) (limiting a deduction for dividends paid on certain employer securities to C corporations); section 448(a) (limiting the use of the cash method of accounting for C corporations); section 465(a)(1)(B) (applying the at-risk limitations to closely-held C corporations); section 469(a)(2)(B) (applying the limitations on passive activity losses and credits to closely-held C corporations); section 995(b)(1)(F)(i) (requiring certain income inclusions with respect to a DISC in the case of a shareholder which is a C corporation); section 1033(i)(2)(A) (precluding the use of section 1033 where the taxpayer is a C corporation and the replacement property is acquired from a related person); section 1042(c)(7) (precluding a C corporation from using the provision to defer gain from the sale of qualified securities); section 1044 (b)(2) (limiting the amount of gain which is excluded by a C corporation under that provision); section 1202(d)(1) (limiting the term "qualified small business" to C corporations); and section 1237(a) (providing a safe harbor regarding the character of the sale of real property subdivided for sale, but only in the case of a taxpayer other than a C corporation).
[21] See S. Rep. No. 91-1530, 91st Cong., 2d Sess. 2 (1970), 1971-1 C.B. 617, 618; S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543.
[22] 1988-2 C.B. 32.

banking or lending business, notwithstanding that a substantial portion of the subsidiaries' gross receipts would have been from interest.[23]

The 80/80 Test

As previously mentioned, the 80/80 test refers to the dual voting power and value tests, where the stock ownership requirement is satisfied if the taxpayer owns stock possessing at least 80 percent of the total voting power of all classes of stock entitled to vote and at least 80 percent of the total value of all of the outstanding stock. Several provisions in the Code, which use this same test, effectively treat ownership of stock meeting the requirements of this test as the substantial equivalent of the direct ownership of the underlying assets of the subsidiary. Thus, for example, if one corporation owns a sufficient amount of stock of another corporation, and certain other requirements are met, the parent corporation is entitled to a 100-percent deduction for dividends received from the subsidiary.[24]

The effect of this provision is to allow the subsidiary to distribute its earnings to its parent without a second level of taxation, in whole or in part. In addition, if a subsidiary was completely liquidated, and the parent receives some value in exchange for its stock in the subsidiary, neither the parent nor the subsidiary recognizes any gain or loss on the complete liquidation.[25] Instead, the parent succeeds to the adjusted tax basis that the subsidiary had in its assets,[26] and also succeeds to the other tax attributes of the subsidiary.[27] If an S corporation is otherwise subject to the provisions of section 1362(d)(3) or section 1375 because it has C corporation earnings and profits, it must determine whether it has excess net passive investment income. If the corporation owns stock of a C corporation meeting the 80/80 test, it is entitled to apply a look-through rule to determine the extent to which dividends from the subsidiary are considered passive investment income.[28] Finally, provided that two or more corporations are includible corporations, as defined in section 1504(b), the corporations are considered as part of an affiliated group and may join in the filing of a consolidated federal income tax return.[29]

Complete Liquidation of Another Corporation

The regulations recognize the relationship between sections 165(g) and 332, considering them as alternative, but mutually exclusive, consequences with respect to the ownership of subsidiary

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[23] See, *e.g.*, Priv. Ltr. Rul. 9218038 (Jan. 29, 1992); Priv. Ltr. Rul. 201347002 (Aug. 26, 2013).
[24] Section 243(a)(3) and (b).
[25] Section 332(a) (for the parent's gain or loss) and section 337(a) (for the subsidiary's gain or loss).
[26] Section 334(b), with certain exceptions not relevant to this issue.
[27] Section 381(a).
[28] Section 1362(d)(3)(C)(iv).
[29] Section 1501. As noted elsewhere, an S corporation is not an includible member of an affiliated group. Thus, an S corporation may not join in the filing of a consolidated return with any other corporation. However, the C corporations owned directly or indirectly by an S corporation may join in the filing of a consolidated return with each other, provided that the other requirements of section 1504(a) are satisfied.

stock. In setting forth what has long been an accepted requirement for a section 332 liquidation, Treas. Reg. § 1.332-2(b) provides that this section applies only to those cases in which the recipient corporation receives at least partial payment for the stock that it owns in the liquidating corporation. The regulation further provides that, "[i]f section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities." As noted above, provided that the gross receipts test is satisfied, the same stock ownership requirement that permits a tax-free liquidation of a *solvent* subsidiary also allows an ordinary loss under section 165(g)(3) with respect to an *insolvent* subsidiary.[30]

Section 1371(a) makes clear that an S corporation could liquidate a C corporation subsidiary on a tax-free basis under section 332 to the same extent that a C corporation parent could have liquidated a similar subsidiary. The same result applies to the consequences of a deemed liquidation resulting from the making of an election under section 1361(b)(3) for a qualified subchapter S subsidiary.[31] Subject to the potential application of section 1374, the parent corporation, having succeeded to the subsidiary's assets on a tax-free basis, could then sell or exchange those assets and recognize gains and losses having the same amount and character as if the subsidiary had sold them directly.[32] Accordingly, if an S corporation could directly recognize ordinary (or section 1231) gains and losses from the sale of the subsidiary's operating assets, it is reasonable to conclude that an S corporation should have the ability to recognize an ordinary loss deduction under section 165(g)(3), provided that the stock ownership and gross receipts tests are satisfied.

III. CONCLUSION

Following the holding in *Rath*, and based on the analysis of the provisions in the Code, it appears that S corporation shareholders can obtain the benefit of section 165(g)(3).[33] Accordingly, the AICPA respectfully requests that the IRS and Treasury conclude that an S corporation is entitled to the benefits of section 165(g)(3) to the same extent as a C corporation and issue the relevant guidance. We believe this approach will develop rules that are equitable and fair, ensuring similarly situated taxpayers are taxed similarly.

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The AICPA appreciates your consideration of these recommendations and we welcome the opportunity to discuss these items further. If you have any questions, please feel free to contact

[30] For a more recent analysis of this dichotomy, see Rev. Rul. 2003-125, 2003-52 I.R.B. 1243 (application of standards under sections 165(g)(3) and 332 resulting from an elective change in the federal tax classification of an entity from a corporation to a disregarded entity).
[31] Treas. Reg. § 1.1361-4(a)(2)(ii), *Example 1*.
[32] Of course, the parent would continue to make adjustments to the basis of the acquired property pursuant to section 1016.
[33] H. Sobol and S. Starr, 732-1st T.M., *S Corporations: Shareholder Tax Issues* at A.1.b.(3)(b).

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Sincerely,

Troy K. Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Mark Mazur, Assistant Secretary, Office of Tax Policy, Department of the Treasury
Ms. Donna M. Young, Deputy Associate Chief Counsel, Passthroughs and Special Industries, Internal Revenue Service
Mr. Benjamin M. Willis, Office of Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury