KOGOD SCHOOL *of* BUSINESS
AMERICAN UNIVERSITY • WASHINGTON, DC

June 24, 2011

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Recommendations for the Department of Treasury and Internal Revenue Service Guidance Priority List

Dear Commissioner Shulman,

The Kogod Tax Center at American University focuses primarily on tax matters that affect small businesses and entrepreneurs. We welcome the opportunity to offer recommendations for inclusion in the Department of Treasury and Internal Revenue Service's Guidance Priority List.

We respectfully request additional guidance in several areas of the tax code—outlined in the enclosed list—that are especially relevant to small businesses and entrepreneurs. If we can share any additional information or be of further assistance, please contact us at 202-885-6506.

Sincerely,

David J. Kautter
Managing Director, Kogod Tax Center
American University

Recommendations for the Department of Treasury and Internal Revenue Service Guidance Priority List

Areas Where Partnership Guidance Is Needed

Conversion of Single Member LLC to a Partnership

Often privately held small businesses operate as sole proprietorships, frequently legally organized as single member limited liability companies (LLCs). As opportunities exist for these single member LLCs to expand they often seek outside equity investors. Doing so typically results in the "conversion" of the LLC to partnership status for tax purposes.

For the efficient flow of capital as well as the efficient administration of our tax laws, it is important that there be adequate technical guidance for both the new investor as well as the original owner to understand the resulting tax consequences of a conversion of this type.

Revenue Ruling 99-5[1] addresses some of the issues involved. However, it leaves several questions open that are important for small business owners to understand before making the decision to attract additional capital. For instance, in the common situation where the single member LLC has liabilities, the seller in Situation 1 in the Rev. Rul. 99-5 needs to know if the buyer receives basis for his or her proportionate share of those liabilities, as would be the situation if the buyer had acquired units of a partnership rather than an LLC, and, if so, that the seller's basis will be diminished accordingly.

Similar guidance is needed to address the situation where the new investor acquires his or her interest by contributing capital in exchange for partnership units (as distinguished from Situation 1 in Rev. Rul. 99-5 where the individual acquires the partnership interest by purchasing a portion of the existing owner's interest).

Treatment of LLC Income as Self-Employment Income

Many privately owned small businesses operate as LLCs. The law is clear that, with few exceptions, income from a partnership is subject to self-employment tax. Guidance is needed to clarify if a similar rule applies to LLCs operating as partnerships.

Currently there are proposed regulations dating back to 1997 but no temporary or final regulations that address limited partners under section IRC Section 1402(a)(13). The

[1] 1999-1 CB 434

IRS has frequently argued that, by definition, an owner of an LLC interest cannot be "materially active" for purposes of applying the passive loss rules of IRC Section 469. Some have taken this to mean that income from an LLC is not subject to self-employment tax.

This is viewed by some to be an aggressive position while an accurate interpretation by others. For this reason alone, we believe it is important that the IRS withdraw the proposed regulations and issue definitive guidance in the form of final or temporary regulations on this matter.

Treatment of Limited Liability Company Members Under Section 469(h)(2)

IRC Section 469(h)(2) provides that "Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."

The treatment of members of a limited liability company (LLC) under IRC Section 469(h)(2) has been the subject of litigation and is a matter on which there continues to be substantial confusion and disagreement. We believe that regulations should be issued clarifying the status of members of an LLC under IRC Section 469(h)(2) and that those regulations should follow the judicial authority in the area and take into account the 2001 revisions to the Uniform Limited Partnership Act.

Areas Where S Corporations Guidance Is Needed

The most common entity for small businesses is the S corporation.

Treatment of Losses Carried Over Due to Lack of Basis

Small businesses frequently incur losses, particularly in their initial years of operation. In the case of an S corporation, these losses can only be used by the shareholders to the extent they have basis in their shares of stock at year-end. Any excess loss is carried over to the subsequent year.

Regulation Section 1.1366-2(a)(2) seems to provide that a "suspended" loss retains its character and is deemed to be incurred by the corporation in the next tax year and allocated to those who were shareholders in the year the loss was generated.

The IRS has interpreted the regulation differently, however. Under the IRS interpretation, the income or loss for the year succeeding the carryover year (the second year) is computed independently of the carryover from the first year and the

result is used to compute the gain or loss on the disposition of stock with the initial loss from the first year carried forward to the third year.

These two alternative interpretations can have significantly different tax effects on those who were shareholders in the year of the initial loss. For instance, if an initial shareholder receives a distribution in excess of basis in the second year his or her capital gain or loss versus ordinary income will differ depending on which interpretation is effective.

> For example: Assume a sole shareholder with a stock basis of $10,000 and the corporation has a loss of $15,000 in its first year. Under both interpretations that would reduce the shareholder's basis to zero and $5,000 of the loss is carried over to year 2.
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> Assuming in year 2, the corporation had net income of, say, $10,000 before considering the carryover loss of $5,000 and makes a distribution of $20,000 to the sole shareholder. Under what we believe is the predominant interpretation under the existing regulation, the $5,000 carryover would be applied against the $10,000 income. The sole shareholder would then be taxed at ordinary rates on the net $5,000 and would have a $5,000 basis resulting in a $15,000 capital gain related to the $20,000 distribution.
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> Under the current IRS interpretation, however, the income of the corporation in year 2 would be computed without regard to the loss carry forward, resulting in the shareholder being taxed on ordinary income of $10,000 which, when added to the shareholder's previous zero basis, would result in a capital gain of $10,000. The year one loss would be carried forward to year 3.
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> Under either scenario the shareholder is taxed on $20,000 of income. The difference is only in the allocation between ordinary and capital gain income, but that is an important difference to taxpayers who anticipate their investment is likely to generate losses in its initial years of operation.

We believe the regulation cited above is clear in requiring that the loss from the first year be treated as if incurred in the second year when calculating the shareholders' basis.

Built-In-Gains Tax

In the current economic environment many privately held small business have been forced to sell appreciated assets in order to raise working capital. IRC Section 1374, as originally enacted required an S corporation that sold an appreciated asset less than ten years after electing S status to pay a tax at the corporate level that simulated the tax it would have paid had it not elected S status. Recent temporary changes in the tax law

have shortened the ten-year holding period necessary to avoid this “double tax” (7 years for assets sold in 2009 or 2010, and 5 years for assets sold in 2011.)

Guidance is needed to address the rather common situation where the asset is sold in a year that would avoid the double tax but a portion or all the income from the sale will be recognized in a later year that, unless the shortened holding period is extended, might not qualify for the exclusion from the double taxation regime. An example is an installment sale in 2011, where the payments are received over five years but the five-year rule applicable in 2011 is not extended.

The clear intent of the law shortening the holding period was to be economically simulative to small businesses by providing them with greater after tax cash flow, thereby enhancing their economic viability and sustainability. Accordingly, we believe the law in effect in the year of the sale should control the characterization of all subsequent payments related to that sale.

Ability to Utilize Suspended Passive Losses

The following is a common situation for small business. An entrepreneur forms an S corporation to begin his or her business that is financed by relatives, say parents, who are not active in the company. In its initial years the company generates losses. The parents’ ability to utilize their proportionate share of the losses is suspended under section 469, the passive activity loss rules.

When it appears the company is self sustaining and no longer in need of the parents’ capital, the entrepreneur redeems the parents’ stock, after which they have no further connection with the business. Under the existing guidance, the tax benefit of the suspended passive losses in this situation could never be utilized.

The guidance that does exist would permit the losses to be used when the related party, the entrepreneur in the example, makes a disposition of the stock. But, in the case of redemption, the stock goes out of existence and there will be no future disposition. We believe this is contrary to the intent of the passive loss rules that we believe were never intended to permanently disallow real economic losses. Guidance should be issued that clarifies that, where the redemption qualifies as a complete termination of the related party’s interest in the S corporation, the redemption triggers the recognition of the suspended passive losses of that shareholder.