Dated: September 24, 2007.

Nancy M. Morris,

Secretary.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–143326–05]

RIN 1545–BE95

S Corporation Guidance Under AJCA of 2004 and GOZA of 2005

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance regarding certain changes made to the rules governing S corporations under the American Jobs Creation Act of 2004 and the Gulf Opportunity Zone Act of 2005. The proposed regulations are necessary to replace obsolete references in the current regulations and to allow taxpayers to make proper use of the provisions that made changes to prior law. In particular, the proposed regulations provide guidance on the S corporation family shareholder rules, the definitions of ''powers of appointment'' and ''potential current beneficiaries'' (PCBs) with regard to electing small business trusts (ESBTs), the allowance of suspended losses to the spouse or former spouse of an S corporation shareholder, and relief for inadvertently terminated or invalid qualified subchapter S subsidiary (QSub) elections. The proposed regulations will affect S corporations and their shareholders. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by December 27, 2007. Outlines of topics to be discussed at the public hearing scheduled for January 16, 2008, at 10 a.m., must be received by December 27, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–143326–05), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–143326–05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov/* (indicate IRS REG–143326–05). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Bradford R. Poston, (202) 622–3060; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Kelly Banks, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by November 27, 2007.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The reporting requirement in these proposed regulations is in § 1.1361–1(m)(2)(ii)(A). This information must be reported by the trustees of trusts electing to be ESBTs. This information will be used by the IRS to determine the number of shareholders of the corporation in which the trust holds stock and thus whether the corporation is an eligible S corporation. The respondents will be trusts making an ESBT election.

The following estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on the information that is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Estimated total annual reporting burden: 26,000 hours.

Estimated average annual burden: 1 hour.

Estimated number of respondents: 26,000.

Estimated annual frequency of response: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) concerning S corporations under sections 1361, 1362, and 1366 of the Internal Revenue Code (Code). These Code sections were amended by sections 231, 232, 233, 234, 235, 236, 237, 238, and 239 of the American Jobs Creation Act of 2004 (Pub. L. 108–357, 118 Stat. 1418) (the 2004 Act) and sections 403 and 413 of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135) (the 2005 Act). This document does not address other amendments made by the 2004 Act or the 2005 Act. In addition, this document contains additional proposed amendments to the regulations under Code section 1362 necessary to conform the regulations to the changes made by section 1305(a) of the Small Business Job Protection Act of 1996 (Pub. L. 104–188, 110 Stat. 1755) (the 1996 Act).

Explanation of Provisions

Increase in Maximum Number of Shareholders

Section 232 of the 2004 Act amends Code section 1361(b)(1)(A) by increasing the permitted number of shareholders from 75 to 100 for a small business corporation eligible to make an S election. This provision is effective for taxable years beginning after December 31, 2004. The proposed regulations remove or amend several references in the regulations under Code section 1361 that cite a specific number of permissible S corporation shareholders, except insofar as such references are necessary in an example. This change will accommodate any future statutory changes in the maximum number of permitted shareholders.

Family Shareholders

Section 1361(c)(1), as amended by section 231(a) of the 2004 Act and section 403(b) of the 2005 Act, treats a husband and wife (and their estates), and all members of a family (and their estates) as one shareholder for purposes of the 100 shareholder limitation. Section 403(b) of the 2005 Act eliminated the requirement of an election in order for a family to be treated as one shareholder, providing instead that members of a family would automatically be treated as one shareholder for purposes of Code section 1361(b)(1)(A). This amendment is effective as if included in section 231 of the 2004 Act for tax years beginning after December 31, 2004. Notice 2005–91 (2005–2 CB 1164), see § 601.601(d)(2)(ii)(*b*), issued prior to the enactment of section 403(b) of the 2005 Act, informed taxpayers that the Treasury Department and the IRS intended to issue guidance regarding the family shareholder election under section 1361(c) and provided that taxpayers could rely on the provisions of Notice 2005–91 until the issuance of that guidance. Although the portions of Notice 2005–91 addressing the manner of making the family shareholder election are no longer relevant, the proposed regulations retain the provisions of Notice 2005–91 describing certain entities other than individuals that will be treated as members of the family.

The family members are determined by reference to a common ancestor. Section 1361(c)(1)(B) defines ''members of a family'' as a common ancestor, any lineal descendant of the common ancestor, and any spouse or former spouse of the common ancestor or any such lineal descendant. Adopted and foster children are included among the lineal descendants as described in section 1361(c)(1)(C). An individual is not eligible to be the common ancestor for purposes of this provision if, on the applicable date, the individual is more than 6 generations removed from the youngest generation of shareholders who would otherwise be members of the family (without regard to the ''six generation'' test of Code section 1361(c)(1)(B)(ii)). Section 403(b) of the 2005 Act also changed the applicable date in section 1361(c)(1)(B)(iii) on which a person will be tested for qualification as a ''common ancestor'' to the latest of (1) The date the S election is made, (2) the earliest date an individual who is a ''member of the family'' holds stock in the S corporation, or (3) October 22, 2004. The regulation clarifies that the ''six generation'' test is applied only at the date specified in Code section 1361(c)(1)(B)(iii) for determining whether an individual meets the definition of ''common ancestor,'' and has no continuing significance in limiting the number of generations of a family that may hold stock and be treated as a single shareholder. The regulation provides that there is no adverse consequence to a person being a member of two families.

Disregard of Unexercised Powers of Appointment in ESBTs

Potential current beneficiaries (PCBs) are treated as shareholders of the corporation for purposes of Code section 1361(b)(1) (which addresses both shareholder eligibility and the permitted number of shareholders). Section 234 of the 2004 Act amended Code section 1361(e)(2) by providing that in determining an ESBT's PCBs for any period, powers of appointment will be disregarded to the extent not exercised by the end of that period. The amended section also increases the period from 60 days to one year during which an ESBT may safely dispose of S corporation stock after an ineligible shareholder becomes a PCB. These amendments apply to taxable years beginning after December 31, 2004.

The amendment overrides current § 1.1361–1(m)(4)(vi) and the illustrative example which provides that any person who may receive a distribution under a currently exercisable power of appointment is a PCB. Under § 1.1361–1(m)(4)(vi), the broad powers of appointment commonly included in many trusts used for estate planning purposes would preclude those trusts from qualifying as ESBTs, because that power would cause the S corporation to have an excessive number of deemed shareholders or to have as deemed shareholders persons ineligible to hold S corporation stock. The proposed regulations remove and replace the sections of the regulation inconsistent with current law.

The Treasury Department and the IRS have received inquiries concerning whether certain powers held by a trustee or any other person who is not a beneficiary will be considered to be powers of appointment for purposes of Code section 1361(e)(2), and thus be disregarded (to the extent not exercised) in determining the PCBs of the ESBT. In particular, there is concern about the powers to add persons to the class of current beneficiaries or to select from an unlimited class of charitable beneficiaries. Under the current regulations, such powers, regardless of the identity of the holder, could result in the termination of the S corporation election if the class of charities that could currently receive distributions or the class of persons who could be added as beneficiaries is sufficiently large to cause the corporation to have more than the number of shareholders allowed by Code section 1361(b)(1)(A).

''Power of appointment'' is not defined or described in either Code section 1361(e)(2) as amended or in current § 1.1361–1(m). However, ''power of appointment'' is described for estate tax purposes in § 20.2041–1(b) of the Estate Tax Regulations and for gift tax purposes in § 25.2514–1(b) of the Gift Tax Regulations. For transfer tax purposes, a power of appointment generally includes the power to appropriate or consume the principal of the trust or the power to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust.

If the transfer tax descriptions are narrowly interpreted, powers held by fiduciaries (who are not also beneficiaries of the trust) to spray or sprinkle trust distributions would generally not be ''powers of appointment.'' Therefore, the relief provided by the amended provision of Code section 1361(e)(2) would not apply to prevent the possible creation of an excessive number of PCBs. These powers would continue to be treated under the general rule of current § 1.1361–1(m)(4)(i), which provides that a PCB ''is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust.'' Any sufficiently broad power to spray or sprinkle trust distributions would result in an excessive number of PCBs and thus

cause the termination of the S corporation election.

Alternatively, if all fiduciary powers to spray or sprinkle trust distributions to a class of current beneficiaries or possible current beneficiaries were deemed to be ''powers of appointment'' for purposes of Code section 1361(e)(2), this would effectively result in the replacement of ''potential current beneficiaries'' as a measuring tool under Code section 1361(b)(1) with ''current beneficiaries,'' as only those actually receiving distributions would ever meet the PCB definition. The 2004 Act, however, did not replace ''potential current beneficiary'' with ''current beneficiary''.

The Treasury Department and the IRS believe that the proper interpretation of the change made by the 2004 Act is that the provision avoids counting as PCBs an unlimited number of potential appointees who may never become permissible beneficiaries. In this manner, the legislative change prevents the mere presence of common estate planning powers in a trust instrument from resulting in a termination of the S corporation election because of an excessive number of PCBs. The power to select from among an unlimited class of charities within the class of beneficiaries who may receive current distributions from a trust in the discretion of a fiduciary is a common estate planning power.

The proposed regulations amend the definition of ''potential current beneficiary'' to provide that all members of a class of unnamed charities permitted to receive distributions under a discretionary distribution power held by a fiduciary that is not a power of appointment, will be considered, collectively, to be a single PCB for purposes of determining the number of permissible shareholders under section 1361(b)(1)(A) unless the power is actually exercised, in which case each charity that actually receives distributions will also be a PCB. The ESBT election requirements under § 1.1361–1(m)(2)(ii)(A) are amended to require a trust containing such a power to indicate the presence of the power in the election statement. This amended PCB definition applies only to powers to distribute to one or more members of a class of unnamed charities which is unlimited in number. The amended PCB definition does not apply to a power to make distributions to or among particular named charities.

The proposed regulations further provide that a power to add beneficiaries, whether or not charitable, to a class of current permissible beneficiaries is generally a power of appointment and thus will be disregarded to the extent it is not exercised. However, if the power is exercised and an unlimited class of charitable beneficiaries is added to the class of current permissible beneficiaries, that class will count as a single PCB under the amended definition of PCB, and, to the extent distributions are actually made to one or more charities, those charities will each count as PCBs.

Transfer of Stock Between Spouses or Incident to Divorce

Section 235 of the 2004 Act amended Code section 1366(d)(2) to provide that if the stock of an S corporation is transferred between spouses or incident to divorce under Code section 1041(a), any loss or deduction with respect to the transferred stock which cannot be taken into account by the transferring shareholder in the year of the transfer because of the basis limitation in section 1366(d)(1) shall be treated as incurred by the corporation in the succeeding taxable year with regard to the transferee. Prior to this amendment, any losses or deductions disallowed under section 1366(d) were personal to the shareholder and did not transfer upon the transfer of the S corporation stock to another person. Section 1366(d)(2) is effective for transfers after December 31, 2004.

The proposed regulations amend the provisions of § 1.1366–2(a)(5) to include this exception to the general rule of nontransferability of losses and deductions. Losses and deductions allocable to the transferor spouse for the taxable year immediately preceding the year of transfer that are subject to the basis limitation rule of section 1366(d) will be treated as incurred by the corporation with respect to the transferor spouse in the taxable year of the transfer. The transferor spouse may use all losses and deductions carried over to the year of transfer if the transferor spouse has sufficient basis in the transferor's adjusted basis in stock or adjusted basis in the indebtedness of the corporation to the transferor. Under § 1.1366–2(a)(4), if the transferor's pro rata share of the losses and deductions in the year of transfer exceeds the transferor's basis in stock or the indebtedness of the corporation to the transferor, then the limitation must be allocated among the transferor spouse's pro rata share of each loss or deduction, including disallowed losses and deductions carried over from the prior year. Under the proposed regulations, losses and deductions carried over to the year of transfer that are not used by the transferor spouse in such year will be prorated between the transferor spouse and the transferee spouse based on their stock ownership at the beginning of the succeeding taxable year. The proposed regulations include examples illustrating these rules. The Treasury Department and IRS request comments on the best methods to ensure that losses are properly allocated between the transferor and transferee spouses, including whether a notification requirement should be imposed on the transferor spouse.

Passive Activity Losses and At-risk Amounts of Qualified Subchapter S Trusts

Section 236 of the 2004 Act amends Code section 1361(d)(1) to provide that, for purposes of applying Code sections 465 and 469 to the beneficiary of a qualified subchapter S trust (QSST) with respect to which the beneficiary has made an election under Code section 1361(d)(2), the disposition of S corporation stock by the QSST shall be treated as a disposition by the beneficiary. This creates an exception to the general rule of § 1.1361–1(j)(8), which provides that the trust, rather than the beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of a disposition of the stock. The proposed regulations add conforming language to § 1.1361–1(j)(8).

Qualified Subchapter S Subsidiary Relief and Inadvertent Invalid Elections or Terminations

Section 238 of the 2004 Act amends Code section 1362(f) to provide that QSubs are eligible for relief for an inadvertent invalid QSub election or termination under the same standards applied to an inadvertent invalid S corporation election or termination. This provision is effective for elections made and terminations occurring after December 31, 2004. The proposed regulations make conforming changes to § 1.1362–4. The proposed regulations make additional changes to § 1.1362–4 addressing the change to Code section 1362(f) made by section 1305(a) of the 1996 Act, which provided relief for corporations with inadvertently invalid S corporation elections, in addition to the relief already available for inadvertent terminations of valid S corporation elections.

Effect on Other Documents

The following publication is proposed to be obsoleted as of the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**:

Notice 2005–91 (2005–2 CB 1164).

Proposed Effective Date

These regulations are proposed to be effective on the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Further, it has been determined that these regulations are not subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6) because the collection of information required by these regulations is imposed on electing small business trusts and such entities are not ''small entities'' for purposes of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Additionally, the information collection burden imposed on the electing small business trusts is minimal. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 16, 2008, beginning at 10 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by December 27, 2007. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Bradford R. Poston of the Office of Associate Chief Counsel (Passthroughs and Special Industries).

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1361–0 is amended by adding a new entry in the table of contents for § 1.1361–1(e)(3) to read as follows:

§ 1.1361–0 Table of contents.

* * * * *

§ 1.1361–1 S Corporation defined.

* * * * *

(e) * * *

(3) Special rules relating to stock owned by members of a family.

Par. 3. Section 1.1361–1 is amended by:

1. Revising paragraphs (b)(1)(i) and (e)(1).

2. Adding paragraphs (e)(3), (h)(1)(vii), and (h)(3)(i)(G).

3. Adding a new sentence to the end of paragraph (j)(8).

4. Adding a new sentence to the end of paragraph (k)(2)(i).

5. Revising paragraphs (m)(2)(ii)(A), (m)(4)(iii), and (m)(4)(vi).

6. Revising paragraph (m)(8), *Example 2.*

7. Revising the seventh sentence of paragraph (m)(8), *Example 5.*

8. Revising paragraph (m)(8), *Example 7.*

9. Adding paragraph (m)(8), *Example 8.*

10. Adding paragraph (m)(8), *Example 9.*

11. Adding a sentence to the end of paragraph (m)(9).

The revisions and additions read as follows:

§ 1.1361–1 S Corporation defined.

* * * * *

(b) * * * (1) * * *

(i) More than the number of shareholders provided in section 1361(b)(1)(A);

* * * * *

(e) *Number of shareholders*—(1) *General rule.* A corporation does not qualify as a small business corporation if it has more than the number of shareholders provided in section 1361(b)(1)(A). Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation. For example, if stock (owned other than by a husband and wife or members of a family described in section 1361(c)(1)) is owned by tenants in common or joint tenants, each tenant in common or joint tenant is generally considered to be a shareholder of the corporation. (For special rules relating to stock owned by husband and wife or members of a family, see paragraphs (e)(2) and (3) of this section, respectively; for special rules relating to restricted stock, see paragraphs (b)(3) and (6) of this section.) The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation. In addition, in the case of stock held for a minor under a uniform transfers to minors or similar statute, the minor and not the custodian is the shareholder. Except as otherwise provided in paragraphs (h) and (j) of this section, and for purposes of this paragraph (e) and paragraphs (f) and (g) of this section, if stock is held by a decedent's estate or a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate or trust (and not the beneficiaries of the estate or trust) is considered to be the shareholder; however, if stock is held by a subpart E trust (which includes a voting trust) or an electing QSST described in section 1361(d)(1), the deemed owner of the

trust is considered to be the shareholder. If stock is held by an ESBT described in section 1361(c)(2)(A)(v), each potential current beneficiary of the trust shall be treated as a shareholder, except that the trust shall be treated as the shareholder during any period in which there is no potential current beneficiary of the trust. If stock is held by a trust described in section 1361(c)(2)(A)(vi), the individual for whose benefit the trust was created shall be treated as the shareholder. See paragraph (h) of this section for special rules relating to trusts.

* * * * *

(3) *Special rules relating to stock owned by members of a family*—(i) In general. For purposes of paragraph (e)(1) of this section, stock owned by members of a family is treated as owned by one shareholder. Members of a family include a common ancestor, any lineal descendant of the common ancestor, and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this six-generation test) be members of the family. For purposes of this test, a spouse (or former spouse) is treated as being of the same generation as the individual to whom the spouse is or was married. This test is applied on the latest of the date the election under section 1362(a) is made for the corporation, the earliest date that a member of the family holds stock in the corporation, or October 22, 2004. For this purpose, the date the election under section 1362(a) is made for the corporation is the effective date of the election, not the date it is signed or received by any person. The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date. The members of a family are treated as one shareholder under this paragraph (e)(3) solely for purposes of section 1361(b)(1)(A), and not for any other purpose, whether under section 1361 or any other provision. Specifically, each member of the family who owns or is deemed to own stock must meet the requirements of sections 1361(b)(1)(B) and (C) (regarding permissible shareholders) and section 1362(a)(2) (regarding shareholder consents to an S corporation election). Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of the other family) will be treated as one shareholder. For purposes of this paragraph (e)(3), any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by that individual, and any eligible foster child of an individual (within the meaning of section 152(f)(1)(C)), shall be treated as a child of such individual by blood.

(ii) *Certain entities treated as members of a family.* For purposes of this paragraph (e)(3), the estate or trust (described in section 1361(c)(2)(A)(ii) or (iii)) of a deceased member of the family will be considered to be a member of the family during the period in which the estate or such trust (if the trust is described in section 1361(c)(2)(A)(ii) or (iii)), holds stock in the S corporation. The members of the family also will include—

(A) In the case of an ESBT, each potential current beneficiary who is a member of the family;

(B) In the case of a QSST, the income beneficiary who makes the QSST election, if that income beneficiary is a member of the family;

(C) In the case of a trust created primarily to exercise the voting power of stock transferred to it, each beneficiary who is a member of the family;

(D) The individual for whose benefit a trust described in section 1361(c)(2)(A)(vi) was created, if that individual is a member of the family;

(E) The deemed owner of a trust described in section 1361(c)(2)(A)(i) if that deemed owner is a member of the family; and

(F) The owner of an entity disregarded as an entity separate from its owner under § 301.7701–3 of the Procedure and Administration Regulations, if that owner is a member of the family.

* * * * *

(h) * * * (1) * * *

(vii) *Individual retirement accounts.* In the case of a corporation which is a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)), a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank or company as of October 22, 2004. Individual retirement accounts (including Roth IRAs) are not otherwise eligible S corporation shareholders.

* * * * *

(3) * * * (i) * * *

(G) If stock in an S corporation bank or depository institution holding company is held by an individual retirement account (including a Roth IRA) described in paragraph (h)(1)(vii) of this section, the individual for whose benefit the trust was created shall be treated as the shareholder.

* * * * *

(j) * * *

(8) * * * However, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary.

* * * * *

(k) * * * (2) * * *

(i) * * * Paragraphs (b)(1)(i), (e)(1), (e)(3), (h)(1)(vii), (h)(3)(i)(G), and the fifth sentence of paragraph (j)(8) are effective on and after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

(m) * * * (2) * * *

(ii) * * *

(A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently holds stock. If the trust includes a power described in paragraph (m)(4)(vi)(B) of this section, then the election statement must include a statement that such a power is included in the instrument, but does not need to include the name, address, or taxpayer identification number of any particular charity or any other information regarding the power.

* * * * *

(4) * * *

(iii) *Special rule for dispositions of stock.* Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

* * * * *

(vi) *Currently exercisable powers of appointment and other powers*—(A) *Powers of appointment.* A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041–1(b) of this chapter and section 2514 and § 25.2514–1(b) of this chapter) is not a potential current

beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph (m)(4)(vi)(A) whether such power of appointment is a ''general power of appointment'' for transfer tax purposes as described in § 20.2041–1(c) and § 25.2514–1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C), will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an excessive number of persons or in favor of a person who is ineligible to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a ''power of appointment'' includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of ''power of appointment'' for purposes of any provision of the Internal Revenue Code or the regulations.

(B) *Powers to distribute to certain organizations not pursuant to powers of appointment.* If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041–1(b) and 25.2514–1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) shall not apply to a power to currently distribute to one or more particular charitable organizations named in the instrument. Each of such organizations is a potential current beneficiary of the trust.

* * * * *

(8) * * *

Example 2. (i) *Invalid potential current beneficiary.* Effective January 1, 2005, Trust makes a valid ESBT election. On January 1, 2006, *A*, a nonresident alien, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within one year after January 1, 2006. As of January 1, 2006, *A* is the potential current beneficiary of Trust and therefore is treated as a shareholder of the S corporation. Because *A* is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any corporation in which Trust holds stock terminates effective January 1, 2006. Relief may be available under section 1362(f).

(ii) *Invalid potential current beneficiary and disposition of S stock.* Assume the same facts as in *Example 2* (i) except that within one year after January 1, 2006, trustee of Trust disposes of all Trust's S corporation stock. *A* is not considered a potential current beneficiary of Trust and therefore is not treated as a shareholder of any S corporation in which Trust previously held stock.

* * * * *

Example 5. * * * Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). * * *

* * * * *

Example 7. Potential current beneficiaries and powers of appointment. M creates Trust from which *A* has a right to all net income and funds it with S corporation stock. *A* also has a currently exercisable power to appoint income or principal to anyone except *A*, *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. The potential current beneficiaries of Trust for any period will be *A* and each person who receives a distribution from Trust pursuant to *A*'s exercise of *A*'s power of appointment during that period.

Example 8. Power to distribute to an unlimited class of charitable organizations not pursuant to a power of appointment. M creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to any organizations described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A,* each then-living descendant of *M*, and each exempt organization described in section 1361(c)(6) that receives a distribution during that period. In addition, the class of exempt organizations will be counted as one potential current beneficiary.

Example 9. Power to distribute to a class of named charitable organizations not pursuant to a power of appointment. M creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to *X*, *Y*, and *Z*, each of which is an organization described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, *X*, *Y*, *Z*, and each living descendant of *M*.

(9) *Effective/applicability date.* * * * Paragraphs (m)(2)(ii)(A), (m)(4)(iii) and (vi), and (m)(8), *Example 2, Example 5, Example 7, Example 8,* and *Example 9* are effective on and after the date of publication of the Treasury decision adopting these rules as final regulations is published in the **Federal Register**.

Par. 4. Section 1.1361–4 is amended by revising paragraph (a)(1) and adding new paragraph (a)(9) to read as follows:

§ 1.1361–4 Effect of QSub Election.

(a) *Separate existence ignored*—(1) *In general.* Except as otherwise provided in paragraphs (a)(3), (a)(6), (a)(7), (a)(8), and (a)(9) of this section, for Federal tax purposes—

(i) A corporation which is a QSub shall not be treated as a separate corporation; and

(ii) All assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.

* * * * *

(9) *Information returns*—(i) *In general.* Except to the extent provided by the Secretary, paragraph (a)(1) of this section shall not apply to part III of subchapter A of chapter 61, relating to information returns.

(ii) *Effective/applicability date.* This paragraph (a)(9) is effective on and after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

Par. 5. Section 1.1361–6 is amended by revising the first sentence as follows:

§ 1.1361–6 Effective date.

Except as provided in §§ 1.1361–4(a)(3)(iii), 1.1361–4(a)(5)(i), 1.1361–4(a)(6)(iii), 1.1361–4(a)(7)(ii), 1.1361–4(a)(8)(ii), 1.1361–4(a)(9), and 1.1361–5(c)(2), the provisions of §§ 1.1361–2 through 1.1361–5 apply to taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part (aside from those sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner.

* * *

Par. 6. Section 1.1362–0 is amended by revising the heading of the table of contents for § 1.1362–4 to read as follows:

§ 1.1362–0 Table of contents.

* * * * *

§ 1.1362–4 Inadvertent terminations and inadvertently invalid elections.

* * * * *

Par. 7. Section 1.1362–4 is amended by:

1. Revising the section heading and paragraphs (a), (b), (c), (d), and (f).

2. Adding paragraph (g).

The addition and revisions read as follows:

§ 1.1362–4 Inadvertent terminations and inadvertently invalid elections.

(a) *In general.* A corporation is treated as continuing to be an S corporation or a QSub (or, an invalid election to be either an S corporation or a QSub is treated as valid) during the period specified by the Commissioner if—

(1) The corporation made a valid election under section 1362(a) or section 1361(b)(3) and the election terminated or the corporation made an election under section 1362(a) or section 1361(b)(3) that was invalid;

(2) The Commissioner determines that the termination or invalidity was inadvertent;

(3) Steps were taken by the corporation to return to or qualify for small business corporation or QSub status within a reasonable period after discovery of the terminating event or invalid election, or the required shareholder consents are acquired; and

(4) The corporation and shareholders agree to adjustments that the Commissioner may require for the period.

(b) *Inadvertent termination or inadvertently invalid election.* For purposes of paragraph (a) of this section, the determination of whether a termination or invalid election was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination or invalid election was inadvertent. The fact that the terminating event or invalidity of the election was not reasonably within the control of the corporation and, in the case of a termination, was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent.

(c) *Corporation's request for determination of an inadvertent termination or invalid election.* A corporation that believes that the termination or invalidity of its election was inadvertent may request a determination from the Commissioner that the termination or invalidity of its election was inadvertent. The request is made in the form of a ruling request and should set forth all relevant facts pertaining to the event or circumstance including, but not limited to, the facts described in paragraph (b) of this section, the date of the corporation's election (or intended election) under section 1362(a) or 1361(b)(3), a detailed explanation of the event or circumstance causing the termination or invalidity, when and how the event or circumstance was discovered, and the steps taken under paragraph (a)(3) of this section.

(d) *Adjustments.* The Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation or QSub during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination or invalid election for an S corporation under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).

* * * * *

(f) *Status of corporation.* The status of the corporation after the terminating event or invalid election and before the determination of inadvertence is determined by the Commissioner. Inadvertent termination or inadvertent invalid election relief may be granted retroactively for all years for which the terminating event or circumstance giving rise to invalidity is effective, in which case the corporation is treated as if its election was valid or had not terminated. Alternatively, relief may be granted only for the period in which the corporation became eligible for subchapter S or QSub treatment, in which case the corporation is treated as a C corporation or, in the case of a QSub with an inadvertently terminated or invalid election, as a separate C corporation, during the period for which the corporation was not eligible for its intended status.

(g) *Effective/applicability date.* Paragraphs (a), (b), (c), (d), and (f) of this section are effective on and after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 8. Section 1.1366–0 is amended by adding new entries in the table of contents for § 1.1366–2(a)(5)(i) through (iii) to read as follows:

§ 1.1366–0 Table of contents.

* * * * *

§ 1.1366–2 Limitations on deduction of passthrough items of an S corporation to its shareholders.

(a) * * *

(5) * * * (i) *In general.*

(ii) *Exceptions for transfers of stock under section 1041(a).*

(iii) *Examples.*

Par. 9. Section 1.1366–2(a)(5) is amended by:

1. Adding the heading and revising the first sentence of paragraph (a)(5)(i).

2. Adding paragraphs (a)(5)(ii) and (a)(5)(iii).

The revisions and additions read as follows:

§ 1.1366–2 Limitations on deduction of passthrough items of an S corporation to its shareholders.

(a) *In general.* * * *

(5) *Nontransferability of losses and deductions*—(i) *In general.* Except as provided in paragraph (a)(5)(ii) of this section, any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. * * *

(ii) *Exceptions for transfers of stock under section 1041(a).* If a shareholder transfers stock of an S corporation after December 31, 2004, in a transfer described in section 1041(a), any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder under paragraph (a)(1) of this section shall be treated as incurred by the corporation in the following taxable year with respect to the transferee spouse or former spouse. The amount of any loss or deduction with respect to the stock transferred shall be determined by prorating any losses or deductions disallowed under paragraph (a)(1) for the year of the transfer between the transferor and the spouse or former spouse based on the stock ownership at the beginning of the following taxable year. If a transferor claims a deduction for losses in the taxable year of transfer, then under paragraph (a)(4) of this section, if the transferor's pro rata share of the losses and deductions in the year of transfer exceeds the transferor's basis in stock or the indebtedness of the corporation to the transferor, then the limitation must be allocated among the transferor spouse's pro rata share of each loss or deduction, including disallowed losses and deductions carried over from the prior year.

(iii) *Examples.* The following examples illustrates the provisions of paragraph (a)(5)(ii) of this section:

Example 1. A owns all 100 shares in *X*, a calendar year S corporation. For *X*'s taxable year ending December 31, 2006, *A* has zero basis in the shares and *X* does not have any indebtedness to *A*. For the 2006 taxable year, *X* had $100 in losses which *A* cannot use

because of the basis limitation in section 1366(d)(1) and which are treated as incurred by the corporation with respect to *A* in the following taxable year. Halfway through the 2007 taxable year, *A* transfers 50 shares to *B*, *A*'s former spouse in a transfer to which section 1041(a) applies. In the 2007 taxable year, *X* has $80 in losses. On *A*'s 2007 individual income tax return, *A* may use the entire $100 carryover loss from 2006, as well as *A*'s share of the $80 2007 loss determined under section 1377(a) ($60), assuming *A* acquires sufficient basis in the *X* stock. On *B*'s 2007 individual income tax return, *B* may use *B*'s share of the $80 2007 loss determined under section 1377(a) ($20), assuming *B* has sufficient basis in the *X* stock. If any disallowed 2006 loss is disallowed to *A* under section 1366(d)(1) in 2007, that loss is prorated between *A* and *B* based on their stock ownership at the beginning of 2008. On *B*'s 2008 individual income tax return, *B* may use that loss, assuming *B* acquires sufficient basis in the *X* stock. If neither *A* nor *B* acquires any basis during the 2007 taxable year, then as of the beginning of 2008, the corporation will be treated as incurring $50 of loss with respect to *A* and $50 of loss with respect to *B* for the $100 of disallowed 2006 loss, and the corporation will be treated as incurring $60 of loss with respect to *A* and $20 with respect to *B* for the $80 of disallowed 2007 loss.

Example 2. Assume the same facts as *Example 1,* except that during the 2007 taxable year, *A* acquires $10 of basis in *A*'s shares in *X*. For the 2007 taxable year, *A* may claim a $10 loss deduction, which represents $6.25 of the disallowed 2006 loss of $100 and $3.75 of *A*'s 2007 loss of $60. The disallowed 2006 loss is reduced to $93.75. As of the beginning of 2008, the corporation will be treated as incurring half of the remaining $93.75 of loss with respect to *A* and half of that loss with respect to *B* for the remaining $93.75 of disallowed 2006 loss, and if *B* does not acquire any basis during 2007, the corporation will be treated as incurring $56.25 of loss with respect to *A* and $20 with respect to *B* for the remaining disallowed 2007 loss.

* * * * *

Par. 10. Section 1.1366–5 is amended by adding a new sentence at the end.

The addition reads as follows:

§ 1.1366–5 Effective/applicability date.

* * * Paragraphs 1.1366–2(a)(5)(i), (ii) and (iii) are effective on and after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–107592–00; REG–105964–98]

RIN 1545–BA11; RIN 1545–AW30

Consolidated Returns; Intercompany Obligations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and withdrawal of proposed regulations.

SUMMARY: This document contains proposed regulations that provide guidance regarding the treatment of transactions involving obligations between members of a consolidated group and the treatment of transactions involving the provision of insurance between members of a consolidated group. The regulations will affect corporations filing consolidated returns.

DATES: Written or electronic comments and requests for a public hearing must be received by December 27, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–107592–00), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–107592–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–107592–00).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments and/or requests for a public hearing, Kelly Banks (202) 622–7180; concerning the proposed regulations, Frances L. Kelly (202) 622–7770 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On July 18, 1995, final regulations (TD 8597) under § 1.1502–13 were published in the **Federal Register** [60 FR 36671], amending the intercompany transaction system of the consolidated return regulations. These final regulations included rules under § 1.1502–13(e) governing the treatment of insurance transactions between members of a consolidated group and rules under § 1.1502–13(g) governing the treatment of obligations between members of a consolidated group (the Current Regulations).

On December 21, 1998, a notice of proposed rulemaking (REG–105964–98) was published in the **Federal Register** [63 FR 70354], which proposed amendments to the intercompany obligation rules of § 1.1502–13(g) (the 1998 Proposed Regulations). After consideration of comments received regarding the Current Regulations and the 1998 Proposed Regulations, the IRS and the Treasury Department believe that the rules governing the treatment of intercompany obligations need to be revised. Accordingly, the IRS and the Treasury Department are withdrawing the 1998 Proposed Regulations and issuing these new proposed regulations in their place. However, for purposes of determining the tax treatment of transactions undertaken prior to the finalization of these proposed regulations, taxpayers may continue to rely upon the form and timing of the recast transaction, as clarified by the 1998 Proposed Regulations.

In addition, the IRS and the Treasury Department propose to revise certain of the rules under § 1.1502–13(e) that apply to intercompany transactions involving the provision of insurance between group members.

Explanation of Provisions

I. Intercompany Obligation Regulations

A. General Application

Section 1.1502–13(g) prescribes rules relating to the treatment of transactions involving intercompany obligations. An intercompany obligation is generally defined as an obligation between members of a consolidated group, but only for the period during which both the creditor and debtor are members of the group.

Section 1.1502–13(g) can apply to three types of transactions: (1) Transactions in which an obligation between a group member and a nonmember becomes an intercompany obligation, such as the purchase by a consolidated group member of another member's debt from a nonmember creditor or the acquisition by a consolidated group member of stock of a nonmember creditor or debtor (inbound transactions); (2) transactions in which an intercompany obligation ceases to be an intercompany obligation, such as the sale by a creditor member of another member's debt to a nonmember or the deconsolidation of either the debtor or creditor member (outbound transactions); and (3) transactions in which an intercompany obligation is assigned or extinguished within the consolidated group (intragroup transactions).