Tax Controversy Corner

When Is an S Corporation a "Corporation" Under the Code?

By Laura E. Krebs Al-Shathir

In the recent case of *Eaglehawk Carbon, Inc.*[1] the Court of Federal Claims addressed an issue that is common throughout the Internal Revenue Code (the "Code"), and one that, in the wake of the IRS Chief Counsel's issuance of CCA 201552026 on Dec. 29, 2015, is ripe for litigation in the context of Code Sec. 165(g)(3), namely, when is an S corporation a "corporation"?

Eaglehawk Carbon

In *Eaglehawk Carbon*, the taxpayer plaintiffs were coal mining companies organized as S corporations, which brought suit to recover refunds plus interest on overpayments of coal sales excise taxes. The parties did not dispute that the plaintiffs overpaid certain coal excise taxes and were owed refunds, plus interest, on their overpayments. The amounts of the overpayments also were not in dispute. Rather, the plaintiffs contended that the interest they received on their overpayments was calculated according to a lower formula than was appropriate and that plaintiffs were owed approximately $6 million of additional interest, which plaintiffs argued was continuing to accrue. The overpayments were made in tax years 1990–1996, and the overpayment refunds were made in April of 2009.

The statute at issue in this case was Code Sec. 6621(a)(1), which provides the formula for the calculation of the amount of interest to which plaintiffs were entitled on their overpayments. If plaintiffs' interpretation of Code Sec. 6621(a)(1) was correct, they, as S corporations, would not be treated as "corporations" under Code Sec. 6621(a)(1), and the amount of interest due to them on the amount of their overpayments would have been based on the same rate applicable to individuals, rather than corporations.

Under Code Sec. 6621(a)(2), a special rate of interest on overpayments applies to corporations, which receive two percentage points plus the federal short-term rate of interest, whereas individuals receive three percentage points plus the federal short-term rate of interest. The flush language of Code Sec. 6621(a)(1) provides, as follows, "To the extent that an overpayment of tax by a corporation for any taxable period (as defined in subsection (c)(3) applied by substituting 'overpayment' for 'underpayment') exceeds $10,000, subparagraph (B) shall be applied by substituting '0.5 percentage point' for '2 percentage points'." Thus, to the extent

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that a corporation's overpayment exceeds $10,000, the corporation receives only one-half (0.5) percentage point (and not two percentage points) plus the federal short-term rate of interest.

The plaintiffs alleged that they were not subject to the lower two percentage point rate applicable to corporations and that they were not subject to the special reduced rate of interest applicable to corporations whose tax overpayment exceeds $10,000. The case was made to the Court of Federal Claims on cross-motions for summary judgment. Ultimately, the court granted the government's motion for summary judgment and denied the plaintiffs' motion for summary judgment. In the opinion, the court recited the standard that, "Tax controversies are well-suited to disposition on cross-motions for summary judgment when the outcome turns on interpretation of the Internal Revenue Code rather than disputes of fact."[2]

In this case, both parties asserted that the meaning of Code Sec. 6621(a)(1) was clear, but the parties' interpretations of the statute were conflicting. In order to determine whether a statute has a clear meaning and is unambiguous, the Court of Federal Claims first examines the plain text of the statute and employs traditional tools of statutory construction, because the plain text of the statute "is of paramount importance."[3] The court noted that, "[A] statute is ambiguous if its terms permit two conflicting but reasonable constructions."[4] Here, the court concluded that only the government, and not the plaintiffs, had a reasonable interpretation of Code Sec. 6621(a)(1), and, therefore, Code Sec. 6621(a)(1) was not ambiguous.[5]

The Court of Federal Claims concluded that, based on the plain text of the statute, "corporations" are subject to the lower federal short-term rate plus two percentage points and that "S corporations are corporations, as both a common sense interpretation of this designation and the IRC indicate."[6] Accordingly, under Code Sec. 6621(a)(1)(B), because the S corporations plaintiffs were "corporations," the court concluded that the lower interest rate applicable to corporations applied to the plaintiffs' overpayments under $10,000.[7] The court similarly concluded that the S corporation plaintiffs were subject to the lower interest rate applicable to corporations' overpayments exceeding $10,000.[8]

The court also analyzed the legislative history to Code Sec. 6621(a)(1) and concluded that there was no legislative history that: (1) contained any direct reference to S corporations, (2) referenced a difference between S corporations and C corporations or (3) referenced the impact of amendments to Code Sec. 6621(a)(1) on S corporations or passthrough entities in general. Accordingly, the court found, "[P]laintiffs have no clear statement of congressional intent with which they might persuade the court to ignore the plain text of Code Section 6621(a)(1)."

CCA 201552026

While the Court of Federal Claims in *Eaglehawk Carbon* determined that an S corporation is a "corporation" for purposes of Code Sec. 6621(a)(1), the IRS Chief Counsel has determined in CCA 201552026 that an S corporation is not a "corporation" for purposes of Code Sec. 165(g)(3). In so doing, the IRS did not give sufficient, if any, regard to the plain text of Code Sec. 165(g)(3).

In a Chief Counsel Advice that was released on December 24, 2015, in concluding that the IRS Chief Counsel would deny a claim for a deduction under Code Sec. 165(g)(3), the Chief Counsel clearly stated its position as to the extent to which S corporations would be considered "corporations" for purposes of Code Sec. 165(g)(3).[9] Quite simply, as set forth in CCA 201552026, the IRS Chief Counsel's position is that S corporations are not entitled to ordinary loss deductions under Code Sec. 165(g)(3), and, therefore, S corporations are *not* treated as corporations under Code Sec. 165(g)(3). Such position starkly contrasts with comments that the American Bar Association Section of Taxation issued on October 30, 2015, in response to the IRS's request for comments on worthless stock deductions under Code Sec. 165(g) for S corporations (the "ABA Tax Section Comments").[10]

Under Code Sec. 165(g)(1), a taxpayer may deduct a loss for worthless stock or other securities as a capital loss. If the requirements of Code Sec. 165(g)(3) are satisfied, however, what otherwise would have generated a capital loss under Code Sec. 165(g)(1) would instead generate an ordinary loss under Code Sec. 165(g)(3). Pursuant to Code Sec. 165(g)(3), any security in a corporation affiliated with a taxpayer that is a domestic corporation is not treated as a capital asset if: (1) the taxpayer owns at least 80 percent of the corporation (the "Affiliation Test"); and (2) more than 90 percent of the aggregate gross receipts for all tax years has been from sources other than passive income (the "Gross Receipts Test"). Thus, in order to claim an ordinary loss under Code Sec. 165(g)(3), in addition to satisfying the Affiliation Test and the Gross Receipts test, the taxpayer must also be a "domestic corporation."

In CCA 201552026, the taxpayer was an S corporation that wholly owned a qualified subchapter S subsidiary (QSub), which operated a regulated business. In year 1, the QSub's business operations were depressed, resulting in the QSub receiving a status letter from an agency. In year 2, the agency appointed another agency as receiver of the QSub. In an attempt by the taxpayer to pass through to its shareholders the QSub's losses as an ordinary loss, the taxpayer terminated its S corporation status, which resulted in the QSub's status also terminating as of the date immediately preceding the date on which taxpayer's S election terminated.[11] After effectuating the termination of its S corporation status, the taxpayer then requested the IRS's opinion as to whether the stock of the QSub could become worthless for purposes of claiming an ordinary deduction under Code Sec. 165(g)(3).

In order to obtain a favorable conclusion from the IRS as to ordinary loss treatment under Code Sec. 165(g)(3), and thereby pass ordinary loss onto its shareholders, the taxpayer in CCA 201552026 needed to overcome three legal hurdles.[12] The third hurdle related to the IRS Chief Counsel's interpretation of the term "corporation" under Code Sec. 165(g)(3). Rather than concluding its advice that the taxpayer's transaction did not trigger ordinary loss treatment under Code Sec. 165(g)(3) by virtue of its resolution of the first two issues, the IRS Chief Counsel went on to state its position that S corporations are not treated as corporations under Code Sec. 165(g)(3). The effect of Chief Counsel's position in CCA 201552026 is that, at least as far as the IRS Chief Counsel is concerned, S corporations are not entitled to ordinary loss deductions under Code Sec. 165(g)(3).

For a variety of reasons, and as supported by the analysis more fully described in the ABA Tax Section Comments, the IRS Chief Counsel's position in CCA 201552026 with respect to Code Sec. 165(g)(3)'s application in the context of S corporations should be revised. First, and importantly, the Chief Counsel did not analyze the plain meaning of the statute. The plain language of Code Sec. 165(g)(3) states that, "any security in a corporation affiliated with a *taxpayer which is a domestic corporation* shall not be treated as capital asset." (Emphasis added.) Thus, Code Sec. 165(g)(3) applies to a taxpayer that is a "domestic corporation," and an S corporation clearly is considered a domestic corporation under the Code. As articulated by the Court of Federal Claims in *Eaglehawk Carbon*, "S corporations are corporations, as both a common sense interpretation of this designation and the IRC indicate."[13] Furthermore, Code Sec. 1361(a) defines an S corporation as a "small business corporation" for which an election under Code Sec. 1362 has been made. A "small business corporation" is defined as a "domestic corporation" that is not an ineligible corporation under Code Sec. 1361(b)(1).

Next, the IRS Chief Counsel framed the issue as one involving the *computation* of income rather than the *character* of income. While discussing a variety of authorities wherein the computation of an S corporation's income was at issue, the IRS focused on Code Sec. 1363(b) and essentially concluded that because an S corporation's income is computed like that of an individual under Code Sec. 1363(b) and individuals are not entitled to ordinary loss deductions under Code Sec. 165(g)(3), S corporations are not entitled to ordinary loss treatment under Code Sec. 165(g)(3).

Clearly, the income of an S corporation is computedin the same manner as that of an individual, with certain exceptions, as described in Code Sec. 1363(b). However, the *character* of any item of income, loss, deduction or credit included in an S corporation shareholder's *pro rata* share is determined at the corporate level under Code Sec. 1366(b). Reg. §1.1366-1(b)(1) provides the example that if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder's *pro rata* share of that gain will also be characterized as capital gain, regardless of whether the shareholder otherwise is a dealer. Accordingly, even the Treasury Regulations under Code Sec. 1366 provide that character of S corporation income is determined at the corporate level, notwithstanding that the character of the item may differ if the item were realized by an individual shareholder.

Nevertheless, the IRS Chief Counsel did not include any discussion of Code Sec. 1366 in CCA 201552026, and, accordingly, appears to have overlooked the fact that the character of an S corporation's item of income or loss (determined under Code Sec. 1366) and computation of an S corporation's income (determined under Code Sec. 1363) are handled differently under the Code. As succinctly stated in the ABA Tax Section Comments, "Section 165(g)(3) governs whether certain kinds of securities are capital assets for purposes of [Code Sec. 165(g)(1)]. The determination of whether a security is (or is not) a capital asset under [Code Sec.] 165(g)(3) in turn determines the character of the loss if such security becomes worthless."[14] Accordingly, Code Sec. 165(g)(3) clearly relates to the character of a loss in the hands of an S corporation, rather than the computation of an S corporation's income. For that reason, the IRS Chief Counsel's reliance on the computational provision of Code Sec. 1363 as supporting its conclusion in CCA 201552026 should be revisited, as should its reliance on authorities wherein the computation of an S corporation's income is at issue.

The IRS Chief Counsel also discussed a variety of unpersuasive legislative history in CCA 201552026. Chief Counsel first analyzed the legislative history to Code Sec. 23(g)(4), the predecessor to Code Sec. 165(g)(3), which predates the existence of the S corporation regime and for that reason could be considered by a court as unpersuasive in deciding how the legislature intended the ordinary loss exception in Code Sec. 23(g)(4) to apply to S corporations. The IRS Chief Counsel also discussed the legislative history to Code Sec. 1363(b), which, as a computational

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Code section, should have little, if any, impact on a determination of the character of an S corporation's income or loss.

Conclusion

The recent decision in *Eaglehawk Carbon* serves as an example of an instance where a court concluded that an S corporation is a "corporation" under the Code. Again, in *Eaglehawk Carbon*, the Court of Federal Claims concluded that the S corporation plaintiffs were considered "corporations" for purposes of Code Sec. 6621(a)(1) based on the plain meaning of the statute. In the context of Code Sec. 165(g)(3), the IRS Chief Counsel reached a different answer, stating that for purposes of Code Sec. 165(g)(3), an S corporation is not considered to be a "corporation."

Notably, any Chief Counsel Advice, including CCA 201552026, may not be used or cited as precedent. Nevertheless, CCA 201552026 puts taxpayers on notice that the IRS Chief Counsel may conclude that S corporations are not able to take ordinary loss deductions under Code Sec. 165(g)(3)—even in situations where the taxpayer S corporation owns stock of a C corporation that was not formerly a QSub.

Given that taxpayers have many compelling arguments, as supported by and outlined in the ABA Tax Section Comments, that the IRS Chief Counsel's position with respect to Code Sec. 165(g)(3) as set forth in CCA 201552026 may be incorrect and that S corporations should, in fact, be treated as "corporations" for purposes of Code Sec. 165(g)(3), this issue appears ripe for litigation, particularly in cases that differ factually from those in CCA 201552026.

ENDNOTES

1 *Eaglehawk Carbon, Inc. et al.*, FedCl, 2015-2 USTC ¶50,387, 122 FedCl 209.

2 *Id.*, at 211, *citing Dana Corp.*, CA-FC, 99-1 USTC ¶50,411, 174 F3d 1344, 1347.

3 *Id.*

4 *Id.*, at 212.

5 *Id.*

6 *Id.*

7 *Id.*, at 213.

8 The court analyzed the flush language of Code Sec. 6621(a)(1) and its application to the S corporation's plaintiffs' overpayments in excess of $10,000. The parties disagreed as to what must be borrowed from Code Sec. 6621(c)(3) to interpret the flush language of Code Sec. 6621(a)(1). It should be noted that Code Sec. 6621(c)(3)(A) defines "large corporate underpayment" as any underpayment of tax by a C corporation for any tax period if the amount of such underpayment for such period exceeds $100,000. Code Sec. 6621(c)(3)(B) defines "taxable period" without any reference to the identity of the taxpayer (as a C corporation or otherwise). The court concluded that the flush language of Code Sec. 6621(a)(1) directs taxpayers to refer to Code Sec. 6621(c)(3)(B) (but not Code Sec. 6621(c)(3)(A)) for the definition of the term "overpayment of tax by a corporation for any taxable period." Analyzing the plain meaning of the statute and applying the doctrine of the last antecedent canon of statutory construction, the court stated that Code Sec. 6621(a)(1) directs taxpayers to apply the definition of the term "taxable period" found in Code Sec. 6621(c)(3)(B) but not the term "corporation" as found in Code Sec. 6621(c)(3)(A) in interpreting Code Sec. 6621(a)(1). Thus, the court disagreed with plaintiffs' argument that, because the flush language of Code Sec. 6621(a)(1) refers to Code Sec. 6621(c)(3) which applies only to C corporations, as an S corporation, the plaintiffs should not be subject to the low federal short-term rate plus one-half (0.5) percentage point on overpayments in excess of $10,000. *Id.*, at 212–215.

9 CCA 201552026 (Aug. 12, 2015).

10 Letter from George C. Howell, III, Chair, Section of Taxation, American Bar Association, to The Honorable John Koskinen, Commissioner, Internal Revenue (Oct. 30, 2015).

11 *See* Reg. §1.1361-5(b)(1).

12 First, the taxpayer needed to successfully argue that Code Sec. 351 applied to treat the QSub termination as a tax-free event. As a result of the QSub election terminating, pursuant to Reg. §1.1361-5(b)(1)(i), the former QSub was treated as a new C corporation acquiring all of its assets and assuming all of its liabilities immediately before the termination from the S corporation parent in exchange for stock of the new corporation. If the deemed creation of the new C corporation qualified under Code Sec. 351, the transaction would be tax-free, but, if not, the transaction would be taxable under Code Sec. 1001, with any potential loss deferred under Code Sec. 267(f)(2)(B). Under Code Sec. 351(a), no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock and immediately after the exchange such person(s) are in control of the corporation. In citing various case law, the IRS concluded that the QSub's termination and deemed formation of a new C corporation did not meet the requirements of Code Sec. 351 insofar as the stock of the QSub was worthless. The IRS stated, "Because worthless stock does not have value, those taxpayer incorporating liabilities in excess of the value of the transferred assets do not satisfy the [Code Sec.] 351 requirements. Thus, such transactions are taxable under [Code Sec.] 1001."

The next barrier to taxpayer obtaining ordinary loss treatment under Code Sec. 165(g)(3) was the IRS's application to the transaction of Reg. §1.165-5(d)(2), which permits Code Sec. 165(g)(3) ordinary loss treatment only if none of the stock of the corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss. The IRS stated that, even if the other requirements of Code Sec. 165(g)(3) were satisfied, the taxpayer failed to state any legitimate reason for acquiring the C corporation stock in the conversion of the QSub to a C corporation other than to trigger an ordinary loss deduction. Therefore, the IRS concluded that Code Sec. 165(g)(3) ordinary loss treatment would be disallowed.

13 *Supra* note 1, at 212.

14 *Supra* note 10.

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