Office of Chief Counsel
Internal Revenue Service

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memorandum

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date: January 15, 2009

to: Associate Area Counsel (Buffalo)
(Small Business/Self-Employed)
Attn: Kevin M. Murphy

from: Chief, Branch 2
(Passthroughs & Special Industries)

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subject: Request for Chief Counsel Advice.

This Chief Counsel Advice responds to your request for assistance dated October 30, 2008 and supplements advice issued on October 17, 2008, (PRESP-124834-08, CCA 200842002). This advice may not be used or cited as precedent.

ISSUES

What is the proper federal income tax treatment of the State of New York Qualified Empire Zone Enterprise (QEZE) Credit for Real Property Taxes as it pertains to both partnerships and S corporations?

LAW AND ANALYSIS

Section 702(a)(7) of the Internal Revenue Code provides that, in determining a partner's income tax, each partner shall take into account separately the partner's distributive share of the partnership's other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary.

Section 704(a) provides that a partner’s distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in Chapter 1, be determined by the partnership agreement.

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if--1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or 2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 1.702-2(a)(8)(i) of the Income Tax Regulations provides, in part, that each partner shall take into account separately, as part of any class of income, gain, loss, deduction, or credit, his distributive share of the following items: recoveries of bad debts, prior taxes, and delinquency amounts (§ 111).

Section 1362(a)(1) provides that generally a small business corporation may elect to be an S corporation.

Section 1363(a) provides that, except as otherwise provided in subchapter S, an S corporation is not subject to the taxes imposed by Chapter 1 of the Code.

Section 1366(a)(1) provides, in part, that, in determining the tax under Chapter 1 of the Code of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, there shall be taken into account the shareholder's pro rata share of the corporation's--(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and (B) nonseparately computed income or loss.

Section 1366(b) provides that the character of any item included in a shareholder's pro rata share under § 1366(a)(1) shall be determined as if the item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

Section 1366(d)(1) provides that the aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—(A) the adjusted basis of the shareholder’s stock in the S corporation (determined with regard to § 1367(a)(1) and (2)(A) for the taxable year), and (B) the shareholder’s adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under § 1367(b)(2) for the taxable year).

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

Section 1371(c)(1) provides that, with certain exceptions, no adjustments shall be made to the earnings and profits of an S corporation.

CONCLUSIONS

CC:ITA concluded in CCA 200842002 that the state franchise tax reduction attributable to the credit is not fundamentally inconsistent, for purposes of applying the tax benefit rule, with a previous § 164 deduction for property taxes taken by a C corporation that uses the cash receipts and disbursements method of accounting. The federal income tax consequence is therefore a reduction in state franchise tax, generally deductible under § 164.

It was further concluded, however, that receipt of a cash payment attributable to the refundable credit is fundamentally inconsistent with a previous § 164 deduction for property taxes. Accordingly, a payment attributable to the refundable credit would be income under the inclusionary part of the tax benefit rule, subject to the provisions of § 111. The refunded amount would be treated as a recovery of property tax, not franchise tax, and would be includable in federal gross income in year 2 depending on the extent to which deduction of the year 1 payment of state property tax reduced the taxpayer's year 1 federal income tax.

Finally, CC:ITA concluded that since the taxpayer has the option of receiving such an excess "refunded" amount of the credit in cash, the taxpayer would be in constructive receipt of that amount even if the taxpayer chose to use it as a credit against state tax for another tax year. However, the taxpayer would also be treated as having made a corresponding payment of state tax for that other tax year.

A similar conclusion applies to S corporations and Partnerships. The deduction for the state franchise tax will pass through to the S corporation shareholders in the year the tax is paid and would reduce each shareholder's basis in stock in an amount equal to the shareholder's allocable share of the deduction subject to the limitations in § 1366(d)(1). Any recovery of tax benefit item would be income to the S corporation that is separately stated and passed through to the shareholders. The treatment of tax benefit items is addressed by the 2008 Shareholder's Instructions for Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc. These instructions refer to the tax benefit rule in the discussion of "other income," which specifically includes "income from recoveries of tax benefit items." The instructions state that a tax benefit item is an amount that was deducted in a prior tax year that reduced the prior year's income tax and that this amount should be reported on Form 1040, line 21, to the extent it reduced the tax. Thus, to the extent that the S corporation must include recaptured tax expense in income in future years, the S corporation must pass that amount through to its shareholders as a separately stated item.

Similarly, a Partnership would pass the amount of a deduction for the payment of state franchise taxes through to its partners as a separately stated item in accordance with the partnership agreement or the distribution rules under § 704. Any prior tax that is

refunded in a subsequent year is an item listed under § 1.702-2(a)(8)(i), which a partner in a partnership is required to take into account as income its separate share of the recovered tax expense following the tax benefit rule.

Please note that we are not opining on the application of the tax benefit rule as it applies to S corporation or partnerships, when there is a change in shareholders or partners from the year in which the deduction in taken to the year in which a refunded amount of the credit is received.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Richard Probst at (202) 622-3060 if you have any further questions.

Attachment (1)
CCA 200842002