S Corp. Shareholder Basis for Circular or Certain Back-to-Back Loans

Practitioners routinely face the challenge of helping S corporation shareholders increase their basis for purposes of deducting pass-through losses under Sec. 1366(d) (1). Often, planning to increase basis will result in shareholders making loans to the S corporation at year end. With regard to shareholder loans to S corporations facilitated by borrowings from a related entity, back-to-back, and circular loans, three Tax Court decisions, including one in 2009, continue the court-imposed requirement that shareholders make an "economic outlay" to acquire basis and demonstrate why practitioners need to exercise care in the construction of shareholder loans to S corporations to provide the best opportunity for increasing basis for deduction of losses.

Back-to-Back Loans

In *Ruckriegel*, T.C. Memo. 2006-78, two 50% shareholders in an S corporation that incurred losses were also 50% partners in a partnership. Upon the advice of the businesses' outside CPA, the partnership advanced funds directly and indirectly, through the S corporation's shareholders, to the S corporation. Certain of the direct loans were recorded through year-end adjusting journal entries as shareholder loans. Shareholder loans were evidenced by promissory notes, although the shareholders had no clear recollection of when the notes were executed, and were documented in the S corporation's board of directors' meeting minutes.

The Tax Court looked at several factors in ruling that the S corporation's shareholders acquired no basis in the partnership's payments directly to the S corporation but did acquire basis in the back-to-back loans the partnership made to the S corporation's shareholders that were then loaned by the shareholders to the S corporation.

With regard to the taxpayers' arguments that the direct payments from the partnership to the S corporation were essentially back-to-back loans through the S corporation's shareholders, the court considered the limited history of the partnership's directly paying expenses on behalf of its partners. The court also considered the advice of the outside CPA to the S corporation's shareholders who, following a disallowance of basis in shareholder loans in a previous IRS examination, believed he had structured the subsequent partnership advances to the S corporation in a manner intended to constitute bona fide back-to-back loans, as evidenced by the promissory notes, corporate minutes, and accounting for the partnership advances. It was apparent that the promissory notes, minutes, and accounting were done after the fact or at year end, not as the partnership made direct payments to the S corporation. The court also found significance in the treatment of some, but not all, of the partnership direct advances as shareholder loans. Certain direct payments were treated as being from the partnership instead of the shareholders.

Short-Term Back-to-Back Loans

In *Russell*, T.C. Memo. 2008-246, short-term loans to an S corporation were originally made by a partnership owned by the S corporation's two shareholders and recorded on the S corporation's books as notes payable to the partnership. At the end of the S corporation's August 31 tax year, an adjusting journal entry reclassified the notes payable to the partnership as notes payable to the S corporation's two shareholders. On September 3, immediately following its August 31 fiscal year, the S corporation repaid the short-term debt with interest directly to the partnership. Even though the S corporation properly accounted for the debt as shareholder loans, the shareholders did not report interest income received from the S corporation or interest expense paid to the partnership on the short-term debt on their individual tax returns. Notes were prepared documenting the loans from the partnership to shareholders and from shareholders to the S corporation.

The Tax Court denied any tax basis for the loans arising from the partnership, agreeing with the IRS that the loans should be classified as a direct loan from the partnership. First, the court found that the S corporation's shareholders made no economic outlay that left them poorer in a material sense. Second, it found that the S corporation's indebtedness ran to the partnership, not to the S corporation's shareholders, and that indirect borrowing, such as a guaranty, surety, accommodation, co-making, or otherwise, gives rise to indebtedness only when the shareholders pay part or all of the existing obligation.

Circular Loans

In *Kerzner*, T.C. Memo. 2009-76, the Tax Court analyzed a situation involving circular loans. Husband and wife each owned 50% of a partnership and an S corporation. Each year, the partnership loaned money to the owners, who used the borrowed funds for loans to the S corporation of an identical amount. The S corporation then paid rent to the partnership of an equivalent amount.

The Tax Court again examined whether the S corporation's shareholders made an economic outlay that rendered them poorer in a material sense. The court saw a circular flow of cash beginning and ending with the partnership. Kerzner argued that he bore an economic outlay because of the risk that the S corporation would not be able to repay him. The Tax Court, citing other cases involving a circular flow of funds (*Oren*, T.C. Memo. 2002-172, aff'd 357 F.3d 854 (8th Cir. 2004);*Kaplan*, T.C. Memo. 2005-218), found an inherent lack of substance in the loans and ruled that the S corporation's shareholders did not make an economic outlay.

Conclusion

Practitioners advising on proper methods to use for shareholders to acquire basis in loans made to S corporations incurring losses can take away several points from these court decisions:

- Identify S corporations with basis limitation issues as soon as possible to emphasize to shareholders the importance of structuring S corporation loans as coming directly from shareholders and to minimize last-minute recharacterization of advances from related entities as back-to-back loans from shareholders.
- Properly document, through interest-bearing promissory notes and contemporaneous corporate minutes, shareholder loans to S corporations. Have shareholders report interest income from these loans and interest expense on money borrowed to make loans to S corporations.
- If the source of shareholder funds for S corporation loans is coming from a commonly controlled pass-through entity, consider taking the funds as a distribution from the entity rather than as a loan from the entity. While back to-back loans have stood up in a few court decisions (such as in *Ruckriegel*), they certainly draw greater attention from the IRS.
- For back-to-back loans, have all payments to make and repay loans go to and from the S corporation and shareholder, not directly to or from the S corporation and the related entity.
- Circular loans are risky. As the *Kerzner* case demonstrates, if funds for the shareholder loan to the S corporation begin and end with the same entity, the shareholder will not likely be considered to have made an economic outlay, which is essential for a shareholder to acquire basis in a loan to the S corporation.

S Corporation Basis Reductions for Nondeductible Expenses

An S corporation's losses and deductions are allocated among its shareholders according to their proportionate ownership of the S corporation's stock. These losses and deductions reduce the shareholder's basis in his or her stock or, if there is none, in the shareholder's loans to the S corporation. However, these losses and deductions are currently deductible by each shareholder only to the extent that the shareholder has basis in his or her stock and loans to the corporation. Any excess amounts of such otherwise deductible losses and deductions over basis for stock and loans are not currently deductible and are treated as arising for that shareholder in his or her next tax year (the carryover provision).

However, there is confusion as to whether the carryover provision also applies to nondeductible, noncapital losses and expenses (e.g., nondeductible meal expenses and fines). When an S corporation has losses and deductions in excess of basis, some of which are nondeductible, noncapital expenses, will there be a carryover of the nondeductible items for purposes of reducing basis in a future year?

Increases and Decreases in Basis

Sec. 1366(d)(1) limits the amount of allowable losses and deductions flowing through to a shareholder under Sec. 1366(a) to the sum of the adjusted basis of the shareholder's stock in the S corporation (determined after giving effect to increases in basis for items of income and the excess of depletion deductions over the basis of the property being depleted) plus the shareholder's adjusted basis of any S corporation indebtedness to the shareholder.

Sec. 1366(d)(2) provides for a shareholder's indefinite carryover of otherwise deductible S corporation losses and deductions that are disallowed by reason of the basis limitation. Any loss or deduction disallowed for any tax year by reason of the basis limitation is treated as incurred by the S corporation in the succeeding tax year for that shareholder. The literal language of the section does not contain any carryover provision for nondeductible, noncapital expenses or for the oil and gas depletion deduction.

Sec. 1367 provides rules for adjustments to S corporation shareholders' basis in their stock. Generally, basis is increased for items of income (including tax-exempt income) and the excess of deductions for non–oil and gas depletion over basis of the property subject to depletion. It also allows for decreases in basis (but not below zero) by each of the following:

- Distributions;
- Items of loss and deduction that flow through to and are deductible by the shareholder;
- Nonseparately computed loss;
- Nondeductible expenses that are not properly chargeable to capital accounts; and
- Depletion deductions for oil and gas property that do not exceed the adjusted basis of such property allocated to the shareholder.

Regs. Sec. 1.1367-1(f) sets forth the ordering rules for tax years beginning on or after August 18, 1998. Under these rules, unless an election is made as provided in Regs. Sec. 1.1367-1(g) (discussed below), the Regs. Sec. 1.1367-1(f) adjustments are made in the following order:

1. Any increase in basis attributable to income items and the excess of non– oil and gas depletion deductions over the basis of the property subject to depletion;
2. Any decrease in basis attributable to S corporation distributions that are not taxable to the shareholder under the distribution rules of Sec. 1368;

3. Any decrease in basis attributable to nondeductible, noncapital expenses and the oil and gas depletion deduction to the extent the depletion deduction does not exceed the proportionate share of the adjusted basis of that property allocated to the shareholder; and
4. Any decrease in basis attributable to separately stated and nonseparately stated items of loss or deduction that are taken into account by the shareholder.

Regs. Sec. 1.1367-1(g) provides an elective ordering rule under which a shareholder may elect to decrease basis under Regs. Sec. 1.1367-1(f)(4) prior to decreasing basis under Regs. Sec. 1.1367-1(f)(3). Thus, the shareholder may elect to allow his or her separately and nonseparately stated items of loss or deduction to reduce basis prior to the nondeductible expenses. The regulation continues by saying that if a shareholder does make this election, any amount of deduction described in Regs. Sec. 1.1367-1(f)(3) (i.e., the nondeductible, noncapital expenses) that exceeds the shareholder's basis in stock and indebtedness is treated, solely for purposes of this section, as such an amount in the succeeding tax year. Thus, if the Regs. Sec. 1.1367-1(g) election is made, the nondeductible, noncapital expenses will carry forward until used to reduce stock or loan basis in a future year. Furthermore, once a shareholder makes an election under Regs. Sec. 1.1367-1(g), he or she must continue to use those rules for that S corporation in future tax years unless the shareholder receives permission from the IRS.

Example 1: On January 1, 2009, *X*,a calendar-year shareholder of *Z*, an S corporation, had a basis in his stock of $5,000. *X* holds no *Z* debt. During 2009, *X*'s share of *Z*'s losses and deductions is $15,000, consisting of $9,000 of ordinary loss and $6,000 attributable to nondeductible, noncapital expenses. In 2010, *X*'s share of *Z*'s taxable income is $11,000.

Under the general rule of Regs. Sec. 1.1367-1(f), the basis adjustments would be calculated in the following manner. *X*'s $5,000 basis as of January 1, 2009, would be reduced by the $6,000 of nondeductible, noncapital losses, but not below zero. Thus, on December 31 the stock's basis would be zero. Under Sec. 1366(d)(2), *X* could not deduct the $9,000 operating loss in 2009, but it would be treated as occurring in the year 2010 for *X*. Then in 2010 *X* would report $11,000 of income, increasing his stock basis to $11,000, and would deduct the $9,000 loss from 2009, reducing his stock's basis to $2,000 on December 31, 2010. The $1,000 of nondeductible losses that did not reduce basis in 2009 would disappear and would not be carried over to a future tax year because the provision for carrying over losses relates only to those losses that are allowable as a deduction.

Example 2: Assume the same facts as Example 1, except that *X* uses the elective ordering rule under Regs. Sec. 1.1367-1(g).

The $9,000 operating loss would reduce the basis of *X*'s stock to zero, allowing *X* a deduction of $5,000 of the operating loss in 2009. The other $4,000 of deductible operating loss would be carried over and treated as incurred for *X* for 2010, the next tax year. In addition, the $6,000 of nondeductible losses would also be treated as incurred in 2010. In 2010, *X* would report the $11,000 as income, increasing his stock basis to $11,000. He would deduct the $4,000 carryover loss from 2009, reducing basis to $7,000, and then would further reduce it by the $6,000 nondeductible 2009 loss. *X*'s stock basis would therefore be $1,000 on December 31, 2010.

Conclusion

S corporation nondeductible, noncapital expenses allocated to a shareholder that exceed the shareholder's basis in the S corporation's stock and loans from the shareholder to the corporation do not carry over to a succeeding shareholder tax year and do not reduce basis in any succeeding shareholder tax year unless an election under Regs. Sec. 1.1367-1(g) is made. Thus, in Example 1, when the election is not made, the $1,000 of nondeductible, noncapital losses in excess of basis in 2009 will not reduce basis in any future year. In Example 2, where the Regs. Sec. 1.1367-1(g) election is made, the $6,000 of nondeductible losses in excess of basis from 2009 will be carried over to the next year (2010) for that taxpayer.

Consequences of S Corporation Termination in a Reorganization

An S corporation can participate as a corporate entity in a corporate reorganization (see the conference committee report to Section 1310 of the Small Business Job Protection Act, H.R. Conf. Rep't No. 737, 104th Cong., 2d Sess. 226 (1996)). This leads to a substantive advantage of S corporations over partnerships: S corporations and their shareholders can accomplish stock exchanges, corporate divisions, mergers, and the other forms of transactions known as tax-free reorganizations, whereas subchapter K of the Code provides no such opportunity for partnerships. However, an S corporation participating in one of these transactions can face the loss of its S status in a number of ways—if, for example, any of its stock is owned by another corporation.

Termination of S Status in Type A, B, or C Reorgs.

If an S corporation is merged or consolidated out of existence in a type A reorganization, its S status will cease. If the S corporation is the acquiring corporation, it can lose S status by exceeding the maximum shareholder limitation, adding an ineligible shareholder, or absorbing a corporation with outstanding stock or debt that constitutes a prohibited second class of stock. Furthermore, it can acquire assets (or earnings and profits) from the target corporation that lead to excess net passive investment income and termination of S status after three consecutive years.

If the S corporation is the acquired corporation in a type B stock-for-stock reorganization, it can lose its S status because it has a corporate shareholder or goes out of existence in a subsequent liquidation.

If the S corporation is the acquiring corporation in a type C reorganization, it can lose its S status because of the existence of a corporate shareholder. However, this risk can be avoided if the stock is transferred to the shareholders of the target corporation. As an alternative, the S corporation can liquidate the target, in which case the "transitory subsidiary" exception should protect its S election. Other risks include gaining an ineligible shareholder, exceeding the shareholder limitation, assuming nonqualifying debt, or acquiring assets (or earnings and profits) from the target that lead to excess net passive investment income and termination of S status after three consecutive years.

If the S corporation is the acquired corporation, it generally will be liquidated following the reorganization, although the IRS has the authority to waive this requirement (Sec. 368(a)(2)(G)). If it remains in existence but transfers away its operating assets, its remaining assets may generate sufficient passive income to subject it to termination of S status after three years.

Termination of S Status in Type D or E Reorgs.

Rules similar to those discussed in the preceding paragraphs apply to various steps in either acquisitive or divisive type D reorganizations.

Termination of the S election can occur in a type E recapitalization if the stock or debt issued in exchange for the outstanding stock or debt violates the single-class of-stock requirement. For example, in a stock-for-stock exchange, the newly issued stock could have distribution or liquidation rights that differ from the original outstanding stock.

In a debt-for-stock exchange, the newly issued debt could fail to meet the straight-debt rules of Sec. 1361(c)(5), which would result in a second class of stock if the debt constituted equity under general principles of tax law and a principal purpose of the debt was to circumvent the distribution or liquidation rights conferred by the outstanding stock or to circumvent the maximum shareholder limitation.

Termination Due to Shareholder Control

Finally, if the new shareholders hold more than 50% of the S corporation's outstanding stock after the reorganization, they can revoke the S election. If the revocation occurs by the 15th day of the third month of the tax year, it can be retroactive to the beginning of the tax year.

Allocating Pass-through Items

If an S corporation terminates its S status as the result of a merger or other tax-free reorganization, the S corporation year (the S short year) ends on the day before the terminating event. If the corporation remains in existence as a C corporation, it must determine which method will apply for allocating income to the S short year:

- The general pro-rata method, in which the income for the year is allocated to the S short year and the following C short year based on the number of days in each short period (Sec. 1362(e)(2)); or
- The specific accounting method, which is made via an election to close the books of the corporation at the end of the S short year (Sec. 1362(e)(3)).

If the reorganization has caused a termination of S status and an exchange of 50% or more of the corporation's stock, the general pro-rata method is not available. The specific accounting method must be used, with the books closed as of the last day of the S short year (Sec. 1362(e)(6)(D)).

Making Distributions

When S status terminates as a result of a reorganization, it may seem that the general distribution rules of Sec. 1368 do not apply because that statute pertains only to distributions "made by an S corporation." However, Sec. 1371(e) allows a one-year (or more) post-termination transition period (PTTP) during which a corporation may make distributions of its accumulated adjustments account (AAA) following termination of S status.

The ability to distribute money as a reduction against stock basis, to the extent of the AAA, during the one-year PTTP is an important privilege for an S corporation that is a party to a reorganization. It is important to note that the post-termination privilege applies only to cash distributions, not property distributions.

Planning tip: If the shareholders of an S corporation that will lose its S status want to withdraw specific items of property from the corporation, they should do so prior to the reorganization.

Deducting Suspended Pass-through Losses

A one-year post-termination privilege is provided for carryover pass-through losses and deductions that have been limited because of insufficient shareholder basis (Sec. 1366(d)(3)). During the post-termination transition period, the shareholder is allowed to restore basis in stock (but not debt) to achieve deductibility of suspended pass-through losses.

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S Corporations: Facing the 15% Sunset

In the throes of economic uncertainty, most business owners are so focused on staying afloat that tax planning becomes an afterthought. It seems less practical to plan for the future when the present is so bleak. However, it is times like these when informed tax planning can be even more critical. Looming tax changes could deliver another blow to unprepared business owners, but an awareness of these changes may enable owners to identify opportunities that may not have existed in better economic times.

One such change with major implications for S corporations with prior C corporation earnings is the sunset of the 15% tax rate on qualified dividends. This favorable rate is due to expire on December 31, 2010, as provided in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).[1] Barring new legislation, in 2011 dividends will again be taxed at ordinary income tax rates. Further, those ordinary rates are scheduled to revert to their amount prior to the Economic Growth and Tax Relief Reconciliation Act of 2001.[2] This means the top ordinary income tax rate of 39.6% will again be in effect. In the case of S corporations with prior C corporation earnings (accumulated earnings and profits), this will be particularly difficult for their shareholders. Distributions after 2010 may be taxed at a rate more than double what they are taxed at currently.

The scheduled rate increases, trapped earnings and profits, and losses being sustained in the poor economy may combine to create a perfect storm for some S corporation owners. But with an appropriate strategy, S corporations and their owners can leverage poor financial performance to reduce or eliminate future tax on accumulated earnings and profits (AE&P). This article discusses how S corporations with AE&P can use current distributions and dividends to create tax savings for their shareholders in future years.

Typical Order of Distributions

When an S corporation makes a distribution to its shareholders, it typically is considered to have come from the following sources in this order:[3]

1. Accumulated adjustments account (AAA): nontaxable to the extent of shareholder basis;
2. For pre-1983 S corporations only, previously taxed income (PTI): non-taxable;[4]
3. AE&P: taxed as a qualified dividend at 15% through 2010;
4. Return of capital: nontaxable to the extent of remaining stock basis; and
5. Capital gain from the deemed disposition of stock: taxed as long-term capital gain if held for one year or more.

The above order applies to distributions of cash as well as noncash property, with the exception of PTI; distributions of PTI must be in the form of cash.[5] Based on the typical order of distributions, AE&P will not be reduced, in the form of dividends, until all the company's AAA has been distributed. For companies with prior C corporation earnings, the AAA balance can act as a shield, preventing the recognition of dividend income by its shareholders upon receipt of distributions. Management can defer this income indefinitely by limiting annual distributions to the amount of the AAA at each year's end.
However, the AAA is reduced not only by distributions but also by any loss and deductions recognized by the company during the year.[6] These losses or deductions can eliminate or greatly reduce any AAA, causing current or future distributions to be taxed as dividends. As companies struggle in the down economy, many are incurring large losses and depleting their AAA balances. If they eventually distribute cash or property next year and the 15% qualified dividend rate has expired as scheduled, they will be taxed on the AE&P distributions at ordinary income rates, which may be as high as 39.6%.

Future-looking taxpayers may prefer to recognize dividend income in 2010 when it is still guaranteed to be taxed at a maximum of 15%. This will eliminate the possibility of paying 39.6% on any future distributions. Furthermore, if the shareholders have experienced losses in 2010 or carried forward an NOL from a prior year, they can offset the dividend income, which could eliminate the AE&P at no tax cost to the shareholders. The issue, however, is whether the company has enough cash or liquid property available in 2010 to make distributions that exceed the AAA and AE&P balances.

Distribute Earnings and Profits First

Fortunately, the IRS allows S corporations to modify the order in which distributions are applied. Sec. 1368(e)(3) provides that an S corporation with AE&P can elect to treat its distributions for the year as AE&P-source funds, and therefore taxable as dividends, to the extent of AE&P. Any distributions exceeding AE&P will then be applied to AAA, and any further remaining amount will follow the sequence provided by Sec. 1368(b) (steps 4 and 5 above).[7] The election to modify the order of distribution sources requires the consent of all shareholders that received a distribution from the S corporation during the tax year (affected shareholders).[8] The reordering applies to all distributions for the year, so the company cannot choose to divide them between AAA and AE&P, but the election applies only for the tax year in which it is made. If the company wants to distribute AE&P before AAA in a subsequent year, a separate election for that year will be required.

To make this election, the company must attach a statement to its timely filed (including extensions) original or amended return. The statement should indicate that the company is electing under Regs. Sec. 1.1368-1(f)(2) to distribute earnings and profits first and must state that all affected shareholders consent to the election. The statement does not need to be signed.

This irrevocable election makes it possible for an S corporation with AE&P and limited cash to treat all distributions made in 2010 as coming from AE&P even if it still has AAA remaining. Shareholders may prefer to make this election to get AE&P out of the company while dividend rates are still 15%.

But what about companies with no cash available to make distributions before December 31, 2010? Many businesses are having trouble acquiring financing, collecting on receivables, and maintaining positive cash flow. However, there are a few ways for such businesses to take advantage of the 15% dividend rate. They may be able to liquidate some assets and then make cash distributions. This is possible, of course, only if the company has nonessential business assets or is willing to sell investment assets at a likely loss. Another option for the company is to make distributions of property other than cash. But if distributed property has a fair market value that exceeds its basis, the S corporation must recognize the difference as taxable gain. If fair market value is less than basis, the corporation does not recognize a loss. A much better option exists for these companies, and that is the election to make a deemed dividend.

Deemed Dividend

A deemed dividend does not require the actual distribution of cash. The S corporation makes an irrevocable election under Regs. Sec. 1.1368-1(f)(3) in the same manner as it would make the election to distribute earnings and profits first.[9] The election allows the company to distribute all or part of its AE&P without transferring any cash to its shareholders. This is because the amount of the dividend is considered to have been distributed in cash and then immediately contributed back to the S corporation. The transaction is treated as having occurred on the last day of the corporation's year and requires all shareholders on that date to include dividend income on their individual returns. As a result, all such shareholders must consent to the election to make the deemed dividend.

The amount of the dividend is determined by the S corporation, with the only restriction being that it cannot exceed the amount of AE&P at year end (reduced by actual distributions of AE&P made during the year). Shareholders are considered to have received their proportionate share of the total deemed dividend based on their ownership percentage at the company's year end. The specific shareholders should be listed on the election statement, with their Social Security numbers and amount of their share of the deemed dividend.

The ability to specify the amount of the deemed dividend is advantageous, particularly in S corporations with one or two shareholders. With basic knowledge of their individual tax situations, the amount of the deemed dividend can be set to take advantage of other factors on the individuals' returns, such as NOL carryovers, current-year losses, or large itemized deductions. In addition, the shareholder's stock basis in the S corporation is increased by the amount of the deemed dividend to reflect the simultaneous contribution to capital.

> ***Example:*** S corporation *Y* has one shareholder, *Z*. *Y* had ordinary business loss of $100,000 for the year ended December 31, 2010, and made no distributions during the year. *Y* has $50,000 in AAA and $150,000 in AE&P on December 31, 2010, after adjusting for the current-year activity. *Z*'s stock basis in *Y* on December 31, 2010, is $150,000 ($100,000 in capital stock plus $50,000 in undistributed S corporation earnings), again after adjusting for current-year activity.

Aware of the sunset provisions in JGTRRA, *Z* elects to make a deemed dividend of $150,000 to eliminate all of *Y*'s AE&P in 2010. *Y* will make the following entry on its books to reflect the simultaneous dividend distribution to *Z* and contribution of capital from *Z*:

Retained earnings $150,000
Paid-in capital $150,000

The $150,000 deemed dividend will be reported on *Y*'s Form 1120S, U.S. Income Tax Return for an S Corporation, Schedule K, line 17c, as well as on a Form 1099-DIV that *Y* will furnish to *Z*. *Z* will report $150,000 of dividend income on his Form 1040, along with the $100,000 of ordinary loss passed through to him by *Y*. *Z*'s stock basis is increased by his $150,000 capital contribution.

Other Considerations

This article focuses on the strategy of distributing AE&P in 2010 in preparation for the scheduled expiration of the 15% qualified dividend rate. However, there are other situations in which an S corporation and its shareholders may benefit from the discussed elections. If the S corporation is subject to the tax on excess net passive income,[10] eliminating AE&P will also eliminate the tax. An S corporation with AE&P that has excess passive investment income for three consecutive tax years will face involuntary termination of its S election.[11] If AE&P is removed, so is the threat of termination.

Ultimately, the decision to make one or all of these elections should be considered in light of the impact on the individual shareholders' taxes. If a shareholder generates a large operating loss in 2010, it may be beneficial to forgo creating dividend income in 2010 and instead carry back the loss up to five years for an immediate refund. In addition, a shareholder's investment interest expense carryover alone may not be reason enough to create dividend income in 2010 because any dividends included in investment income lose their favorable tax rates. Conversely, the limitation on itemized deductions is completely phased out for 2010, so the additional dividend income would not negatively affect the deduction amount for this year only.

Conclusion

Clearly, there are many factors for shareholders to consider prior to making the elections, and all affected shareholders must consent to them. Fortunately, the shareholders do not have to make these elections until the due date of the S corporation's return, including extensions. This should give shareholders and their tax advisers an opportunity to assess their 2010 individual tax situations before deciding to make the election to distribute earnings and profits or the election to make a deemed dividend.

The economic recession has obviously created severe hardship for businesses and their owners. Despite a myriad of current legislation aimed at providing tax relief, there are sunset provisions in prior law that, if fulfilled, will increase tax rates and increase the troubles of S corporation owners that must take taxable distributions. For that reason, informed tax planning remains as important as ever in 2010. There are specific elections available to S corporations that enable them to distribute earnings and profits before AAA or to make a deemed dividend. These elections may allow proactive owners to take advantage of recent business losses and the expiring favorable dividend rates to reduce or eliminate tax on future distributions.

Footnotes

[1] Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27.

[2] Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16.

[3] Sec. 1368(c).

[4] Regs. Sec. 1.1368-1(d)(2).

[5] Id.

[6] Regs. Sec. 1.1368-2(a)(3)(i)(A).

[7] If the company has PTI in addition to AE&P and wishes to forgo distribution of PTI, a separate election under Regs. Sec. 1.1368-1(f)(4) is needed. Absent this election, but with the election to distribute earning and profits first, the distribution order will be PTI, then AE&P, and finally AAA.

[8] Sec. 1368(e)(3)(A).

[9] Upon making this election, the company is considered to have made the election under Regs. Sec. 1.1368-1(f)(2) to distribute AE&P first. The company therefore does not have to make a specific election for that. But if it has PTI, the election to forgo distribution of PTI must still be made separately.

[10] Sec. 1375(a)(1).

[11] Sec. 1362(d)(3)(A).

Planning to Escape the S Corporation Built-in Gains Tax in 2010

The American Recovery and Reinvestment Act of 2009, P.L. 111-5, suspended imposition of the built-in gains (BIG) tax for tax years beginning in 2009 and 2010 for qualifying S corporations. This means that the BIG tax will not be imposed during 2009 and 2010 for an S corporation if the seventh tax year of the corporation's 10-year recognition period ended before those tax years (Sec. 1374(d)(7)(B)). However, unless the S corporation's 10-year recognition expires in 2009 or 2010, the S corporation will evidently again be subject to the BIG tax for the tax year beginning in 2011 through the end of the 10-year recognition period.

Planning Opportunities

The 2009–2010 BIG tax suspension period provides unprecedented opportunities for eligible S corporations to escape the BIG tax. The planning strategy is to accelerate or delay the disposition of built-in gain assets as necessary so that dispositions take place during the S corporation's suspension period (e.g., 2010 for S corporations whose 10-year recognition period began in 2003).

An S corporation whose 10-year recognition period began in 2002 will not be subject to the BIG tax for tax years beginning in 2009 or 2010.

> ***Example 1:*** *ABC*, a calendar-year C corporation, elects S status on April 1, 2002. The seventh tax year of *ABC*'s 10-year recognition period ends on December 31, 2008. Thus, *ABC*'s net recognized built-in gain during 2009 and 2010 will not be subject to the BIG tax. *ABC*'s 10-year recognition period ends on March 31, 2012, so *ABC* will evidently again be subject to the BIG tax beginning with calendar year 2011.

The application of the BIG suspension rules requires the practitioner to make a clear distinction between the 10-year recognition period rules and the suspension qualification rules. The 10-year (120-month) BIG recognition period begins on the date the corporation's S election becomes effective (Sec. 1374(d)(7)(A); Regs. Sec. 1.1374-1(d)). Similarly, for transferred basis assets, the BIG recognition period begins on the date the S corporation acquires an asset from a C corporation or from an S corporation subject to the BIG tax (Sec. 1374(d)(8)).

However, the BIG tax suspension rules apply to tax years beginning in 2009 or 2010 if the seventh tax year in the recognition period preceded 2009 or 2010 (Sec. 1374(d)(7)(B)). Thus, the BIG tax suspension rules evidently are keyed to the corporation's tax year rather than to any specific 12-month period within the normal 10-year (120-month) recognition period. In Example 1, the corporation's 10-year recognition period began on April 1, 2002, the date of its S election. Accordingly, the seventh full year of its BIG recognition period would end on March 31, 2009. However, because the BIG tax suspension rules seem to be keyed to the corporation's tax year, the corporation qualifies for the suspension of the BIG tax because its seventh tax year in the recognition period (i.e., the calendar year ending December 31, 2008) ended before 2009.

Caution: The Code states that the BIG tax will not apply "if the 7th taxable year in the recognition period" preceded a tax year within the 2009–2010 suspension period (Sec. 1374(d)(7)(B)). However, the instructions to Schedule D of Form 1120S, U.S. Income Tax Return for an S Corporation, say that the BIG tax does not apply "if the 7th year of the applicable recognition period ended before the tax year."

By omitting the word "taxable," the instructions could be interpreted to mean that the seven years are measured in calendar years (i.e., 84 months) rather than counting a short tax year as one year, as the Code evidently allows.

An S corporation whose 10-year recognition period began in 2003 will be exempt from the BIG tax for the tax year beginning in 2010 only.

> ***Example 2:*** *ABC* elects S status on April 1, 2003. The seventh tax year of *ABC*'s 10-year recognition period ends on December 31, 2009. Thus, *ABC*'s net recognized built-in gain during 2010 will not be subject to the BIG tax. *ABC*'s 10-year recognition period ends on March 31, 2013, so *ABC* will evidently again be subject to the BIG tax from January 1, 2011, through the end of the recognition period.

An S corporation whose 10-year recognition period expires during the 2009–2010 suspension period will not be subject to BIG tax after the tax year beginning in 2008.

> ***Example 3:*** If *ABC* elects S status on January 1, 2001, the seventh tax year of its 10-year recognition period ends on December 31, 2007 (i.e., before the beginning of the 2009 tax year). *ABC* 's 10-year recognition period expires on December 31, 2010, and *ABC* is exempt from the BIG tax during 2009 and 2010, so *ABC* will not be subject to the BIG tax rules after December 31, 2008.

Applying the Suspension Period to Transferred Basis Property

A separate 10-year recognition period applies to transferred basis property received from a C corporation or an S corporation subject to the BIG tax rules. So even if an S corporation's recognized built-in gains are otherwise exempt from BIG tax during the 2009–2010 BIG tax suspension period, the corporation can be subject to the tax during that period if the corporation received transferred (substituted) basis property from a C corporation or an S corporation subject to the BIG tax rules.

The recognition period is normally measured from the date the property is acquired by the S corporation, not the date of election of S corporation status (Sec. 1374(d)(8); Regs. Sec. 1.1374-8). Gain on the disposition of transferred basis property is exempt from the BIG tax during tax years beginning in 2009 and 2010 if the property is acquired by the S corporation seven years before those tax years (Sec. 1374(d)(8)).

> ***Example 4:*** The facts are the same as in Example 1. On February 1, 2005, *ABC* acquires appreciated land as part of a reorganization. *ABC* faces the BIG tax if it disposes of the land on or before January 31, 2015 (i.e., within 10 years from the date it acquired the land). *ABC* now has two 10-year recognition periods. The first begins on April 1, 2002, and applies to property on hand when the S election became effective. The second begins on February 1, 2005, and applies to the land received in the reorganization.

Evidently, *ABC* must have held the transferred basis land for seven calendar years from the date the corporation acquired the land (see Sec. 1374(d)(8)). Thus, the seven-year period expires on January 31, 2012, and the 2009–2010 BIG suspension period does not apply to the land.

Reducing Net Unrealized Built-in Gain During the Suspension Period

The maximum built-in gain an S corporation must recognize is the net unrealized built-in gain (the excess of the aggregate FMV over the aggregate adjusted basis of all assets on hand as of the first day the S election is effective) (Sec. 1374(d)(1)). The Code states that "[i]n the case of any taxable year beginning in 2009 or 2010, no tax shall be imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year" (Sec. 1374(d)(7)(B)).

This seems to mean that for S corporations that are exempt from the BIG tax during 2009 and 2010, the net recognized built-in gain is calculated but no BIG tax applies. Therefore, the net unrealized built-in gain (i.e., the overall limit) evidently is reduced by built-in gain recognized but not taxed, which likewise reduces the maximum amount of built-in gain that is subject to tax after 2010. This treatment is in accordance with the instructions to Form 1120S, Schedule D.

The wording of Sec. 1374(d)(7)(B) sounds as though the net recognized built-in gain (the amount of built-in gain that is subject to tax after applying the appropriate limitations) is calculated in the regular manner, except that no tax applies to built-in gains recognized by qualifying S corporations during the 2009–2010 BIG tax suspension period.

Carryover of BIG

According to the instructions to Schedule D (Form 1120S), the carryover of net recognized built-in gains in excess of the taxable income limitation is calculated as if the built-in gains excluded during the suspension period had actually been recognized. This appears to mean that the taxable income limit is applied to built-in gains recognized during the suspension period and built-in gains in excess of the taxable income limit carry over to the following year, even though the recognized built-in gain was not taxed during the suspension period. IRS guidance is needed to clarify this issue.

Avoiding S Corporation Debt Obligations That Are a Second Class of Stock

Under certain circumstances, debt owed by an S corporation to one or more shareholders will be a second class of stock. An obligation (whether or not designated as debt) generally will be treated as a second class of stock if (1) it constitutes equity or otherwise results in the holder's being treated as a shareholder under general tax law and (2) a principal purpose of the obligation is to circumvent the distribution or liquidation rights conferred by the outstanding stock or to circumvent the maximum shareholder limitation (Regs. Sec. 1.1361-1(l)(4)(ii)).

Whether an obligation constitutes debt or equity can be important for the following practical reasons:

- The continued validity of the corporation's S election depends on having only one class of stock; and
- Payments on debt will reduce the corporate income available for distribution and likely will differ from amounts that would otherwise be distributed to the shareholders on equity.

For these reasons, and because the parameters of the "principal purpose" test are unclear, the practitioner should be aware of factors the courts consider in determining whether an obligation is debt or equity. The Tax Court has identified and applied various factors in concluding that the obligation under consideration was equity, including the intent of the parties, thin versus adequate capitalization, the source of repayment, and the right to enforce repayment (*American Offshore, Inc.*, 97 T.C. 579 (1991); *Gray*, T.C. Memo. 1997-67). For additional assurance that the obligation will not jeopardize the corporation's S status, the planner can structure the obligation to meet the straight debt safe harbor described below.

Observation: The one-class-of-stock rules provided in Regs. Sec. 1.1361-1(l) do not apply to obligations issued before May 28, 1992, and not materially modified after that date. However, S corporations and their shareholders can apply the regulations to prior tax years (Regs. Sec. 1.1361-1(l)(7)).

Relying on the Straight Debt Safe Harbor

Debt that meets the definition of "straight debt" is not a second class of stock, regardless of whether such debt is classified as equity under general tax law principles. A straight debt instrument is a written unconditional promise to pay (whether or not embodied in a formal note) on demand or on a specific date a sum certain in money (Sec. 1361(c)(5)). In addition, straight debt must meet the following requirements:

1. The interest rate and payment dates are not contingent on profits, corporate discretion, etc.;
2. The instrument is not convertible into stock; and
3. The lender is an individual (other than a nonresident alien), an estate, a trust that is eligible to hold S corporation stock, or a person actively and regularly engaged in the business of lending money (e.g., a bank).

Example 1: STI is an S corporation owned by B. B is president of the company and devotes 100% of his time to its activities. He contributed $5,000 to the company when it was formed in exchange for the stock. Five years ago, when STI was a regular C corporation, B was required to inject an additional $100,000 into the corporation. His controller advised him to lend the money to the corporation so it could be withdrawn later without the risk of dividend treatment. B loaned $100,000 to the company and received a $100,000 written demand note bearing an interest rate of 10%. About two years ago, STI converted from C to S corporation status. In analyzing STI's note to B, the tax practitioner confirmed that the note is not convertible into STI stock and verified that the other straight debt safe harbor requirements are met. Therefore, the note meets the statutory criteria for safe-harbor debt.

Thin versus adequate capitalization is a factor commonly used by the courts. Thus, in this example, an IRS contention that the company is inadequately capitalized is possible because STI's outstanding debt is 20 times its outstanding capital stock. However, since STI's obligation meets the straight debt safe-harbor rule, it will not be considered a second class of stock.

Even if an obligation is subordinated to other debt of the corporation, it can still qualify as straight debt. Straight debt ceases to qualify if it is transferred to an ineligible S corporation shareholder or is materially modified so the straight debt requirements are no longer met.

An obligation issued by a C corporation that satisfies the definition of straight debt is not treated as a second class of stock if the corporation elects S status, even if the debt is considered equity under general tax law principles. In addition, conversion to S status is not treated as an exchange of debt for stock with respect to such an obligation (see Regs. Sec. 1.1361-1(l)(5)(v)).

Short-Term Unwritten Advances and Proportionately Held Debt

In addition to the safe harbor for straight debt obligations, there are two additional safe harbors to prevent certain debt being treated as a second class of stock (Regs. Sec. 1.1361-1(l)(4)(ii)(B)). The safe harbors are for certain short-term unwritten advances and proportionately held debt.

Unwritten advances that (1) do not exceed $10,000 in the aggregate at any time, (2) are treated as debt by the parties, and (3) are expected to be repaid within a reasonable time are not treated as a second class of stock (even if considered equity under general tax law principles).

Proportionately held debt includes any class of obligations considered equity under general tax law principles and held by the shareholders in the same proportion as the S corporation's outstanding stock. Note that debt held by a sole shareholder of an S corporation always meets the definition of proportionately held debt. Thus, debt held by shareholders in the same proportions as their stock ownership (including debt owed by the corporation to a sole shareholder) will not be considered a second class of stock.

Example 2*:* Assume the same facts as in Example 1 except the interest rate called for in the note was contingent upon the corporation's profits.

While the loan no longer qualifies for the straight debt safe harbor (because interest is contingent on the corporation's profits), it does qualify for the proportionately held safe harbor. The regulations explicitly state that obligations held by the sole shareholder of an S corporation are always considered proportionately held.

If the debt is disproportionately held, it will not create a second class of stock unless the debt has a principal purpose of circumventing the distribution or liquidation rights conferred by the outstanding shares of stock or circumventing the 100-shareholder limitation (Regs. Sec. 1.1361-1(l)(4)(ii)(B)(2)).

Example 3: Now assume that B is only a 50% shareholder (yet all loans have come from him).

If the debt owed to B by the corporation qualifies as straight debt, it does not result in a second class of stock. But even if the straight debt requirements are not met, the mere fact that the debt is disproportionately held will not create a second class of stock, unless it is considered to be equity and has a principal purpose of circumventing the distribution or liquidation rights conferred by the outstanding shares of stock, or circumventing the 100-shareholder limitation.

Loaning Distributions Back to the Corporation

Shareholders can lend back to the corporation all or some distributions to them without breaching the one-class-of-stock rules. However, the shareholders should not be under any obligation to recontribute the distributions, and the notes issued to the shareholders should meet the straight debt criteria (Letter Ruling 9746038).

Example 4: E Corp. is an S corporation that makes periodic distributions to its shareholders. It needs to fund its expansion but wants to minimize its commercial borrowing by obtaining loans from its shareholders. The corporation proposes that the shareholders recontribute to E all or a portion of their cash distributions in exchange for one or more promissory notes. The shareholders, however, would be under no obligation to lend the distributions back to the company. The promissory notes would carry interest at a rate equal to the applicable federal rate in effect at the time of each transaction. Interest payments would not be contingent on E's profits, and the notes would not be directly or indirectly convertible into stock.

The IRS has ruled under similar facts that a second class of stock will not result when distributions are recontributed to the corporation in exchange for promissory notes (Letter Ruling 9746038). The IRS attached importance to the fact that the shareholders were under no obligation to loan their cash distributions to the corporation. The ruling concludes that the notes issued by the corporation to the shareholders would be considered straight debt. Thus, any cash distributions by E to its shareholders followed by a loan by the shareholders of part or all of their cash distributions back to E will not result in E's being treated as having a second class of stock.

Recapture of Sec. 179 Expense Deduction for Pass-through Entities

The new extended dollar limitation under Sec. 179 allows a taxpayer to elect to expense up to $250,000 of the cost of qualifying property placed in service during a tax year. Practicing CPAs who prepare tax returns are relatively knowledgeable about how to report the Sec. 179 expense deduction. There is one area of Sec. 179, however, that can be tricky and is not well understood: how to report the recapture of Sec. 179 expense for pass-through entities at both the entity and owner levels. This item addresses how S corporations and partnerships that have a Sec. 179 recapture event should report the event to their owners and how a tax return preparer of an individual who receives a Schedule K-1 with supplemental Sec. 179 recapture information should report the recapture on Form 1040, U.S. Individual Income Tax Return.

For pass-through entities, recapture of the Sec. 179 expense deduction information is required when the entity disposes of an asset for which the entity passed through Sec. 179 expense to its owners on a Schedule K-1 (Sec. 1245(a); Regs. Sec. 1.179-1(e) (3)). Recapture of Sec. 179 expense deduction information is also required when there is a decline in business use that triggers recapture. If property for which a Sec. 179 expense deduction was claimed ceases to be used more than 50% in business at any time before the end of the property's recovery period, partial recapture of the deduction is required (Secs. 179(d)(10) and 280F(b)(2); Regs. Sec. 1.179-1(e)).

Entity Reporting for an Asset Disposition

When preparing Form 1120S, U.S. Income Tax Return for an S Corporation, or Form 1065, U.S. Return of Partnership Income, if a pass-through entity disposed of Sec. 179 property during the tax year, the amount of the Sec. 179 expense previously passed through to its owners on a Schedule K-1 is treated as depreciation and must be recaptured under Sec. 1245 to the extent of any gain realized on the disposition at the owner level. The tax gain or loss on disposition of Sec. 179 assets will not be reported on page 1 of Form 1120S or Form 1065, will not be reported on Schedule K, and will not be included on the Form 4797, Sales of Business Property, prepared by the pass-through entity. The entity will eliminate net book gain or loss on Sec. 179 assets from taxable income and present

it on the entity tax return as a Schedule M-1 adjustment. The information necessary to calculate the tax gain or loss at the owner level will be reported on a Form 1120S, Schedule K-1, in box 17, Other Information, and designated as code K, "dispositions of property with section 179 deductions." For a partnership the same information will be reported on Form 1065, Schedule K-1, box 20, Other Information, designated as code L. Both codes K and L will refer to a supporting schedule.

Because the pass-through entity must maintain fixed asset depreciation schedules for tax purposes, which includes the Sec. 179 expense deduction, it has the information needed to prepare the supporting schedule necessary for codes K and L items. The instructions to the Schedules K-1 for Forms 1065 and 1120S state that for codes K and L the pass-through entity should provide the owner the following information:

- Description of the disposed property;
- Date acquired and placed in service;
- Date of sale or disposition;
- Owner's distributive share of sale price;
- Distributive share cost and selling expense;
- Distributive share of depreciation;
- Distributive share of Sec. 179 expense;
- If distribution is due to a casualty or theft, the information necessary for the owner to complete Form 4684, Casualties and Thefts; and
- Installment sale information, if applicable.

Most tax preparation software applications will automatically handle the entity-level reporting of a disposition of a Sec. 179 asset from the information entered on a sale of a business asset screen. However, it is important that tax preparers understand how and where the disposition information is reported and that the tax gain or loss on the disposition of Sec. 179 assets is reported at the owner level.

Owner Reporting for Disposition

As described above, an S corporation will report the information necessary to calculate the tax gain or loss at the owner level on a Form 1120S, Schedule K-1, in box 17, Other Information, designated as code K. A partnership will report the information on Form 1065, Schedule K-1, in box 20, Other Information, designated as code L. In both cases, the entry will refer to a supporting schedule containing detailed information.

On Form 4797, depreciation allowed or allowable includes the Sec. 179 expense deduction actually claimed in prior-year tax returns. If an owner was unable or ineligible to deduct the Sec. 179 expense deduction for a disposed asset, the depreciation reported as allowed or allowable on Form 4797 will include only the Sec. 179 expense deduction actually claimed in prior-year tax returns. Thus, the gain or loss on the disposition of an asset can vary between owners of the same entity. When faced with the task of preparing such a Form 4797, the preparer must review prior-year Forms 1040 to see if all Sec. 179 expense deductions from the pass-through entity have been deducted.

It is important for a preparer to understand that the gain or loss on the disposition of a Sec. 179 asset is reported at the owner level and that the information necessary to compute the gain or loss on Form 4797 is found only in the statement attached to the related Schedule K-1. It would be very easy for a preparer of a Form 1040 to skip this information and thus misreport the income or loss from the pass-through entity. The misreported income or loss could be significant, and the preparer firm would have difficulty explaining why it had not prepared the return correctly.

Entity Reporting: Recapture Due to Decline in Use

The other occurrence that can trigger a recapture of Sec. 179 expense deduction is a decline in business use of property to 50% or less at any time before the end of the property's recovery period. If this situation occurs, the pass-through entity is required to inform its owners that they may have to recapture a portion of previously distributed Sec. 179 expense deduction, and the entity must provide the information necessary for the owner to determine how much the owner must recapture.

The pass-through entity must first recompute the depreciation on all Sec. 179 assets for which the business use drops to 50% or less. It does this by taking the Sec. 179 expense passed through to the owners and applying the same life and method used for regular tax depreciation for this asset. The accumulated depreciation on the Sec. 179 expense through the end of the current tax year is compared with the Sec. 179 expense passed through to the owners for this asset. The difference is allocated to each owner based upon his or her ownership percentage in the year the Sec. 179 expense was passed through to the owners. An S corporation reports the tentative recapture of Sec. 179 expense on Form 1120S, Schedule K-1, in box 17, Other Information, and designated as code L, "recapture of section 179 deduction." A partnership reports the same information on Form 1065, Schedule K-1, in box 20, Other Information, designated as code M. The dollar amount of the recapture is listed next to the respective codes.

The pass-through entity is required to attach a supporting schedule to each owner's K-1 that breaks out the owner's share of the depreciation that was allowed or allowable on the property and the owner's share of the Sec. 179 expense that was passed through

and the years in which the expense was passed through. The recapture amount will not appear on page 1 of Form 1120S or Form 1065 or on Schedule K.

The pass-through entity is required to complete Part IV of Form 4797, using the amounts computed above. The entity will report the Sec. 179 expense deduction(s) passed through to owners in a prior year on line 33. It will report the recomputed depreciation on the Sec. 179 expense deduction on line 34. The difference between the two amounts is reported on line 35 as the recapture amount. The owners must also complete Part IV of Form 4797 and submit it as part of their 1040 return. The pass-through entity must provide the necessary details in a schedule attached to an owner's Schedule K-1. The schedule must contain information for each asset subject to Sec. 179 recapture. Specifically, it must contain the year the asset was placed in service, the amount of Sec. 179 expense, the amount of recalculated depreciation, and the recapture amount. Each owner will have to determine how much of the Sec. 179 expense was deducted on the owner's Schedule E in prior-year Forms 1040 in order to correctly complete Part IV of Form 4797.

Going forward, the pass-through entity must modify its tax depreciation schedules by deleting the Sec. 179 expense deduction, reducing accumulated depreciation by the net recapture amount, and increasing the depreciable basis of the asset by the net recapture amount. The alternative minimum tax and adjusted current earnings depreciation schedules must also be modified.

Example: In 2007 a $20,000 Sec. 179 asset with a five-year life is placed in service, and $15,000 of Sec. 179 expense deduction for this asset is passed through to the owners. The business use percentage of this asset falls below 51% in 2008. The 2007 Sec. 179 expense deduction must be recaptured in 2008.

Assume the asset was depreciated for tax purposes using the modified accelerated cost recovery system (MACRS) and a half-year convention. Prior to recapture, the depreciable base would be $5,000 and the accumulated depreciation through 2008 would have been $17,600 ($5,000 × 52%

+ $15,000 of Sec. 179 expense deduction).The recapture is computed by applying the MACRS two-year accumulated depreciation percentage of 52% to the Sec. 179 expense deduction of $15,000, which equals $7,800. The Sec. 179 expense passed through to the owners in 2007 of $15,000 must be recaptured to the extent it exceeds the accumulated depreciation on the Sec. 179 expense deduction of $7,800 ($15,000 × 52%). The tentative recapture of Sec. 179 expense deduction in 2008 is $7,200 ($15,000 – $7,800). The depreciable base for this asset is increased to $12,200 ($5,000 + $7,200), and the accumulated depreciation through 2008 will be adjusted to $10,400 ($17,600 – $7,200).

Owner Reporting: Recapture Due to Decline in Use

As described above, an S corporation will report the tentative recapture of Sec. 179 expense on Form 1120S, Schedule K-1, in box 17, designated as code L. A partnership will report the information on Form 1065, Schedule K-1, box 20, Other Information, designated as code M. The dollar amount of the recapture will be listed next to the respective codes, and the entry will contain a reference to a schedule providing the required detail information. A preparer must be sure to look for the schedule related to the entry because knowing the recapture amount alone does not provide the information necessary to complete Part IV of Form 4797.

The schedule should contain information for each asset subject to Sec. 179 recapture due to decline in business use to 50% or less. Specifically, it should contain the year the asset was placed in service, the amount of Sec. 179 expense, the amount of recalculated depreciation, and the recapture amount. The preparer will have to determine how much of the Sec. 179 expense was deducted on Schedule E in prior-year Forms 1040 in order to correctly complete Part IV of Form 4797. If the owner did not claim a deduction for the full amount of the Sec. 179 expense in a prior year or years, line 33 of Form 4797 must be adjusted by the unclaimed amount, which will affect the dollar amount of the recapture of Sec. 179 expense deduction.

Note that the recapture of Sec. 179 expense deduction determined in Part IV of Form 4797 is reported as nonpassive income on Form 1040, Schedule E, Supplemental Income and Loss. According to the 2008 instructions for the Form 1040, Schedule SE, the recapture of income resulting from the decline in the business use of Sec. 179 property is subject to self-employment tax (IRS, 2008 Instructions for Schedule SE (Form 1040), Self-Employment Tax, p. SE-3).

Recognizing When an S Corporation Has Accumulated Earnings and Profits

Both a C corporation and an S corporation can distribute taxable dividends to the extent that the corporation has accumulated earnings and profits (AE&P). An S corporation cannot generate earnings and profits (E&P) but, as discussed in the following paragraphs, a C corporation's AE&P transfers to the S corporation when the S election is made (Sec. 1371(c)).

Defining Dividends

Dividends are distributions of current E&P or AE&P of a C corporation (Sec. 316(a)). An S corporation can pay a dividend only when AE&P that arose when the corporation was in C status is distributed (Sec. 1371(c)). Therefore, a corporation that has been an S corporation since inception and has not acquired another corporation with AE&P cannot issue a dividend.

For federal income tax purposes, a “distribution” is a payment in cash or property from a corporation to a shareholder based on stock ownership. A “dividend” is a distribution from AE&P (Sec. 316). Therefore, a distribution may or may not include a dividend. State law and corporate minutes often refer to distributions to shareholders as dividends without regard to whether AE&P is actually distributed.

Calculating C Corporation E&P

C corporations generate positive or negative E&P each year, calculated by making annual adjustments to taxable income. Depreciation, for example, can cause one such adjustment. For purposes of calculating taxable income, assets generally can be depreciated under the modified accelerated cost recovery system (MACRS), but they must be depreciated under the alternative depreciation system (ADS) when computing E&P (Sec. 312(k)(3) (A)). In addition, the Sec. 179 expense is deducted for regular tax purposes in the year the asset is placed in service but is deducted pro rata over five years when determining E&P (Sec. 312(k)(3)(B)). Furthermore, the Sec. 179 expense may be handled entirely differently for book purposes in arriving at retained earnings.

The term “retained earnings” refers to a corporation’s undistributed earnings; its computation is normally governed and determined by generally accepted accounting principles (GAAP). AE&P is also a measure of the undistributed earnings of a corporation, but from a tax point of view. In other words, accounting rules govern the determination of retained earnings, while AE&P is calculated under tax law. Because of these differences, AE&P seldom matches retained earnings.

Some S Corporations Will Not Have AE&P

AE&P is significant because its distribution results in a taxable dividend. An S corporation does not generate E&P, but many S corporations have AE&P because of previous operation as a C corporation. An S corporation can also have AE&P when it acquires certain other corporations that have AE&P. Accordingly, an S corporation will not have AE&P if it was never a C corporation and has not acquired another corporation.

When a C corporation becomes an S corporation, the AE&P retains its character (i.e., distributions of AE&P continue to be taxable dividends). However, S corporation income that already has been taxed can be distributed first, generally with no current tax effect on the shareholder.

Reducing AE&P by Distributions and Other Items

C corporation AE&P is frozen on the date the corporation converts to S status. The AE&P generally will not increase (except when the corporation acquires another corporation with AE&P) and will be reduced only by the following transactions:

- Distributions treated as dividends (Sec. 1371(c)(3));
- Payment of tax at the corporate level because of general business credit recapture (Sec. 1371(d)(3));
- Certain redemptions, reorganizations, liquidations, or corporate divisions (Sec. 1371(c)(2)); and
- Payment by the S corporation of LIFO recapture (Sec. 1363(d)(5)).

S corporation transactions do not increase an S corporation’s frozen AE&P balance, and it is reduced only by the items listed in the previous paragraph. By comparison, certain other negative adjustments to E&P are allowable to a C corporation. Depreciation, for example, will cause positive adjustments to a C corporation’s E&P at first and negative adjustments after the depreciation methods begin to equalize.

Example 1: Z is a C corporation that, for tax purposes, breaks even every year. Z elects S status at the beginning of the current year when it has $75,000 of AE&P caused by the difference between depreciation under MACRS and ADS. In the first year of S status, depreciation per the tax return under MACRS is $90,000 while depreciation under ADS would be $100,000. If Z had remained a C corporation, the $10,000 difference would be a negative adjustment, and Z would reduce its AE&P by that amount. Because the corporation is in S status, however, no AE&P adjustment for the depreciation difference is allowable.

Business credit recapture is paid at the corporate level if the credit was originally claimed while the corporation was a C corporation (Sec. 1371(d)). Business credit recapture paid at the corporate level reduces the corporation’s AE&P (Sec. 1371(d)(3)). In addition, the recapture tax paid by the S corporation is a nondeductible, noncapitalizable expense that reduces basis. However, the business credit recapture tax paid by the S corporation does not reduce an accumulated adjustments account (AAA) because the recapture is a federal tax attributable to a C corporation year, and an AAA is not reduced by such items (Sec. 1368(e)(1)(A)).

As illustrated below, an S corporation’s AE&P is not adjusted if the adjustment was based on an estimate under the completed contract method and the estimate turns out to be wrong (*Cameron*, 105 T.C. 380 (1995)). The Eighth Circuit reached the same conclusion in *Broadaway*, 111 F.3d 593 (8th Cir. 1997).

Example 2: C is a C corporation that uses the completed contract method of accounting for long-term contracts. C is not required to use the percentage of completion method for regular tax purposes, but it calculates its E&P using that method (Sec. 312(n)(6)). For simplicity, assume that C has one contract and no AE&P at the beginning of 2008. The contract is not completed during that year, so C shows no income or loss on its Form 1120, U.S. Corporation Income Tax Return. C estimates that under the percentage of completion method it would have $50,000 of income, so that amount is the AE&P balance on January 1, 2009, when C elects S status. On January 15, 2009, C distributes $45,000 to Q, its sole shareholder. Q’s basis in stock is $60,000. C’s net operating income shown on its 2009 Form 1120S, U.S. Income Tax Return for an S Corporation, is $1,000. Under these facts, C’s AAA before considering the distribution is

$1,000, so the distribution would be a $1,000 nontaxable distribution of AAA and a $44,000 dividend. The dividend would reduce the AE&P balance from $50,000 to $6,000. Q, however, discovers that the $50,000 income estimate under the percentage of completion method should have been only $7,000. If the AE&P balance on January 1, 2009, was $7,000, the $45,000 distribution would be (1) a $1,000 nontaxable distribution of AAA, (2) a $7,000 dividend, and (3) a $37,000 nontaxable return of basis.

According to the Tax Court's ruling in *Cameron*, the beginning AE&P balance cannot be changed from $50,000 to $7,000, even though the incorrect estimate would have corrected itself if C had remained a C corporation. The Tax Court ruled that, under Regs. Sec. 1.451-1(a), if income is properly accrued based on a reasonable estimate and the exact amount is found to be different, the difference is taken into account in the tax year in which the exact amount is determined. Electing S status is a voluntary act, and one of its consequences is the freezing of the AE&P.

Final Regs. Issued on S Corp. DOI Income Exclusion and Tax Attributes

NEWS NOTES

by Alistair M. Nevius, J.D.

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On October 30, the IRS issued final regulations (T.D. 9469) governing how an S corporation reduces its tax attributes under Sec. 108(b) when the S corporation has discharge of indebtedness (DOI) income that is excluded from gross income under Sec. 108(a).

The regulations address situations in which the aggregate amount of the shareholders' disallowed Sec. 1366(d) losses and deductions that are treated as a net operating loss (NOL) tax attribute of the S corporation exceeds the amount of the S corporation's excluded DOI income. The final regulations generally adopt the provisions of proposed regulations that were issued in August 2008 (REG-102822-08).

Background

Sec. 108(a) excludes DOI income from gross income if the discharge occurs while the taxpayer is bankrupt or insolvent, in which case the exclusion from income is limited to the amount by which the taxpayer is insolvent. Under Sec. 108(b), the taxpayer must reduce certain specified tax attributes—in a specified order—to the extent DOI income is excluded from gross income. The first tax attribute reduced is any NOL and any NOL carryover for the tax year of the discharge.

Under the rules of Sec. 1366(a), if an S corporation excludes DOI income from its gross income under Sec. 108(a), the amount excluded reduces the S corporation's tax attributes under Sec. 108(b). The reduction of tax attributes occurs after the S corporation's items of income, loss, deduction, and credit for the tax year of the discharge pass through to its shareholders under Sec. 1366(a).

Final Regulations

The final regulations provide an ordering approach for determining the character of the amount of the S corporation's excess deemed NOL that is allocated to a shareholder. The approach is based on one commentator's recommendation that the final regulations' approach be consistent with the method for determining the character of a shareholder's losses and deductions under Sec. 1366(d). Under this approach, an S corporation's excess deemed NOL that is allocated to a shareholder consists of a proportionate amount of each item of the shareholder's loss or deduction that is disallowed for the tax year of the discharge under Sec. 1366(d)(1).

The final regulations also modify the shareholder information reporting requirement so the S corporation does not have to depend on shareholders who fail to furnish information or who provide incorrect information. In certain situations, the S corporation may rely on its own books and records as well as other information available to it to determine a shareholder's disallowed losses or deductions under Sec. 1366(d)(1), provided the S corporation knows that the amount reported by the shareholder is inaccurate or the information, as provided, appears to be incomplete or incorrect.

There are no special rules to provide for consequences to shareholders who either fail to report this information or report incorrect information to the S corporation. However, the IRS and Treasury note in the regulations' preamble that Sec. 6037(c) requires that a shareholder of an S corporation must treat a "subchapter S item" on his or her return in a manner consistent with its treatment on the S corporation's return. The preamble states that an S corporation's excess deemed NOL that is allocated to a shareholder is a subchapter S item for purposes of Sec. 6037(c) and that the consequences of failure to comply with Sec. 6037(c) are sufficient to encourage shareholders to cooperate with the S corporation in order to avoid inconsistencies between the S corporation's return and the shareholder's return.

Several people who commented on the proposed regulations recommended that S corporation NOLs carried forward from one or more C corporation tax years should be considered S corporation tax attributes for purposes of Sec. 108(b)(2). The final regulations did not adopt this suggestion.

One commentator suggested that the final regulations should clarify how the allocation rules in Prop. Regs. Sec. 1.108- 7(d)(2) apply when an S corporation, with the consent of all affected shareholders, makes a terminating election. According to the IRS, regardless of whether a terminating election is made, all disallowed losses and deductions of a shareholder under Sec. 1366(d)(1), including disallowed losses and deductions of a terminating shareholder, are treated as an S corporation's deemed NOL. However, the impact of a terminating election on the allocation of the DOI income may result in a different allocation of the S corporation's excess deemed NOL among the shareholders. Therefore, the final regulations add an example to clarify how the allocation rules apply when a terminating election is made.

The regulations were effective October 30.

Sec. 465 Traps for the Unsuspecting S Corporation Shareholder

S CORPORATIONS

by Lewis Taub, CPA

Published July 01, 2010

EXECUTIVE SUMMARY

- The amount of loss passed through from an S corporation that a shareholder can deduct is limited to the shareholder's amount at risk in the corporation. The amount a shareholder has at risk in an S corporation is calculated separately from the shareholder's basis in the corporation and is frequently a different amount.

  A taxpayer's at-risk amount for an interest in an S corporation includes the amount of money and the adjusted basis of other property contributed to the activity, as well as certain loans made to the corporation by the shareholder. Whether loans to an S corporation are included in the shareholder's at-risk amount depends on a number of factors, including the source of the funds loaned and the security given for the loans.

- A shareholder's amount at risk is increased by the shareholder's pro-rata share of the S corporation's items of income, including tax-exempt income, and decreased by the shareholder's pro-rata share of the S corporation's loss or deductions, including nondeductible expenses that are not capitalizable. In certain circumstances, the repayment of loans to the S corporation will increase or decrease the shareholder's at-risk amount.

When an S corporation has losses, one concern is whether the shareholders have basis in the stock or debt in order to use this loss on their tax returns. The basis issue was discussed in depth last month.[1] However, an issue often overlooked by shareholders and tax practitioners is whether shareholders have a sufficient amount at risk with regard to the investment in the S corporation. The at-risk rules are set out in Sec. 465. This article will address those rules, which without proper planning can limit the amount of deductible losses.

Congress originally enacted the at-risk rules in the Tax Reform Act of 1976[2] to curb tax shelters that gave taxpayers deductions for nonrecourse debt. However, the scope of the rules has been continually broadened.

The most inclusive provision of Sec. 465 is found in Sec. 465(c)(3), which states that for tax years beginning after December 31, 1978, the section applies to each activity engaged in by a taxpayer in carrying on a trade or business. Therefore, in the context of S corporations, the rules apply to any S corporation shareholder engaged in a trade or business. Often practitioners do not give the application of the rules to S corporations sufficient consideration because they incorrectly presume the concept applies predominantly to partnerships.

Contribution of Cash or Other Property

Sec. 465 starts simply enough by stating that a taxpayer is at risk for an activity for the amount of money and the adjusted basis of other property contributed to the activity. What if a shareholder contributes property that is subject to a debt? The amount at risk depends upon whether the shareholder is personally liable for the debt. If so, the shareholder's amount at risk is increased by the full amount of the property's adjusted basis. If the shareholder is not personally liable for the repayment of the loan, the amount at risk is increased by the adjusted basis of the property contributed and decreased by the nonrecourse debt.[3]

Is the Shareholder at Risk for Borrowed Amounts?

A very significant difference between a shareholder's basis and at-risk amount may arise with regard to loans made by a shareholder to an S corporation. Under Secs. 1366 and 1367(b) and the applicable regulations, a shareholder's basis is increased by loans made to the S corporation. However, under Sec. 465, such loans might not increase the shareholder's at-risk amount. Specifically, Sec. 465(b)(2) states that an S corporation shareholder is at risk only with respect to amounts borrowed for use in the corporation to the extent that the shareholder:

> (A) is personally liable for the repayment of such amounts; or (B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the fair market value of the taxpayer's interest in such property).

Therefore, under (A) above, if a shareholder borrows funds from a bank and subsequently lends those funds to the S corporation, the terms of the note between the bank and the shareholder will determine the shareholder's liability. However, in the case of money

borrowed from a related party as opposed to from a bank, the substance of the transaction, and not the form, will govern whether the S corporation shareholder is at risk.[4]

Another frequently overlooked at-risk issue occurs under (B) above when a shareholder borrows money from an unrelated party, pledges the property of an S corporation as security, and lends the funds to the S corporation. This loan from the shareholder to the S corporation gives the shareholder basis in debt but does not increase his or her at-risk amount. The effect is seen in Example 1.

Example 1: *E* is a 100% shareholder of an S corporation. The corporation is in need of cash. *E* borrows $50,000 from a bank on a nonrecourse basis and pledges the S corporation's assets to secure the loan. *E* subsequently loans these funds to the S corporation. Prior to making the loans to the S corporation, *E*'s basis and at-risk amount had been brought down to zero from losses of the entity. In the current year, the S corporation has an ordinary loss of $20,000.

The impact on *E* is as follows:

Impact on basis:

Basis from loan to S corp.	$50,000
Ordinary loss	(20,000)
Stock basis	$30,000

Impact on at-risk amount:

Amount at risk	0
Ordinary loss allowed	0

E must meet both tests in order to take the S corporation's loss. Therefore, although *E* obtains basis in the debt, he cannot take the loss because he is not at risk for the loan obtained from the bank, which is secured by the company's assets. This is not an uncommon situation; company assets are often security for a loan the shareholder takes out in order to loan funds to the S corporation. A guarantee by the shareholder of a loan made directly from the bank to the S corporation would not create basis.[5] Therefore, the shareholders often use the back-to-back loan described above to create basis but neglect to consider the at-risk issue. Clearly, in order to avoid the trap of Sec. 465(b)(2)(B), collateral other than assets used by the activity must be put into place. It is important to note that the result would be the same if *E* pledged the S corporation stock as collateral for the loan from the bank.[6]

Exception for Qualified Nonrecourse Financing

The result above would be different in the case of qualified nonrecourse financing under Sec. 465(b)(6). A shareholder is at risk with regard to qualified nonrecourse financing that is:

- Borrowed with respect to the activity of holding real property;
- Borrowed from a qualified person;
- Financing for which no person is personally liable for repayment; or
- Not convertible debt.[7]

A qualified person is a person who is actively and regularly engaged in the business of lending money and not:

- A related person with respect to the shareholder or the corporation;
- A person from whom the S corporation acquired the property; or
- A person who receives a fee for the S corporation's investment in the property.[8]

When qualified recourse financing is structured as a back-to-back loan or as a capital contribution to the S corporation, the shareholder can take advantage of Sec. 465(b)(6). More specifically, the S corporation shareholder will be at risk if the shareholder borrows money from a bank on a nonrecourse basis and loans the funds to the S corporation, which in turn uses the funds to purchase real estate for its activity of holding real estate. The loan is secured by the corporation's real estate. Despite the fact that the loan is secured by assets used by the S corporation, the shareholder is at risk.

It is worthy of note that neither the statute nor the regulations define the term "activity." However, the fact that a loan is secured by real property does not necessarily mean that the loan was secured as part of the activity of holding real property. For example, if a business purchases real estate to store rental equipment and takes out a loan secured by the real property, the loan would be considered to be made in connection with the activity of renting property, not the activity of holding real estate.

Amounts Borrowed from Persons Having an Interest in the Activity

S corporation shareholders also need to be aware that a shareholder is not at risk with regard to amounts borrowed from any person who has an interest in the activity or from a person who is related to a person with such an interest.[9] Regs. Sec. 1.465-8 states that amounts borrowed from someone who has an interest other than as a creditor or who is related to an individual who has an interest other than as a creditor will not increase the shareholder's amount at risk. The idea behind this limitation is that a creditor that has an additional financial interest in the activity other than as a creditor might not enforce his or her rights as a creditor if they conflict with other interests.

Under Regs. Sec. 1.465-8, even if an S corporation shareholder is personally liable for repayment of a loan for use in the S corporation, the shareholder will not be considered at risk if the money is borrowed from a person who has either a capital interest in the S corporation or an interest in the entity's net profits. A shareholder of an S corporation is considered to have a capital interest in the entity. Therefore, an S corporation shareholder is not at risk for a loan from another shareholder of the same corporation, even if the shareholder is personally liable for the loan repayment.[10]

With regard to an "interest in the net profits" of the activity, an employee's or independent contractor's compensation that is in part or in full determined by the net profits of the activity will be a disqualifying interest.[11] Therefore, a shareholder would not be at risk for money borrowed from an employee of the S corporation whose annual bonus was fixed as a percentage of the corporation's net profits. The same at-risk trap exists if the S corporation shareholder borrows money from a creditor as described above if the loan is nonrecourse and secured by assets with a readily ascertainable fair market value.[12]

The S corporation shareholder needs to be aware that the rules for borrowing from such "disqualified interests" contain related-party provisions. Specifically, the shareholder would not be at risk for an amount borrowed from persons who are related to those who have disqualifying interests. A person is related for purposes of the at-risk rules if:

- The person is related under either Sec. 267(b) or Sec. 707(b)(1), substituting 10% for 50%; or
- The related person and the person with the disqualifying interest are engaged in trades or businesses under common control, within the meaning of subsections (a) and (b) of Sec. 52.[13]

Purchase of S Corporation Stock

Does the purchase of S corporation stock by an individual create an at-risk amount for the purchaser? Prop. Regs. Sec. 1.465-22(d) responds to this question by stating that the payments by a purchaser to a seller of the interest in an activity are treated as if the payments that were made to the seller were contributed to the S corporation. Therefore, if the purchaser pays for stock in cash from his or her personal funds, the amount at risk would equal the purchase price. However, if the purchased stock was financed with a nonrecourse loan secured by the stock purchased or the assets of the S corporation, the purchaser's amount at risk would be zero under Sec. 465(b)(2)(B), as previously discussed.

Adjustments to the At-Risk Amount

Once a shareholder establishes an at-risk amount by virtue of a particular transaction or set of transactions, the individual must be aware of items that will increase or decrease that amount.

First, and similar to the computation of the shareholder's basis, the pro-rata share of the S corporation's items of income, including tax-exempt income, will increase the shareholder's at-risk amount.[14] Of course, a shareholder's at-risk amount is increased by additional capital contributions of cash and property and also for shareholder loans made to the S corporation, subject to the previously discussed Sec. 465(b)(2).

Second, and also similar to the computation of the shareholder's basis, a shareholder's pro-rata share of the S corporation's loss or deductions, including nondeductible expenses that are not capitalizable, will decrease the at-risk amount.[15] In addition, the shareholder's at-risk amount for debt is reduced by distributions of money as a loan repayment to the extent that the payment decreases the shareholder's basis in the debt.[16]

It is well established that an S corporation shareholder cannot be at risk for a guarantee of S corporation debt. However, what if an S corporation shareholder repays part or all of the debt? Will the shareholder be entitled to an increase in the at-risk amount? The answer is a conditional "yes." Specifically, the at-risk amount will increase only when the shareholder no longer has a legal right to seek indemnification from the primary obligor on the loan, that being either the S corporation or another shareholder.[17]

An earlier section addressed the at-risk implications when the S corporation shareholder borrows money from a bank on a recourse or a nonrecourse basis and contributes or loans these funds to the S corporation. What is the effect on the at-risk amount when the shareholder repays the creditor? The answer is different depending upon whether the loans are recourse or nonrecourse. In general, loan repayments on a recourse loan will not increase the shareholder's at-risk amount. However, there are two situations in which these repayments will decrease a shareholder's at-risk amount. First, if a shareholder repays the recourse debt with assets that are used in the corporation (which could be, for example, stock of the S corporation), the shareholder's at-risk amount will decrease by the adjusted basis of the assets. Second, if an S corporation shareholder uses funds that would not increase the shareholder's at-risk amount if contributed directly to the S corporation to repay the recourse debt, the shareholder's at-risk amount is decreased by this repayment.[18]

> ***Example 2:*** In 2008, *Q*, an individual calendar-year taxpayer, borrows $10,000 from a bank, assuming personal liability for repayment, for use in *P*, an S corporation of which she is the sole shareholder. At the close of 2008, *Q*'s amount at risk in the activity is $10,000. In December 2009, *Q* borrows $3,000 from another source for which she is not personally liable and that is secured by property used in the activity. She uses the funds to pay the bank. If no other factors occur during the year to affect *Q*'s at-risk amount in the activity, *Q*'s amount at risk will be decreased by the amount of the repayment because she used funds for the repayment that would not have increased her at-risk amount had they been contributed to the activity. Therefore, at the close of 2009 *Q*'s amount at risk is $7,000. The result would be the same if the $3,000 used for the repayment of the loan were withdrawn from *P*.

A different set of rules controls when an S corporation shareholder has incurred nonrecourse debt. Repayments may increase or decrease the amount at risk depending upon two key factors. Specifically:

- Did the nonrecourse debt increase the S corporation shareholder's at-risk amount when the loan was incurred?

- Would the funds or property used to pay back the loan increase the shareholder's at-risk amount if these were contributed directly to the corporation?

If the S corporation shareholder's nonrecourse loan did not increase the shareholder's amount at risk at the time the loan was incurred, repayments of it would result in an increase in the S corporation shareholder's amount at risk (Prop. Regs. Sec. 1.465-25(b)(2)(i)). However, if the amounts used to repay the nonrecourse indebtedness would not have increased the S corporation shareholder's amount at risk if contributed directly to the S corporation, the shareholder's amount at risk is unaffected by the repayment. If the S corporation shareholder's nonrecourse loan did increase the shareholder's amount at risk at the time the loan was incurred, subsequent repayments will not increase the S corporation shareholder's amount at risk.[19] However, if the amount used to repay this type of nonrecourse loan would not increase the S corporation shareholder's at-risk amount if contributed directly to the S corporation, the repayment would actually decrease the S corporation shareholder's at-risk amount.

Part of the lesson from these details is that the impact on the amount at risk for S corporation shareholders' repayments of loans, the proceeds of which were subsequently loaned to the corporation, depends on many circumstances surrounding the loans and the funds used for repayment. The result will typically be different than the impact of the basis computation; hence, another Sec. 465 trap lurks in these rules.

At-Risk Aggregation Rules

Congress originally enacted the at-risk rules to combat what was perceived to be an abusive tax shelter in which the investor's goal was to obtain large deductions without actually being at risk of any loss from the investment. Along these lines, there was also concern that investors would invest in several different entities with several ventures and attempt to use losses from one activity to offset the income of another activity. As a result, Sec. 465(c)(2) contains rules that forbid such offsetting. These rules are not addressed here because this article deals with the at-risk rules as they pertain to operating businesses.

It is, however, worthy of note that Sec. 465(c)(3) does contain aggregation rules for activities that constitute a trade or business that is operated in an S corporation and owned by shareholders who are active in the business of the entity. Specifically, if an S corporation carries on a trade or business and at least 65% of any losses from the trade or business are allocable to individuals who actively participate in its management, all activities comprising the trade or business must be aggregated.[20] If this allocation rule is met and, for example, an S corporation has both a shoe repair business and a seasonal accounting practice, the activities are combined in determining both the amount at risk and the amount of losses that can be taken on the shareholder's returns.

However, if, in contrast, the S corporation has one owner and two activities, one in which the shareholder participates and the other in which the shareholder does not participate, it is possible that the amount at risk for each activity may be required to be separately computed, and the amount of income or loss from each activity is also separately computed. In order to determine the at-risk amount for each activity, the shareholder may be required to apply tracing rules (similar to the interest expense tracing rules of Sec. 163) for moneys invested and loaned to each activity. There is, however, no clear authority on the subject. This represents a significant difference from basis calculation, which determines one basis amount for each shareholder regardless of the number of activities.

Recapture of Losses Where Amount at Risk Is Less Than Zero

Losses cannot reduce the amount at risk to below zero. Once the at-risk amount is zero, losses are suspended. However, the amount at risk may go below zero by means of reductions of liabilities, distributions of cash, or the conversion of loans from recourse to nonrecourse. If a shareholder's amount at risk is below zero at the end of a tax year, the shareholder recognizes income to the extent of the negative amount.[21] It is as if the shareholder is recapturing prior losses. This amount of income becomes deductible once the shareholder is sufficiently at risk again. Example 3 illustrates the provision.

> ***Example 3:*** *M* is an S corporation formed on January 1, 2008. *J*, the sole shareholder, invests $30,000 of cash in exchange for *M* stock. *J* also borrows $30,000 from a third party on a recourse basis. The lender is not an *M* shareholder and is not related to a shareholder. *J* loans the additional $30,000 to *M*. *J*'s at-risk amount is $60,000. In 2008 *M* has a net operating loss of $50,000. *J* can deduct the entire loss of $50,000. On January 1, 2009, *J*'s at-risk amount is $10,000 ($60,000 – $50,000). On December 31, 2009, the $30,000 that *J* borrowed is converted into a nonrecourse loan. As a result, the amount at risk is (–$20,000). *J* is required to include the negative at-risk amount in income. If in 2010 *J*'s amount at risk is increased by $20,000 or more, *J* can deduct the $20,000 included in gross income in 2009.

A question arises concerning the character of the income recognized when an at-risk amount becomes negative. Suppose an S corporation repays loans from shareholders that have basis lower than the face amount. Such payments could create negative at-risk amounts. Is the income to the shareholder ordinary or capital? Typically, the income resulting from repayment of a loan that is evidenced by a note is capital in nature (Sec. 1271(a)). However, should the income be considered ordinary because the deductions being recaptured were deducted as ordinary losses? There is no IRS guidance on this matter. Another consideration in such a situation is that if the at-risk and basis amounts are different, separate calculations of the impact will be required.

Conclusion

Got basis? That is not enough. Separate calculations are required to determine the at-risk amount of S corporation shareholders. This concept is often not considered in tax planning with regard to the taxable income and loss of an S corporation because the term "at risk" is often perceived to apply only to partnerships. But Sec. 465 contains many traps that will limit S corporation shareholders from deducting their pro-rata share of the company's losses on their tax returns. Often the amount at risk is quite different from the shareholder's basis in stock and/or debt. In fact, the at-risk amount is often less than the basis amount. Practitioners must be fully cognizant of the Sec. 465 rules in order to properly plan for the impact of the S corporation's year-end results.

Footnotes

[1] See Sullivan, "The Story of Basis," 41 *The Tax Adviser* 398 (June 2010).

[2] Tax Reform Act of 1976, P.L. 94-455.

[3] Prop. Regs. Sec. 1.465-23(a).

[4] *Riggs*, T.C. Memo. 1992-323; *Berger*, T.C. Memo. 1994-298.
[5] *Perry*, 47 T.C. 159 (1966), aff'd, 392 F.2d 458 (8th Cir. 1968); *Raynor*, 50 T.C. 762 (1968).

[6] Prop. Regs. Sec. 1.465-25(b)(1)(i).

[7] Sec. 465(b)(6)(B).

[8] Sec. 465(b)(6)(D), referencing Sec. 49(a)(2)(D)(iv).

[9] Sec. 465(b)(3).

[10] Regs. Sec. 1.465-8(b)(2).

[11] Regs. Sec. 1.465-8(b)(3).

[12] Regs. Sec. 1.465-8(c).

[13] Sec. 465(b)(3)(c).

[14] Prop. Regs. Sec. 1.465-22(c)(1).

[15] Prop. Regs. Sec. 1.465-22(c)(2).

[16] Prop. Regs. Sec. 1.465-22(b).

[17] Prop. Regs. Sec. 1.465-6(d).

[18] Prop. Regs. Sec. 1.465-24(b).

[19] Regs. Sec. 1.465-25(a)(2), referring to Regs. Sec. 1.465-24(b).

[20] Sec. 465(c)(3)(B).

[21] Sec. 465(e)(1).

The Story of Basis

EXECUTIVE SUMMARY

Basis in an asset can result from a taxpayer's investment of loaned funds, regardless of whether the loans are recourse or nonrecourse to the taxpayer.

Subject to Secs. 465 and 469, S corporation shareholders can deduct losses passed through from an S corporation up to the amount of their basis in the corporation, including their debt basis in the corporation. However, debt basis is limited to indebtedness of the S corporation directly to the shareholder.

- When a shareholder contributes money or encumbered property to an S corporation, the form of the transaction may determine whether the transaction creates debt basis in the S corporation for the taxpayer.

Basis is a beneficial concept for a taxpayer—it shields the taxpayer from tax on the sale of an asset and can produce losses that reduce tax liability. It has been described as a "summary of the tax impact of [past] events" that have affected an asset.[1] Nevertheless, basis can be elusive: It can appear or disappear when we are not paying attention.[2] It can cling to an asset, be adjusted up or down, replicate itself, or shift to another asset. In other words, the summary that basis provides can have a number of potential twists and turns.

This article explains some of the basics of basis and one of the subplots in the general story it tells, using the following situation:

Example 1: *A* has decided to invest in real estate, so she takes funds that she has recently inherited ($400x) and buys a 20% interest in land. The seller is looking for a buyer for the other 80% of his real estate.

A will have a cost basis in her 20% interest in the real estate. Although there is no all-purpose definition of basis for tax purposes, according to Sec. 1012 the basis of property is its cost, except as otherwise provided. There does not appear to be any issue associated with determining *A*'s basis in her 20% interest in the land after she buys it. If she were to sell the 20% interest in the land, she would be able to get back her $400x without tax consequences; her basis in the 20% interest reflects the amount she paid for the land.

The underlying principle of basis determinations is expressed by the general meaning of the word "basis": "a relation that provides the foundation for something . . . the fundamental assumptions from which something is begun or developed or calculated or explained."[3] Under the federal tax laws, that fundamental assumption or foundation is the measurement or amount that the owner of property is treated as having invested in the asset, the amount that the taxpayer can withdraw or receive from the property without realizing income or gain from the property. As a result, to the extent basis includes untaxed dollars, basis determinations can provide the foundation for a tax shelter, allowing taxpayers to receive what some may perceive to be excessive tax benefits. From another perspective, as long as basis accurately tracks what is defined as the taxpayer's economic investment in property, it is performing its function appropriately.

Basis from Proceeds of Debt

Under a traditional balance sheet approach to wealth, if both the asset and liability sides of the balance sheet increase equally, there is no net increase in net worth. Thus, incurring debt does not increase a taxpayer's net worth; the cash received as debt proceeds is exactly offset by a liability to repay the debt. Because under our income tax system a taxpayer must "realize" income or gain before tax is imposed, borrowing money does not have immediate tax consequences. Borrowed cash is full basis, untaxed money in the borrower's hands. These funds may be used to purchase assets with a full cost basis that enable the taxpayer to earn profits and suffer losses in operating or disposing of the assets.[4] If the debt is genuine and reasonable in terms of the fair market value (FMV) of the purchased property, the full amount of borrowed funds generally gives rise to cost basis.[5]

> ***Example 2:*** *A* wants to get started building on her land, but the seller has not been able to find a buyer for the rest of the land parcel. *A* discusses this with her banker, who suggests that she could borrow enough money to buy the seller's entire parcel. Because *A* is risk averse, the banker suggests that she borrow the funds on the security of the purchased real estate, without any personal obligation to repay the debt. *A* is intrigued by the possibility of obtaining money to make the investment and not being personally obligated to repay the loan.

The banker is suggesting that *A* borrow on a nonrecourse basis. Generally, nonrecourse debt is debt for which the lender has no recourse against the borrower personally, and the lender can proceed against the security for the loan only if the borrower defaults. Debt for which the borrower has personal liability is termed recourse debt.

Recourse and Nonrecourse Debt in *Crane* and *Tufts*

The tax treatment of recourse debt generally has been clear: The obligor has full basis in cash or property acquired with recourse debt and, if a buyer assumes, or takes the property subject to, a mortgage for which the seller is personally liable, the full amount of the recourse debt is included in the seller's amount realized. Because the buyer is treated as satisfying a personal obligation of the seller, under the principles established in *Old Colony Trust Co.* and *Hendler*,6 the seller has income equal to the amount of the obligation satisfied. As a result, the tax treatment of recourse debt is not controversial: The borrower has full basis in assets acquired with recourse debt, and the amount realized on the sale of the asset subject to the debt includes the full amount of the debt. Because there is no personal liability for nonrecourse debt, however, the buyer who assumes (or takes subject to) nonrecourse debt is not satisfying an obligation of the seller. Thus, the proper tax treatment of nonrecourse debt both for basis purposes and to determine the amount realized on the sale was originally uncertain.

The Supreme Court established favorable tax treatment of nonrecourse debt in *Crane*.[7] In that case, Mrs. Crane inherited a mortgaged apartment building and lot from her husband. The property had an appraised value equal to the mortgage. Mrs. Crane operated the building, collected the rents, paid for operating expenses and taxes, and paid the net amount to the lender for seven years. She reported the gross rentals as income and claimed expenses for taxes, operating expenses, depreciation, and interest on the mortgage. On November 29, 1938, with foreclosure looming, Mrs. Crane sold the property to a third party for $3,000 in cash, subject to the mortgage, and paid $500 in sale expenses. For tax purposes, she claimed that the property's FMV was zero at the time she inherited it and that she had a zero basis in the property. She reported the cash received, minus expenses, as gain on sale of the apartment building.

The IRS argued that the property's value was not the net equity but the gross value of the property undiminished by the mortgage and that its original basis in Mrs. Crane's hands was $262,042.50, its appraised value in 1932 ($55,000 allocable to land and $207,042.50 to building). During the seven years that Mrs. Crane held the building, there was allowable depreciation of $28,045.10 on the building, leaving an adjusted basis of $178,997 at the time of sale. Moreover, the IRS argued that the amount realized on sale included both the cash received and the amount of the mortgage that the buyer assumed.

The Supreme Court was divided when it decided *Crane.* The decision rested on a number of theories. The Court determined that the nature of debt as recourse or nonrecourse is not relevant to the calculation of the purchaser's basis when property is purchased with the proceeds of a borrowing. Because the taxpayer is obligated to repay the loan, the taxpayer includes the full amount of the loan in basis. The Court proceeded to treat the amount realized in the same way it had treated basis, including the full amount of the debt as proceeds of the sale of the underlying property. As the Court explained:

> [W]e are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. . . . If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.[8]

In a footnote, the Court noted:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.[9]

In *Tufts*,[10] the Supreme Court decided the case posited in the *Crane* footnote. *Tufts* acknowledged and developed one of the subplots relating to basis: the inclusion of untaxed borrowings in basis despite the fact that the borrower has no risk of loss because he or she has no personal liability, and the security for the loan is worth less than the amount of the debt. In *Tufts*, the Court took note of the economic reality that when a borrower obtains funds on a nonrecourse basis, the lender has the full risk of loss. A footnote to the *Tufts* decision explains:

> The Commissioner might have adopted the theory, implicit in Crane's contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee. . . . We express no view as to whether such an approach would be consistent with the statutory structure and, if so, and *Crane* were not on the books, whether that approach would be preferred over *Crane's* analysis. We note only that the *Crane* Court's resolution of the basis issue [i.e., including nonrecourse debt in cost basis] presumed that when property is purchased with proceeds from a nonrecourse mortgage, the purchaser becomes the sole owner of the property. . . . The nonrecourse mortgage is part of the mortgagor's investment in the property, and does not constitute a coinvestment by the mortgagee.[11]

The Court also acknowledged that "the Commissioner's choice in *Crane* 'laid the foundation stone of most tax shelters,'" citing an article by Boris Bittker.[12] The Court noted that Congress acted to curb shelter activity by enacting Sec. 465 to stop a taxpayer from taking "depreciation deductions in excess of amounts he has at risk in the investment."[13]

The *Crane* court had justified its decision based on two theories that were not adopted by the Court in *Tufts.* First, the *Crane* court noted that the taxpayer had obtained an economic benefit from the purchaser's assumption of the mortgage—a benefit that was identical to that conferred by the cancellation of personal debt. Given the facts of *Tufts*, however, in which the asset securing the debt was under water, the Court was obliged to abandon this justification for treating relief of nonrecourse debt as included in the amount realized when the property securing the debt was transferred.[14]

Second, the *Crane* court reasoned that the taxpayer had taken advantage of depreciation deductions relating to its basis, a tax-benefit analysis. In contrast, the *Tufts* court reasoned that its analysis applies even when the taxpayer has taken no deductions for the basis and that a tax-benefit analysis was not necessary to explain its conclusion.[15]

Instead, in *Tufts* the Court agreed with the reasoning in *Crane* that if nonrecourse debt is included in basis, it is necessary to treat the amount realized in the same manner—by including the full amount of the nonrecourse debt.[16] The *Tufts* Court held that "a taxpayer must account for the proceeds of obligations he has received tax-free and included in basis."[17]

There is an interesting subplot in this story. In her concurring opinion in *Tufts*, Justice O'Connor argued that a better approach to nonrecourse debt would be to treat the loan retirement and the security disposition as two separate transactions on the grounds that the Code treats different sorts of income differently: Gain on the disposition of the property may qualify for capital gains treatment, and cancellation of indebtedness is ordinary income. Nevertheless, Justice O'Connor agreed that the IRS took the position espoused by the majority in *Tufts* and that "it is difficult to conclude that the Commissioner's interpretation of the statute exceeds the bounds of his discretion. . . . One can reasonably read § 1001(b)'s reference to 'the amount realized *from* the sale or other disposition of property' to permit the Commissioner to collapse the two aspects of the transaction."[18]

As a result of the approach taken by the IRS and the majority in *Tufts,* there is now a world of uncertainty in characterizing income or gain realized when debt is the subject of a foreclosure transaction.[19] The character of debt as recourse or nonrecourse has significant tax consequences, but there is little guidance on how individual debts should be classified when they have characteristics of both types of debt. What is not uncertain, however, is that both recourse and nonrecourse debt can give rise to basis if the debt is valid indebtedness.

Basis and the S Corporation

> ***Example 3:*** *A* borrows $1600x on a nonrecourse basis and acquires the rest of the land from the seller. She then decides to form an S corporation (*B* Inc.) in order to proceed with development of the land. Two of *A*'s relatives (Aunt *C* and Uncle *D*) join with *A* in forming *B* Inc. *A* contributes the land (subject to the debt) in exchange for 50% of the stock in the S corporation. *C* and *D* contribute $200x each for 25% of the stock. *B* Inc. borrows $200x each from *C* and *D* and borrows $800x from a bank. In its first year, *B* Inc. reports total net losses from operations of $1600x. *A*, *C*, and *D* are anxious to use those losses to offset other income for tax purposes. They understand that special rules apply for an S corporation.

First, it is necessary to determine the investors' initial basis in *B* Inc. as well as the corporation's basis in its assets. Generally, under Sec. 351, no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock and if immediately after the exchange the transferors are in control of the corporation (as defined in Sec. 368(c)). Thus, *A*, *C*, and *D* can transfer property and cash to *B* Inc. in exchange for all of the corporation's stock without immediate tax consequences. Under Sec. 362(a), *B* Inc. will have a basis in the land contributed by *A* that is equal to *A*'s basis in the land ($2,000x) and full basis in the cash contributed by *C* and *D* ($200x each).[20]

With respect to stock basis, under Sec. 358(a) *C* and *D* will have a basis in their stock equal to their basis in the cash contributed. *A*'s basis in her stock will also be determined under Sec. 358, but for *A* there is a twist. Under Sec. 358(a), *A*'s initial basis in the stock will be equal to her basis in the land she contributes to *B* Inc. Under Sec. 358(d), however, that initial basis will be reduced by the liability to which the contributed property is subject. Thus, *C* and *D* will have a cost basis in their stock of $200x under Sec. 358(a)(1), and *A* will have basis in her stock of $400x, an amount that does not reflect her original cost basis in the land. She loses all her cost basis attributable to the debt incurred to purchase the land. In this case, *A*'s stock basis reflects her net equity value in *B* Inc. This twist brings us back to Mrs. Crane's argument that she should be treated as owning only the net equity in the property she inherited.[21]

Basis in S corporation stock is important for a number of reasons. It allows the shareholder to pass through losses and deductions generated by the S corporation and allows the shareholder to receive distributions tax free under Sec. 1368.[22] Basis is generally

determined as of the end of the S corporation's tax year (Regs. Sec. 1.1367-1(d)) and is adjusted for items of income, loss, and deduction at that time.
Under Sec. 1366(a)(1), each shareholder is allocated a pro-rata share of each item of the corporation's income, gain, loss, and deduction. S corporations cannot make special or disproportionate allocations. As a result, *A* will be allocated 50% of all losses ($800x), and *C* and *D* will each be allocated 25% of the losses ($400x each). The losses will reduce the shareholders' stock basis by $400x for *A* and $200x each for *C* and *D*. Each of the shareholders will then have a zero basis in the stock of *B* Inc. *C* and *D* also have debt basis, however, so they have access to more losses.

Debt Basis in an S Corporation

Under Sec. 1366(d)(1), a shareholder in an S corporation can take into account losses and deductions passed through by the S corporation that do not exceed the shareholder's adjusted basis in his or her stock and the shareholder's adjusted basis in any indebtedness of the S corporation to the shareholder. Sec. 1366(d)(1) makes it clear that the only debt basis taken into account for this purpose is indebtedness of the S corporation to the shareholder. In other words, nonshareholder debt does not provide debt basis to the shareholder for purposes of passing through losses and deductions. Thus, the debt of the S corporation to the bank does not provide any of the shareholders with debt basis. Nor does a guarantee of corporate debt by a shareholder provide debt basis to the shareholder under Sec. 1366. For example, in *Raynor*,[23] the court held that a shareholder does not obtain basis for a guarantee (despite having a liability under the guarantee) until payment is actually made.[24] Courts have also denied basis when the shareholder is a co-borrower with the S corporation on a loan.[25] The ostensible purpose of this rule is to limit the taxpayer's ability to use losses and deductions to the taxpayer's "investment" in the S corporation[26] as reflected in taxpayer contributions and loans to the corporation.[27]
Therefore, under the rules applicable to S corporations, *A, C,* and *D* will each have the same basis for purposes of losses and deductions ($400x). *C* and *D* each have an additional $200x of basis in indebtedness of *B* Inc. to each of them individually and will be able to have an additional $200x of losses pass through to them from the S corporation. At the end of the year, *A*, *C*, and *D* will have zero stock basis, *C* and *D* will have zero debt basis, and each of the shareholders will have $400x of losses that passed through from *B* Inc. *A* will have suspended losses of $400x under the rules of Sec. 1366(d). The suspended losses would be carried forward indefinitely under Sec. 1366(d)(2) for *A*'s use if she were to obtain additional basis in *B* Inc.
A could obtain additional basis in a number of ways. She could contribute more money to *B* Inc.; the S corporation could begin to make money and allocate net income to *A* and the other shareholders; or she could lend money to *B* Inc. Certain approaches are not open to *A*, however. She cannot obtain debt basis by guaranteeing the bank debt or the nonrecourse debt to which the land is subject,[28] and she cannot obtain basis by contributing an IOU to the S corporation.[29]

Back-to-Back Loans

At this point, *A* may be thinking that she should have consulted her tax adviser as well as her banker. *A* could have structured her acquisition of land and stock in a manner that would have given her more basis for purposes of taking losses. For example, she could have contributed her inheritance ($400x) to *B* Inc. in exchange for 50% of the stock and borrowed $1600x from the bank. *A* could then have lent the borrowed funds to *B* Inc. *B* Inc. could have used its cash to purchase the land for $2,000x. Under these circumstances, *A* would have stock basis of $400x, and, assuming the transactions are properly documented and the substance of the arrangement is consistent with its form, she is likely to have basis in indebtedness of the S corporation of $1600x. Under these circumstances, *A* would not have any suspended losses after the first year of *B* Inc.'s operations and would have $1200x of remaining debt basis.
This approach is termed a back-to-back loan, which in the S corporation context has caused some tax uncertainty. In a back-to-back loan, a shareholder borrows the funds and then lends them to the S corporation. A number of courts have approved back-to-back loan arrangements where the loans are valid debt and the shareholder documents them appropriately and makes payments in a manner that is consistent with the loan documents. Therefore, if *A* had borrowed the funds from a bank, had documented the loan from the bank and the loan to *B* Inc. appropriately, and all payments were made in accordance with the loan documents (i.e., from *B* Inc. to *A* and from *A* to the bank), it is likely (although not certain) that under current case law *A* would have debt basis in her loan to the S corporation.
For example, in *Raynor*, the court allowed the shareholder basis for borrowed funds that the shareholder then lent to the S corporation. In *Gilday*,[30] the shareholder obtained basis when he exchanged his note for the S corporation's note with the lender bank. Nevertheless, the IRS has successfully attacked back-to-back loans in certain circumstances. The courts have found that a shareholder cannot claim basis credit where there is no actual economic outlay. This is most frequently the case where there are related-party debt restructurings that the taxpayer intends to create basis and where the form of the transactions is not consistent with the substance the taxpayer claims.[31]
Restructuring existing debt increases the risk that the shareholders' new debt basis will not be respected under Sec. 1366(d). In *Oren*,[32] the court did not accept a circular flow of cash that the taxpayers intended to create basis because no one's economic position was changed in the process.[33] In *Kaplan*,[34] the taxpayers accomplished the circular cash flow with a third-party bank, and the court disregarded the restructured loans. In *Kerzner*, however, the shareholder borrowed from a bank and contributed the proceeds to the S corporation, which then paid the proceeds to related entities, and the related entities lent the proceeds to the shareholder to repay the original bank loan.
Thus, the story of basis comes full circle. Properly structured, the cost basis in the land (partially funded by debt) can be reflected in *A*'s S corporation basis (also partially attributable to debt). However, as was previously noted, basis can be elusive and can disappear if not carefully watched.

Conclusion

As *A*'s story shows, basis may provide a summary of the tax impact of past events, but that tax impact is not intuitively obvious or logically consistent in many situations. Congress has seen fit to provide special rules to trace a taxpayer's investment through nonrecognition transactions (by replicating basis of contributed property in the stock received) but also to avoid loss duplication (when basis would ordinarily replicate in a nonrecognition transaction) and provide unique rules for measuring a taxpayer's investment in an S corporation. Once basis is determined under these rules, *A*'s next hurdle is to determine if she can actually use the losses generated

and passed through by *B* Inc. *A* must also navigate the at-risk rules of Sec. 465 and the passive activity rules of Sec. 469. (The at-risk rules will be discussed in the July issue.)

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Footnotes

[1] Anderson, "Federal Income Tax Treatment of Nonrecourse Debt," 82 *Colum. L. Rev.* 1498 (1982), citing Surrey, Warren, McDaniel, and Ault, *Federal Income Taxation* 391 (1972).
[2] See, e.g., T.D. 9475 and commentary; Zhu, "Basis Disappearance in All-Cash D Reorganizations," 126 *Tax Notes* 950 (February 22, 2010).
[3] Princeton University, *Wordnet 3.0*, http://tinyurl.com/basisdefined.

[4] Back-to-back loans raise the issue of whether borrowed funds can create debt basis, a special kind of basis in an S corporation. The considerations relating to back-to-back loans are addressed later in this article.

[5] *Estate of Franklin*, 544 F.2d 1045 (9th Cir. 1976); *Pleasant Summit Land Co.*, 863 F.2d 263 (3d Cir. 1988).
[6] *Old Colony Trust Co.*, 279 U.S. 716 (1929); *Hendler*, 303 U.S. 564 (1938).
[7] *Crane*, 331 U.S. 1 (1947).

[8] Id. at 14.

[9] Id., n. 37.

[10] *Tufts*, 461 U.S. 300 (1983).

[11] Id. at 308, n. 5.

[12] Bittker, "Tax Shelters, Nonrecourse Debt, and the *Crane* Case," 33 *Tax L. Rev.* 277, 283 (1978).
[13] *Tufts* at 309, n. 7.
[14] Id. at 311, n. 11 ("Although the economic benefit prong of *Crane* also relies on a freeing-of-assets theory, that theory is irrelevant to our broader approach").
[15] Id. at 310, n. 8 ("Our analysis applies even in the situation in which no deductions are taken. It focuses on the obligation to repay and its subsequent extinguishment, not on the taking and recovery of deductions").
[16] *Crane* at 13.
[17] *Tufts* at 313.

[18] Id. at 320 (emphasis added).

[19] See, e.g., Cuff, "Indebtedness of a Disregarded Entity," 81 *Taxes—The Tax Magazine* No. 3 (March 2003).
[20] Sec. 362(a). We assume that the FMV of the land *A* purchased equals at least its basis at the time of contribution to *B* Inc.

[21] See Regs. Sec. 1.358-3(b), Example (1).

[22] In this case, *B* Inc. has never been a C corporation and has no earnings or profits. As a result, to the extent of the shareholder's basis in stock, the S corporation can make distributions as a tax-free return of capital under Sec. 1368(b)(1).
[23] *Raynor*, 50 T.C. 762 (1968).

[24] See also Rev. Rul. 75-144, 1975-1 C.B. 277.

[25] See, e.g., *Maloof*, 456 F.3d 645 (6th Cir. 2006).

[26] S. Rep't No. 1983, 85th Cong., 2d Sess. 2209 (1958).

[27] The rules relating to debt basis in an S corporation are much more restrictive than those applicable to partnerships. In the case of a partner, Sec. 752 provides partners with outside basis for all debts of the partnership.

[28] See, e.g., *Raynor*, 50 T.C. 762 (1968); *Underwood*, 535 F.2d 309 (5th Cir. 1976).
[29] Rev. Rul. 81-187, 1981-2 C.B. 167. But see *Perachi*, 143 F.3d 487 (9th Cir. 1998), in which the court allowed the shareholder to obtain additional basis through the contribution of a note where the corporation was at risk of bankruptcy.
[30] *Gilday*, T.C. Memo. 1982-242.
[31] See, e.g., *Foust*, T.C. Memo. 1995-481; *Russell*, T.C. Memo. 2008-246. For more on economic outlay, see Porcaro and Burton, "Economic Outlay Revisited," 40 *The Tax Adviser* 292 (May 2009).
[32] *Oren*, T.C. Memo. 2002-172.
[33] See also *Kerzner*, T.C. Memo. 2009-76.
[34] *Kaplan*, T.C. Memo. 2005-218.

Current Developments in S Corporations (Part II)

EXECUTIVE SUMMARY

- The IRS issued letter rulings granting taxpayers relief for the late filing of an S corporation election in over 100 cases during the past year.
- The IRS continued its policy of liberally granting relief through the letter ruling process for inadvertent terminations due to corporations having more than one class of stock or having ineligible shareholders.
- In the *Dansby* case, the Tax Court held that a corporation did not qualify as an S corporation where the taxpayer did not introduce credible proof showing that a Form 2553 had been timely filed for the corporation.
- The Fifth Circuit in *Minton* held that Regs. Sec. 1.1361-1(l)(7) permits retroactive application of Regs. Sec. 1.1361-1(l), which contains the one-class of- stock rules, only to prior tax years and not to prior transactions.

Part I of this two-part article, in the October issue, examined recent S corporation operational tax issues. Part II discusses S corporation eligibility, elections, and termination issues. It covers significant topics related to a second class of stock, trusts owning S corporation stock, and an interesting ruling on the reelection of S status. In addition, numerous letter rulings on corporate and shareholder eligibility are discussed. This S corporation tax update covers the period July 9, 2008–July 9, 2009.

The general definition of an S corporation includes restrictions on the type and number of shareholders as well as the type of corporation that may qualify for the election. If an S corporation violates any of these restrictions, its S status is automatically terminated. However, the taxpayer can request an inadvertent termination ruling under Sec. 1362(f) and, subject to IRS approval, retain its S status continuously. Congress had requested that the IRS be lenient in granting inadvertent election and termination relief, and the rulings discussed below show clearly that the IRS has abided by congressional intent.

Late Elections

In an attempt to reduce the number of late filing requests, the IRS issued Rev. Proc. 2003-43,[1] which grants S corporations, qualified subchapter S subsidiaries (QSubs), electing small business trusts (ESBTs), and qualified subchapter S trusts (QSSTs) a 24-month extension to file Form 2553, Election by a Small Business Corporation (Under Sec. 1362), Form 8869, Qualified Subchapter S Subsidiary Election, or a trust election without obtaining a letter ruling, and Rev. Proc. 2007-62,[2] which supplements Rev. Proc. 2003-43 and provides an additional method for certain taxpayers to request relief for a late S corporation election and a late corporate classification election that is intended to be effective on the same day. To obtain relief under Rev. Proc. 2007-62, the corporation must file a properly completed Form 2553 with its Form 1120S, U.S. Income Tax Return for an S Corporation, for the first year the corporation intended to be an S corporation. A statement explaining the reason for the failure to file a timely election must also be included on the Form 2553.

It appears that the intent of the revenue procedures is working. Even though the IRS continues to receive late-filing requests,[3] it issued fewer than 120 rulings this year regarding the late filing of Form 2553 compared with over 300 letter rulings per year issued on the topic before the procedure's issuance. In all the rulings during the period covered here, the IRS allowed S status under Sec. 1362(b)(5) as long as the taxpayer filed a valid Form 2553 within 60 days of the ruling.[4] Most of the rulings dealt with a corporation requesting S corporation status from inception. However, several rulings[5] requested relief from a late filing for a date subsequent to the inception of the company. In each of the cases, the IRS granted the taxpayer's request.

In several other situations,[6] the IRS ruled that the late filing was inadvertent and granted the corporation relief but did not rule on whether the entity would otherwise qualify for S corporation treatment. Thus, these companies may still have some issues to resolve to make sure the S election was valid. Preparers should be aware that FIN 48[7] is now effective for all corporations, including S corporations. Under this standard, all S corporations should check to make sure they have a valid S election in place.

In an interesting situation[8] after a husband and wife formed a company, they created grantor trusts A and B. Both of them then transferred their shares in the company to their respective trusts. The husband died, terminating A's grantor trust status. The company then elected S corporation status. However, neither the wife, as B's deemed owner, nor the husband's estate, as A's deemed owner, filed Form 2553, and the husband's estate never made an ESBT election for A, rendering it an ineligible shareholder. Thus, the company's S corporation election was ineffective. In this situation the IRS held that the various failures were inadvertent and that the company was entitled to S corporation status from the period beginning with the date on which it originally was made.

In some situations an entity is formed as either a limited liability company (LLC) or a limited liability partnership (LLP) but wishes to be treated as an S corporation. In the past the entity had to file both Form 8832, Entity Classification Election, and Form 2553. However, for elections after July 20, 2004, Regs. Sec. 301.7701-3(c) (1)(v)(C) eliminates the need to file Form 8832. Instead, a partnership or disregarded entity that would otherwise qualify to be an S corporation and that makes a timely and valid election to be treated as an S corporation on Form 2553 will be deemed to have elected to be classified as an association taxable as a corporation. Even though Form 8832 does not have to be filed when the election is made, the corporation must attach a copy to its first tax return when filed.

Nonetheless, there were still several instances[9] in which the entity was required to file Form 8832, electing to be treated as a corporation, and then file Form 2553 to be taxed as an S corporation. However, in cases in which the entity failed to file either of the

elections, the IRS granted these entities relief and allowed S status from inception as long as both forms were filed within 60 days of the ruling. The change in the regulations omitted the requirement to file Form 8832, not Form 2553, but in two situations in 2008 a company filed Form 8832 but not Form 2553.[10] In both situations, the IRS granted the company S status if it filed Form 2553 within 60 days. With the change in the regulations, there should be far fewer instances of this type of ruling in the future.

In another ruling,[11] a company was required to file both Form 8832 and Form 2553 and a QSub election for its wholly owned subsidiary. It did not file any of the elections; nevertheless, the IRS granted relief. Specifically, it concluded that the S corporation had satisfied the requirements with respect to the late entity classification and the late QSub election. The IRS also concluded that, provided the parent otherwise qualified as an S corporation (a subject on which the IRS did not opine), that parent had met the criteria for relief from its untimely S corporation election.

To qualify as an S corporation, the corporation and all its shareholders on the date of the election (as well as other affected shareholders) must timely file a valid Form 2553. This election should be sent by certified mail (return receipt requested), registered mail, or a preapproved private delivery service (e.g., FedEx, DHL, or UPS).

In a 2008 ruling,[12] the shareholders did not file a timely S election. During the time between inception and the request for this ruling, the respective interests of the shareholders had changed, and there was a possibility that the corporation had made disproportionate distributions during certain periods. However, the S corporation advised the IRS that it had taken steps to address that issue, and it sought a ruling that the IRS would recognize it as an S corporation from the date of formation. The IRS granted relief, ruling that the corporation had reasonable cause for its failure to timely elect S corporation status and that its belated S corporation election would be treated as timely filed. The IRS also determined that if a second class of stock was created, thus terminating the election, such termination was inadvertent and would be disregarded. The IRS conditioned the ruling on the company's election otherwise being valid and on the S corporation and the shareholders making adjustments required by the Service.

In past years the IRS has granted S status from date of incorporation even though it did not have any record of receiving Form 2553 and there was no proof of the taxpayer's mailing it. However, when the taxpayer raised this issue in court,[13] the judge ruled that the corporation did not qualify as an S corporation. In this case, IRS records showed no evidence that a Form 2553 on behalf of the corporation was ever received or processed. There was also nothing in the taxpayer's attorney's file that proved the taxpayer had ever mailed a Form 2553 to the IRS on behalf of the corporation. The taxpayer alleged that he filed the corporation's 2000 and 2001 federal income tax returns as though the corporation were a C corporation only because the corporation had not yet received an answer to its application for S corporation status. The taxpayer offered as evidence two documents he said had been attached to the corporation's federal income tax returns that purportedly stated that the corporation was awaiting a determination regarding its S status and was filing as a C corporation because it had not received an S determination. However, the IRS had no record of having received such documents with the corporation's 2000 and 2001 tax returns. Because the taxpayer did not offer any persuasive or credible proof of timely mailing a Form 2553, the judge denied the claim.

Who Signs Form 2553

When a corporation files Form 2553, all shareholders must consent to the election. In Letter Ruling 200909027,[14] a company elected to be an S corporation, and its stockholders were an individual and three trusts. The beneficiaries of the trusts did not consent to the Form 2553 for the trusts. Consequently, the trusts did not properly consent to the entity's election to be an S corporation. The failure of the trusts' beneficiaries to properly consent to the election made the election invalid. The IRS concluded that the S corporation election was ineffective because of the failure of the trust beneficiaries to consent but that the ineffectiveness of the election was inadvertent. Thus, the entity would be treated as an S corporation provided that the election was otherwise valid.

Corporate Eligibility

Sec. 1361 does not allow certain types of corporations to elect S status, including certain financial institutions, insurance companies, foreign corporations, and corporations electing Sec. 936 status. In addition, there are restrictions on who can own the stock of an S corporation and the type of stock an S corporation can issue.

One Class of Stock

Sec. 1361(b)(1)(D) prohibits an S corporation from having more than one class of stock, defined as equal rights to distributions and liquidations (but not voting rights). Under the facts of Letter Ruling 200849003,[15] a domestic corporation elected S status. Thereafter, however, the company made disproportionate distributions to shareholders to defray income taxes attributable to the company's income. When the S corporation discovered the error, it rectified the matter for year 3 but had not yet done so for years 1 and 2. The corporation reported that it would do so if the IRS ruled that any termination that occurred because the company had a second class of stock was inadvertent, which it did.

In Letter Ruling 200924019,[16] an S corporation entered into an informal unwritten employment agreement with two individuals as officers and employees. It represented that all its outstanding shares conferred identical rights to distribution and liquidation proceeds and that it made distributions to its shareholders only in proportion to the shareholders' stock ownership. It further represented that the circumvention of the one-class-of-stock requirement was not a principal purpose of the employment agreement. Finally, it represented that the corporation and each of its shareholders had filed all returns consistent with the S election remaining in effect. The IRS concluded that the employment agreement was not a governing provision and therefore did not cause the S corporation to have more than one class of stock.

In another ruling,[17] an S corporation amended its articles of incorporation to include both voting and nonvoting shares, and its shareholders exchanged some of their voting shares for nonvoting shares. Following the exchange, the shareholders' legal counsel and accountants advised them that the amended articles could be interpreted to provide differing rights to voting shares and nonvoting shares upon the occurrence of certain hypothetical events. In order to eliminate any potential inconsistencies, amendments to the amended articles were filed with the secretary of state. The IRS concluded that the S corporation election might have terminated because the entity might have had more than one class of stock. However, if the S election was terminated, such a termination was inadvertent.

In Letter Ruling 200914005,[18] the taxpayer asked the IRS to rule on whether an S corporation could revoke its status as an S corporation. However, the IRS also ruled on whether a second class of stock may have terminated the company's S election earlier. In this situation, as part of a stock incentive compensation program, the entity granted shares of restricted class B common stock to certain key employees in two years. The restricted stock was subject to vesting in equal increments over a number of years. The S corporation did not treat the unvested restricted stock as outstanding stock even though the shareholders had made Sec. 83(b) elections. The IRS concluded that if the erroneous failure to treat the restricted stock as outstanding stock caused the entity's S election to terminate, the termination was inadvertent; the company would be treated as continuing to be an S corporation from its election to its revocation date, provided that the subchapter S election was not otherwise terminated.

In another situation, [19] the company was a state corporation formed under a plan of reorganization to acquire Y stock. Subsequently, the company elected to be treated as an S corporation and Y elected to be a QSub. The company also adopted a restricted stock plan benefiting certain individuals who made Sec. 83(b) elections. The company did not treat unvested restricted shares as outstanding shares. It did not know that all those shares were required to be treated as outstanding as of the date of the awards. When the company discovered the error, it asked for IRS relief from any termination of either entity's subchapter S status due to the company's improper treatment of restricted shares. The IRS held that any resulting termination of either entity's S status was inadvertent; the company was entitled to be treated as continuing to be an S corporation, and Y would continue to be treated as a QSub.

A similar situation occurred in Letter Ruling 200917006,[20] where a company elected S corporation status when its current owners were an individual and two trusts. The company then executed a stock subscription agreement with another entity. This agreement may have been an event that terminated the company's S status. However, while the subscriber transferred funds to the company in order to acquire the stock, no stock certificate was issued, and its name was not entered on the company's books as a shareholder. The company's tax advisers later informed it that the subscriber was an ineligible shareholder. The company then retroactively amended the subscription agreement to provide for issuance of the shares directly to trusts 1 and 2. The company sought a ruling that it continued to be an S corporation notwithstanding the terminating event, on the grounds that the termination was inadvertent and was not motivated by either tax avoidance or retroactive tax planning. The IRS agreed.

In Letter Ruling 200914019,[21] a holding company that elected S corporation treatment became the parent of a common parent through a redemption transaction that restructured the common parent. To ensure that the terms of the redemption were fair to an employee stock ownership plan (ESOP) and two other stock plans, the plans adopted a floor price agreement and a valuation methodology. The common parent entered into split-dollar life insurance agreements with the CEO and a trust, both of which were shareholders of the company. The IRS concluded that the provisions would be disregarded in determining whether the outstanding shares of company stock conferred identical rights. Therefore, the company would not be considered as having more than one class of stock as a result of the floor price agreement and the valuation methodology. In addition, the IRS determined that the common parent did not enter into the insurance agreements to circumvent the one-class-of-stock requirement. Therefore, the company would not be considered as having more than one class of stock as a result of the split-dollar life insurance agreements.

Usually companies try to prove that they did not have a second class of stock. The opposite problem occurred in *Minton*,[22] in which the taxpayer tried to prove that the S corporation had a second class of stock so that she would not have to report her share of the S corporation's income. The shareholders of the S corporation orally agreed to make a monthly distribution to the company's founder, who was semi-retired. Accordingly, the taxpayer's attorney advised her that this agreement created a second class of stock and thus terminated the S election. However, the corporation continued to file 1120S returns, and the other shareholders treated it as such.

The Tax Court held that the agreement did not create a second class of stock because the taxpayer could not prove that there was a binding agreement to make the payments. The taxpayer appealed the court's decision. The Fifth Circuit[23] concurred with the Tax Court's decision even though the judge determined that the lower court erred in applying an election under Regs. Sec. 1.1361-1(l)(7) in that the provision permits retroactive application only to prior tax years and not to prior transactions. The judge ruled that the error was harmless because the evidence was not convincing that the transaction created a second class of stock.

QSub Election

A subsidiary that wants to be treated as an S corporation must be wholly owned by a parent S corporation, and a QSub election must be properly filed. The election should be filed on Form 8869 by the fifteenth day of the third month after the effective date. In the past, numerous ruling requests involved a late filing of this election.

The IRS can now waive inadvertently invalid QSub elections and terminations that occur after 2004 if the conditions of Sec. 1362(f) are met. This is consistent with Rev. Proc. 2004-49,[24] which simplifies the procedure to request relief for a late QSub election by allowing the S corporation to attach a completed Form 8869 to a timely filed tax return for the tax year the QSub was created. Despite this, there were still requests for rulings[25] seeking relief for the late filing of a QSub election. In each of these, the IRS determined that the taxpayer had shown good cause for the delay and granted an extension of 60 days from the ruling date to make the election.

Two rulings dealt with whether a company qualified to make a QSub election. In Letter Ruling 200916010,[26] an S corporation acquired all the stock of another corporation. It intended to treat the subsidiary as a QSub but failed to file the required election. The QSub thereafter issued stock options to employees, the fair market value of which exceeded the exercise price ("in the money options"). After an employee exercised an option and received QSub shares, the QSub canceled all outstanding options and repurchased the stock. In requesting a ruling, the S corporation stated that neither it nor its shareholders nor its subsidiary understood that the issuance of the options could cause the QSub to have an owner other than the S corporation and that the conduct was not motivated by tax avoidance or retroactive tax planning. They asked the IRS to rule that neither entity's status had been affected adversely by such errors, which the IRS did. Therefore, the corporations were allowed to keep their S and QSub status.

In another situation,[27] a domestic corporation that was an S corporation acquired the stock of another corporation. The S corporation intended to treat the stock acquisition as an acquisition of assets by making a Sec. 338(h)(10) election and also intended to elect to treat the company as a disregarded entity (DE). Though the S corporation made the first election, its tax professional erroneously advised that it was not required to make a QSub election in order to treat the subsidiary as a DE. When the S corporation later discovered that this advice was incorrect, it asked for an extension of the deadline to make the election and for relief from the inadvertent termination of its S status because of the missing QSub election. The IRS held that the S corporation was allowed to make a late QSub election on behalf of the subsidiary and that the termination of the S status was inadvertent.

Earnings and Profits

If an S corporation has subchapter C accumulated earnings and profits (AE&P), it will be subject to a tax under Sec. 1375 on its excess net passive investment income if its total passive investment income exceeds 25% of its gross receipts. Most of the rulings in this area have dealt with whether rental real estate activities were active or passive in nature for purposes of the tax. Under Regs. Sec. 1.1362-2(c)(5)(ii)(B), rents received by a corporation are treated as from an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business.

Since the issuance of the regulations, the IRS has been lenient in its definition of passive income; as a result, the number of ruling requests is down significantly. In the period covered, income from commercial and residential rentals was deemed to be active income.[28] In these rulings, the S corporation provided various services to the tenants, including utilities and maintenance for common areas, landscaping, garbage removal, and security. In addition, the S corporation handled leasing and administrative functions, including billing, collecting rent, finding new tenants, and negotiating leases. In one of the rulings,[29] the IRS stated that whether the S corporation was performing significant services was based on facts and circumstances, such as the number of people employed to provide the services or the types and amounts of costs incurred.

In Letter Ruling 200841004,[30] an S corporation engaged in leasing tangible property. The S corporation's employees provided services that included equipment pickup and delivery; equipment maintenance, replacement, and repair; and customer training and demonstration. As with real estate rentals, the IRS found that the rents were not passive investment income under Sec. 1362(d)(3)(C)(i).

Sec. 1362(d)(3) Terminations

A corporation may also have its S status terminated if it has AE&P and its passive investment income exceeds 25% of its gross receipts for three consecutive years under Sec. 1362(d)(3). The IRS has issued several rulings on termination of S status for this reason.

In one situation,[31] the taxpayer was a domestic corporation that elected S corporation status. At the start of year 1, it had AE&P due to its prior existence as a C corporation. For each of the next three consecutive years, the taxpayer had passive investment income exceeding 25% of its yearly gross receipts, triggering the termination of its S election. The company sought relief from the IRS, advising that it did not realize that excessive passive investment income could trigger termination. It also stated that it had taken corrective actions to assure that it would not have excessive passive investment income in the future. The IRS held that the S corporation had satisfied the requirements for relief from an inadvertent termination and would be treated as an S corporation for the desired period, notwithstanding the termination. However, the IRS conditioned relief on the S corporation's filing amended returns and paying the Sec. 1375 tax on excess net passive income.

In Letter Ruling 200927028,[32] a company that elected to be an S corporation had subchapter C earnings and profits at the close of each of three consecutive tax years and had gross receipts for each of those years, more than 25% of which were passive investment income. As a result, its S election terminated, but it represented that this termination was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. The corporation distributed all its subchapter C earnings and profits to its shareholders and, along with its shareholders, agreed to make any required adjustments consistent with its treatment as an S corporation. The IRS concluded that the termination was inadvertent and that it would treat the entity as continuing to be an S corporation. The IRS made the same ruling in another situation with similar facts.[33]

In Letter Ruling 200928024,[34] an S corporation intended to invest in publicly traded limited partnerships (PTPs) that purchased, transported, stored, and/ or marketed oil and gas. It identified to the IRS three specific PTPs that were actively engaged in such pursuits, stating that each met the qualifying income exception of Sec. 7704(c), that none was an electing large partnership, and that normal flowthrough provisions in governing law applied. Finally, the S corporation advised that it intended to invest in other similar PTPs and asked for rulings relative to how the IRS would treat income from the proposed investments. The IRS held that the taxpayer's distributive shares of the gross receipts of the identified PTPs were includible in its gross receipts for purposes of Secs. 1362 and 1375 and that its distributive shares of gross receipts attributable to the exploration, development, mining, production, processing, refining,

transportation, or marketing of any mineral or natural resources did not constitute passive investment income. This would seem to open up the planning possibility of using certain PTPs to avoid the passive investment income from exceeding 25% of gross receipts.

Shareholder Eligibility

Sec. 1361(b) restricts ownership in an S corporation to U.S. citizens, resident individuals, estates, certain trusts, and certain tax-exempt organizations. In Letter Ruling 200917008,[35] a corporation made an S election when all its shareholders were eligible shareholders that had consented to the S election. The S corporation agreed to enter into a transaction with an unrelated third party involving the creation of a partnership between the S corporation and the third party.

In connection with this transaction, investors that were not permissible S corporation shareholders purchased some of the S corporation stock. The S corporation represented that it was unaware that the purchase of its stock by the impermissible shareholders would cause a termination of its S election. Furthermore, it relied on a CPA firm to prepare its income tax returns and for tax advice, but the firm never advised that the ownership of stock by the impermissible shareholders would result in the termination of the S election. All the stock held by the ineligible shareholders was redeemed. The IRS concluded that although the S corporation election had terminated, the termination was inadvertent.

In one instance,[36] a corporation elected to be treated as an S corporation, but one of its owners was another S corporation, an ineligible shareholder. When the company discovered that the ownership by another S corporation made the S election ineffective, the shareholder distributed its shares in the taxpayer in the first corporation to its sole shareholder, an individual. The IRS held that the ineffectiveness of the taxpayer's S corporation election was inadvertent. However, the IRS disclaimed any ruling as to whether the corporation otherwise qualified as an S corporation and did not address whether the distribution to the individual would be a taxable event. If the stock had appreciated in value or was worth more than the shareholder's basis, Sec. 311(b) would apply to create a recognized gain at the corporate level that would pass through and be taxable to the shareholder.

In another instance,[37] on the date of its formation as a state limited partnership, a company made an S election. Its owners included another S corporation, an ineligible shareholder. The company did not know that an S corporation was ineligible and that the company's S election might be ineffective. It was also unclear whether the company, at the time of formation, had a second class of stock, the existence of which would have meant that the company was ineligible for S corporation status. After the company's counsel advised it of such defects, the S corporation shareholder merged into the company. The IRS held that the company's election was ineffective due to the presence of an ineligible shareholder and also due to the circumstances involving a second class of stock. However, because those defects and circumstances were inadvertent and had been remedied, relief under Sec. 1362 was granted.

In Letter Ruling 200926028,[38] an entity elected to be an S corporation and intended to treat Y, another corporation, as a QSub. However, the QSub election was ineffective due to procedural defects. It was also ineffective because an ineligible entity was a shareholder of Y at the time of the election. After the company discovered that the QSub had an ineligible shareholder, all parties involved took corrective action to restore Y 's status as an eligible QSub. The IRS ruled that Y would be treated as a QSub provided that its election was not otherwise terminated and that the company could keep its S status.

Partnerships

A partnership is an ineligible S corporation shareholder. In one situation,[39] S corporation stock was transferred to a partnership—an ineligible shareholder— and then transferred to a second partnership, also ineligible. Thereafter, both partnerships transferred their stock to eligible shareholders. The IRS found that the termination was inadvertent. The S corporation never treated the partnerships as shareholders; instead, the eligible shareholders were treated as the owners for the entire time.

In one instance,[40] a state corporation with six wholly owned subsidiaries and two shareholders elected to be an S corporation. One shareholder transferred its shares to a state limited partnership, an ineligible shareholder, triggering the termination of the S corporation election. Other events, including an unauthorized filing of an S corporation revocation and the issuance of shares to an IRA, also an ineligible shareholder, occurred thereafter. Once they knew the extent of the irregularities, the S corporation and its shareholders took corrective action and asked the IRS to treat the termination as inadvertent, which it did.

In another situation,[41] at the time an entity elected S status, its shareholders were individuals. It converted to a state limited partnership upon the creation of LLC1, with the individuals as limited partners and LLC1, which the individuals owned, as the general partner. After the entity became aware that as a result of its conversion its S election terminated, it effectuated a series of transactions that created additional LLCs such that a single member owned each of the new LLCs and they could qualify as disregarded entities. To further remedy the terminating event, the entity represented that it would convert to a corporation under state laws if necessary. The IRS concluded that the entity's S corporation election terminated when LLC1 became the general partner and that it might have terminated if the conversion of the entity to a state limited partnership created a second class of stock. However, the IRS concluded that the termination was inadvertent.

In yet another situation,[42] an entity was incorporated under state law and later elected S corporation status. In the period between formation and election, the company's stock was held through limited partnership arrangements adopted by groups of family members. With the intent of meeting subchapter S criteria, those family groups collectively formed four grantor trusts to hold the S corporation stock. However, because individuals did not wholly own the grantor trusts, they were ineligible to hold S corporation shares, and the transfer of the stock to the trusts terminated the S election. The S corporation proposed to amend and restate three of the trusts in the manner required to address their ineligibility and to terminate the fourth. The IRS held that while the S corporation was invalid by reason of the presence of ineligible shareholders, that invalidity was inadvertent and the company would be treated as an S corporation from the election, assuming that the described steps were taken.

LLCs

Like a partnership, an LLC is an ineligible shareholder. However, in Letter Ruling 200927014,[43] the IRS was asked whether an LLC could be an eligible S corporation shareholder if the LLC was a disregarded single-member LLC (SMLLC). The answer was that the SMLLC could be an eligible shareholder because the LLC's owner (assuming he or she is an eligible shareholder) would be treated as the owner of the S corporation. Many tax professionals and the IRS have used this concept to establish or continue a valid S corporation as discussed below.

In one instance,[44] X was formed as a single-member LLC treated as a disregarded entity for federal tax purposes. X acquired Y, an S corporation. As part of the acquisition, the sole shareholder of Y became a member of X. As a result, X had more than one member. X became a partnership for federal tax purposes and was therefore an ineligible shareholder of Y. Consequently, Y 's S corporation election terminated. The IRS concluded that Y 's S corporation election terminated inadvertently and granted X an extension of time to make the appropriate elections.

In another situation,[45] an S corporation issued shares of its stock to an LLC, an ineligible corporation shareholder. The members of the LLC were two individuals. The S corporation redeemed all of the shares of the S corporation stock held by the LLC. The IRS concluded that the termination of the S corporation election was inadvertent. Thus, it would continue to treat the entity as an S corporation, provided that its election was otherwise valid. During the termination period, the individuals would be treated as the owners of the S corporation stock in proportion to their ownership interests in the LLC. The LLC could not be treated as a shareholder for any period it held an interest in the entity.

IRAs

The general rule is that an IRA cannot be an S shareholder. There have been several rulings in which S corporation stock was transferred to an IRA.[46] In these situations, either the S corporation or the S shareholder transferred the stock to an IRA. When the company discovered the problem, the shares were transferred to the beneficiaries of the IRAs. The IRS determined that the termination of the S election was inadvertent. The only difference in the rulings was who would be treated as the shareholder during the period the IRA held the stock.

In Letter Ruling 200915020, the IRA, not the IRA's beneficiary, was treated as the shareholder for the time the stock was held by the IRA when the S corporation had a loss; the rest of the time the beneficiary was considered the shareholder. Treating the IRA as the shareholder is a relatively new concept, but for the past few years the IRS has ruled that if an S corporation had a loss while an IRA held the stock, the IRA would be considered the shareholder, whereas if the S corporation had income, the beneficiary would be considered the shareholder. By treating the IRA as the owner when the S corporation has a loss, no one gets the benefit of this loss in the current year, especially because no special allocation provision is permitted for an S corporation.

Trusts

Certain trusts are allowed to own S stock. However, there are strict rules that the trusts must follow to continue as eligible shareholders. Therefore, an S corporation and its tax advisers must constantly monitor trust shareholders' elections, trust agreements, and their subsequent modifications for compliance with S eligibility rules. The Service has ruled on several situations involving trusts as S shareholders.

In the first ruling,[47] S stock was transferred to a trust, an ineligible shareholder, with the result that the S election terminated. Only later, in connection with the S corporation's proposed sale, did the company and its shareholders discover that a terminating event had occurred. In seeking relief, the S corporation and its shareholders stated that they were unaware of the terminating event and had not intended that the corporation's S election terminate. The IRS granted the relief and held that the termination was inadvertent. The Service also ruled that the corporation would be treated as continuing to be an S corporation provided that, within 60 days, the trustee of the trust filed an election to be treated as an ESBT and that payment of the amount determined to be the required adjustment under Sec. 1362(f)(4) was made.

Testamentary Trusts

In a 2009 ruling,[48] S stock was used to fund two revocable trusts. When the grantor died, the trust remained a permissible S shareholder for two years under Sec. 1361(c)(2)(A)(iii). However, the trustee did not distribute the assets within the two-year period, making the trust an ineligible shareholder. Both trusts had the same three beneficiaries, and both were divided into and merged into three different trusts. The resulting trusts did not qualify as QSSTs and did not elect to be treated as ESBTs. When termination of the taxpayer's S status was discovered, the governing trust agreements were amended to satisfy the QSST criteria. The IRS concluded that the termination was inadvertent but conditioned the ruling on the shareholders' adjusting their interests as appropriate and the trusts' filing the appropriate elections within 60 days of the ruling.

In a similar situation,[49] stock was transferred to a trust on the death of the shareholder. The trust was eligible to be a QSST so that it could hold the stock more than two years, but the beneficiary failed to make the QSST election. The IRS ruled that the termination was inadvertent contingent upon certain enumerated conditions being met, including an adjustment under Sec. 1362(f)(4), a specified payment, and the beneficiary's filing of a valid QSST election within 60 days of the ruling. A similar ruling can be found in three other letter rulings.[50]

In a very common situation,[51] an S corporation transferred stock to a grantor trust that was an eligible shareholder. On the death of the grantor, the assets of the grantor trust transferred to another trust that was eligible to be either a QSST or an ESBT. In each of the

situations, either the beneficiaries or the trustee of the recipient trusts failed to file the appropriate election. In all the situations, the IRS determined that the S election was terminated when the trust became an ineligible shareholder but that the termination was inadvertent. Consequently, the IRS ruled that it would continue to treat the entity as an S corporation, contingent on the recipient trusts making the appropriate election within 60 days of the ruling.

In Letter Ruling 200928020,[52] S corporation stock was transferred to a grantor trust and was later transferred to a second grantor trust. When the grantor died, the stock was allocated between a trust described under Sec. 1361(c)(2)(A) (i) and a trust that was intended to be a QSST. However, not only did the trust's beneficiary fail to make a timely QSST election, but the trust was not eligible for QSST status. Later the trustee won a court order modifying the trust to qualify for QSST status. The IRS ruled that the termination of the corporation's S status was inadvertent and it would be treated as continuing to be an S corporation from the date of termination, provided that a completed QSST election was filed within 60 days of the ruling.

In another situation,[53] a grantor trust owned S stock. When its grantor died, the grantor trust became irrevocable. Its terms provided for transfer of its S stock to a family trust, but that transfer did not occur. When the grantor trust became an ineligible shareholder, the S election terminated. Later the grantor trust transferred its shares to the family trust, but its income beneficiary failed to make a timely QSST election. The IRS ruled that the termination was inadvertent and allowed the corporation to retain its S status as long as the income beneficiary filed a valid QSST election and any affected shareholders filed amended returns made necessary by the ruling.

Other Trust Issues

Election requirements: Another problem encountered by trusts is that for both a QSST and an ESBT, a separate election must be made for the trust to qualify as an eligible S shareholder. Often this election is filed incorrectly or not timely filed, and an inadvertent termination ruling is needed. During the period covered, there were numerous instances[54] in which a trust was intended to be treated as either a QSST or an ESBT and met all the requirements, but the trustee or beneficiary failed to file the election. The IRS determined in each case that there was good cause for the failure to make the election and granted a 60-day extension from the ruling date to make the election. In each of these cases, the ruling was contingent on the corporation's being treated as an S corporation from the time the trust received the stock until the present. Therefore, all shareholders had to include their pro-rata share of the corporation's income, make any needed adjustments to basis, and take into account any distributions made by the S corporation. If necessary, the corporation and its shareholders were required to file amended tax returns.

In Letter Ruling 200927027,[55] S stock was transferred to a trust that was represented as a permissible S shareholder. That stock was subsequently transferred to two other trusts, both of which were supposed to be ESBTs, but no elections were made. In addition, because the beneficiaries of two trusts had withdrawal powers, both trusts were ineligible shareholders, and the transfer of the stock terminated the S election. The corporation took steps to ensure that the trusts were eligible shareholders. The IRS held that the termination was inadvertent and that the corporation would be treated as continuing to be an S corporation. It also held that the two trusts would be treated as ESBTs for the relevant period.

One issue that trusts must be careful of is who signs the trust election. The proper individuals to make the election are the beneficiary of a QSST and the trustee of an ESBT. In one instance,[56] the trustee of a QSST, instead of the minor beneficiary or her legal representative, signed both the Form 2553 and the QSST election. In another situation,[57] the beneficiary of an ESBT, not the trustee, signed the Form 2553. The Service determined in both instances that the S election was inadvertently invalid and allowed the company to retain its S status.

It is important to make sure that the trusts meet all the proper requirements and that all the beneficiaries are qualified beneficiaries. In one instance,[58] a trust was eligible to make an ESBT election. The trust was the sole owner of the S corporation. Beneficiaries of the trust were an individual and two trusts. One of those trusts (T3) was a tax-exempt organization. The other trust (T2) had several beneficiaries; when they all died the remainder would go to T3. Because T2 was not a charitable remainder trust, all the beneficiaries qualified for ESBT purposes.

Letter Ruling 200921022[59] deals with a case in which a trust was funded with the stock of an S corporation and elected to be a QSST. However, the trust did not meet the qualifications of a valid QSST. It was eligible to be an ESBT but did not make the required election. Therefore, the trust was an ineligible shareholder, which caused the S corporation election to be invalid. The trust was split into two trusts for the benefit of two separate beneficiaries, and S corporation stock was transferred. Neither of the new trusts made any elections to be treated as either QSSTs or ESBTs. The IRS ruled that the S corporation election was ineffective because the first trust was an ineligible shareholder but that the ineffectiveness was inadvertent. Likewise, to the extent the S corporation election would have terminated when the first trust transferred stock to the other two trusts, such termination was also inadvertent.

***Income distribution*:** One condition for qualifying as a QSST is that the trustee must distribute all the income each year. In Letter Ruling 200928025,[60] S corporation stock was transferred to trusts intended to be QSSTs. Although the trust instruments did not require the trustees to distribute all the income to each of the trust's current income beneficiaries, the S corporation represented that it and the grantors, trustees, and beneficiaries intended that trustees would actually distribute all such income. Due to an oversight, the beneficiaries of the trusts failed to make QSST elections. In addition, some of the trusts failed to distribute to their respective beneficiaries an immaterial amount of income. The IRS concluded that the S corporation termination was inadvertent and that it would continue to treat the entity as an S corporation, provided the election was valid, and the trusts would be treated as QSSTs if the beneficiaries filed appropriately completed QSST elections. Likewise, in Letter Ruling 200925031,[61] even though the trust agreement required that all the income be distributed, the trusts did not comply. Even so, the IRS determined that the termination of the S status was inadvertent.

One income beneficiary: Another requirement for a QSST is that it have only one current income beneficiary. In one situation in 2009,[62] a QSST had only one income beneficiary; however, when that beneficiary died, his children became the trust's beneficiaries. Because the trust had more than one income beneficiary, it no longer qualified as a QSST. However, the trust qualified to be an ESBT. Because no ESBT election was made, the trust was an ineligible shareholder and its ownership triggered the termination of the corporation's S election. The IRS determined that the taxpayer's S election terminated when the trust ceased to qualify as a QSST and failed to timely file an ESBT election. Given the facts, the IRS ruled the termination was inadvertent.

Terminations

Under Sec. 1362(g), if an S corporation's election is terminated, it is not eligible to reelect S status for five tax years. S and C short years are treated as two separate tax years. In one instance,[63] an entity terminated its S corporation election by recapitalizing its common stock into common stock and an ESOP convertible preferred stock. The entity's four shareholders sold the ESOP convertible stock to the entity's ESOP, and two shareholders elected Sec. 1042 treatment on the sale of their stock. The entity then redeemed all its common stock, causing the ESOP to become its sole shareholder.

The IRS denied the entity's request for permission to reelect S corporation status before the expiration of the five-year statutory waiting period. The entity terminated its S corporation status by creating two classes of stock. The shareholders compounded the error by selling their stock to the ESOP because only C corporation shareholders may sell their stock to an ESOP and defer the gain under Sec. 1042 by reinvesting the proceeds in publicly traded stocks and bonds. The election of Sec. 1042 treatment by the two shareholders precluded Sec. 1362(g) relief without regard to the redemption of the entity's stock, causing a more than 50% ownership change as described in Regs. Sec. 1.1362-5(a).

Notes

[1] Rev. Proc. 2003-43, 2003-1 C.B. 998.

[2] Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

[3] See, e.g., IRS Letter Rulings 200932013 (8/7/09), 200923009 (6/5/09), 200915021 (4/10/09), and 200903074 (1/16/08).

[4]See, e.g., IRS Letter Rulings 200928012 (7/10/09), 200919021 (5/8/09), 200906038 (2/6/09), and 200845033 (11/7/08).

[5] See IRS Letter Rulings 200928002 (7/10/09), 200927001 (7/2/09), and 200914016 (4/13/09).

[6] See IRS Letter Rulings 200931035 (7/31/09), 200916019 (4/17/09), and 200906005 (2/6/09).

[7] Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. Note that FASB has codified its accounting standards; FIN 48 is now mostly codified in Accounting Standards Codification Subtopic 740-10.

[8] IRS Letter Ruling 200908008 (2/20/09).

[9] IRS Letter Rulings 200917017 (4/24/09), 200910022 (3/6/09), 200908010 (2/20/09), 200906029 (2/6/09), and 200849010 (12/5/08).

[10] IRS Letter Rulings 200903071 (1/16/09) and 200843028 (10/24/08).

[11] IRS Letter Ruling 200927026 (7/2/09).

[12] IRS Letter Ruling 200842033 (10/17/08).

[13] *Dansby*, T.C. Memo. 2009-70.

[14] IRS Letter Ruling 200909027 (2/27/09).

[15] IRS Letter Ruling 200849003 (12/5/08).

[16] IRS Letter Ruling 200924019 (6/12/09).

[17] IRS Letter Ruling 200921001 (5/22/09).

[18] IRS Letter Ruling 200914005 (4/3/09).

[19] IRS Letter Ruling 200901011 (1/2/09).

[20] IRS Letter Ruling 200917006 (4/24/09).

[21] IRS Letter Ruling 200914019 (4/3/09).

[22] *Minton*, T.C. Memo. 2007-372.

[23] *Minton*, 562 F.3d 730 (5th Cir. 2009).

[24] Rev. Proc. 2004-49, 2004-33 I.R.B. 210.

[25] See, e.g., IRS Letter Rulings 200928026 (7/10/09), 200909018 (2/27/09), 200910016 (3/6/09), and 200845016 (11/17/08).

[26] IRS Letter Ruling 200916010 (4/17/09).

[27] IRS Letter Ruling 200903062 (1/16/09).

[28] See, e.g., IRS Letter Rulings 200923007 (6/5/09), 200905012 (1/30/08), and 200845006 (11/7/08).

[29] IRS Letter Ruling 200932010 (8/8/09).

[30] IRS Letter Ruling 200841004 (10/10/08).

[31] IRS Letter Ruling 200930027 (7/24/09).

[32] IRS Letter Ruling 200927028 (7/12/09).

[33] IRS Letter Ruling 200906019 (2/6/09).

[34] IRS Letter Ruling 200928024 (7/10/09).

[35] IRS Letter Ruling 200917008 (4/24/09).

[36] IRS Letter Ruling 200921027 (5/22/09).

[37] IRS Letter Ruling 200907012 (2/13/09).

[38] IRS Letter Ruling 200926028 (6/26/09).

[39] IRS Letter Ruling 200847013 (11/21/08).

[40] IRS Letter Ruling 200906015 (2/6/09).

[41] IRS Letter Ruling 200908009 (2/20/09).

[42] IRS Letter Ruling 200927006 (7/2/09).

[43] IRS Letter Ruling 200927014 (7/2/09).

[44] IRS Letter Ruling 200914008 (4/3/09).

[45] IRS Letter Ruling 200851008 (12/19/08).

[46] IRS Letter Rulings 200931039 (7/31/09) and 200915020 (4/10/09).

[47] IRS Letter Ruling 200924009 (6/12/09).

[48] IRS Letter Ruling 200932031 (8/7/09).

[49] IRS Letter Ruling 200932001 (8/7/09).

[50] See IRS Letter Rulings 200929002 (7/17/09), 200932022 (8/7/09), and 200927029 (3/31/09).

[51] See, e.g., IRS Letter Rulings 200908007 (2/20/09), 200906037 (2/6/09), and 200843007 (10/24/08).

[52] IRS Letter Ruling 200928020 (7/10/09).

[53] IRS Letter Ruling 200931036 (7/31/09).

[54] See, e.g., IRS Letter Rulings 200925027 (6/19/09), 200917024 (4/24/09), 200902001 (1/9/09), and 200845036 (11/7/08).

[55] IRS Letter Ruling 200927027 (7/2/09).

[56] IRS Letter Ruling 200909017 (2/27/09).

[57] IRS Letter Ruling 200909003 (2/27/09).

[58] IRS Letter Ruling 200912005 (3/20/09).

[59] IRS Letter Ruling 200921022 (5/22/09).

[60] IRS Letter Ruling 200928025 (7/10/09).

[61] IRS Letter Ruling 200925031 (6/19/09).

[62] IRS Letter Ruling 200927012 (7/2/09).

[63] IRS Letter Ruling 200851003 (12/19/08).

Current Developments in S Corporations (Part I)

EXECUTIVE SUMMARY

- The American Recovery and Reinvestment Act of 2009 made a number of changes that affect S corporations, including a suspension for 2009 and 2010 of the Sec. 1374 built-in gains tax for S corporations in their eighth, ninth, or tenth year of the recognition period.
- The 2008 Tax Extenders and AMT Relief Act extended to 2008 and 2009 the rule that the decrease in an S corporation shareholder's stock basis for a charitable contribution of property by the S corporation is equal to the shareholder's pro-rata share of the adjusted basis of the property.
- The IRS issued final regulations on how the suspended losses of an S corporation are treated when a shareholder divorces and a portion of the shareholder's shares in the S corporation are transferred to his or her ex-spouse.
- The Mortgage Forgiveness Debt Relief Act of 2007 added a new penalty for S corporations that fail to timely file their returns or fail to provide information required on the return. The amount of the penalty is partially based on the number of shareholders in the corporation.

This two-part article discusses recent legislation, cases, rulings, regulations, and other developments in the S corporation area. Part I covers operational issues; part II, in the November issue, will cover S corporation eligibility, elections, and termination issues.

During the period of this S corporation tax update (July 9, 2008–July 9, 2009), the American Recovery and Reinvestment Act of 2009[1] (ARRA) had a direct impact on S corporation operations. The Tax Extenders and AMT Relief Act[2] (TEARA) also had provisions that affect S corporations and their shareholders. Several regulations were issued giving guidance on the proper treatment for suspended losses and divorce as well as open account debt.

The potential zero capital gain rate for 2008 and 2009 continues to be an attractive tax planning tool that may affect S corporations and their shareholders' behavior. The government has released preliminary information about the National Research Program regarding S corporations audited for tax years 2003 and 2004. The article first looks at tax planning opportunities related to appreciated S corporation stock.

Zero Capital Gains Rate in 2008 and 2009

Because the capital gains rate for individual taxpayers in the lower two tax brackets is zero in 2008 and 2009, many taxpayers are (or were) gifting appreciated S corporation stock to their children, grandchildren, or parents. In 2008, the tax law extended the kiddie tax to income (including capital gains and dividends) of 18-year-olds who do not provide more than half of their support and to 19- to 23-year-olds who are full-time students[3] and do not provide more than half of their own support. Thus, the 0% tax rate generally will not be available to students through age 23 unless they have significant earned income or possibly trust fund income that contributes to their own support. This leads to a balancing act. Parents may hire a child to legitimately work for them and pay him or her enough to meet the 50% self-support test but not so much that they exceed the first two bracket limits ($33,950), including the capital gains generated. The parent will also lose the dependency exemption.

Example 1*:* Child C, age 22, is in graduate school and has $5,000 dividend income and $2,000 ordinary income from an S corporation, plus $10,000 earned income from summer work and from helping his parents with computer work in their business. His total support is $18,000. In February 2009, C's parents give him stock worth $24,000, with a basis of $4,000 and a holding period of at least one year. He has a standard deduction and personal exemption that puts his 2009 taxable income in the first two tax brackets (i.e., under $33,950). Assuming that C sells the gifted stock in 2009, he will pay no tax (0% tax rate) on the $20,000 capital gain and the $5,000 dividend income, for a tax savings over his parents' hypothetical tax on the dividend and capital gains of $3,750 ($25,000 × 15%).
Example 2*:* A retired married couple, A and B, defer pension distributions and invest primarily in tax-exempt bonds. They are living off the interest from those bonds. Their S corporation K-1 shows ordinary income of $40,000, and they receive distributions of $50,000 during the year. They have itemized deductions of $30,000. Their net ordinary income is $10,000 ($40,000 – $30,000). Therefore, if they recognized $200,000 in capital gains or dividend income through the S corporation or otherwise, $57,900 of the gain would be subject to a 0% tax rate. The other $142,100 would be subject to the normal 15% tax rate. This results in a federal tax savings of $8,700.

IRS Audit Rates and NRP Study

To put S corporations and their individual shareholders' audit rates in perspective, it helps to see what other business entities' audit rates are. During the audit period October 1, 2007–September 20, 2008, for C corporations with less than $10 million of assets, the audit rate was 1%, while those with more than $10 million of assets were audited 15.3% of the time. This is to be contrasted with S

corporations and partnerships, which had a 0.4% audit rate. Individuals were audited 1% of the time (of which one-third were related to earned income tax credit issues and 77% were correspondence audits). Farm activity was audited at 0.6%. Schedule Cs with less than $25,000 in gross receipts were audited at 1.2%, those with $25,000–$100,000 at 1.9%, those with $100,000–200,000 at 3.8%, and those over $200,000 at 3.1%.

At a recent IRS Tax Research conference (July 8–9, 2009), the preliminary results of the National Research Program on S corporations were reported. The program audited 1,200 S corporations for tax year 2003 and 3,700 for tax year 2004. It found 12% underreporting for 2003 and 16% for 2004. It also discovered that small S corporations (defined as having less than $200,000 in assets) had a higher percentage of underreporting than large S corporations. It found that this underreporting mirrored the underreporting on Schedule Cs. The interesting question is whether the IRS will adjust small S audit rates to the Schedule C rates described above (1.2%– 3.8%), rather than the historically low S corporation audit rate of 0.4%.

American Recovery and Reinvestment Act of 2009 (ARRA)

Signed into law on February 17, 2009, ARRA affects S corporations and their shareholders in several ways. First, it extended the increased Sec. 179 deduction limits ($250,000/$800,000) to 2009. Second, it also extended the 50% bonus depreciation rules (Sec. 168(k)) to 2009.

Example 3*:* In 2009, X, an S corporation, places in service $600,000 of equipment with a five-year class life. X may pass through to its shareholders $250,000[4] of Sec. 179 depreciation and $210,000[5] of bonus and regular depreciation. Thus, the combination of Sec. 179, bonus depreciation, and MACRS results in 77% of the asset being expensed in the year placed in service. The shareholders would reflect their share of the $250,000 Sec. 179 deduction on their individual tax returns but would not have to count the $600,000 asset acquisitions for the $800,000 threshold limit. Note that the shareholders and X each must have sufficient trade or business income (including salary) to utilize their Sec. 179 amount.

Third, due to the economic problems that many companies are facing, Congress allowed regular tax and AMT net operating losses (NOLs) arising in tax years ending in 2008 to be carried back three, four, or five years if the taxpayer is eligible and so elects. To be an eligible small business, the business's average gross receipts for 2008,[6] 2007, and 2006 must be less than $15 million. In the case of an S corporation and its shareholders, both must meet the eligible small business test. Note that gross receipts includes net sales (unreduced by cost of goods sold) tax-exempt income, cancellation of debt (COD) income, original issue discount, etc.

Fourth, Sec. 1374(d)(7) was enacted, which exempts for 2009 and 2010 Sec. 1374's built-in gain (BIG) imposition if the S corporation is in its eighth, ninth, or tenth year of the recognition period. This will result in a significant cash flow savings for some S corporations and will require substantial tax planning from the tax adviser. For example, if an installment sale of BIG property occurred in a prior year, it may be advisable to recognize the gain in 2009 or 2010, assuming it qualifies as an eligible year. It may even be prudent to trigger the installment gain by using the installment note as collateral for a loan.

The AICPA's S Corporation Technical Resource Panel is requesting clarification from Treasury on a number of issues related to this BIG holiday. For example, if the taxpayer's net recognized built-in gain is limited by taxable income in its eighth recognition period year (2009) and in 2011 it is subject to BIG, is the 2009 suspended gain forgiven or subject to Sec. 1374 tax? In addition, there seems to be a difference in which years qualify as eighth, ninth, or tenth for Sec. 1374 as opposed to the carryover basis rules of Sec. 1374(d)(8). For the former, tax year seems to be the criterion. Thus, in switching from a C fiscal year to an S calendar year, a corporation may have had a short tax year. For the carryover basis provisions, the law seems to look to 12-month periods. Whether this is a drafting error or the intention of Congress remains to be seen.

Fifth, Sec. 108(i) was enacted to allow COD income normally recognized in 2009 or 2010 to be deferred to 2014, when it will be taxed over five years. This is available when the borrower or a party related to the borrower buys back the debt. The tax adviser must be aware of a variety of events that may trigger early recognition of the deferred gain, including pass-through entity owners' sale of their interest. This may not be an optimal election if NOLs are available to offset the COD income. In addition, if the taxpayer is bankrupt, the COD income is not taxable, but if the taxpayer elects to postpone the gain under Sec. 108(i), it would be taxable. Unfortunately, there are many unanswered questions that will arise relative to this deferral, and the S Corporation Technical Resource Panel has asked Treasury to clarify many of these issues.

Sixth, private activity bond interest is exempt from AMT for bonds issued in 2009 and 2010, which may affect investment strategies of S corporations and their shareholders.

2008 Tax Extenders and AMT Relief Act (TEARA)

TEARA was signed into law on October 3, 2008, and has had a significant direct and indirect impact on S corporations and their shareholders.

Tax Preparer Penalty

Tax advisers are likely aware that for tax returns prepared after May 22, 2007, the substantial authority standard continues to apply, rather than the more-likely-than-not (MLTN) requirement for returns that are not considered tax shelters or that contain listed transactions. If the position is disclosed, the reasonable basis standard is sufficient to avoid penalties. Also note that the extension of tax preparer penalties to gift tax returns, estate tax returns, payroll taxes, etc., has not been repealed.

Research and Development Credit

Some S corporations are performing Sec. 174 R&D and are eligible for Sec. 41 R&D credits that would pass through to their shareholders. TEARA extended the R&D credit for 2008 and 2009 and repealed the alternative incremental credit for tax years beginning after December 31, 2008. For tax years ending after December 31, 2008, it also increased the simplified credit now being used by many taxpayers to 14% from 12%.

Superexpensing Provision Related to Movie/TV and Other Accelerated Depreciation Rules

In the past, the $15 million super expensing provision of Sec. 181 was all or nothing. That is, if the cost of an otherwise qualified movie exceeded $15 million, nothing was allowed to be expensed under Sec. 181. Instead, the normal income forecast method depreciation rules would apply. TEARA instead allows $15 million of the costs of a qualifying movie to be expensed even if the aggregate costs of the movie exceed $15 million. Sec. 199 qualified wages will also now include loan-out payments.[7] Many loan-out companies are established as S corporations to avoid the personal holding company rules applicable to C corporations. Loan-out companies are incorporated vehicles for talent to work for a movie or television production company.

TEARA also includes provisions that extend to 2008 and 2009 the expensing of environmental remediation costs[8] and the 15-year amortization of qualified restaurant and leasehold improvements.[9]

Charitable Contribution of Appreciated Property and Stock Basis

The IRS issued Rev. Rul. 2008-16[10] to clarify the adjustments to S stock basis for the contribution of appreciated property by an S corporation to a qualified charitable organization. Essentially, the treatment[11] is that a shareholder's adjusted basis in stock is increased by the appreciation embedded in the gifted property and is then reduced by the fair market value (FMV) of the property gifted (but not below zero). Originally, these rules applied only to 2006 and 2007,[12] but TEARA extended their application to 2008 and 2009. It should be noted that the charitable contribution is still subject to Sec. 1366(d) limitations and Sec. 170 50% or 30% adjusted gross income limits.

Example 4: Y, an S corporation, is owned by B, its sole shareholder. B has an adjusted basis of $1,000 in Y stock. In 2009, Y contributes appreciated long-term capital gain property worth $500 with an adjusted basis of $200. The charitable gift will be reflected on Schedules K and K-1 and deductible on B's individual tax return to the extent of the $500 FMV. The $1,000 adjusted basis in B's stock will be reduced by $200 (the gifted property's adjusted basis). Another way to view this transaction would be to increase adjusted basis by the appreciation in the gifted property to $1,300 ($1,000 + $300) and then reduce it by the FMV of the gift ($500) to $800.

Example 5: Assume the same facts as in Example 4, but B's adjusted basis in Y stock is $150. After the charitable gift is reflected, his basis in the stock will be zero. B would have a $500 Sec. 170 deduction flow through to the individual tax return, but Sec. 1366(d) would limit his deduction to $450 ($150 basis + $300 appreciation), and $50 would be suspended until there was sufficient basis.

Example 6: Assume the same facts as in Example 4, but B's basis in the S stock is $0. B currently deducts $300 (the appreciation) as a Sec. 170 expense. His adjusted basis in Y stock remains at zero, and he has a suspended $200 charitable contribution deduction.

Other S Corp. Current Operating Developments

Losses and Limitations

A major motivation for a corporation choosing S status is the ability to flow entity-level losses through to its shareholders. There are several hurdles that a shareholder must overcome before losses are deductible, including Sec. 183 (hobby loss), Sec. 1366 (adjusted basis), Sec. 465 (at risk), and Sec. 469 (passive activity loss) rules. Several regulations, court cases, and rulings were issued relative to these loss limitation rules.

Divorce and Suspended Losses

Final regulations[13] were issued in August 2008 dealing with the appropriate treatment of a divorce where S corporation suspended losses exist. Basically, in the year of the divorce and the dividing of the S corporation shares per Sec. 1041, each party picks up his or her share of current- year activity, and the transferor gets all the suspended losses, if sufficient basis exists in the year of transfer. In the year after transfer, the suspended losses are split between the transferor and transferee by their respective ownership at the beginning of that year.

Example 7: A owns 100% of X Corp., an S corporation, in 2007. X has current and suspended losses of $100,000, and A has no basis in stock or debt. In 2008, X has a loss of $80,000, and in July A and B divorce and A transfers one-half of the X stock to B. B is entitled to $20,000 in losses (½ year × ½ stock × $80,000), and A is entitled to all the $100,000 suspended losses from 2007 and $60,000 of the current-year loss, subject to having sufficient basis for loss purposes. In 2009, X has a $70,000 loss. B would be entitled to $35,000 of the 2009 loss plus $50,000 of the suspended loss plus $20,000 of the 2008 loss. A would be entitled to a $35,000 2009 loss plus a $50,000 2007-andbefore suspended loss plus his $60,000 2008 loss.

Example 8: Assume the same facts as in Example 7, but A contributes $10,000 in 2008. Then he would be able to use current and suspended losses against his basis. Thus, $6,250 ($100,000 ÷ $160,000 × $10,000 basis) would be losses allocated to A from the suspended account and $3,750 ($60,000 ÷ 160,000 × $10,000) would be allocated to A from the current loss and be deductible to A at the individual level. Therefore, in 2009 B would be allocated half of the $93,750 suspended loss.

Open Account Loans

In October 2008, Treasury issued final regulations[14] that are effective for debt created after October 20, 2008. Basically, open account debt that exceeds $25,000 per shareholder will be treated like notes. The amount owed will be measured at the corporation's tax year end or when stock is sold. These regulations were issued in response to the *Brooks* case,[15] which involved open account debt. In that case, two shareholders lent their S corporation money on open account so that at the end of any given year the shareholders had basis in the loans and could deduct the S corporation's losses. However, because they always increased the loan by year end, no ordinary income was recognized on the repayment of the outstanding loan with a zero basis.

The IRS maintained that the debt repayments should be treated separately, like notes, so that the repayment resulted in income to the brothers at the time of the repayment, when the loan basis was zero. The court held that no income recognition was required because the loans were open advances.

Back-to-Back Loans

Kerzner[16] is the most recent case addressing the back-to-back loan strategy among related parties. This case involved a round-tripper scenario in which a partnership lent money to an individual who lent money to the loss S corporation that paid the partnership rent.

No principal or interest on the notes was paid. The court held that this was not an economic outlay and therefore no Sec. 1366(d) basis for loss was created. The AICPA's S Corporation Technical Resource Panel has submitted comments to Treasury encouraging a safe harbor for back-to-back loans with unrelated and related parties; hopefully this proposal will be included in proposed regulations to be issued before year end.

On July 8, 2009, the IRS issued Notice 2008-1[17] and Tax Resources for Small Businesses Issue No. 2009-14, which discusses S corporation stock and debt basis, reasonable compensation, and medical insurance that may be a useful secondary source for S corporation clients.

Penalties for Nontimely Filing of 1120S Tax Return Information

In what will probably be a surprise to many tax practitioners, the Mortgage Forgiveness Debt Relief Act of 2007[18] enacted a new provision that imposes a penalty of $85 per shareholder per month (not to exceed 12 months) if the S corporation does not timely file its corporate return or if it fails to provide information required on the return.[19] The law is effective for 2007 1120S tax returns[20] and is imposed on the S corporation. For returns required to be filed after December 31, 2008 (2008 Forms 1120S, U.S. Income Tax Return for an S Corporation), the penalty was raised to $89[21] per shareholder per month. It counts husbands and wives as two shareholders; it counts the sale or gifting by one shareholder to another as two different shareholders. It is unclear how the provision would treat ownership in a community property state where actual ownership may be in one person's name.

Example 9: H and W and their two children own all the stock of XYZ Corp. In October 2008, the two children gift some stock to their spouses. In 2009, the S corporation forgets to include the distribution amount on the 2008 1120S Schedules K and K-1. The S corporation could be liable for a penalty of $6,408 ($89 × 6 × 12) for this innocent mistake.

What is particularly disturbing about this provision is that, in the authors' experience, rarely (if ever) is the date of distributions included on Schedule K and the related K-1s. Yet when one looks at Secs. 6037(a) and (b), this information is supposed to be reported to the government and the shareholders.

Built-in Gains (Sec. 1374)

ARRA has obviously reduced the stress and impact of Sec. 1374 for 2009 and 2010. Nonetheless, attention must be paid to this area of the law for its impact on past and future years and current years that are not in the eighth, ninth, or tenth year of the recognition period. In Letter Ruling 200925005[22] the IRS ruled on a common situation in which a cash-basis personal service corporation converts from C to S status and has accrued salaries payable to both owner-employees and no owner-employees. The ruling basically holds that a less than 5% shareholder and no owners may be paid anytime during the recognition period and still qualify for a built-in loss deduction. The 5% or greater owners must be paid within 2½ months after the liability would be accrued.

Letter Ruling 200909001[23] was a favorable ruling that dealt with an S corporation with some assets that had been held 10 years and others that had not. The S corporation put both groups of assets in an LLC and sold the LLC interest. The IRS ruled that there was no BIG on the sale of partnership interests related to the less-than-10-year held property. Similarly, Letter Ruling 200910030[24] dealt with a converted S corporation that had converted exactly 10 years before and distributed appreciated stock and LLC interests to its shareholders. The ruling held that Sec. 311(b) gain recognition would be triggered but no Sec. 1374 tax would be due.

In *MMC Corporation*,[25] a C corporation was required to make a Sec. 481 adjustment over multiple years. During those years, it converted from C to S status. The court held that the Sec. 481 adjustment was subject to Sec. 1374. Interestingly, a similar situation occurred with a bank that wanted to switch from C to S status, and Rev. Proc. 2008-18[26] allowed the bank to include the full Sec. 481 adjustment in income of the last C year rather than in each of the S years. The bank needs to attach a Form 3115, Application for Change in Accounting Method, on the last C year's return as well as on the first S year's return to comply with the revenue procedure.

FIN 48 and Private Companies

The Financial Accounting Standards Board (FASB) had postponed the effective date of complying with FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, but has announced that it will be effective for private companies for periods beginning after December 29, 2008 (basically 2009 on). Generally, Statement of Financial Accounting Standards (FAS) No. 109, *Accounting for*

Income Taxes, and FIN 48 would not affect S corporations because the tax liability is incurred at the shareholder level. However, if the company had federal or state corporate-level taxes such as Sec. 1374 BIG, it would be subject to these complicated rules. Note that the FASB has stated that private companies will have more limited disclosure requirements than public companies.

Banks and Sec. 291(a)(3)

When a corporation converts from C to S status, it needs to be aware of the impact of Sec. 291. This tax provision is a vestigial organ from the old corporate add-on minimum tax days, but it still applies today. For example, Sec. 291(a)(1) requires an S corporation that sells real estate within three years after converting to S status to characterize 20% of the lower of gain recognized or straight-line depreciation as ordinary income.

In *Vainisi*,[27] the Tax Court held that Sec. 291(a)(3), which requires a 20% disallowance on interest expense related to tax-exempt income, applies to a qualified S subsidiary (QSub) bank even three years after conversion.

Beneficial Interest in an S Corp.

Klaas[28] involves a 100% shareholder of an S corporation where the entity sold an RV park but the owner did not want it taxed at the shareholder level. After the fact, the owner changed the order of events such that an offshore corporation was deemed to have sold the assets. The court held that the reality of the transaction was that the S corporation sold the property, and the shareholder had to include the gain in his taxable income.

Also in the past year, the Supreme Court denied *certiorari* in the *Hightower*[29] case, which dealt with beneficial ownership in an S corporation when there are disputes and disagreements between the shareholders. *Hightower* involved two 50-50 shareholders of a software S corporation with a serious dispute that led to Mr. Hightower's being forced to resign as chairman of the board and losing management control of the company. The other shareholder offered and paid $47 million per the company's buy-sell agreement. Even though Hightower still was fighting the arbitration decision in state court, he took the sales proceeds. The court ruled that Hightower was no longer a shareholder as of October 2000 when he surrendered his stock and accepted payment.

Dunne[30] involved a taxpayer who was the sole shareholder for most of an S corporation's existence. For various reasons he brought in a 50% shareholder. After several years, they had disputes and disagreements about the future direction of the company. The two men discussed an informal agreement to sell Dunne's interest in the S corporation in 1996, but they did not negotiate an agreement as to price or other terms at that time. In January 1997 Mr. Dunne rejected the price offered, and he continued to receive distributions and shared in the economic benefits and burdens of the S corporation. He also held himself out to be the 50% owner, secretary, and chairman of the board of the company. In early 1997 the other shareholder fired him as an employee, and in May 1997 they came to a formal agreement as to the buyout price, including a portion of the price determined by future revenue from a government contract for the fire extinguishing chemical Halon. Mr. Dunne continued to represent himself to third parties after the May 1997 agreement as an officer and owner of the company. The judge held that May 1997 was when the economic benefits and burdens of ownership were terminated and therefore only the K-1 income through May was taxable to Dunne.

Tax-Deferred Reorganizations

The flexibility engendered by the QSub disregarded entity rules generated some merger and acquisition activity involving S corporations. In one of the more common scenarios, ruled on in Letter Ruling 200839017,[31] an S corporation changed to an LLC and immediately checked the box to be treated as a corporation. The government ruled that this was an F reorganization. Similarly, Rev. Rul. 2009-15[32] discusses the treatment of a partnership or LLC that checks the box or, under a state formless conversion statute, converts to corporate status and immediately elects S status. The ruling treats the partnership ownership as ending the day before the S year (December 31) and the S year as beginning with all qualified shareholders on January 1. Therefore, the S corporation status is established at its incorporation, and no C corporation year exists.

However, there are two issues that the tax adviser needs to be cognizant of. In either scenario (check the box or formless conversion statute), the ruling treats the partnership as transferring all the assets to the S corporation. If there were any non– bona fide liabilities transferred along with the assets, Sec. 357(b) would treat all the liabilities as boot and create a potentially large and unwanted recognized gain. The second issue is if a partner has negative partnership basis, the act of incorporating will trigger gain recognition. Thus, recognized gain will be triggered by the partner/shareholder being relieved of debt because the debt is not available under the corporate regime to allow basis for loss purposes.

Corporate division: Letter Ruling 200915001[33] involves an S corporation with multiple QSubs, including some with significant foreign activities. A spinoff that would allow better credit ratings for one of the businesses was approved. Rev. Proc. 2009-25[34] presents a pilot program that allows a rifle-shot approach to Sec. 355 or divisive D reorganization issues by allowing the IRS to opine on an issue or two without blessing the totality of the plan. Thus, issues for this pilot program might include whether a transaction meets the continuity-of-business enterprise criteria or a business is described in Sec. 355(b)(2)(C) (i.e., it was not acquired in a transaction in which gain or loss was recognized in whole or in part).

Notes

[1] American Recovery and Reinvestment Act of 2009, P.L. 111-5.

[2] Tax Extenders and AMT Relief Act, part of the Economic Stabilization Act of 2008, P.L. 110-343.

[3] This assumes that the children aged 19–23 are not married. If they are, the new expanded kiddie tax will not apply.

[4] Assuming sufficient taxable income at the S and shareholder levels.

[5] $600,000 – $250,000 = $350,000 × 50% = $175,000; asset basis is now $175,000 × 20% MACRS rate = $35,000. $35,000 + $175,000 = $210,000; January 1, 2009, asset basis is $140,000.

[6] See Rev. Proc. 2009-19, 2009-14 I.R.B. 747.

[7] Sec. 199(b)(2)(D).

[8] Sec. 198(h).

[9] Secs. 168(e)(3)(E)(iv) and (v).

[10] Rev. Rul. 2008-16, 2008-11 I.R.B. 585.

[11] See Karlinsky and Brown, “S Corporations’ Charitable Contributions of Appreciated Property and Shareholders’ Adjusted Basis in S Stock,” 39 The Tax Adviser 183 (March 2008).

[12] Pension Protection Act of 2006, P.L. 109-280, §1203.

[13] Regs. Sec. 1.1366-2(a)(5).

[14] T.D. 9428, amending Regs. Sec. 1.1367-2(a).

[15] Brooks, T.C. Memo. 2005-204. For more on Brooks, see the previous S corporation current development articles: 37 The Tax Adviser 670 (November 2006); 38 The Tax Adviser 677 (November 2007); and 39 The Tax Adviser 682 (October 2008).

[16] Kerzner, T.C. Memo. 2009-76

[17] Notice 2008-1, 2008-2 I.R.B. 251.

[18] Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142.

[19] Sec. 6699.

[20] S corporation tax returns required to be filed after December 20, 2007.

[21] Worker, Retiree, and Employer Recovery Act of 2008, P.L. 110-458, §128(a).

[22] IRS Letter Ruling 200925005 (6/19/09).

[23] IRS Letter Ruling 200909001 (2/27/09).

[24] IRS Letter Ruling 200910030 (3/6/09).

[25] MMC Corporation, No. 08-9002 (10th Cir. 1/15/09).

[26] Rev. Proc. 2008-18, 2008-10 I.R.B. 573.

[27] Vainisi, 132 T.C. No. 1 (2009).

[28] Klaas, T.C. Memo. 2009-90.

[29] Hightower, No. 06-73838 (9th Cir. 2/12/08), aff’g T.C. Memo. 2005-274, cert. denied, S. Ct. Dkt. 08-436 (U.S. 11/3/08).

[30] Dunne, T.C. Memo. 2008-63.

[31] IRS Letter Ruling 200839017 (9/26/08).

[32] Rev. Rul. 2009-15, 2009-21 I.R.B. 1035.

[33] IRS Letter Ruling 200915001 (4/10/09).

[34] Rev. Proc. 2009-25, 2009-24 I.R.B. 1088.

March 2010

Tax Planning & Practice Guide

Highlights of the HIRE Act of 2010

On March 18, the President signed the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act, P.L. 111-47) into law. As can be inferred from its title, it includes new incentives to encourage hiring. But it also contains provisions to encourage investment in business machinery and equipment, as well as new crackdowns on offshore noncompliance and other provisions. Specifically, the HIRE Act:

- Exempts employers from paying the employer share of Social Security employment taxes on wages paid in 2010 to newly hired qualified unemployed workers. These are workers who: (1) begin employment with the employer after Feb. 3, 2010 and before Jan. 1, 2011, (2) were previously unemployed and (3) do not replace other employees of the employer. The payroll tax relief applies only for wages paid with respect to employment beginning on Mar. 19, 2010 (the day after the enactment date) and before 2011.
- Provides employers with an up-to-$1,000 tax credit for retaining qualified unemployed workers. The workers must be employed by the employer for a period of not less than 52 consecutive weeks, and their wages for such employment during the last 26 weeks of the period must equal at least 80% of the wages for the first 26 weeks of the period.
- For tax years beginning in 2010, boosts to $250,000 the maximum amount that can be expensed under Code Sec. 179 , and boosts to $800,000 the beginning of the investment based phase-out amount.
- Allows issuers of certain tax credit bonds to elect to receive a direct payment instead of a tax credit to the bondholder.
- Enacts a comprehensive set of measures to reduce offshore noncompliance.
- Delays the application of worldwide allocation of interest for an additional three years.
- Tinkers with estimated tax payments of large corporations in future tax years.

This Tax Planning & Practice Guide highlights the key tax provisions in the HIRE Act, with citations to the Act and the applicable Code sections affected by it, plus observations and illustrations illustrating the Act's practical consequences.

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¶106. Small employer health insurance credit.

Under pre-Act law, there is no tax credit for employers that provide health coverage for their employees.

New law. For tax years beginning after Dec. 31, 2009, a tax credit is provided for an eligible small employer for nonelective contributions to purchase health insurance for its employees. (Code Sec. 45R , as added by Health Care Act Sec. 1421, as amended by Health Care Act Sec. 10105) An eligible small employer (ESE) for this purpose generally is an employer with no more than 25 full-time equivalent employees ("FTEs") employed during its tax year, and whose employees have annual full-time equivalent wages that average no more than $50,000. (Code Sec. 45R(d)) However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of not more than $25,000. (Code Sec. 45R(c))

The contributions must be provided under an arrangement that requires the eligible small employer to make a nonelective contribution on behalf of each employee who enrolls in certain defined qualifying health insurance offered to employees by the employer equal to a uniform percentage (not less than 50%) of the premium cost of the qualifying health plan. (Code Sec. 45R(d)(4))

The credit is only available to offset actual tax liability and is claimed on the employer's tax return. The credit is not payable in advance to the taxpayer or refundable. Thus, the employer must pay the employees' premiums during the year and claim the credit at the end of the year on its income tax return. (Committee Report). The credit is a general business credit, and can be carried back for one year and carried forward for 20 years. (Code Sec. 38(b) , Code Sec. 39(a)) The credit is available for tax liability under the alternative minimum tax. (Code Sec. 38(c)(4)(B)(vi))

Year the credit is available. The credit is initially available for any tax year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage within the meaning of Code Sec. 9832 , which is generally health insurance coverage purchased from an insurance company licensed under State law.

For tax years beginning in years after 2013, the credit is only available to an eligible small employer that purchases health insurance coverage for its employees through a State exchange and is only available for a maximum coverage period of two consecutive tax years beginning with the first year in which the employer or any predecessor first offers one or more qualified plans to its employees through an exchange.

Calculation of credit amount. The credit is equal to the lesser of the following two amounts multiplied by an applicable tax credit percentage: (1) the amount of contributions the ESE made on behalf of the employees during the tax year for the qualifying health coverage and (2) the amount of contributions that the employer would have made during the tax year if each employee had enrolled in coverage with a small business benchmark premium. (Code Sec. 45R(b)) To calculate the contributions under the second of these two amounts, the benchmark premium is multiplied by the number of employees enrolled in coverage and then multiplied by the uniform percentage that applies for calculating the level of coverage selected by the employer. (Committee Report)

The applicable percentage is 35% for tax years beginning in after 2009 and before 2014. It is 50% for tax years beginning after 2013. (Code Sec. 45R(b))

The credit is reduced for employers with more than 10 FTEs but not more than 25 FTEs. It is also reduced for an employer for whom the average wages per employee is between $25,000 and $50,000. (Code Sec. 45R(c))

Tax-exempt 501(c) organizations are allowed the credit in a lesser amount against certain payroll taxes. (Code Sec. 45R(f))

Special rules. The credit reduces the employer's deduction under Code Sec. 162 for contributions. (Code Sec. 45R(e)(5))

Aggregation rules apply in determining the employer. (Code Sec. 45R(b))

Self-employed individuals, including partners and sole proprietors, 2% shareholders of an S Corporation, and 5% owners of the employer (within the meaning of Code Sec. 416(i)(1)(B)(i)) are not treated as employees for purposes of this credit. Any employee with respect to a self employed individual is not an employee of the employer for purposes of this credit if the employee is not performing services in the trade or business of the employer. Thus, the credit is not available for a domestic employee of a sole proprietor of a business. There is also a special rule to prevent sole proprietorships from receiving the credit for the owner and their family members. (Code Sec. 45R(e)(1) ; Committee Report)

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New IRS Audit Technique Guide pinpoints problems to avoid when making shareholder loans

IRS recently released a comprehensive **Market Segment Specialization Program** (**MSSP**) Audit Technique **Guide** on Shareholder Loans (**Training** 3147-118, 3-01). This Audit **Guide**, which can be found at IRS's website (point your browser to http://ftp.fedworld.gov/pub/irs-**mssp**/a8shloan.pdf), provides valuable information for tax professionals setting up, monitoring, or reporting the tax consequences of, shareholder loans from corporations. It pinpoints the problem areas that IRS agents are instructed to probe for, and explains how imputed interest should be calculated in a variety of term- and demand-loan situations, complete with Excel™ spreadsheet formulas.

Following is an overview of some of the key areas agents are instructed to examine when determining whether an advance is a bona fide shareholder loan.

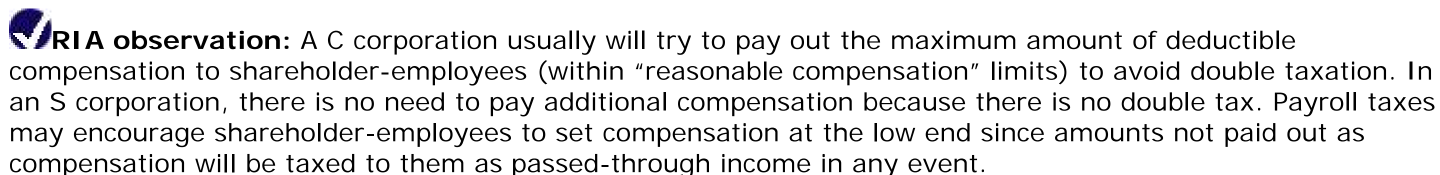
Whether amount is a bona fide loan. The test for deciding if a disbursement to a shareholder is a loan is whether, at the time it was made, the shareholder intended to repay it and the corporation intended to require repayment. However, it's not enough for the shareholder and an officer of the corporation to testify that they each had the requisite intent. This intent must be shown by objective facts. Following are the twelve factors that are most often considered in deciding whether withdrawals are loans or distributions, and the **MSSP Guide's** interpretation:

(1) *The extent to which the shareholder controls the corporation.* The probability of an arm's length transaction is far greater if the shareholder receiving the loan does not own a majority (directly or through attribution) of the corporate stock. However, the **MSSP Guide** stresses that the critical element is the extent to which the shareholder can control the corporation's affairs, regardless of whether that control derives from stock ownership, family relationship, or some other source.
(2) *Whether security was given.* The failure to provide security may be an indication that a distribution was intended. However, the **MSSP Guide** notes that in Shea, Richard v. U.S., (1982, DC AL) 51 AFTR 2d 83-658 , the court held that where a corporation's articles of incorporation provide that it has a lien on its shares of stock for any debt or liability incurred to it by a stockholder, the fact that no security is

given for the advances made to a shareholder does not preclude a finding that the advances are bona fide loans, even though the shareholders were unaware of this provision when the advances were made.
(3) *Is the shareholder in a position to repay the loan?* The shareholder's salary, other income, and net worth are relevant in determining the shareholder's ability to repay, but the **MSSP Guide** notes that in Smith, Robert, (1980) TC Memo 1980-15 , the mere fact that a shareholder had a good credit rating was not conclusive to establish that he could repay the advances.
(4) *Adequate earnings and profits.* The fact that a corporation has a deficit or no E&P, doesn't mean a distribution is a bona fide loan. It simply means that the distribution cannot be classified as a dividend, but could be a return of capital or capital gain. Agents are told to consider whether there is adequate E&P before challenging the validity of a loan.
(5) *Certificate of debt is given to the corporation.* Agents are told that the lack of a note is not a determinative factor. The **MSSP Guide** points out that there are numerous court cases where no note was issued for advances, but, based on other factors, the advances were accepted as bona fide loans.
(6) *Is there a repayment schedule or an attempt to repay?* Agents are cautioned that even if repayments are made, the fact that the amount advanced continues to increase over a sustained period of years would tend to support constructive dividend treatment.
(7) *Is there a set maturity date?* The **MSSP Guide** says that even in the absence of a fixed maturity date, a loan will be respected as such if it is repaid within a reasonable period of time. However, constructive dividend treatment may be indicated where an examination reveals that a shareholder annually reissues a term note for the previous amount owed, plus some or all of the accrued interest.
(8) *Whether the corporation charges interest.* Generally, a failure to charge interest supports a finding that there's a constructive dividend or that there are imputed dividends under the below market interest rules of Code Sec. 7872 .
(9) *Whether the corporation has made systematic efforts to obtain repayment.* A shareholder's failure to make payments, or only minimal payments, indicates a constructive dividend, particularly if the corporation is not taking steps to enforce the loan. If a closely held corporation does not apply pressure on a borrowing shareholder for repayment, the transaction may not be at arm's length.
(10) *Magnitude of the advances.* The **MSSP Guide** tells agents that large advances to a controlling shareholder where his ability to repay is essentially contingent on future events is an indication of a constructive dividend.
(11) *Whether there's a ceiling on the amount the corporation can advance.* Although seldom a key factor, the existence of a numerical ceiling on the amount that can be advanced to a shareholder would tend to support a finding that the advance is bona fide debt. The **MSSP Guide** notes that courts have also held that a corporation's having to obtain the consent of an equal controlling block of stock to make an advance imposes a de facto ceiling on the amounts that can be advanced.
(12) *Dividend history of the corporation.* Adequate earnings and profits with respect to the advances made, coupled with no history of paying dividends, favors constructive dividend treatment.

The **MSSP Guide** stresses that the above 12 factors must be viewed as a whole and that the list is not all-inclusive. Agents are told to delve into any facts that may provide insight into the parties' intent at the time of the distribution.

S corporation issues. If the entity making the advances is an S corporation and the initial determination is that a debt is bona fide using the above factors, examining agents are told that another test of the validity of the debt must be considered, namely whether the S corporation reasonably compensated the shareholder who received the advances. If it did not, agents are told to evaluate whether all or part of the advances should be reclassified as compensation, subject to employment taxes.


RIA observation: A C corporation usually will try to pay out the maximum amount of deductible compensation to shareholder-employees (within "reasonable compensation" limits) to avoid double taxation. In an S corporation, there is no need to pay additional compensation because there is no double tax. Payroll taxes may encourage shareholder-employees to set compensation at the low end since amounts not paid out as compensation will be taxed to them as passed-through income in any event.

Once the examining agent has determined that advances made by an S corporation to a shareholder are not bona fide debt, he is directed to see if the S corporation's Accumulated Adjustments Account (AAA) has a sufficient balance to absorb the advance. If the answer is "yes," there is no tax impact and the AAA is reduced by the amount of the advance. If the AAA is less than the advance in question and no prior accumulated earnings and profits exist from a prior C corporation status, the examining agent must consider whether the

shareholder who got the advance received reasonable compensation. The examining agent also is told to probe whether the advance/distribution was made with respect to the shareholder's stock.

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July 23—Senate takes another stab at passing a small business jobs bill.

The Senate leadership appears to be making a determined effort to pass a "new and improved" version of H.R. 5297, the "Small Business Jobs Act." The latest substitute amendment to the House-passed version of the bill includes, among items, a provision removing cell phones from the listed property category, and provisions dealing with, among other things, guarantee fees and nonqualified annuity contracts.

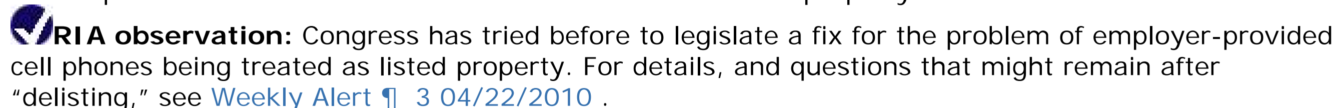
Review of recent developments. On June 15, the House passed H.R. 5297, the Small Business Jobs and Credit Act of 2010, which includes a tax title called the Small Business Jobs Tax Relief Act of 2010. Changes in this bill include: A 100% exclusion of gain under Code Sec. 1202 from the sale of certain small business stock acquired at original issue and held for more than five years; a rewrite and liberalization of the Code Sec. 6707A penalty for failure to disclose certain reportable transactions (including listed transactions); an exception to the "at-risk" rules for nonrecourse loans that are guaranteed by the Small Business Administration (SBA); liberalized dollar limits for business startup deductions under Code Sec. 195 ; and new, more restrictive rules for grantor retained annuity trusts (GRATs). See ¶ 1785 and ¶ 1786 for more details.

Before the July 4th recess, the Senate considered but did not act on a substitute amendment to the House-passed version of H.R. 5297. Late on July 21, Senate Finance Chair Max Baucus (D-MT) unveiled a "new and improved" version of his substitute amendment with the hope of garnering enough support to pass a bill.

What's in the latest version. Here's a summary of the tax breaks for business in Baucus's latest substitute amendment:

> ... A 100% exclusion of gain under Code Sec. 1202 from the sale of certain small business stock acquired at original issue and held for more than five years. The change would be effective for stock acquired after the date of enactment and held for more than five years. Additionally, the gain wouldn't be an alternative minimum tax (AMT) preference.
> ... For the first tax year of the taxpayer beginning in 2010, eligible small businesses could carry back unused general business credits for five years. Eligible small businesses would consist of sole proprietorships, partnerships and non-publicly traded corporations with $50 million or less in average annual gross receipts for the prior three years.
> ... For tax years beginning in 2010, eligible small businesses, as defined above, would be able to use all types of general business credits to offset their AMT.
> ... Where a corporation formed as a C corporation elects to become an S corporation (or where an S corporation receives property from a C corporation in a nontaxable carryover basis transfer), the S corporation is taxed at 35% on all gains that were built-in at the time of the election if the gains are recognized during the recognition period. The recognition period generally is the first ten S corporation years (or the ten-period after the transfer). For tax years beginning in 2009 and 2010, no tax is imposed on the net unrecognized built-in gain of an S corporation if the seventh tax year in the recognition period preceded the 2009 and 2010 tax years. The substitute amendment would, for any tax year beginning in 2010, shorten the holding period of assets subject to the built-in gains tax to 5 years if the fifth tax year in the recognition period precedes the tax year beginning in 2011.
> ... Under current law, the Code Sec. 179 expensing limit for tax years beginning in 2010 is $250,000, and the maximum expensing amount is reduced (i.e., phased out, but not below zero) by the amount by which the cost of Code Sec. 179 property placed in service exceeds $800,000 (the investment ceiling). For tax years beginning after 2010, these amounts are to revert to $25,000 and $200,000 respectively. The substitute amendment would for tax years beginning in 2010 and 2011 increase the maximum Code Sec. 179 expensing amount to $500,000 and the investment ceiling to $2,000,000.
> ... For property placed in service after Dec. 31, 2009, in tax years beginning after that date, qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) would be eligible for $250,000 of expensing under Code Sec. 179 . The dollar cap would apply to the aggregate cost of qualified real property.

... Bonus 50% first year depreciation would be extended to apply to property placed in service in 2010 (in 2011, for certain long production period property).
... Bonus depreciation would be decoupled from allocation of contract costs under the percentage of completion accounting method rules for assets with a depreciable life of seven years or less. According to a summary of the substitute amendment, this change would allow contractors that do not complete contracts within the same year in which they are entered into to benefit from bonus depreciation.
... For a tax year beginning in 2010, the deduction for startup expenses under Code Sec. 195 would be increased from $5,000 to $10,000 and the phase-out threshold would be increased from $50,000 to $60,000.
... For a tax year beginning after Dec. 31, 2009, but before Jan. 1, 2011, when calculating self-employment taxes, the deduction for health insurance costs of a self-employed taxpayer under Code Sec. 162(l) could be taken into account (i.e., could be deducted) in computing net earnings from self-employment.
... Cell phones would be removed from the definition of listed property under Code Sec. 280F .



RIA observation: Congress has tried before to legislate a fix for the problem of employer-provided cell phones being treated as listed property. For details, and questions that might remain after "delisting," see Weekly Alert ¶ 3 04/22/2010 .

Revenue offsets. The substitute amendment would pay for its tax breaks with the following revenue raisers:

... The Code Sec. 6707A penalty for failing to disclose a reportable transaction would be overhauled. The minimum penalty would be $10,000 for corporations and $5,000 for individuals, and the maximum penalty would be $50,000 for corporations and $10,000 for individuals (for failure to report a listed transaction, the maximum penalty would be $200,000 and $100,000 respectively). These changes would be retroactively effective to penalties assessed after Dec. 31, 2006. The substitute amendment also would require IRS to provide an annual report to the Congressional tax-writing committees giving an account of certain tax-shelter related penalties asserted during the year.
... For payments made after Dec. 31, 2010, persons receiving rental income from real property would have to file information returns to IRS and to service providers reporting payments of $600 or more during the year for rental property expenses. Exceptions would be provided for individuals renting their principal residences (including active members of the military), taxpayers whose rental income doesn't exceed an IRS-determined minimal amount, and those for whom the reporting requirement would create a hardship (under IRS regs).
... For information returns required to be filed after Dec. 31, 2010, the Code Sec. 6721 penalties for failure to timely file information returns to IRS would be increased. For example, the first-tier penalty would be increased from $15 to $30, and the calendar year maximum would be increased from $75,000 to $250,000. For small filers, the calendar year maximum would be increased from $25,000 to $75,000 for the first-tier penalty. The minimum penalty for each failure due to intentional disregard would be increased from $100 to $250. The Code Sec. 6722 penalties for failure to file information returns to payees would be similarly increased.
... For levies issued after the enactment date, the substitute amendment would (1) clarify that Treasury's continuous levy authority on government payments to Federal contractors who owe back taxes to IRS applies to amounts paid for property, as well as to payments for goods and services; and (2) allow IRS to issue levies before a collection due process (CDP) hearing on Federal tax liabilities of Federal contractors (taxpayers would have an opportunity for a CDP hearing within a reasonable time after a levy is issued).
... For tax years beginning after Dec. 31, 2010, retirement savings plans sponsored by state and local governments (i.e., governmental Code Sec. 457(b) plans) would be able to include Roth accounts.
... For distributions after the enactment date, 401(k), 403(b), and governmental 457(b) plans could permit participants to roll their pre-tax account balances into a Roth account. If the rollover is made in 2010, the participant could elect to pay the tax in 2011 and 2012.
... For fuels sold or used after Dec. 31, 2009, eligibility for the Code Sec. 40 tax credit for the production of biofuel from cellulosic feedstocks would be limited to fuels that are not highly corrosive (i.e., fuels that could be used in a car engine or in a home heating application).
... Holders of nonqualified annuities (annuity contracts held outside of a qualified retirement plan or IRA) could elect to receive part of the contract in the form of a stream of annuity contracts, leaving the remainder of the contract to accumulate income on a tax-deferred basis.
... Amounts received directly or indirectly for guarantees of indebtedness of the payor issued after the enactment date would be sourced like interest and, as a result, if paid by U.S. taxpayers to foreign persons would generally be subject to withholding tax. The change would prospectively overturn the

holding in Container Corporation, Successor to Interest of Container Holdings Corporation, Successor to Interest of Vitro International Corporation, (2010) 134 TC No. 5 , that fees paid by a U.S. subsidiary to its foreign parent for guaranteeing the subsidiary's debt were analogous to payments for a service and therefore were not U.S. source income. No inference would be intended with respect to the treatment of guarantees issued before the enactment date.

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Federal Tax Alert: Capital Contributions Can't Increase Shareholder's Basis in Loans to S Corporation

(Article No. ta-062010-0053, June 11, 2010)

Citations: Nathel, (CA 2 06/02/2010) 105 AFTR 2d ¶2010-927

Taxing Authority: Federal

Topics: Partnerships/S Corps/LLCs; Individual Income Tax

Forms Affected:

- **Form 1040, U.S. Individual Income Tax Return**
- **Form 1120S, U.S. Income Tax Return for an S Corporation**

Related Resources:

Christian & Grant: Subchapter S Taxation ¶ 19.02

The Court of Appeals for the Second Circuit, affirming the Tax Court, has rejected the contention of two S corporation shareholders that their capital contributions to the S corporation should be treated as S corporation tax-exempt income for purposes of computing the shareholders' tax basis in their loans to the S corporation.

Background. A shareholder's tax basis in his stock and loans to an S corporation is adjusted to reflect the shareholder's share of income (including tax-exempt income), losses, deductions, and credits of the S corporation, as calculated under IRC § 1366(a)(1) . Under IRC § 1367(a)(1) , a shareholder's tax basis in his S corporation stock is increased by, among other things, the shareholder's share of the S corporation's income items (including tax-exempt income).

Under IRC § 1367(a)(2) , a shareholder's tax basis in his S corporation stock is decreased (but not below zero) by, among other things, the shareholder's share of losses and deductions. If a shareholder's tax basis in his S corporation stock is reduced to zero by his share of the losses of the S corporation, any further share of the S corporation's losses decreases, but not below zero, the shareholder's tax basis in outstanding loans the shareholder has made to the S corporation. (IRC § 1367(b)(2)(A) , Reg § 1.1367-2(b)(1)) If the shareholder's basis in debt was so reduced, any net increase in basis in a subsequent tax year is first applied to restore the shareholder's basis in debt before it is applied to restore the shareholder's basis in stock. (IRC § 1367(b)(2)(B))

Facts. S corporation shareholder brothers Ira and Sheldon Nathel treated $1,437,248 in capital contributions that they had made to the S corporations as income to the entities (excludable under IRC § 118) that under IRC § 1367(b)(2)(B) restored or increased their tax basis in the loans that they had previously made to the S corporations.

IRS determined that the $1,437,248 capital contributions couldn't be treated as restoring or increasing the brother's tax basis in their loans to the S corporations. Rather, the contributions increased their basis in their S stock, resulting in additional ordinary income being charged to them on receipt of the S corporation loan payments.

The Tax Court held that for purposes of IRC § 1366(a)(1) , the $1,437,248 capital contributions to the S corporations did not constitute income to the S corporations and that under IRC § 1367(b)(2)(B) , these capital contributions did not restore or increase the brother's tax basis in their loans to the S corporations. Reg §

1.118-1 specifically provides that capital contributions do not constitute income to an S corporation. Nor, the Court found, were the capital contributions tax exempt income.

The Court reasoned that by attempting to treat their capital contributions to the S corporations as income to the S corporations, Ira and Sheldon in effect sought to undermine three cardinal and long-standing principles of the tax law: (1) that a shareholder's contributions to the capital of a corporation increase the basis of the shareholder's stock in the corporation; (2) that equity (i.e., a shareholder's contribution to the capital of a corporation) and debt (i.e., a shareholder's loan to the corporation) are distinguishable and are treated differently by both the Code and the courts; and (3) that contributions to the capital of a corporation do not constitute income to the corporation.

Appeals Court. Before the Second Circuit, the brothers argued that capital contributions constitute "items of income (including tax-exempt income)" for purposes of IRC § 1366(a)(1)(A) . The Court observed that they made this argument even though IRC § 118(a) provides that gross income does not include capital contributions. The Court said that it knew of no case that has decided whether capital contributions constitute income items under IRC § 1366(a)(1)(A) . However, cases addressing the scope of income under IRC § 61(a) and the Sixteenth Amendment indicate that capital contributions traditionally have not been considered income. Therefore, the Court said, they should not be considered "items of income" under IRC § 1366(a)(1)(A) .

The brothers argued that capital contributions should be regarded as items of tax-exempt income. According to them, there would be no reason to exclude capital contributions from gross income as IRC § 118(a) does if they were not already included in gross income under IRC § 61(a) . The Court rejected this view. The legislative history showed that Congress did not consider capital contributions to be generally includible in gross income when it created the exclusion. Accordingly, the Second Circuit affirmed the judgment of the Tax Court.

Background Information: Federal Tax Coordinator ¶ D-1761 et seq.; United States Tax Reporter ¶ 13,664 ; Tax Desk ¶ 614,701

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