1999 Income Tax School

C CORPORATIONS

A. Fringe Benefits 62

1. Exclusion from Employee Gross Income . 62
Fringe benefits are taxable, with certain exceptions as outlined in the tax code and I.R.C. §132.

2. Employee Requirement 62
The exclusion of certain fringe benefits is generally extended only to benefits provided to employees.

3. Nondiscrimination Requirement 63
In general, most fringe benefits are excludable only if they are extended to all employees.

4. Tax-Free Fringe Benefits 63

5. Fringe Benefits Excludable by C Corporation Shareholders but Not by Partners or More than 2% S Corporation Shareholders . 63
Example provided.

B. Stock Redemptions. 64

1. Introduction 64
Shareholders may be able to claim a stock redemption as a capital loss or gain.

2. Substantially Disproportionate Redemption 64
Shareholders must meet three conditions to be eligible to claim substantially disproportionate redemption.

3. Complete Termination of a Shareholder's Interest 66
Complete termination of a shareholder's interest has a greater tax benefit than substantially disproportionate redemption.

4. Redemptions in Partial Liquidation 66
In order to qualify as an exchange, a corporation must meet certain requirements.

5. Redemption to Pay Estate Tax 66
A shareholder can receive capital gain treatment if the stock was received through the estate of a deceased shareholder.

6. Applicability to S Corporations and C Corporations 67
Shareholders in both types of corporations are subject to the same rules for receiving capital gains on the redemption of shares.

C. Corporate Liquidations 67

1. Introduction 67
The liquidation of a corporation is taxable at the shareholder and corporation levels.

2. Special Considerations in Liquidating a Loss Corporation 68
Subject to certain limits, corporations and shareholders are allowed to recognize losses on complete liquidation of corporations.

D. Conversion of a C Corporation to S Corporation Status 71
C corporations may wish to convert to S status because their income may cause their effective tax rate to be 34% or greater.

1. Actions Necessary to Become Eligible for S Election 72
A corporation must meet all of the eligibility requirements for an S corporation prior to filing an election.

2. Procedures for Making the S Election . . . 74
Corporations must use Form 2553 to file an election as an S corporation, and must meet all of the eligibility requirements prior to filing the election.

3. Suspended Losses from C Corporation Years 75
In general, an S corporation cannot use any carryover originating before the S election. The term *carryover*, however, has had to be defined by the courts.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

1999 Income Tax School

C CORPORATIONS

The following discussion of C corporations is concerned with:

- Fringe benefits and their treatment to shareholder-employees
- Redemptions of stock from shareholders
- Liquidations of C corporations and S corporations, especially as the rules relate to unprofitable corporations
- Converting a C corporation to S corporation status
- Suspended losses, and what happens to them when a C corporation becomes an S corporation

A. FRINGE BENEFITS

1. EXCLUSION FROM EMPLOYEE GROSS INCOME

Except as otherwise provided in the Code, fringe benefits are taxable. The Code does identify a number of nontaxable fringe benefits, such as educational assistance, dependent care, health and accident insurance, and group term life insurance, to name a few. In addition, I.R.C. §132 is a catchall provision for those items that are not covered by some specific statutory provision. Among the items identified in §132 are rules covering *de minimis fringes,* which allow exclusion of any property or service that has a value so small as to make accounting for it unreasonable or administratively impractical.

In the case of a taxable fringe benefit, the employee must include the fair market value of the benefit less the amount, if any, paid for the benefit [Treas. Reg. §1.62-21(b)].

- The value of a benefit is normally the amount that an individual would have to pay for the benefit in an arm's-length transaction.
- The regulations under I.R.C. §62 provide special rules for determining the value of employer-provided vehicles, chauffeur services, and certain other items [Treas. Reg. §1.62-21(b)(4) and (5)].

The employer is normally allowed to deduct the cost of providing the fringe benefit as a business expense under I.R.C. §162.

2. EMPLOYEE REQUIREMENT

The exclusion extended to select fringe benefits is normally available only for benefits provided to employees. Any fringe benefit that does not qualify for the exclusion under a specific statutory provision is treated as compensation income to the recipient and must be included in wages for employment tax purposes [Treas. Reg. §1.61-21(a)(1) and (2)]. Taxable fringe benefits are reported by the employer on Form W-2. However, employer payments for accident and health insurance are specifically excluded from FICA wages [I.R.C. §3121(a)(2)(B)].

© 1999 Copyrighted by the Board of Trustees of the University of Illinois
Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

3. NONDISCRIMINATION REQUIREMENT

For the most part, the various fringe benefits are excludable only if they are offered to all employees on a nondiscriminatory basis. However, an employer may provide accident and health insurance on a purely discriminatory basis.

4. TAX-FREE FRINGE BENEFITS

The Code and Regulations allow the following fringe benefits to be granted to employees in a tax-free manner:

1. §132: Certain fringe benefits (no-additional-cost services, qualified employee discounts, working condition fringe benefits, de minimis fringe benefits, on-premise athletic facilities, employer-provided eating facilities, qualified transportation fringe benefits, qualified moving expense reimbursements)
2. §127: Educational assistance programs
3. §117(d): Qualified tuition reduction
4. §129: Dependent care assistance programs
5. §119: Employer-provided meals and lodging
6. §107: Rental value of parsonages (and rental allowances furnished to ministers)
7. §74: Employee achievement awards
8. §104, 105, and 106: Medical and disability benefits
9. §79: Group term life insurance
10. §101: Employee death benefits
11. §120: Amounts received under qualified group legal service plans
12. §112: Certain combat pay
13. §113: Mustering out pay
14. §134: Certain military benefits
15. Treas. Reg. §1.61-2: Housing and subsistence furnished to military personnel

5. FRINGE BENEFITS EXCLUDABLE BY C CORPORATION SHAREHOLDERS BUT NOT BY PARTNERS OR MORE THAN 2% S CORPORATION SHAREHOLDERS

1. Group term life insurance premiums
2. Amounts received under accident and health plans
3. Premiums on employer-paid accident and health insurance
4. Meals and lodging provided by the employer
5. Parking and transit passes

The preferred treatment of fringe benefits for C corporation shareholders may make the C corporation a better entity for the closely held business. The following example illustrates the distinction between a C corporation and an S corporation.

Example 1. Jay operates a consulting business, Jayco. Jayco's annual income, before any compensation, is $110,000. Jayco pays Jay a salary of $80,000. It also contributes $20,000 to its qualified pension and profit-sharing plans. It provides Jay with medical reimbursement, and accident and health insurance. The cost of these medical plans is $10,000 per year.

If Jayco is a C corporation, it has no taxable income. Jay's taxable income is his salary of $80,000. If Jayco makes an S election, Jay will still have his salary of $80,000, plus $10,000 of income that passes through from the corporation, from the health plan costs. He would be entitled to the deduction for self-employed health insurance, on page 1 of his Form 1040.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

In cases where the corporation is involved in farming, or operates a hotel or apartment complex, it may have a need for a resident manager. In this situation, the resident manager may be able to exclude the value of any meals and lodging provided to the employee for the convenience of the employer (I.R.C. §119). Exclusion of this fringe benefit is available to a shareholder, even a 100% owner, of a C corporation. However, a shareholder (actual or constructive) of more than 2% of an S corporation's stock may not exclude this value, even if he or she is a bona fide full-time employee. See the discussion of constructive ownership in the following section.

B. STOCK REDEMPTIONS

1. INTRODUCTION

The shareholder may be able to treat a stock redemption as a capital gain or loss. However, a stock redemption may also be treated as a dividend to the shareholder. Avoiding dividend treatment is discussed below.

A "stock redemption" is simply a purchase by the corporation of its own stock from its shareholders [I.R.C. §317(b)]. From the shareholder's view, a redemption of his or her stock is simply a sale of the corporation's own stock back to the corporation. When the shareholder desires to dispose of part or all of his or her interest in the business, the redemption may be useful as a financing technique.

There are four tests for capital gain treatment listed in I.R.C. §302. If a redemption passes any one of these tests, it is treated as an exchange. Otherwise, it will be a dividend (to the extent of the corporation's accumulated earnings and profits as of the close of the taxable year of the redemption). The four tests are:

1. Not essentially equivalent to a dividend [I.R.C. §302(b)(1)]
2. Substantially disproportionate (non–pro rata) [I.R.C. §302(b)(2)]
3. Complete termination of the shareholder's interest in the corporation [I.R.C. §302(b)(3)]
4. Redemption from noncorporate shareholder in distribution qualifying as a partial liquidation [I.R.C. §302(b)(4)]

A fifth test, found in I.R.C. §303, allows certain redemptions to be treated as exchanges when the stock has been transferred due to the death of a shareholder.

The first test, "not essentially equivalent to a dividend," is a backstop provision used only on rare occasions. The fourth provision, the partial liquidation, is also an unusual transaction. Therefore, the transactions most likely to be useful are the substantially disproportionate redemption [I.R.C. §302(b)(2)] and the complete termination of a shareholder's interest [I.R.C. §302(b)(3)].

2. SUBSTANTIALLY DISPROPORTIONATE REDEMPTION

The substantially disproportionate redemption is a strictly mechanical test. In brief, it requires that the shareholder meet **all** of the following tests:

1. Immediately after the redemption the shareholder **owns less than 50%** of the total combined voting power of all classes of stock entitled to vote. For this purpose, the percentage of stock ownership after the redemption must take into account the reduced number of shares outstanding.
2. The percentage of voting stock owned by the shareholder after the redemption is **less than 80% of the percentage of voting stock** owned by the shareholder before the redemption. For this purpose, the percentage of stock ownership after the redemption must take into account the reduced number of shares outstanding.
3. The percentage of common (voting and nonvoting) stock owned by the shareholder after the redemption is **less than 80% of the percentage of common stock** owned by the shareholder before the redemption.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Example 2. C Corporation has 1,000 shares of stock outstanding. As part of a plan, the corporation redeemed stock from several of the shareholders. The stock owned by all of the shareholders prior to the redemption and the shares redeemed are shown below. Each shareholder had a basis of $10 for each share of stock and received $100 for each share redeemed.

Shareholder	*Shares Owned*	*Shares Redeemed*
Ruth	600	380
Sharon	200	140
Debbie	200	80
	1,000	600

	Ruth	*Sharon*	*Debbie*	*Total*
Pre-redemption	600	200	200	1000
Redeemed	–380	–140	–80	–600
Post-redemption	220	60	120	400
Pre-ownership%	60%	20%	20%	
Post-ownership% (based on 400 outstanding)	55%	15%	30%	
80% test:				
80% × Pre-redemption%	48%	16%	16%	
Treatment	Dividend $38,000	Sale $12,600*	Dividend $8,000	

* $14,000 amount realized – $1,400 basis

a. Constructive Ownership of Stock

One of the problems in dealing with the substantially disproportionate redemption is that it uses the constructive ownership rules of I.R.C. §318. Thus, an individual is treated as owning stock that certain family members own, as well as stock owned by other businesses, trusts, or estates in which the individual has an interest. An individual also is treated as the owner of any stock on which he or she holds an option to buy.

Four basic types of constructive ownership are found in I.R.C. §318:

1. Family
2. Entity to an owner (e.g., from a partnership, corporation, estate, or trust to the partner, shareholder, or beneficiary)
3. Owner to an entity (e.g., from a shareholder, partner, or beneficiary to a corporation, partnership, trust, or estate)
4. Option

The family attribution rules are rather narrow. An individual's family includes only the following:

- Spouse
- Children
- Grandchildren
- Parents

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

No reattribution is allowed. Stock deemed owned by virtue of the family rule cannot be reattributed to another family member, since to do so would extend the definition of family [I.R.C. §318(a)(5)(B)].

Example 3. A father, his son, and his son's wife own all of the shares of a redeeming corporation equally. The father is deemed to own only the shares of his son. The shares of his son's wife are not attributed to the son and then reattributed to the father. Similarly, there is no attribution of a grandparent's stock to a grandchild.

3. COMPLETE TERMINATION OF A SHAREHOLDER'S INTEREST

The complete termination of a shareholder's interest has a significant advantage over the substantially disproportionate redemption. In testing for an individual's ownership after the redemption, there is **no constructive** ownership from **family** members.

Thus, an individual can retire from a family corporation and allow his or her children to retain ownership. However, this waiver of constructive ownership **does not apply** to any stock held through estates, trusts, other business entities, or options.

The individual must completely retire and resign from any directorship, as well as from **any** active employment. There are also some 10-year tests.

- He or she may not reacquire any interest for 10 years, unless the reacquisition is due to the death of another shareholder. The individual must agree to hold the statute of limitations open for the redemption year, and agree to notify the IRS of any reacquisition of stock.
- If the shareholder has received or given away any stock within the last 10 years, he or she may wish to request a ruling from the IRS that the transfer was not tax motivated. Often, the IRS rules that a gift of stock to family members within the last 10 years is not tax motivated, if the family member who receives the gift continues an active association with the corporation.
- Finally, the individual must not have acquired the stock as a gift from any person who continues to be a shareholder within the past 10 years. Thus, parents cannot give their stock to their children, then have the corporation reacquire the children's stock, and treat the transaction as a capital gain to the children.

4. REDEMPTIONS IN PARTIAL LIQUIDATION

A partial liquidation focuses on activity at the corporate level, as opposed to the shareholder level. General requirements for a partial liquidation to qualify as an exchange are:

1. A distribution is treated as a partial liquidation and therefore qualifies for sale treatment if it is to a noncorporate shareholder and is not essentially equivalent to a dividend [I.R.C. §302(b)(4)].
2. Only distributions to noncorporate shareholders can qualify for partial liquidation treatment. For this purpose, an S corporation is considered a noncorporate shareholder [I.R.C. §302(e)(5)].
3. A partial liquidation must be attributable to a genuine contraction of the corporation's business. To qualify under this criterion, the distribution must either:
   a. Be attributable to the corporation's ceasing to conduct a qualified business, or
   b. Consist of the assets of a qualified business.

Immediately after the exchange the corporation must still be actively engaged in a qualified business. Activities in which the corporation is engaged must constitute an active business and not an investment.

5. REDEMPTION TO PAY ESTATE TAX

Another provision that allows a shareholder to receive capital gain treatment on a redemption is found in I.R.C. §303. This provision applies only to stock that has been received through a deceased shareholder's estate. The estate or other holder can have enough stock redeemed to pay the federal and state

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

estate taxes attributable to the decedent's stock in the business. In this situation the redemption need not pass any of the other redemption tests listed above.

6. APPLICABILITY TO S CORPORATIONS AND TO C CORPORATIONS

Shareholders in C corporations and S corporations are subject to the same rules for receiving capital gain treatment on the redemption of their shares.

C. CORPORATE LIQUIDATIONS

1. INTRODUCTION

In general, the liquidation of a corporation is a completely taxable event, at both the corporation and shareholder levels. Thus it is akin to riding a tiger, in that it may be very inexpensive to get property into the corporation, but prohibitively expensive to get it back out. Often, an alternative is for the corporation to become an S corporation. These problems are discussed later in the chapter.

The liquidating corporation recognizes all gains and losses on distribution of property in liquidation (I.R.C. §336). In general, the property distributed to the shareholders is treated by the corporation as if it were sold to the shareholders at fair market value on the date of liquidation. There are some special rules to be observed, however.

In general, the related-party loss disallowance rules of I.R.C. §267 do not apply. Thus, a corporation can distribute depreciated property to a person who owns more than 50% of the corporation's stock, and in many cases the corporation is still allowed to deduct the loss. However, losses are disallowed if property is distributed to the controlling shareholder or a related party, and:

1. The property was received as a contribution to capital or received in an I.R.C. §351 exchange within the last five years, **or**
2. The distribution of loss property is not pro rata [I.R.C. §336(d)(1)]. (Note that **either** of these conditions causes the corporation to be unable to deduct the loss.)

The special gain recharacterization rule of I.R.C. §1239 applies to property distributed to an actual or constructive majority shareholder. Under this rule, any gain recognized by the corporation is ordinary income if the property is depreciable by the receiving party. Thus, the corporation could not use gain on a building to offset capital losses.

Losses may be limited on recently acquired property if it is not related to the corporation's business [I.R.C. §336(d)(2)]. This disallowance rule applies to any property contributed to the corporation within the past two years prior to the liquidation if:

1. The corporation's basis exceeded the fair market value of the property at the time of contribution, **and**
2. The property is unrelated to the corporation's trade or business activities. (Note that both criteria must apply. Also this may be a partial, rather than a complete, disallowance of the loss.)

The shareholders report all gains and losses on the disposition of their shares in a complete liquidation (I.R.C. §331). [Different rules govern the treatment of a parent corporation and a subsidiary corporation (I.R.C. §§332, 337).]

The basis of the property received in the liquidation is its fair market value at the date of the distribution [I.R.C. §334(a)].

The same general rules apply to both C and S corporations, although the incidence of tax may be quite different, due to the double tax on C corporation distributions and the single tax on S corporation distributions. The S corporation recognizes all gains and losses on the distribution of property in a complete liquidation. The gains and losses, however, pass through to the shareholders, and adjust their stock basis at the moment of liquidation. See the 1996 *Income Tax Workbook* for demonstrations of the differing tax treatments of C and S corporations and their shareholders.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

The discussion turns next to some different applications of the liquidation rules. First, the special problems faced by a loss corporation are discussed and demonstrated. The next part concerns special rules dealing with installment receivables and corporate liquidations.

2. SPECIAL CONSIDERATIONS IN LIQUIDATING A LOSS CORPORATION

a. Corporate Rules: C Corporations

In general, both the corporation and the shareholders are allowed to recognize losses on complete liquidations of corporations, subject to the limits discussed above. The ability to recognize a loss, however, does not necessarily provide a tax benefit. For instance, if the corporation is a C corporation, it must be able to carry a net loss back to one of its last two taxable years, or it will receive no tax benefit.

Example 4. Downco has assets with aggregate adjusted basis of $2,500,000 and fair market value of $2,000,000. If it liquidates, it will be allowed to recognize the loss, provided it does not fall subject to one of the loss disallowance rules of I.R.C. §336(d). Downco may still face some problems in getting any tax refund for its recognized losses. For example,

1. If the loss is capital, it could not offset ordinary income in any year. It could be carried back three years against any capital gains of the corporation. There would be no carryforward, since the corporation is being liquidated.
2. If the loss is ordinary, there must be income in the year of liquidation or one of the two preceding taxable years in order for Downco to claim a refund based on a carryback.

b. Shareholder Rules: C Corporations

In a corporate liquidation, a shareholder treats the receipt of corporate property as a sale of his or her stock (I.R.C. §331). Shareholders also have some important considerations for liquidating a loss corporation. In general, the loss will be capital, subject to all of the usual capital loss limitations, such as the $3,000 maximum deduction against ordinary income.

In general, a person who actually or constructively owns more than 50% of a corporation's stock is not allowed to recognize any loss on a sale of property to the corporation. However, this rule does not apply to stock transferred by a shareholder in complete liquidation of the corporation [I.R.C. §267(a)(1)]. Therefore, a shareholder who receives property in a complete liquidation recognizes a capital loss if his or her stock basis is more than the fair market value of the property received from the corporation.

However, if the stock is I.R.C. §1244 stock and the shareholder realizes a loss on the liquidation, the loss is an ordinary loss subject to the limitations of §1244. Section 1244 characterizes certain **losses** as **ordinary**, whether they are incurred on an actual sale of stock or when the stock becomes worthless. Section 1244 has no effect on any **gains** on the disposition of stock. The principal benefit of §1244 is that it allows an investor to claim a loss deduction in excess of that normally allowed for capital losses. The benefit of this characterization, however, has its own limits. An investor is limited to a $50,000 ordinary loss deduction from §1244 stock in any taxable year, but the limit is doubled to $100,000 if the shareholder files a joint return.

The $100,000 limit for joint filers is not dependent upon the actual losses sustained by each of the spouses. If one of the spouses disposes of §1244 stock, and the stock is separate property, that person may claim the entire $100,000 limit on a joint return.

The ordinary loss deduction of §1244 is allowable only to **individual** shareholders. The term individual does not include any estate or trust, regardless of how the entity acquired the stock. [Treas. Reg. §1.1244(a)-1(b)(2).] Therefore, an estate of a deceased or bankrupt shareholder could not claim ordinary loss on the disposition of stock under §1244.

The only person entitled to claim an ordinary loss deduction under §1244 is the original holder of the stock [Treas. Reg. §1.1244-(a)(1)(b)(2)]. (Also see *Harwell*, TC Memo 1974-153.) Therefore, it would appear that any transfer, even a gift between husband and wife, would cause the stock to lose its §1244

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

character. (See *Priznant*, TC Memo 1971-176, where a partnership that held §1244 stock had transferred its shares to a partner before the stock was disposed. The partner could not claim §1244 loss treatment.)

Section 1244 stock has three essential requirements, as articulated in I.R.C. §1244(c):

1. The issuing corporation must have been a small business corporation at the time the stock was issued.
2. The stock must have been issued directly to a holder in exchange for property.
3. The corporation's gross receipts from certain passive sources must not have exceeded 50% of its total receipts for a five-year period ending with the corporation's taxable year immediately preceding the shareholder's loss.

At the time the stock is issued, the corporation must have received no more than $1,000,000 of property in exchange for stock, or as a contribution to capital [§1244(c)(3)(A)]. The test is made with respect to the adjusted basis of the property to the corporation. Accordingly, if property was received in a §351 exchange, the corporation would use the shareholder's basis, plus any gain recognized by the shareholder.

c. Payment of Corporate Liabilities

In most cases, debts of a closely held corporation are guaranteed by the shareholders. If there are insufficient assets in the corporation to pay the debts, the shareholders must pay these obligations with personal funds. When the corporation to be liquidated is a C corporation, the shareholder will generally treat the payment of corporate liabilities as a capital loss, either directly or indirectly, depending on the manner in which the debt is paid.

If the shareholder pays a debt on behalf of the corporation by contributing money to the corporation's capital immediately before the liquidation, the contribution would add to the shareholder's adjusted basis in his or her stock at the time of liquidation. Such contribution to capital does not increase basis for §1244 ordinary loss purposes.

A shareholder might attempt to treat a contribution to a dying corporation as a loan, in order to gain a business bad-debt deduction. This technique is not always successful. For example, in *Sutherland,* several shareholders had loaned money to an ailing S corporation. [The shareholder-creditors had claimed a bad-debt deduction when the corporation failed. The Tax Court held that the purported debts were really contributions to capital, rather than valid debts. Therefore, the shareholders were limited to a capital loss on the worthlessness of stock, rather than an ordinary deduction for a bad debt. (*Sutherland,* 58 TCM 1117, TC Memo 1991-619)]. See *Plante v. Comm.*, 83 AFTR 2d 99-993 (11th Cir.), for a similar result.

In some cases, the amount realized may not be finally determined until some years after the liquidation occurs. For example, the corporation may have had a contingent liability that the shareholder was obligated to pay at some later date. If the shareholder pays that contingent liability in a year *after* the liquidation, the amount of such payment is a capital loss since it relates back to the original transaction [*F. D. Arrowsmith*, 52-2 USTC 9527 (S.Ct.)].

d. Liquidating a Distressed S Corporation

There is possibly no transaction in which the distinction between the C corporation and the S corporation is more important than a liquidation. One of the principal differences arises when the S corporation has sustained heavy tax losses. These will generally be ordinary deductions to the shareholder, who can claim them against his or her other taxable income. Under the *Arrowsmith* rule, a shareholder who pays off debts of a corporation after the corporation has liquidated will be allowed a capital loss deduction. In some cases, this rule may work extreme hardships.

Example 5. Brenda is the sole owner of Songco. She has personally guaranteed a $750,000 note from Songco to First Bank. After selling all of its assets, Songco has only $150,000 to pay the bank loan. The sum total of Songco's income and loss is a net ordinary loss of $600,000.

Brenda has worked out a schedule whereby she will pay the remaining $600,000. Brenda plans to liquidate Songco. If Brenda liquidates Songco and pays the bank, she will be allowed a $600,000 capi-

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

tal loss deduction under the *Arrowsmith* rule. The loss will be deductible to the extent of Brenda's capital gains plus $3,000 per year, with any nondeductible loss carried forward.

In this situation, there is very little that can be done to help a shareholder in a C corporation. There is no possibility of claiming an ordinary loss of this magnitude under I.R.C. §1244. It would be unlikely that any loss would be allowed under I.R.C. §1244 if the shareholder had purchased stock when the failure of the corporation was a foregone conclusion. Similarly, a shareholder would have little success claiming a business bad-debt deduction for a loan to a corporation that is no longer likely to be a going concern. An S election, however, could provide enormous tax savings.

Example 6. Refer to Example 5. If Songco is an S corporation, and had been an S corporation when it incurred the $600,000 ordinary loss, Brenda may be able to claim an ordinary loss deduction, although the situation requires careful planning. In this situation, Songco had probably suffered substantial ordinary losses, and Brenda's basis has already been reduced to zero, with $600,000 suspended losses in excess of her basis. If Brenda liquidates Songco, she will have no opportunity to use her suspended losses in a future year, since the corporation will no longer exist. She would be well advised to pursue one of the following courses of action.

1. Keep Songco's existence intact **until she has paid the bank loan**. Each payment will be treated as a contribution to capital and will give her additional stock basis. The added stock basis will enable her to deduct suspended losses (Rev. Rul. 70-50, 1970-1 CB 178; Rev. Rul. 71-288, 1971-2 CB 319).
2. Brenda could arrange with the bank to substitute her personal note for the corporation's note, **before she liquidates Songco.** She should obtain competent legal advice on whether this action will cause subrogation under state law. If subrogation occurs, she will be allowed full basis (Rev. Rul. 75-144, 1975-1 CB 277). If subrogation does not occur, she may nevertheless be able to claim basis at the time she substitutes the note [*Gilday, Donald S.*, 43 TCM 1295 (1982)]. This immediate increase to basis will allow her to deduct all previously suspended losses, to the extent she now has basis. She may then liquidate Songco.

Either of these options will allow Brenda to claim the $600,000 ordinary loss suspended from prior years on her personal return for the year of liquidation.

e. Liquidating Distributions of Installment Receivables

A corporation may sell all, or substantially all, of its operating assets prior to liquidation. If the purchaser's consideration is all or primarily cash, there is little tax planning to be done. If, however, there have been substantial gains on the sale of the corporation's property, and a substantial portion of the consideration received is in the form of installment notes, there are significant tax planning opportunities.

f. Shareholder Considerations on Receipt of Installment Obligation

In general, a shareholder must take into account the fair market value of all property received in any distribution from any corporation [I.R.C. §§301(b), 334(a)]. There is, however, a special rule for receipt of an installment obligation from a corporation when the corporation is completely liquidated. If the installment receivable was generated in a liquidating sale of assets by the corporation, the shareholder treats the receivable as if it were received for an installment sale of stock [I.R.C. §453(h)(1)]. The shareholder must allocate his or her stock basis between the installment receivable and any other property received from the corporation in proportion to the relative fair market values.

Example 7. At the time of liquidation in 1999, Carco, Inc. had two remaining assets–cash of $60,000 and a note receivable of $120,000 arising from the sale of land. The note was payable in six installments of $20,000 beginning on January 31, 2000. The land, which had a basis of $40,000, was sold shortly after the plan of liquidation had been adopted. On October 31, 1999, the corporation distrib-

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

uted the cash and note to its sole shareholder, Anne, in complete liquidation. Anne had a basis in her stock of $18,000.

Anne realizes a gain of $162,000 ($60,000 + $120,000 – $18,000). However, Anne is allowed to report the gain allocable to receipt of the note as the note is collected. To determine the gain allocable to receipt of the note, the shareholder's basis is allocated between the note and other amounts received based on relative fair market values.

Allocated to cash:

$$\frac{\text{Cash}}{\text{Total receipts}} \quad \frac{\$60{,}000}{\$180{,}000} \times 18{,}000 = \$6{,}000 \text{ basis}$$

Allocated to note:

$$\frac{\text{Note}}{\text{Total receipts}} \quad \frac{\$120{,}000}{\$180{,}000} \times 18{,}000 = \$12{,}000 \text{ basis}$$

Cash received in 1999	$60,000
Basis of cash	(6,000)
Gain recognized in 1999	$54,000

The balance of the gain, $108,000 ($162,000 – $54,000), is reported as the note is collected. The new basis in the note is $12,000, resulting in a new gross profit ratio of 90% ($120,000 – $12,000 = $108,000/$120,000). Therefore, Anne's gain recognized in 2000 and each of the next five years is $18,000 ($20,000 × 90%).

To qualify for the deferral, the corporation must have adopted a plan to liquidate before making the sale that generated the receivable. In addition, the installment receivable must have been generated by a sale of the liquidating corporation's assets within the 12-month period ending on the date of the liquidating distribution.

Example 8. In 1997 Donco, Inc. sold some land on the installment method. The sale price was $400,000, and Donco's basis in the land was $150,000. In 1998 Donco received an offer for all of its remaining assets, for which it had a basis of $700,000. Upon receipt of the offer, Donco adopted a plan to liquidate. It sold all of its remaining property to the purchaser and received an installment obligation for $2,400,000. After the sale of its remaining properties, Donco's only two assets were the two installment receivables, which it then distributed to its shareholders. The shareholders must take the installment receivable from the early sale into account at its fair market value, since it arose from a sale that was completed before Donco adopted its plan to liquidate. The shareholders would take the other receivable, from the liquidating sale, into account as an installment sale for their stock, in the same manner as in Example 7.

D. CONVERSION OF A C CORPORATION TO S CORPORATION STATUS

A C corporation may wish to convert to S status. Many corporations have income that causes their effective rate of tax to be 34% or more. Corporations may be so profitable that it is difficult to zero out their taxable incomes. Bonuses to shareholder-employees may face disallowance as excessive compensation. A corporation may be facing tax on unreasonable accumulation of earnings. The choices may now be limited to double taxation for the foreseeable future, a complete liquidation of the corporation, or an S election.

Some C corporations may find that they would be better off as limited-liability companies. Unfortunately, there is no easy way to "convert" a corporation to a limited-liability company. To become a

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

limited-liability company the corporation would need to liquidate and distribute its assets to its shareholders, who would contribute this property to the limited-liability company. Alternatively, the corporation could contribute its assets to the limited-liability company and distribute the limited-liability company interest to its shareholders. In either case, there would be a fully taxable liquidation, to both the corporation and the shareholders.

In many cases, the S election is the most desirable alternative. This section covers the problems encountered in converting a C corporation to S corporation status.

1. ACTIONS NECESSARY TO BECOME ELIGIBLE FOR S ELECTION

Before filing the S election, the corporation must meet all of the eligibility requirements for an S corporation. To qualify, an existing corporation may need to take corrective action for situations already in existence. The steps needed could include the following.

a. Eliminate Ineligible Shareholders

S corporations are limited to a maximum of 75 shareholders [I.R.C. §1361(b)(1)(A)]. Counting shareholders is generally straightforward, but there are a few special rules. Husband and wife are counted as one owner [I.R.C. §1361(c)(1)]. Note that this special treatment of husband and wife as one shareholder is limited to the 75-shareholder count. It does not extend to the consent to the S election. If any shares are jointly owned by persons other than husband and wife, each person is counted as a separate owner.

Ineligible shareholders must be eliminated before the election is filed. The only eligible holders are:

1. Individuals (U.S. citizens or residents)
2. Estates (of decedents or bankrupt individuals)
3. Specified types of trusts
   - Voting
   - Testamentary
   - Grantor, or beneficiary-controlled
   - Qualified Subchapter S Trust (QSST)
   - Electing Small Business Trust (ESBT)
4. Charities and pension trusts, in S corporation years beginning after 1997. Pension trusts include Employee Stock Ownership Plans (ESOPs) but do not include IRAs.

Practitioner Note. All income flowing through from the S corporation is taxable to charities and pension trusts as unrelated business taxable income (UBTI)[I.R.C. §512(e)]. However, this rule does not apply to ESOPs.

- This treatment extends to nonbusiness income such as interest or dividends.

A trust may or may not be an eligible shareholder of an S corporation.

- A grantor trust is eligible. Two types of trusts that might fall into this category are the revocable living trust and the *Crummey* trust.
- Any trust other than a grantor trust should have its provisions reviewed by competent tax counsel. If the trust can qualify to be a QSST or ESBT, it should file the proper election with Form 2553, or within 2 months and 15 days after the corporation files Form 2553 to elect S status. There are some relief rules for late elections.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Some of the options to eliminate ineligible persons are:

1. Purchase of shares by an eligible shareholder
2. Redemption of the shares by the corporation

b. Create a Single Class of Stock

An S corporation must have a **single class of stock** [I.R.C. §1361(b)(1)(D)]. The Code does not define "class of stock" within Subchapter S or Subchapter C. The Code specifically allows differences in voting rights [I.R.C. §1362(c)(4)]. The Code also provides that corporate obligations cannot create a second class of stock, even if they are reclassified as shareholders' equity, if they meet the "straight debt safe harbor."

Under the regulations, a corporation has a second class of stock if the corporation's charter, state law, articles of incorporation, bylaws, or other binding agreements among shareholders confer varying rights to distributions or liquidation proceeds to any shares [Treas. Reg. §1.1361-1(l)(2)(i)]. Differences in the timing of distributions may not create a second class of stock, although the IRS may apply I.R.C. §7872 or other recharacterization provisions [Treas. Reg. §1.1361-1(l)(2)(i)]. Distributions made within a reasonable time following the end of a taxable year may be made in accordance with the shareholders' varying interests during that year, even though they vary significantly from the proportionate shareholdings at the time the distributions are actually made [Treas. Reg. §1.1361-1(l)(2)(iv)].

> Buy-sell and redemption agreements do not create a second class of stock unless the agreement is an attempt to circumvent the class-of-stock rule and the purchase price differs significantly from the stock's fair market value [Reg. §1.1361-1(l)(2)(iii)]. (See also Ltr. Ruls. 8506114, 8927027, 8908069, 8937034, 9011055).] These provisions are often used in connection with transfer restrictions that keep S corporation shares from falling into the hands of ineligible persons. Transfer restrictions should be in the bylaws or other agreements of every S corporation, to avert the possibility of disqualification.

A corporation with multiple classes of stock must take action to meet the single-class-of-stock requirement.

1. It may redeem preferred stock. **Caution:** Treatment of redemption proceeds as a dividend is likely. See the previous discussion of redemptions.
2. If shareholders hold preferred stock in proportion to common stock, they may contribute the preferred stock back to the corporation.
3. The corporation may recapitalize under the tax-free reorganization provision of I.R.C. §368(a)(1)(E). Holders of preferred stock may exchange it for common stock. If the reorganization is properly executed, the entire transaction is tax-free.

c. Member of Affiliated Group

If a corporation owns a subsidiary corporation, it must evaluate the desired tax treatment of the corporation.

If the parent S corporation owns all of the stock of a subsidiary corporation, the subsidiary may be combined with the parent as a "Qualified Subchapter S Subsidiary" (QSub), which is treated as a completely transparent division. To gain this treatment, the parent S corporation must file an election to treat the subsidiary as if it had liquidated. The election must be filed within 2 months and 15 days after the date the parent's S election is to take effect, or the subsidiary corporation will be treated as a C corporation for the portion of the year before the QSub election was effective [Notice 97-4 1997-2 IRB].

If the parent corporation owns less than 100% of the stock of the subsidiary, the subsidiary cannot be a QSub. Therefore, the parent must acquire all of the stock, or merge or liquidate the subsidiary corporation. Alternatively, the subsidiary could remain in existence as a C corporation.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

d. Other Steps

A corporation should undertake other steps when the effective date of the election nears.

If the corporation maintains qualified pension and profit-sharing plans, the plans should be reviewed immediately for loans to shareholder-employees. Any loan to a shareholder who owns more than 5% of the stock in the corporation is a prohibited transaction [I.R.C. §4975]. When a plan engages in a prohibited transaction, a 15% excise tax is imposed on the disqualified person.

The tax is imposed as a percentage of the fair market value of the amount involved in the prohibited transaction. In the case of a loan, the "amount involved" is the fair market value of the use of the money, which would constitute a reasonable rate of interest [Treas. Reg. §53.4941(e)(1)(1)(b)(4), Example 4]. If a loan to a shareholder is outstanding at the time the election takes effect, the loan is immediately treated as a prohibited transaction [Dept. of Labor Opinion No. 84-44A (11/9/84)].

Failure to take corrective action can result in disqualification of the plans, although the IRS has indicated that plan loans to shareholder-employees may be granted exemption from prohibited transaction status. Such exemption is granted on a case-by-case basis and typically requires the borrower to pledge property as security (Ann. 92-182, 1992-52 IRB 45).

If the corporation uses the LIFO method of accounting for inventory, it will recapture its LIFO reserve. This will result in an immediate tax liability.

In addition, the corporation should conduct a study of its current and accumulated earnings and profits. Earnings and profits could result in taxable dividends to shareholders, instead of the anticipated tax-free distributions. If the corporation anticipates significant passive investment income, the presence of accumulated earnings and profits can create serious problems, such as:

1. A corporate-level tax that may exceed the tax the corporation would have paid if it remained a C corporation
2. Termination of the S election, resulting from a combination of accumulated earnings and profits and excessive passive investment income

The corporation should also determine the amount and nature of any appreciation or depreciation of its assets while it was a C corporation. The appreciation may result in a corporate-level tax on built-in gains. This tax is not likely to be a prohibitive cost of the S election, but it may be reduced through various planning strategies.

2. PROCEDURES FOR MAKING THE S ELECTION

The corporation must file an election to be an S corporation, using Form 2553. The election is not a complicated matter, but the corporation should follow the procedures meticulously. The corporation must meet all of the eligibility requirements before it can file a valid election. The rules are statutory, and the IRS has only limited flexibility in enforcement. The Service has generally refused to honor the argument that the substance of the election dominates the form. In this case, the form and the substance have equal importance. The IRS has occasionally been merciful, and allowed an election despite some minor defect.

a. Dates for Filing the Election

The corporation may file during the taxable year immediately prior to the year in which the election takes effect; or the corporation may file within two months and 15 days of the beginning of the taxable year [I.R.C. §1362(b)(1)(B)].

b. Relief for Late and Defective Elections

Prior to the Small Business Job Protection Act of 1996, the statute permitted no flexibility on the deadlines or accuracy of Form 2553. However, the 1996 act made two significant liberalizations in this regard. The IRS may waive the deadline for any late election if there was **reasonable cause** for the late election [I.R.C. §1362(b)(5)].

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

There have been significant developments in these areas since the middle of 1996. They receive substantial discussion in the "S Corporations" chapter.

3. SUSPENDED LOSSES FROM C CORPORATION YEARS

An S corporation cannot utilize any carryover generated before the S election was in effect [I.R.C. §1371(b)(1)]. The legislative history of Subchapter S is silent on the inclusiveness of the terms "carryforward" and "carryback." Since the legislative history of this provision is minimal, it may be difficult to interpret the term "carryover," which is used only in a few specific instances. Over the years, the IRS and the courts have given it a rather broad definition, and have held it to include such items as disallowed passive activity losses [*St. Charles Investment Co.*, 110 TC No. 6 (1998)]. The courts have taken a dim view of any creative methods of using prior C corporation carryforwards, for example, to add to basis of property sold after the S election takes effect [*Rosenberg*, 96 TC 451 (1991)].

Based on the foregoing analysis, it is reasonable to conclude that all of the following become unusable when a C corporation becomes an S corporation:

- The corporation's net operating loss carryforward (except that it may be used to offset taxable built-in gains)
- The corporation's capital loss carryforward (except that it may be used to offset taxable built-in gains)
- The corporation's unused §179 deduction, if it exceeded the corporation's taxable income (apparently, this amount may **not** be used to offset taxable built-in gains)
- The corporation's charitable contribution carryforward (apparently, this amount may **not** be used to offset taxable built-in gains)
- The corporation's losses suspended under the at-risk rules of I.R.C. §465; this applies only to certain closely held corporations (apparently, this amount may **not** be used to offset taxable built-in gains)
- The corporation's suspended passive activity losses under I.R.C. §469, if the corporation is either a closely held corporation or a personal service corporation (apparently, this amount may **not** be used to offset taxable built-in gains)

However, there are some things that a corporation can deduct after it converts to S status. These include amounts accrued to shareholders but disallowed under I.R.C. §267(a)(2), which delays deductions until the shareholder reports it in income. Also deductible are nonqualified deferred compensation plans, which are deductible by the employer when he or she reports the amount as income.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

1999 Workbook

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.