Chapter 10: S Corporation

Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

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As this edition goes to press, the S corporation remains the most popular business entity for tax purposes. It dominates both the C corporation and partnership entites, and is expected to continue in its number one position for the foreseeable future.[1] Thus, the claims that the limited liability company treated as a partnership will become the dominant entity have shown no signs of materializing, and the S corporation remains an important business form for the closely-held business.

Although the S corporation has many features in common with the partnership, it has others that are derived from C corporation taxation. Moreover, it has a few characteristics that neither of these other entities possess.

Among the more important unique attributes of S corporations are the restrictive ownership rules, which generally limit eligible shareholders to individuals, estates, and trusts. Also, there are specific election requirements for the S corporation which are not relevant to the C corporation or partnership. In this year's chapter, the discussion centers on compensation, distributions, other dealings between the S corporation and its shareholders, and a brief introduction to special taxes on passive investment income that are unique to S corporations.

1. IRS, *Statistics of Income Bulletin — 2004*, Corporation Income Tax Returns, p. 10, IRS Statistics of Income Bulletin, summer 2006 (Rev. 09-2006)

COMPENSATION AND FRINGE BENEFIT ISSUES

Although an S corporation and partnership have many similarities, the employment status of owners is a significant difference. Shareholders are employees to the extent that they are compensated for services. Officers, which include most S corporation shareholders, are also employees unless they perform no services for the corporation. Salary is income when received by the shareholder-employee, assuming that the recipient uses the cash method of accounting.[2] Contrast this with the treatment of the allocation of income to shareholders, which occurs at the end of the corporation's taxable year and is determined by the corporation's method of accounting. If services are performed, the shareholder must be paid a reasonable wage (salaries are subject to FICA and FUTA for withholding and employer payroll taxes).[3]

There is no self-employment income passing through from S corporations to shareholders for purposes of Keogh plans; nor is there self-employment tax. IRC §1402 does not include a person's share of income from an S corporation as self-employment income. The IRS recognized the fundamental difference between the two entities in Rev. Rul. 59-221, which analyzed the self-employment tax statute and concluded that a shareholder of an S corporation does not personally carry on the corporation's trade or business activities.[4]

CONSTRUCTIVE DISTRIBUTIONS

The IRS has long held the power to treat bargains to shareholders as constructive distributions. In the C corporation context, unreasonable compensation is the most prominent target. There have been other attacks, including free use of the company car and payment of personal expenses such as travel and entertainment. In some cases, S corporations have been denied deductions for payment of shareholders' personal expenses such as home improvements and entertainment expenses that had no connection to the business.[5] Thus, the purported expenses were actually treated as constructive distributions to the shareholders.

In some cases, shareholders have turned the constructive distribution rules to their advantage. *Lohrke v. Comm'r* illustrates the principle that a shareholder and a corporation may have such interwoven business relationships that a payment by one on behalf of the other may be deductible.[6] Mr. Lohrke was president of a corporation and personally held a patent on one of the corporation's products. When the corporation sold some defective goods, the shareholder paid some expenses to rectify the situation and deducted them on his personal tax return. The IRS adjusted the payments made by Mr. Lohrke and treated them as contributions to the capital of the corporation whose actions had necessitated the expenditures. However, the Tax Court found that Mr. Lohrke's licensing activity constituted a trade or business which was so closely related to that of his corporation that the payment of these expenses benefited the businesses of both the corporation and the shareholder. The court allowed Mr. Lohrke the deduction. This case has been cited frequently and some decisions refer to "the *Lohrke* rule."

Constructive distributions to shareholders create a potential disproportionate distribution. Inadvertently, a disproportionate distribution could terminate the S corporation election.

> **Caution.** The *Lohrke* rule may provide some valuable hindsight protection from a complete disallowance of deductions. However, it is always best to have the form of the transaction reflect the desired tax treatment. Some of the cases that cite the *Lohrke* decision probably could have been resolved without the cost of litigation if the parties had merely written checks, drawn up notes, and made the proper entries in the accounting records.

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2. IRC §451
3. IRC §3121
4. Rev. Rul. 59-221, 1959-1 C. B. 225
5. *Handke v. Comm'r,* TC Memo 1990-273, May 31, 1990; *Deihl v. Comm'r,* TC Memo 2005-287, December 15, 2005
6. *Lohrke v. Comm'r,* 48 TC 679 (1967), Acq., 1968-2 C.B. 2

REASONABLE COMPENSATION

The code allows deductions for compensation but only to the extent the deduction amount is considered reasonable.[7] When the employer is a C corporation, the IRS's disallowance of excess compensation usually occurs when the recipient is a shareholder and the compensation in excess of the deductible amount is usually treated as a dividend. The reasonableness of compensation is inherently subjective and it varies by case. There is frequent litigation on this problem in the C corporation context but considerably less so in the S corporation arena.

Since the shareholders include all income from the S corporation on their personal tax returns, regardless of the level of compensation, an S election reduces the risk that the IRS will disallow excessive compensation to a shareholder-employee.

However, an S election may not completely eliminate the risk of disallowance of compensation or completely neutralize its effect. There are several instances when it would be beneficial to use compensation to drive the corporation's taxable income to zero (for example, when the S corporation is subject to the built-in gains tax or the passive investment income tax). In such cases, the IRS could disallow compensation.

In the case of *Westbrook v. Comm'r* (Westbrook is an S corporation), excessive compensation to the son of the sole shareholder was disallowed.[8] The son's personal return was not discussed in the case. It is likely that the son was required to claim all his salary, including the disallowed portion, as income on his personal return. The case of *White's Ferry v. Comm'r* points out the importance of documentation of past services performed by a shareholder. A special bonus of $75,000 was challenged by the IRS but was upheld as reasonable compensation by the Tax Court.[9] In another case, the IRS tried to claim that year-end bonuses in excess of $500,000 were disguised dividends, but the court found that the vast majority were reasonable compensation.[10]

INSUFFICIENT COMPENSATION

One major problem that arises with the taxation of S corporations is that the controlling shareholders may take too little out of the corporation as compensation. Occasionally, this scheme is an attempt to shift income to other shareholders, usually family members. The other, more frequently encountered use of this technique is avoidance of FICA by characterizing compensation as distributions rather than as wage or salary income.

Note. According to the IRS Fiscal Year 2006 Enforcement and Service Results report presented by Commissioner Everson, audits of S corporations increased by 34% over the previous year, from 10,417 to 13,984 in fiscal year 2006. The IRS has been under pressure from Congress to pursue S corporations that are not complying with owner compensation rules. This is no surprise given that the U.S. Senate Finance Committee's 2005 report entitled "Options to Improve Tax Compliance and Reform Tax Expenditures" identified S corporation compensation to be a compliance problem area.

Family S Corporations

Family income shifting is one area addressed specifically within Subchapter S. IRC §1366(e) states that a family member who provides services or capital to the corporation should receive reasonable compensation, or the income of the corporation may be reallocated among the family members. Under current (post-1986) law, the kiddie tax removed much of the tax avoidance potential from this strategy. Cases dealing with it are rare but occasionally happen.

7. IRC §162(a)(1)
8. *Westbrook v. Comm'r*, TC Memo 1993-634, December 29, 1993
9. *White's Ferry, Inc. v. Comm'r*, TC Memo 1993-639, December 29, 1993
10. *Brewer Quality Homes, Inc. v. Comm'r*. TC Memo 2003-200, July 10, 2003

The IRS has been successful in reallocating income to a family member when the services that person performed were substantial.[11] The mere fact that there is a family S corporation, however, does not give the IRS the power to reallocate income to a family member who has performed only minimal services.[12]

Compensating Shareholder-Employees by Distributing S Corporation Profits

Publicity abounds about the tax planning of John Edwards, the Democratic candidate for vice-president in 2004 and candidate for president in the 2008 Democratic primaries. Prior to becoming a U.S. senator, he had been a successful trial attorney. His law practice was incorporated, with an S election in effect. In 1997, the law practice received millions of dollars from a personal injury case and other settlements (line 17 of his Form 1040 shows a $10,550,559 entry from Schedule E) and it paid him a salary of $360,000, which was subject to FICA tax. It is not known how much cash he actually withdrew from the corporation, but the majority of the income obviously was exempt from payroll taxes. If the line 17 amount were subjected to Medicare tax as self-employment income, the additional tax would be nearly $306,000. Senator Edwards' returns for tax years 1994 through 2003 are accessible online at the Tax History Project, **www.taxhistory.org**.

Other S corporation shareholders, in much more modest circumstances, try to have the corporation pay little or no compensation. The rationale is that if the shareholder-employee receives no salary, then the corporation is not liable for payroll taxes and is not obligated to withhold employee FICA or income tax. Although this scheme may work if the corporation makes no distribution, the IRS has long exercised its power to treat distributions from S corporations to shareholder-employees as salary if the distributions are, in substance, compensation to the shareholder-employee.

The IRS has been wary of this scheme for many years. Rev. Rul. 74-44[13] held that amounts paid to shareholders of an S corporation as compensation for services is subject to withholding and payroll taxes.

That ruling addressed a situation in which an S corporation paid its shareholders no salaries and distributed profits. The IRS held that the distributions were really a disguised form of compensation and that the corporation was responsible for payroll taxes. In 1989, the IRS prevailed on this issue in the district court case of *Radtke v. U.S.* The total compensation at issue was less than $20,000.[14] In this case, an attorney had incorporated his law practice and was the sole shareholder.

The corporation filed a valid S election. Mr. Radtke entered into an employment contract with his S corporation whereby he would receive no compensation for services. At various times during the year, the corporation declared and distributed dividends (state law term). The courts held that the payments were taxable as compensation. The S corporation was required to pay back FICA and FUTA taxes and was denied a claim for a refund.

Treatment of Officers

Almost all cases involving insufficient compensation of S corporation shareholders involve compensation of officers. In general, any officer of the corporation is considered an employee for FICA tax purposes.[15] Only if the officer performs no more than minor services and is not entitled to any compensation can the officer be treated as **not** being an employee.[16] Consequently, the amount of compensation or the amount of services, per se, is not an important factor.

The case of *Barron v. Comm'r* gives a clear explanation of the Tax Court's reasoning. Although it is a summary opinion and has no precedential value, it is concise and well-reasoned.

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11. *Fundenburger v. Comm'r*, TC Memo 1980-113, April 14, 1980; *United States v. Bishop*, 291 F.3d 1100 (5th Cir. 2002)
12. *Davis v. Comm'r*, 64 TC 1034 (1975)
13. Rev. Rul. 74-44, 1974-1 CB 287
14. *Radtke v. U.S.* 895 F.2d 1196 (7th Cir. 1990)
15. IRC §3121(d)(1) and IRC §3306(i)
16. Treas. Regs.§§31.3121(d)-1(b) and 31.3306(i)-1(e)

The corporation in question was an accounting practice.[17] The sole shareholder was the only CPA employed by the firm. Mr. Barron received minimal compensation in one year and none in the other years. The IRS employment tax division used a survey from a placement firm to determine a reasonable level of compensation. The amounts claimed as compensation and the amounts actually distributed to the shareholder are compared to the "reasonable" level imputed by the IRS.

Year	Compensation Claimed on Original Returns	Distribution on Original Returns	IRS's Reasonable Compensation Assertion
1994	$2,000	$56,352	$45,000
1995	0	53,257	47,500
1996	0	83,341	49,000

The Tax Court ruled in favor of the IRS in each year.

Note. The IRS used easily accessible industry compensation information to determine reasonable compensation. That type of information is generally the best unbiased source for compensation amounts.

More Recent Litigation

In 2002, a case of interest to professional tax practitioners was heard by the U.S. Tax Court. *Joseph M. Grey Public Accountant, P.C., Petitioner v. Comm'r* involved a tax and bookkeeping practice incorporated as an S corporation.[18] The case does not discuss whether or not there were other employees. The sole shareholder, Mr. Grey, performed virtually all services relating to client work and practice management for the corporation. However, Mr. Grey did not have the corporation treat him as an employee. In 1995, Mr. Grey reported net income from the S corporations of $33,196. He also reported $6,000 on his Schedule C corresponding to the deduction the corporation claimed for independent contractors. In 1996, the net income of the S corporation was $24,990 after deducting $7,200 for independent contractors and $6,000 for rent. Mr. Grey reported each of these amounts on his Form 1040. He based this reporting on a presumption that he was not an employee of the corporation.

The Tax Court was unimpressed with Mr. Grey's arguments, although there is no evidence that either the IRS or the court considered the returns frivolous. The IRS assessed approximately $6,000 of payroll taxes in each of the two years, although the details in the case are not sufficient to replicate the calculations. Nor is there any mention of the self-employment tax Mr. Grey might have paid, since his personal return was not a subject of the case.

Mr. Grey changed his argument shortly before appearing in court to request "Section 530 relief." This provision allows some safe-harbor treatment for independent contractor status.[19] However, for this safe-harbor rule to apply, there must be a reasonable basis for not treating the person as an employee. The examples of reasonable basis include; judicial precedent, a past IRS audit of the taxpayer in which there was no assessment based on this treatment, or a long-standing industry practice. Mr. Grey had none of these factors in his favor. Therefore, the IRS prevailed.

Beginning in 2001, the IRS focused on Mr. Grey's clients, who were sole shareholder S corporations. These clients were in a variety of businesses and covered a wide range of income levels. What they had in common was a persistent understatement of compensation and the same tax preparer. A brief summary of each of these cases is given on the following page.

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17. *Wiley L. Barron, CPA, Ltd. v. Comm'r,* TC Summ. Op. 2001-10 (February 7, 2001)

18. *Joseph M. Grey Public Accountant, P.C., Petitioner v. Comm'r,* 119 TC 121 (2002), *aff'd.,* 93 Fed. Appx. 473 (3rd Cir. 2004), *Nu-Look Design, Inc. v. Comm'r,* 543 US 821 (2004)

19. Section 530 refers to a section of the Revenue Act of 1978, not the Internal Revenue Code.

Cite	Year	Total Income	On Original Return
Yeagle Drywall Co. v. Comm'r, TC Memo 2001-284	1995 1996 1997	$27,000 $33,000 $35,000	Corporation distributed all of the income to the shareholder. Paid no wages.
Veterinary Surgical Consultants P.C. v. Comm'r, 117 T.C. No. 14 (2001)	1994 1995 1996	$84,000 on Sch. E and $125,000 on Form 1099 $173,000 on Sch. E and $225,000 on Form 1099 $161,000 on Sch. E and $213,000 on Form 1099	Shareholder deposited all corporate receipts into personal bank account.
Veterinary Surgical Consultants P.C. v. Comm'r, TC Memo 2003-48	1997 1998	$215,000 on Sch. E and $26,000 on Form 1099 $316,000 on Sch. E and $46,000 on Form 1099	Repeat performance, same procedures, different years.
Cohen v. Comm'r, TC Memo 2003-42	1996	Taxable income of $290.37 and "unexplained deposits" of $264,870.56	EIC also claimed. Court upheld tax of $135,120, additional tax of $27,024, and penalty of $22,912.80
Mike J. Graham Trucking, Inc. v. Comm'r, TC Memo 2003-49	1995 1996 1997	$14,000 $36,000 $25,000	Withdrew funds from corporation's account "as need arose."
Specialty Transport & Delivery Services, Inc. v. Comm'r, TC Memo 2003-51, Affirmed, 94 AFTR 2d 2004-1364 (3rd Cir)	1996 1997 1998	$16,000 $27,000 $38,000 on Sch. E, $15,000 on Form 1099, and paid rent of $7,200 to shareholder	Withdrew funds from corporation's account "as need arose."
Nu-Look Design, Inc. v. Comm'r, TC Memo 2003-52, Affirmed, 93 AFTR 2d 2004-608 (3rd Cir)	1996 1997 1998	$11,000 $14,000 $7,000	Withdrew funds from corporation's account "as need arose."
Water-Pure Systems, Inc. v. Comm'r, TC Memo 2003-53	1996 1997 1998	$26,000 $17,000 on Sch. E and $16,500 on Form 1099 $4,800 on Sch. E and $20,000 on Form 1099	Withdrew funds from corporation's account "as need arose."

Caution. The IRS has considerable powers to enforce payroll tax collection. The penalties for failure to comply may be quite severe and may be enforced against employees of the corporation. Accordingly, persons who provide services to an S corporation should receive wages or a salary. Care should be taken to document that the amounts paid as salary are reasonable in relation to services performed. If the corporation pays no salary to a shareholder, it should be able to demonstrate that the shareholder performed no services to the corporation or that the shareholder received no distributions from the corporation in the taxable year.

New Government Initiatives

The IRS took on new initiatives to fight the loss of FICA taxes on income of S corporations. For new S corporations, the routine response to filing Form 2553, *Election by a Small Business*, now contains a statement that the corporation should compensate its shareholders and that the IRS will be enforcing this rule.[20] In addition, the Treasury Inspector General for Tax Administration released a report decrying the tax avoidance that results from not collecting self-employment tax from S corporation shareholders.[21]

Finally, the Joint Committee on Taxation selected employment tax of S corporation shareholders as one of the areas that needs to be revised in order to improve tax collections.[22] It is evident that the inability to collect self-employment tax from S corporations and their shareholders has become an integral part of the "tax gap" that the government claims it needs to rectify. Therefore, this area should be high on the tax professionals' watch list for future governmental activity.

Social Security Earnings

The Social Security Administration (SSA) has examined S corporation shareholders in attempts to deny or reduce benefits to early retirees.[23] The courts seem to make their determinations based on the facts of each case. For example, distributions to persons who actually perform services for their S corporations were considered wages for purposes of the earned income ceiling.[24] These cases had factual similarity to the cases in which the IRS employment tax division was able to impose FICA and FUTA tax on corporations that attempted to disguise compensation in the form of distributions.

For certain early retirees, there is a limit on the maximum earned income they can receive in a year without losing benefits. Under current law, this rule applies to persons who retire at age 62 and continues until they reach normal retirement age. At this writing, the normal age is being phased up from the traditional age of 65, and will eventually reach age 67. After normal retirement age, there is no limit on the income of any type that a person may receive. However, during the early retirement period, any income in excess of the limit reduces benefits. In 2007, the limit is $12,960.[25]

> **Note.** See Chapter 13, "Elder Issues," for a thorough discussion on the taxability of social security benefits.

However, the SSA has not accomplished the same level of success as the IRS in recharacterizing income. In one case, a court refused to reallocate salary from a wife to her husband, which would have denied the husband social security benefits.[26] Similarly, one court refused to find that constructive receipt of corporate profits should be treated as earned income, which would have denied the shareholder social security payments.[27] In a more recent case, a district court held for the shareholder and did not treat undistributed income as earned income for purposes of the social security limit.[28]

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20. IRS, CP [business filer notice] 261 — Notice of Acceptance as an S Corporation
21. IRS, Report # 2005-30-080
22. U.S. Congress, Joint Committee on Taxation, report JCS-02-05
23. Prior to 1997 the limit applied to all years before reaching age 70.
24. *Ludeking v. Finch*, 421 F.2d 499 (8th Cir. 1970); *Somers v. Gardner*, 254 F. Supp. 35 (E.D. VA, 1966), *Weisenfeld v. Richardson*, 463 F.2d 670 (3rd Cir. 1972)
25. www.ssa.gov
26. *Gardner v. Hall*, 366 F.2d 132 (10th Cir. 1966)
27. *Letz v. Weinberger*, 401 F. Supp. 598 (D. Co. 1975)
28. *Picha v. Shalala*, unreported decision, 1995 WL 387791 (N.D. ILL.)

In *Mason v. Barnhart*, a shareholder tried a novel argument. He had agreed to report income before it was received in cash. This payment had the effect of shifting income away from the S corporation, in which he and his two children were each one-third shareholders. The object was to enable Mr. Mason to pay all the taxes on the S corporation's income for the year. In that year, he was subject to the social security earnings limit and the income he reported exceeded his limit. When the SSA decided to disallow benefits, he claimed that since he had received no cash, he did not receive any earned income. The 8th Circuit held that he was bound to report consistently and found that he was in excess of the limit for the year.[29]

OTHER COMPENSATION AND BENEFITS ISSUES

> **Note.** See Chapter 9, "Small Business Issues," Issue 1, for a thorough discussion of the variety of fringe benefits available for employers to provide to employees.

In general, an S corporation is treated as an employer and may deduct the cost of providing tax-favored fringe benefits to employees. Under general tax law rules, an employer can deduct the cost of these fringe benefits. The code provides statutory exclusions for employees who do not include the value or cost of the fringe benefits in income. However, when the S corporation pays for certain fringe benefits on behalf of a person owning more than 2% of the corporation's stock, the tax advantage may be significantly reduced.

The wording of the code is somewhat imprecise, stating that for purposes of fringe benefit provisions, an S corporation is treated as a partnership, and any 2% shareholder must be treated as a partner.[30]

The statute defines a 2% shareholder as a person who owns more than 2% of the S corporation's stock at any time during the corporation's taxable year.[31] It refers to the attribution rules of IRC §318 for constructive ownership and subjects a constructive owner of more than 2% of the shares to the same treatment. This rule prevents any shareholder from employing a family member in order to provide tax-free fringe benefits from the corporation to the family unit. The constructive ownership rules of IRC §318 treat a shareholder's spouse, children, parents, and grandchildren as constructive owners of his stock.

To understand the problem better, it is necessary to determine which benefits a self-employed person may exclude and which exclusions are limited to statutory employees. The following may only be excluded by an employee and may not be excluded by a self employed person, including a partner:

1. Amounts received under accident and health plans (uninsured)
2. Premiums on employer-paid accident and health insurance
3. Exclusion of meals and lodging provided by the employer
4. Parking and transit
5. Group term life insurance premium exclusion

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29. *Mason v. Barnhart*, 406 F.3d 962 (8th Cir. 2005)
30. IRC §1372
31. IRC §1372(b)

Medical Benefits

From a tax point of view, when S corporations and their shareholders are involved, it is important to distinguish between insured plans and uninsured plans. Although the tax law does not define insurance per se, various courts have addressed the issue. The U.S. Supreme Court held that there must be two factors present in an insurance contract:

1. Risk shifting
2. Risk distribution[32]

The former occurs when the arrangement shifts the risk of economic loss. The latter occurs when the party who now bears the risk has offsets to cover the possibility of a catastrophic claim.[33] In an uninsured health plan, the employer must pay certain health costs if they are incurred by one of the covered employees. In an insured plan, the employer pays an issuance company a certain amount and the insurer then agrees to pay whatever health costs arise.

When the company provides medical benefits, it is required to include the value of these benefits on the shareholder-employee's Form W-2. The employee then determines his own tax treatment.

1. If the medical plan is uninsured, the shareholder-employee receives no tax benefit, other than an itemized deduction for medical expense. However, rank and file employees who do not meet the 2% threshold may still benefit from one of these plans.
2. If the medical plan is insured, the shareholder-employee reports the payment as gross income, but may be able to claim a page 1 deduction, which essentially cancels out the gross income.

> **Caution.** An employer offering health insurance to an employee must be aware of the Health Insurance Portability and Accountability Act of 1996 (HIPAA).[34] This act added various penalties for failure to comply with its provisions. The major provisions include nondiscrimination of coverage offered and release of unauthorized information about an individual's health. The penalties include substantial excise taxes imposed on employers who violate these provisions.

Deduction for Medical Insurance Costs. Self-employed persons may deduct the cost of their health and accident insurance costs in arriving at adjusted gross income.[35] This deduction is limited to the person's self-employment income. Although this provision does not cover employees, a shareholder-employee of an S corporation is able to deduct the same percentage of the cost of insurance provided by the S corporation. Wage or salary income is treated as earned income for purposes of the limit.[36] However, the shareholder-employee's share of the S corporation's taxable income is not treated as earned income for this purpose. Therefore, if the S corporation reports a loss for a tax year and the wages to the shareholder are at least as high as the insurance premium, the shareholder meets this test for claiming the deduction.

Although the statute clearly applies the deduction rules to S corporation shareholders, the IRS has been having second thoughts on the treatment of health insurance policies for shareholder-employees of S corporations. In 2006, a well-reasoned Chief Counsel's advice memorandum concludes that the health insurance deduction is allowed to proprietors regardless of whether the policy is issued to the business or to the individual.[37] This memorandum also concludes that the proprietor may not aggregate multiple businesses for purposes of the earned income limit. Rather, there must be sufficient income from the business or businesses that sponsor the health insurance plan in order to deduct the premiums. This memorandum does not address partnerships or S corporations. **This omission indicates a critical difference between the proprietorship and the S corporation.**

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32. *Helvering v. LeGierse*, 312 US 531 (1941). The IRS has recently cited this case in Rev. Rul. 2005-40, 2005-2-CB4
33. *Humana Inc v. Comm'r*, 881 F.2d 247 (6th Cir. 1989).
34. P.L. 104-191
35. IRC §162(l)
36. IRC §162(l)(5), amended by the Revenue Reconciliation Act of 1990.
37. CCA 200524001, (May 17, 2005)

In order to claim a deduction, the taxpayer must generally pay the expense. Consequently, if the shareholder buys her own insurance and pays the premiums, the corporation will not pay any expense that it might treat as a deduction. However, if the corporation adopts the plan, buys the policy, and pays the premiums, the corporation is entitled to a deduction as long as the shareholder is a bona fide employee. Hence, the obvious answer is for the corporation to buy the policy. However, some states impose an obstacle to doing so. Apparently, there are some that do not permit insurance companies to issue health policies to companies with only one employee.[38] In these instances, when the employee buys the plan personally, the IRS advises that the self-employed health insurance deduction is not allowable.[39]

> **Note.** The American Institute of Certified Public Accountants Federal Tax Division proposed a revenue ruling that would allow the deduction in these states when the employer adopts a plan and directs the employee to purchase the policy. The employer could either pay the premiums directly or reimburse the employee. This letter was submitted in December 2006. As of mid 2007, the IRS has not issued a new ruling.

To comply with the rules and still receive the deduction, several methods may be used. All are legal, but some are more complex than the shareholder might prefer. One method includes reincorporating in a state that permits single-employee coverage. Another method involves the S corporation transferring some operations to a C corporation, compensating the shareholder-employee from the C corporation, perhaps in addition to the compensation received from the S corporation.

> **Note.** The insufficient compensation cases cited previously show how taxpayers can be overzealous in their efforts to save the obvious taxes and miss some more substantial savings. In the cases where the shareholder received no salary, the corporation could not deduct any health insurance that it might pay. Moreover, the corporation could not make any contributions to a qualified retirement plan on behalf of a shareholder who is not an employee. It may be worth paying some FICA and FUTA to qualify for the tax advantages of these fringe benefits.

Health Savings Accounts. The health savings account (HSA) allows an individual to claim a deduction in arriving at AGI for health care costs, which is almost universally preferable to the itemized deductions otherwise allowed for these expenditures. In structure, the HSA resembles the traditional individual retirement arrangement (IRA). Contributions to the plan are deductible and distributions from the plan may be taxable. However, distributions from the plan are not taxable if used to pay the plan owner's medical expenses during his lifetime or up to one year after death. One of the principal appeals of the HSA is that there is no use-it-or-lose-it rule, which allows amounts set aside in healthy years to be available in a high-cost year. The contributions for any given taxable year may be made up to the date for filing the owner's return for the year (April 15 of the following year in most cases).

The deduction is the lesser of the participant's deductible amount on the insurance policy or a statutory limit.[40]

> **Note.** See Chapter 1, "Individual Taxpayer Problems," Problem 2, for more information on HSAs.

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38. Internal Revenue Service Headliner Volume 163 (May 15, 2006)
39. Ibid.
40. IRC §223(b)(2)

The limit on contributions to the HSA is indexed annually for inflation. In 2007, the limit is $2,850 for self-only coverage and $5,650 for a family plan.[41] The HSA is available only to a person who is covered by a high deductible health plan.[42] This term means a deductible amount of at least $1,000 for an insured-only plan or $2,500 for family coverage.[43] However, the HSA owner may have other coverage for vision, dental work, accidents, long-term care, disability, or casualty insurance.[44] There are additional contributions allowable for persons aged 55 or older.[45]

Caution. An employer may make contributions to the HSA on behalf of rank and file employees, and for the benefit of 2% shareholders. If the S corporation wants this benefit limited to any particular employee or employees, such as officers or merely the chief executive officer, it must be wary of any nondiscrimination rules.[46] Employer contributions to HSAs are **not subject to these or any other nondiscrimination tests,** so the corporation may make this contribution on behalf of as many or as few employees as it desires. However, if it makes the contribution on behalf of anyone, the HIPAA rules may require the corporation to make the plan available to a broad class of employees. If this rule is a problem, the corporation may be better off not making any contributions on behalf of the shareholder-employee, who could make his contributions directly.

Withholding and Payroll Tax on Fringe Benefits. In general, all compensation paid by an employer to an employee is subject to FICA. This rule specifically includes the "cash value of all remuneration" which is paid in a medium other than cash.[47] However, there are some exceptions which may exempt certain items from the FICA tax base. IRC §3121(a)(2)(B) specifically excludes employer contributions on behalf of an employee for medical and hospitalization expenses from the definition of **wages**. To qualify for the social security tax exclusion, the payment must be made in accordance with a plan to benefit all, or a class of, employees. IRC §3121(a)(2)(B) does not discriminate between medical payments that might be **excluded** from an employee's gross income and medical payments **included** in gross income. Therefore, insurance paid on behalf of 2% shareholders qualifies for this payroll tax exclusion.[48]

Other Fringe Benefits

Meals and Lodging. A more than 2% shareholder may not exclude from income meals and lodging provided to him by the S corporation. Therefore, the shareholder is required to include the value of the meals and lodging on his personal tax return.

Parking and Transit. A 2% shareholder in an S corporation must include the value of parking and transit provided by the S corporation in his gross income.[49] However, if the value of transit passes provided by the employer does not exceed $21 per month, the shareholder-employee may exclude the benefit as a de minimis fringe benefit.[50] The value of parking away from the principal place of business may be excluded.[51] The value of these benefits is reported as noncash compensation on the employee's Form W-2.[52]

41. Rev. Proc. 2007-36, 2007-22 IRB 1335
42. IRC §223(c)(1)
43. IRC §223(c)(2)
44. Notice 2004-2, 2004-2 IRB 269, Q-6 (September 3, 2004)
45. IRC §223(b)(3)
46. IRC §105(h) defines the nondiscrimination rules applicable to health plans.
47. IRC §3121(a)
48. Announcement 92-16, 1992-5 IRB 53 (February 2, 1992)
49. Notice 94-3, 1994-3 IRB 14, Q-5.b (January 17, 1994)
50. Notice 94-3, 1994-3 IRB 14, Q-7.a (January 17, 1994)
51. Notice 94-3, 1994-3 IRB 14, Q-7.b (January 17, 1994)
52. Notice 94-3, 1994-3 IRB 14, Q-12.a (January 17, 1994)

OFFICE IN HOME AND RENTALS BETWEEN S CORPORATIONS AND SHAREHOLDERS

The S corporation and its shareholders may rent property from each other. If the corporation rents real estate to the shareholder, it must be wary of the vacation home rules which apply at the corporate level in the same manner that they do for an individual. Consequently, it makes little tax sense for a corporation to own a residence and rent it to the shareholder as a personal residence. The corporation wouldn't be able to claim depreciation or other deductions to the extent that these expenses exceed the income from the rental. Thus, the shareholders may be claiming rental income on their own returns as it passes through from the S corporation, with no corresponding personal deductions. Moreover, the parties would lose the potential exclusion on the gain from a sale if the residence is not owned by the individual occupant. In a multiple shareholder situation, it may make economic sense to rent property to a shareholder, but there are few, if any, tax advantages in most situations.

Rental of shareholder-owned property to the corporation provides some tax advantages, although there are some pitfalls. Similarly, there may be some considerations for using a portion of the shareholder's home for the S corporation's activities.

OFFICE IN HOME

In general, an individual is allowed to claim office in home deductions if the use meets certain strict criteria. In most classes, the portion of the home must be used exclusively for the business activity, although there are some exceptions for child care operations and storage of inventory. In most cases, the office of an employee must be for the employer's convenience and there must not be a suitable alternative location for the employee to perform his activities. In the S corporation situation, it might be feasible to claim office in home deductions if the S corporation has no place of business other than the shareholder's home.

However, as stated previously, an S corporation shareholder is not self-employed with respect to the S corporation income. Therefore, the office in home produces itemized deductions, which are subject to the 2% AGI limit and phaseout for higher income taxpayers.

When a shareholder claims the office in home deduction and the IRS challenges the deduction, the cases are factual in nature. In *LaFavor v. Comm'r,* shareholders who were a married couple failed to provide any evidence of the use of the office in their home. As a consequence, the IRS and Tax Court denied the deduction.[53] However, in *D'Angelo v. Comm'r,* the Tax Court allowed the deduction.[54]

PROPERTY RENTED TO THE S CORPORATION

Rental of shareholder-owned property to the S corporation may make sense from a tax point of view. It provides a means of getting some of the cash flow out of the corporation without incurring any payroll taxes, because real estate rent is not self-employment income and is also not wage or salary. Even the ill-fated *Grey* case discussed earlier used this technique, although the details in the case are not sufficient to determine whether or not the IRS recharacterized any of the rent as compensation.

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53. *LaFavor v. Comm'r*, TC Memo 1998-366, October 8, 1998

54. *D'Angelo v. Comm'r*, TC Memo 2003-295, October 23, 2003

Rental of Office in Home

Although this may be a useful technique for getting cash out of the corporation to the shareholder, it does not produce any additional tax benefits. If an employee rents a portion of his home to the employer, the employee is **not entitled** to any deductions for the cost of owning and operating the office.[55] This rule is not limited to shareholder-employees of S corporations. It covers any employee of any employer.

In *Roy v. Comm'r*, an S corporation shareholder rented the residence he owned to the corporation. The corporation paid the shareholder $1,000 per month for the use of the 5-acre tract on which the residence was located. The IRS denied depreciation and other deductions associated with the residence, and the monthly rental amount was income to the shareholder. The shareholder claimed that the $12,000 was de minimis and should be excluded. Neither party raised the issue of whether the value of the lodging was excluded from income on the grounds that the shareholder/employee was required to accept the lodging as a condition of employment.[56]

Other Rental Dealings

Other rental dealings between the S corporation and shareholders or parties related to shareholders may invite scrutiny. As may be expected, there should be evidence of the actual business purpose of the transaction. For example, in *Chin v. Comm'r*, an S corporation conducted no apparent trade or business, yet it paid rent to the sole shareholder's mother for use of her home. The court upheld the IRS's disallowance of the deduction.[57]

One tax saving scheme that renting property to the S corporation cannot accomplish is production of passive income for the shareholder, if the shareholder materially participates in the S corporation's trade or business.[58] This rule is not limited to S corporations. It also includes property rented to a C corporation or partnership in which the taxpayer has an interest.[59] Unfortunately this rule may create a mismatch of income and loss types from a single activity.

In the case of *Carlos v. Comm'r*, husband and wife shareholders in two S corporations also owned real estate outside the corporations, which they rented to the corporations. According to the books and records, one of the properties produced a net loss and the other showed net income for the year in question. Under the regulations, it was permissible to aggregate the two rental properties into a single activity[60] so the owners combined the loss from one property with the income from the other to show net rental income.

Mr. and Mrs. Carlos characterized this income amount as nonpassive in accordance with the regulations. However, the IRS disagreed and split the activity into a mix of nonpassive income and passive loss. The Tax Court held that the IRS was within its authority to do so and upheld the deficiency.

If the rental properties were treated as separate activities, one would have produced net income and the other a net loss. However, the parties treated the two rental properties as a single activity and showed net overall income.

The IRS disaggregated the two properties and the result was one income activity and one loss activity. The income from the profitable rental was not passive because it was rented to an S corporation in which the owners materially participated. However, the Tax Court held that the loss from the unprofitable rental was treated as passive and the owners were unable to offset this loss with the rental income from the other property.[61]

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55. IRC §280A(c)(6)
56. *Roy v. Comm'r*, TC Memo 1998-125, March 31, 1998
57. *Chin v. Comm'r*, TC Memo 2003-30, February 6, 2003
58. Treas. Reg. §1.469-2(f)(6)
59. Treas. Reg. §1.469-4(a) and Temp. Treas. Reg. §1.469-2T(e)(1)
60. Treas. Reg. §1.469-4(c)(1)
61. *Carlos v. Comm'r*, 123 TC 275 (2004)

DISTRIBUTIONS OF CASH AND PROPERTY

> **Note.** See Chapter 11, "Entity Issues," for other distribution issues and the effect of S corporation distributions on debt basis.

The application of individual tax rates to corporate income is only one of the benefits to the S election. Without special rules for distributions, however, Subchapter S would be almost useless for profitable corporations. The reduction in tax rates to the individual level would be cold comfort to a shareholder who was liable for tax on corporate income, if the only way to get cash out was treatment as a dividend.

Fortunately, Subchapter S provides rules that allow most shareholders to take most distributions tax-free. However, there are enough complications in the distribution rules that the tax professional needs to study them carefully. Following the rules that work most of the time can lead to some trouble in unusual cases. With over 3 million corporations filing S corporation returns each year, even a low percentage of unusual situations can turn out to be problematic for many tax professionals. The crux of the matter is that the distribution rules do not depend only on the corporation's current year activity. The tax treatment may vary between two S corporations with similar current year income and losses, but different tax histories. Moreover, the tax treatment to the shareholder may depend on the shareholder's basis, in addition to certain corporate accounts. Finally, not all of the relevant information may have ever been reported on the corporation's tax returns, even if it has been in complete compliance with the tax laws throughout its entire history.

The treatment of cash distributions from an S corporation to a shareholder are relatively simple, although there are a few important rules to follow. For this purposes, there are two classifications of S corporations:

1. S Corporations that **do not have** any accumulated earnings and profits from prior years in which they were C corporations.
2. S Corporations that **have** accumulated earnings and profits from prior years in which they were C corporations.

Either type may be a former C corporation. Generally, a corporation that has always been an S corporation will be in the first category, but earnings and profits may arise as a result of certain acquisitions of other corporations.

The S corporation with no earnings and profits has relatively simple rules, although the reader knows that few things in tax law are truly simple.

EARNINGS AND PROFITS

The term **earnings and profits** describes a C corporation's equity balance that is treated as dividends to the shareholders, if it is ever distributed. All distributions from a C corporation are dividends to the extent they do not exceed the corporation's earnings and profits at the time of the distribution.[62]

Under post-1982 law, an S corporation does not generate any earnings and profits and does not pay dividends (in the tax sense of the word) from its earnings in Subchapter S years.[63] However, any balance remaining from C corporation years is taxed to the shareholders if the distributions ever reach a certain level. After a brief discussion of earnings and profits, the discussion turns to the S corporation distribution rules.

A C corporation's earnings and profits measure what amount of the corporation's income is distributable, rather than what is taxable. There is no inclusive definition of earnings and profits in the code or regulations. However, there are partial definitions throughout both. The statutes have changed over the years as corporations developed schemes, usually focusing on differences between financial accounting income and tax accounting income. Consequently, Congress stepped forward when corporations reported high income on financial statements and little or no taxable income. When Congress felt there were abuses, Congress changed the rules.

62. IRC §§301(c) and 316
63. IRC §1371(c)(1)

An easy example concerns depreciation. A taxpayer is not required to use the same depreciation life or method on its tax returns that it uses on financial statements. Some corporations, especially public utilities, show high financial income but virtually eliminate their taxable incomes by using different depreciation methods for tax and financial reporting. Therefore, they could appear to distribute only a reasonable portion of their income, but the distribution would exceed earnings and profits and thus not be a dividend. The excess of a distribution over the earnings and profits is treated as a reduction of basis by each recipient shareholder. If a distribution exceeds both the corporation's earnings and profits and the shareholder's basis, the excess is treated as a gain from the sale of stock.[64] Consequently, Congress required corporations to use straight-line depreciation for earnings and profits purposes beginning in 1972.[65] Over the years, other timing differences were accelerated, such as installment sales, completed contract accounting, and buildup in LIFO reserves.[66]

In a sense, current earnings and profits approximate the financial accounting measure of net income after tax. However, there are enough differences between the two sets of rules that it is best to begin with the definition of taxable income and then apply modifications. The IRS provides Form 5452, *Corporate Report of Nondividend Distributions*, for the calculation of earnings and profits. This form includes a worksheet that provides columns for comparing book income and taxable income. It lists some of the adjustments but not all that may be necessary for the calculations.

The principal differences between taxable income and **current** earnings and profits can be summed up in four categories:

1. **Tax-exempt income** is included in current earnings and profits, as are artificial deductions such as the dividends-received deduction.
2. **Disallowed expenses** such as federal income tax, meals and entertainment, and excess capital losses reduce current earnings and profits.
3. **Carryover deductions** such as the net operating loss, net capital loss, and excess charitable contribution are added to current earnings and profits in the year they are deducted.
4. **Timing items** such as depreciation, installment sales, and completed contract accounting are all recalculated in a manner that generally slows down deductions and speeds up income for current earnings and profits compared to taxable income.

The term **accumulated earnings and profits** (AEP), as used in tax law, means the balance accumulated at the end of the immediate prior year. As a result, a corporation may simultaneously have both current earnings and profits and AEP.

To determine each year's AEP:

- Begin with the prior year's balance,
- **Add** current earnings and profits (including the four items above), and
- **Subtract** any dividend paid during the year.

64. IRC §§301(c)(2) & (3). These rules parallel the S corporation rules for corporations with no earnings and profits.

65. IRC §312(k). There are also special lives for ACRS and MACRS property that slow the cost recovery down for measuring earnings and profits.

66. IRC §312(n)

From the S corporation perspective, the important aspect is determining the corporation's AEP as of its final day in its final C corporation year.

> **Note.** An S corporation that never had earnings and profits or disposed of the balance in prior years may acquire new AEP, but only in unusual circumstances. If an S corporation acquires another corporation via merger or other tax-free reorganization or in a nontaxable liquidation, such as a QSub election, the prior corporation's AEP becomes that of the acquiring corporation.

Knowing an S corporation's AEP accomplishes two objectives:

1. The shareholders know if any distributions from the corporation are taxable as dividend income.
2. The corporation can assess the possible exposure to passive investment income problems, as discussed later.

There are possible events that reduce the corporation's AEP after the S election takes effect. The most common event is a distribution of the earnings and profits, which may be accidental or deliberate. This is discussed below.

DISTRIBUTION FROM S CORPORATION WITH NO AEP

When an S corporation has no AEP, taxability of the distribution is based entirely on the shareholder's basis and not on any accounts on the corporation's books. When an S corporation has no AEP, any distributions are excluded from the shareholder's gross income to the extent they do not exceed the shareholder's stock basis. **Distributions in excess of a shareholder's stock basis are treated in the same manner as gains from the sale of stock.**[67]

The major problem for these corporate shareholders is to determine how much basis is available at the time of a distribution. A shareholder increases basis for income from the S corporation and decreases basis for both losses and distributions. As long as the sources of basis (last year's ending basis plus this year's income) exceed both current year losses and distributions, the distributions are tax-free to the shareholder. However, when the uses exceed the sources, it is important to have some ordering rules.

Basis Adjustments for Income and Losses

Shareholders must adjust their stock basis annually for the allocable portion of S corporation income and losses. When there is more than one shareholder during the tax year, the corporation must allocate each item of income or loss on a per-day, per-share basis. However, all basis adjustments are deemed to occur at the end of each tax year. If a shareholder disposes of her entire shareholdings during a year, the basis is adjusted on the final day that the person holds the stock.

Between 1983 and 1996. For taxable years beginning after 1982 and before 1997, a shareholder calculated basis adjustments in the following order:

1. The starting point was stock basis at the end of the prior year (or at time of acquisition, if this is the first year the shareholder owned the stock).
2. Next the shareholder added all income items including bottom-line, separately reported, and tax-exempt income. The result was basis available for losses and distributions.
3. Next came the losses and deductions for the year. There were general and elective ordering rules, which are the same as those available under current law. The shareholder did not reduce stock basis below zero, although if the losses exceeded stock basis, the excess could reduce debt basis. The remaining basis, if any, provided the upper limit on tax-free distributions.
4. Finally the shareholder subtracted distributions (other than dividends from the corporation's AEP). Distributions could not reduce basis to a negative number. If the distributions exceeded basis, the excess was treated as a capital gain.

67. IRC §1368(b)

After 1996. For all taxable years beginning after 1996, the law now provides that distributions are treated as reductions of basis **before losses.** Adjustments occur in the following order:

1. Start with basis at the end of the prior year.
2. **Add** all income items, including bottom-line, separately reported, and tax-exempt income. The result is the basis available for tax-free distributions.
3. **Subtract** distributions (other than dividends from the corporation's AEP). Do not reduce basis to a negative number. If distributions exceed basis, the excess is treated as a capital gain. The result is the basis available for losses.

The treatment of losses can vary depending on the presence of nondeductible expenses items such as premiums on key-employee insurance, the 50% disallowed meal and entertainment expenses, and others. There is a **general ordering rule** and an **elective ordering rule.**

Ordering Rules for Losses

The code does not specify the treatment of nondeductible expenses in relationship to deductible losses and expenses, except to state that the shareholder reduces basis for both categories.[68] However, the regulations are written so that the disallowed expenses, such as the nondeductible portion of meals and entertainment, are taken into account before the potentially deductible losses.[69]

The regulations provide an elective ordering rule which allows the shareholder to claim the deductible items first. However, the cost of this election is that the shareholder must carry forward the disallowed items and treat them as future reductions of basis.[70] As disallowed items, they will never produce tax benefit. Since the elective ordering rule is binding on a shareholder for life, it should only be undertaken with care.

Example 1. A shareholder has $100 basis in his S corporation stock at the start of the current year. The S corporation has no income in the current year. The shareholder is allocated $70 of ordinary loss and $80 of disallowed expenses. Under the general ordering rule, the shareholder reduces stock basis to $20 for the disallowed items. That allows him to claim $20 of the ordinary loss and carry $50 forward to next year.

The elective ordering rule provides a tax benefit to the shareholder under these circumstances. He compares the beginning basis of $100 to the $70 of potentially deductible losses. Since his basis exceeds the loss for the year, he claims all of it. He then uses $30 of the $80 of disallowed items to reduce basis to zero and carries the remaining $50 of disallowed items forward. These offset any basis increases, such as those created by income, capital contributions, and future loans to the corporation.

Using the **general rule,** he was only able to claim a $20 deduction for the year. The **elective rules** allowed him to claim $70. Consequently, it may appear that all shareholders faced with these limits should opt for the elective rule. However, it has some side effects.

Alternatively, assume that the shareholder had only $10 of basis at the beginning of the year. His share of the deductible loss was $70 and his disallowed items were $80. Under the general ordering rule, he would use $10 of the disallowed items to reduce basis to zero. He would then carry forward all his allowable losses of $70 and claim no deduction in the current year.

68. IRC §§1367(a)(2)(B), (C), and (D)
69. Treas. Reg. §1.1367-1(f)
70. Treas. Reg. §1.1367-1(g)

Interaction between Basis Adjustments and Distributions

As stated above, when there is enough basis to absorb both losses and distributions for the year, the shareholder merely claims both as reductions of basis. The losses may be subject to other limitations such as at-risk and passive activity loss limits; however, the distributions are tax-free. **Example 2** shows some rudimentary basis calculations. Careful study sets the stage for a confusing inconsistency later.

> **Example 2.** Teresa is the sole shareholder of Laredo Corporation, a calendar-year S corporation. On January 1, 2007, Teresa's basis in her stock is $240,000. During 2007, the corporation has $150,000 of capital gains, $10,000 of tax-exempt interest income, and $190,000 of ordinary loss. Teresa receives $280,000 of distributions in 2007. Laredo has no AEP. Teresa's income, losses, and distributions are:
>
> | | |
> |---|---|
> | Beginning basis | $240,000 |
> | Income items (taxable + exempt) | 160,000 |
> | Basis before distributions | $400,000 |
> | Less: tax-free distributions | (280,000) |
> | Basis before loss items | $120,000 |
> | Less: loss items (limit to basis) | (120,000) |
> | Ending basis | $ 0 |
>
> All the distributions are tax-free, since she has sufficient stock basis. However, she can only claim $120,000 of the ordinary loss and must carry $70,000 forward to 2008.

DISTRIBUTIONS FROM S CORPORATIONS WITH AEP

Although the S corporation does not accumulate earnings and profits while its S election is in effect, it may have been a C corporation before it became an S corporation. If it had AEP as a C corporation and did not distribute them as of the current year, they remain potentially taxable as dividends if they are ever distributed. When an S corporation has earnings and profits, there are two important corporate accounts. The corporation must determine the status of these accounts before it can inform the shareholder of the nature of the distribution. The accounts are:

1. **Accumulated Adjustments Account (AAA).** This account is the first source of distributions. Distributions that do not exceed this account are treated as reductions of basis (and gain if the distribution exceeds the shareholder's basis) in the same manner as a distribution from an S corporation with no AEP. This account is reported on Form 1120S, Schedule M-2.

2. **Accumulated Earnings and Profits (AEP)**. This is the maximum amount of distributions that may be taxed as dividends while the S election is in effect. Unfortunately, there is no place on any tax return to calculate or even report the balance of this account.

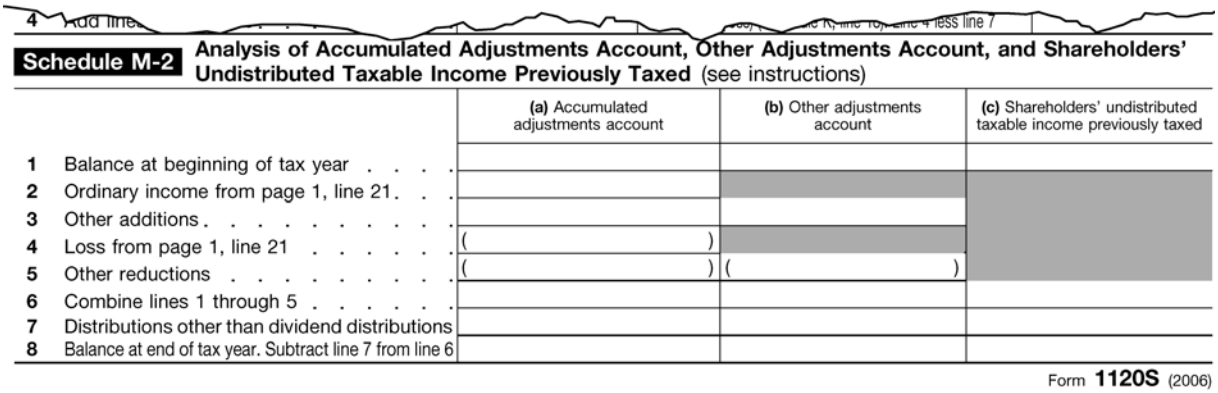
There are some other accounts that appear on Schedule M-2. These are not usually as important as the AAA and AEP.

1. **Undistributed Taxable Income Previously Taxed to Shareholders (or Previously Taxed Income or PTI)** is an accumulation of income for a specific shareholder that occurred when the corporation was an S corporation between 1958 and 1982. Distributions that exceed the AAA may come from this account and are treated as reductions of basis (and gain if they exceed basis) in the same manner as a distribution from the AAA. However, the account balances are personal to each person who was a shareholder during the pre-1983 years and cannot be transferred to any other person. When one of these people terminates interest in the S corporation, that balance disappears. This account is reported on Form 1120S, Schedule M-2.

2. The **Other Adjustments Account** (OAA) is a catch-all account for the items of income and loss that do not fit into any other categories. The most frequent examples of items that affect the OAA are life insurance proceeds, key-employee insurance premiums, exempt bond interest income, and related expenses. This account is reported on Form 1120S, Schedule M-2. However, since the corporation has exhausted all of its AEP before it ever gets to this account, the OAA has no significance.

Accounting for Distributions

Schedule M-2 provides reconciliation between the beginning and ending tax balances for the AAA, PTI (in total), and OAA.



4 Add lines . . . . . less line 7

Schedule M-2 **Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (see instructions)

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year			
2	Ordinary income from page 1, line 21 . .			
3	Other additions			
4	Loss from page 1, line 21	( )		
5	Other reductions	( )	( )	
6	Combine lines 1 through 5			
7	Distributions other than dividend distributions			
8	Balance at end of tax year. Subtract line 7 from line 6			

Form **1120S** (2006)

Unfortunately, the ordering of items on this schedule does not allow it to be a useful indicator of distribution. The column ordering is wrong for this purpose, since PTI is the second source (column c) and accumulated earnings and profit, the middle layer, is missing entirely. Moreover, the row ordering in the AAA column may not always be accurate.

Ordering of Distributions from S Corporations with AEP

Layer	Description	Source	Taxability	Effect on Basis
1.	All S corporations to the extent of AAA	AAA, as adjusted for current year's income and loss items	Not taxable unless in excess of shareholder's basis	Reduce basis to the extent thereof
2.	Distributions to shareholders who have pre-1983 PTI accumulations	Previously taxed income	Not taxable unless in excess of shareholder's basis	Reduce basis to the extent thereof
3.	***S corporations which have AEP***	***AEP***	***Ordinary income***	***No effect on basis***
4.	All remaining distributions	OAA, then paid-in capital	Not taxable unless in excess of shareholder's basis in stock	Reduce basis to the extent thereof

The Distribution Sandwich. The "layers" of an S corporation's capital may be viewed as a sandwich as illustrated in the above table. In the middle is layer #3, which provides taxable distributions that have no effect on any shareholder's basis. Before the corporation reaches that layer, there are two other layers (#1 and 2). These layers provide a limit on which distributions are tax-free and reduce basis or create capital gain if the distributions exceed any shareholder's basis. The bottom layer (#4) is the same as the top (#1). It provides reductions of basis to the extent thereof and capital gain thereafter.

Before the shareholder can determine the nature of any distribution from the corporation, the corporation must compare the amount of the year's distributions with the different equity accounts. It then tells the shareholder how much of the distribution came from the middle layer — the accumulated earnings and profit — and how much did not. The amount that came from the middle layer is not affected by any shareholder's basis, and does not affect basis. The shareholder must then compare this amount with his predistribution basis to determine the outcome.

AAA Compared to Basis Adjustments. The AAA is increased for all taxable (but not tax-exempt) items of income of the corporation after the S election takes effect. It is not personal to any shareholder, but is a corporate level account. It is not necessarily shown on financial statements as part of book retained earnings. The rationale for this account is that when any shareholder takes an item of S corporation taxable income into account, the shareholders should be permitted to withdraw an equivalent amount as reductions of basis before they receive taxable dividend distributions.

The following rules require careful attention, especially when comparing the AAA items to shareholder basis adjustments:

1. Basis may never be negative. The AAA may be negative, if losses exceed income. However, distributions may not reduce the AAA to below zero.
2. Although basis is adjusted for tax-exempt income and expenses related to the production of it, the AAA does not include any of these items. Instead, they are posted to the OAA.
3. The AAA has a different ordering rule than the basis adjustments. Both measures start with the balance from the prior year. However, basis may not be less than zero, whereas the AAA may be negative.
4. For both, the next act is to increase for the current year's income. The adjustments to basis include any tax-exempt income, whereas the adjustment to the AAA does not.
5. If there are any losses of the corporation, the two sets of accounting rules diverge. Whereas the basis calculation takes distributions after income and before losses, the AAA puts losses before distributions, at least in part. To add to the confusion, the losses subtracted from the AAA, at this point, do not exceed the current year's income items.
6. Next are the distributions. Usually, the shareholder's basis is greater than the AAA, although the reverse is possible.
7. Finally, any losses that exceed the current year's income result in a net negative adjustment for the AAA. At this point, all losses reduce basis. Again, basis may not be less than zero and the AAA may be negative.

Note. In Treas. Reg. §1.1368-2, there is a strange set of effective dates. For tax years beginning before 1997, the regulations ignore the net negative adjustment and require the AAA to be reduced for all of a year's losses before distributions. This was the rule that applied to basis and AAA before amendment by the Small Business Job Protection Act of 1996. The next set of rules applies to tax year beginning after August 18, 1998, leaving a gap of nearly 20 months. The problem was that the IRS wrote proposed regulations that did not correctly express the rules about the net negative adjustment. Consequently, there was erroneous guidance during this period of time.

Example 3. Refer to the facts in **Example 2.** As was the case in **Example 2,** on January 1, 2007, Teresa's basis in her stock is $240,000. During 2007, the corporation has $150,000 of capital gains and $190,000 of ordinary loss. Teresa receives $280,000 of distributions in 2007. Assume the same facts, except Laredo has $300,000 AEP at the beginning of the year and Laredo's AAA balance was $240,000 at the beginning of the year.

Note. It is extremely unlikely that the AAA and shareholder's basis will be identical. However, in this example it helps to illustrate the different calculations for AAA and basis.

Before Teresa can determine the tax treatment of her distributions, the corporation must determine how much, if any, of the distribution is a dividend from AEP. The first step is to calculate the AAA as follows:

Beginning balance	$240,000
Income items (taxable only)[a]	150,000
Balance before losses and distributions	$390,000
Less: losses (limited to income above)	(150,000)
Balance before distributions	$240,000
Less: distributions (not to exceed above balance)	(240,000)
Balance after distributions	$ 0
Less: net negative adjustment	(40,000)
Ending balance	($ 40,000)

[a] Tax-exempt income of $10,000 goes to OAA, which has no significance to the corporation or to any shareholder.

Thus, the corporation is able to tell Teresa that her distributions consist of:

Distribution from AAA	$240,000
Distribution from AEP	40,000
Total distribution	$280,000

Teresa can now determine her basis, which affects how much distribution will be tax-free and how much loss she will be able to claim this year:

Beginning basis	$240,000
Income items (taxable + exempt)	160,000
Basis before distributions	$400,000
Less: tax-free distributions from AAA	(240,000)
Basis before loss items	$160,000
Less: loss items (limited to basis)	(160,000)
Ending basis	$ 0

All the distributions from AAA are tax-free, because she has sufficient basis. However, she can only claim $160,000 of the ordinary loss and must carry $30,000 forward to 2008. She must also include $40,000 of the distribution on her return as dividend income.

DISTRIBUTIONS OF NONCASH PROPERTY

This transaction is one in which the S corporation election occupies a middle ground between the partnership and the C corporation. A partnership can distribute property to its partners with no recognition of gain or loss in some circumstances.[71] A C corporation must recognize gain if the property's FMV at the date of distribution exceeds the corporation's basis in the property.[72] However, the corporation cannot recognize loss on the distribution (except for distribution in complete liquidation of the corporation) if the property's basis exceeds its FMV on the distribution date.[73]

The S corporation is subject to the same general rules as the C corporation in that it must recognize gain on distributions of appreciated property, but may not recognize losses on distributions of depreciated property.[74]

71. IRC §§731(a) and 731(b). There are several complicated exceptions to this rule.

72. IRC §311(b)

73. IRC §311(a)

74. IRC §§311(a) and 311(b). This rule applies to both C and S corporations. See IRC §1371(a).

Regardless of what happens to the corporation distributing the property, the shareholder takes a basis in the property equal to its FMV.[75]

Example 4. Use the same facts as **Example 3**. The corporation had earnings and profits of $300,000. Laredo distributed some vacant land with a basis of $200,000 and an FMV of $280,000. This fact changes the numbers considerably.

The corporation must first calculate its income. The capital gain is now $230,000 ($150,000 + $80,000), because Laredo must recognize gain on the distribution of the land to Teresa. Again, the first step is to calculate the AAA.

Beginning balance	$240,000
Income items (taxable only)[a]	230,000
Balance before losses and distributions	$470,000
Less: losses (limited to income above)	(190,000)
Balance before distributions	$280,000
Less: distributions (not to exceed above balance)	(280,000)
Balance after distributions	$ 0
Less: net negative adjustment[b]	0
Ending balance	$ 0

[a] Tax-exempt income of $10,000 goes to OAA, which has no significance to the corporation or to any shareholder.

[b] Loss of $190,000 did not exceed the income of $230,000.

Thus, the corporation is able to tell Teresa that her distributions consist of:

Distribution from AAA	$280,000
Distribution from AEP	0
Total distribution	$280,000

Teresa can now determine her basis which affects how much of the distribution will be tax-free and how much loss she may be able to claim this year.

Beginning basis	$240,000
Income items (taxable + exempt)	240,000
Basis before distributions	$480,000
Less: tax-free distributions from AAA	(280,000)
Basis before loss items	$200,000
Less: loss items (limited to basis)	(190,000)
Ending basis	$ 10,000

All of the distributions from AAA are tax-free because she has sufficient basis. She can claim all $190,000 of the ordinary loss. She does not include any dividend income.

75. IRC §§301(b) and 1371(a)

Effect of 15% Dividend Rate on S Corporation Distributions

The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the tax rate on certain dividends to 15% (5% for some low-bracket individuals). The Gulf Opportunity Zone Act of 2005 extended this rule through 2010. Dividends from domestic corporations qualify for the 15% rate.[76] Because all S corporations must be domestic corporations, dividends from S corporations could qualify. The distribution must be a **dividend**, as used in the code. In the S corporation context, relatively few distributions meet this definition. An S corporation with no earnings and profits will not make a distribution that qualifies for this rate. However, in most cases, the distribution from one of these S corporations is not taxable at all. In other cases, the distribution will be taxable at capital gain rates.

For a corporation with AEP, dividends occur only when the corporation's distributions within the taxable year exceed the AAA[77] or if the corporation elects to bypass AAA, discussed below. The only instances in which the dividends from an S corporation's AEP do not qualify would be if a shareholder did not meet the requisite holding period[78] or if the shareholder elected to treat the dividend as investment income.[79]

DISTRIBUTION ELECTIONS

In most situations, the distribution hierarchy provides an equitable formula for distributions from S corporations. The AAA rules allow shareholders to withdraw income that was reported on returns as tax-free recovery of investment. The AEP, which would have been dividend income if distributed when the corporation was still a C corporation, is still taxable as dividend income when distributed. However, this does not happen until the shareholders have had a chance to withdraw all of the income that has been taxable since the S election took effect.

It might be prudent to treat distributions as dividends if the corporation has passive investment income problems, discussed below. Alternatively, if the shareholders believe that the tax rate on dividends is likely to increase in the near future, it may be a good time to take advantage of the 15% dividend tax rate. A shareholder may also take a dividend and elect to treat it as investment income if the investment interest limits prevent deduction of some current or carried forward expense.

> **Example 5.** Use the facts in **Example 3**, in which the corporation distributed $280,000 in cash. Teresa believes that the rate on dividends will increase in the near future. She intends to take out considerably more cash than the AAA is likely to allow her to take tax-free. She might want the corporation to elect to treat the 2007 distribution as a dividend from its AEP.

Election to Bypass AAA

An S corporation, with the consent of all shareholders who receive distributions during a taxable year, may elect to distribute AEP before AAA.[80] An S corporation may elect to bypass the AAA and instead treat AEP as the first source of distribution during the taxable year. Once the election is made for a taxable year, it applies to all distributions made during the year until earnings and profits are exhausted. However, the election is only for one year and does not affect any other taxable year.[81]

Any shareholder who receives a distribution during the taxable year must consent to the election to distribute earnings and profits before AAA.[82] The language of the code seems to be relatively straightforward in that the corporation could not selectively impose a limit on the portion of a distribution that it wanted to treat as a dividend. The IRS has stated that an S corporation could not split a year's distributions between dividends and AAA.[83]

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76. IRC §1(h)(11)(B)(i)(I)
77. IRC §1368(c)(2)
78. IRC §1(h)(11)(B)(iii)(I)
79. IRC §163(d)(4)(B)
80. IRC §1368(e)(3)
81. Treas. Reg. §1.1368-1(f)(1)
82. Treas. Reg. §1.1368-1(f)(5)
83. Letter Ruling 8935013 (May 30, 1989). See also Treas. Reg. §1.1368-1(f)(1).

Election to Bypass PTI

If a corporation has previously taxed income (PTI), it is the second layer of distributions. The bypass election literally places the AAA after AEP. Therefore, an election under IRC §1368(e)(3) places PTI first in the hierarchy.[84] This can be a beneficial situation when all of the current shareholders have PTI accounts and want to plan for a transfer of shares.

However, an S corporation may need to exhaust its entire balance of AEP if it intends to avoid passive investment income problems. Therefore, with only the election to bypass AAA, the corporation will need to distribute its PTI accounts plus its earnings and profits.

A corporation may also make an election to distribute AEP before PTI.[85] The election is filed with a timely Form 1120S for the tax year of the distributions.[86] All shareholders must consent. This election, combined with an election to bypass AAA, will assure that the corporation may exhaust its AEP. It may also allow for equalization of tax treatment between shareholders.

Deemed Dividend Election

In order for an S corporation to eliminate earnings and profits, it must make a sufficient distribution. To avoid passive investment income problems, the distribution must exhaust the entire balance. The corporation must make this distribution before the year end. Consequently, an inaccurate calculation of earnings and profits (a fairly likely event, except in the simplest circumstances) may show that the corporation had not made a sufficient distribution during the taxable year. Fortunately, there is a deemed dividend election that treats the corporation as if it had distributed all its earnings and profits on the final day of the taxable year of the election. The shareholders are treated as if they received dividends in proportion to their stock ownership on the final day of the year and then contributed the cash back to the corporation as a contribution to capital. As a result, the deemed dividend election essentially converts the corporation's AEP to shareholder basis.

The corporation must make the bypass election for any cash or property that it distributed during the year. The corporation elects to treat any remaining AEP after distributions as a deemed dividend distributed prorated to the shareholders on the last day of the S corporation's taxable year.[87] Each shareholder must consent to the election and each shareholder must include the deemed dividend on his return for the year.[88]

PASSIVE INVESTMENT INCOME

Certain S corporations need to be concerned about levels of passive investment income. If the S corporation has no AEP (from prior C corporation years), there are no limits or problems with passive investment income. However, if the S corporation has AEP, there are **two potential problems** if the corporation's passive investment income exceeds 25% of its gross receipts:

1. In any year in which the corporation's passive gross receipts are too high, there is a 35% corporate level tax on the corporation's excess net passive income.[89]
2. If the corporation's passive investment income exceeds 25% of its gross receipts for three consecutive years (and the corporation has AEP in each of those years), the corporation loses its S status at the beginning of the next year.

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84. Treas. Reg. §1.1368-1(f)(2)(ii)
85. Treas. Reg. §1.1368-1(f)(4)
86. Treas. Reg. §1.1368-1(f)(5)
87. Treas. Reg. §1.1368-1(f)(3)
88. Treas. Reg. §1.1368-1(f)(3)(ii)
89. IRC §1375

DEFINITIONS OF PASSIVE INVESTMENT INCOME

Definitions of passive investment income are found in IRC §1362(d)(3). Stated briefly, sources of passive investment income are as follows:

1. Interest
2. Dividends
3. Annuities
4. Rents
5. Royalties
6. Gains from sale of stock or securities (although this category is no longer passive for taxable years beginning after 2007)[90]

Special Problems with Interest Income

Tax-exempt interest is passive income for these purposes.[91] However, the statute excludes interest on notes from sale of inventory interest derived by a lending or finance company, and some banking income, discussed below.

Dividend Rules

In general, dividends are treated as passive investment income. However, dividends received from a C corporation in which the S corporation owns 80% or more of the stock are not treated as passive investment income to the extent they are attributable to nonpassive income of the subsidiary.[92] In 2000, the IRS issued regulations to interpret the rule added by the Small Business Job Protection Act of 1996. The parent S corporation must:

1. Determine the mix of the subsidiary corporation's earnings and profits
2. Apply the mix of the earnings and profits to the actual dividend received

Bank Income

Income received by banks is not treated as passive if it meets any of the following categories:[93]

1. All loans and REMIC regular interests owned by the bank
2. Assets required to be held to conduct a banking business (such as Federal Reserve Bank stock, etc.)
3. Assets pledged to a third party to secure deposits or business
4. Investment assets that are held by the bank to satisfy reasonable liquidity needs

90. Small Business and Work Opportunity Tax Act of 2007 (PL 110-28, May 25, 2007), §8231, amending IRC §1362(d)

91. Treas. Reg. §1.1375-1(f), Example 2

92. IRC §1362(d)(3)(E)

93. Notice 97-5, 1997-1 CB 352 (December 20, 1996)

Income from Rents

Income from "rents" is subject to frequent litigation and rulings. It is not passive if significant services are provided. Regulations issued in November 1992 provide two general tests for income which may or may not be considered passive rental income:

1. Rents received in the course of an active trade or business whose purpose is renting property are not passive.[94]
2. When the lessor incurs substantial costs for the rental activity, the income is not passive. This rule does not apply to rents received under a net lease.[95]

Royalties

In general, royalties include payments for use of intangible property and interests in oil, gas, and mineral property. Until 1992, royalties were always passive investment income, with some narrow exceptions. Final regulations issued in November 1992 substantially liberalized the treatment of royalties. Royalties, derived in the active course of a trade or business, are not passive investment income if the royalty owner meets one of two conditions:

1. The property owner created the licensed property, or
2. The property owner incurs substantial costs for the development or marketing of the property.[96]

Tax on Excess Net Passive Income

Having defined "passive investment income," the next step is to compute excess net passive income. Excess net passive income can be represented as:

$$\frac{\text{(Passive investment income} - \text{(.25} \times \text{Gross receipts))}}{\text{Passive investment income}} \times \text{Net passive income} = \text{Excess net passive income}$$

The corporation computes the tax on this figure at the highest corporate rate (currently 35%). The passive income tax is limited to the tax on the corporation's taxable income.[97] Taxable income is computed as if the corporation was a C corporation, except that it is not allowed the special deduction for dividends received. It is also not allowed to use any carryover deductions.

The corporation's passive income tax reduces amounts reported to shareholders.[98] The corporation must apportion the tax to each category of passive income in proportion to net income from each source.[99]

S Election Termination Due to Excess Passive Income

If an S corporation has accumulated subchapter C earnings and profits and has passive income in excess of 25% of its gross receipts in three consecutive tax years, the S election is terminated on the first day of the following year.[100] An S corporation that discovers passive investment income after the fact may apply for inadvertent termination relief, which is usually granted.[101]

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94. Treas. Reg. §1.1362-2(c)(5)(ii)(B)(2)
95. Ibid.
96. Treas. Reg. §1.1362-2(c)(5)(ii)(A)(2)
97. IRC §1375(b)(1)(B)
98. IRC §1366(f)(3)
99. Treas. Reg. §1.1366-4(c)
100. IRC §1362(d)(3); Treas. Reg. §1.1362-2(c)
101. Jamison, Robert W., *S Corporation Taxation*, Chapter 13 (CCH Incorporated, 2007)

In addition, the IRS may waive the tax on passive income but only for erroneous earnings and profits calculations.[102] The corporation must have made a good faith determination that it had no AEP at the end of the year. Within a reasonable time after discovery of the earnings and profits, the corporation must distribute all AEP.

Planning Strategies for Dealing with Passive Investment Income

The passive investment income tax and termination are significant problems for S corporations that have the deadly combination of excess passive investment income and AEP at the end of the year. There are several planning strategies that the corporation and shareholders may employ.

Nonpassive Investments. An S corporation may invest in a partnership that has active gross receipts. An example is an oil or gas drilling venture. These normally have high gross receipts in relation to net income. If the general partner provides significant services, the gross receipts would not be passive investment income to the S corporation. The S corporation's distributive share of a publicly-traded partnership's gross receipts received by S corporation from petroleum product trade, storage, and transportation is not passive investment income within meaning of IRC §1362(d)(3)(C)(i).[103] This type of investment often produces extremely high gross receipts per dollar of investment and per dollar of net income. Therefore, the flow-through effect may raise the denominator of the investor's gross receipts to ensure other types of passive investment income do not exceed 25%.

Bypass and Deemed Dividend Elections. An S corporation may use the dividend (bypass) election of IRC §1368(e)(3) to avoid the passive investment income tax. If the S corporation does not have sufficient distributions in a taxable year to exhaust its AEP, the corporation and its shareholders may make a deemed dividend election. This allows the corporation to treat the shareholders as if they had received dividends for the corporation's entire balance of AEP at the close of the taxable year.[104]

Example 6. Use the same facts as **Example 5.** The corporation distributed $280,000 in cash. In this case, the capital gain of $150,000 was passive investment income (although this would not be possible after 2007). The other gross receipts of the corporation were $160,000 and the exempt income was municipal bond interest. As a result, the gross receipts, for purposes of the passive investment income test for 2007, were:

Capital gain	$150,000
Exempt interest	10,000
Other, from active business	160,000
Total income	$320,000
The excess passive gross receipts are:	
Total passive income ($150,000 + $10,000)	$160,000
Less: 25% of total income	(80,000)
Excess portion	$ 80,000

The corporation might be subject to a 35% tax on $80,000. However, the corporation also had a significant ordinary loss, which eliminated the corporation's tax liability for the year. If the corporation exceeded the 25% limit for three consecutive years, it would lose its election if it still had any earnings and profits at the end of Year 7. If it eliminated its earnings and profits at the end of 2007, it would preserve its eligibility for S status.

102. IRC §1375(d)

103. Letter Ruling 200240043 (June 28, 2002)

104. Treas. Reg. §1.1368-1(f)(3)

The first step would be the bypass election, which treats the entire distribution as a dividend from earnings and profits. However, as stated in **Example 3,** the corporation's AEP at the beginning of 2007 was $300,000. Consequently, even with the bypass election, there are still $20,000 earnings and profits at the end of the year and the corporation's S election terminates as of the next year.

There is valuable hindsight planning that can save the situation. If the corporation made a deemed dividend election, it would treat the remaining $20,000 as an end of 2007 dividend to Teresa. Teresa must report all $300,000 of the actual and deemed distribution as dividend income, although in 2007 it would qualify for the capital gain rate of 15% income tax. The corporation would not be subject to the passive investment income problems. Beginning in 2008, the nature of the distributions are all determined by reference to Teresa's basis because Laredo is now an S corporation with no AEP.