Chapter 11: Entity Issues

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

GENERAL TAX MATTERS

This chapter consists of numerous issues arising from recent IRS rulings or questions posed to the author in his tax consulting practice.

ISSUE 1: PREPAYMENTS FOR FUTURE SERVICES BY ACCRUAL BASIS TAXPAYER[1]

Accrual basis taxpayers may **not** currently deduct prepayments for future services under the 3½ month rule or the recurring item exception. However, prepayments are deductible if all the services connected with that prepayment are provided within the respective 3½ or 8½ month period following the end of the tax year in which they were paid. In addition, a deduction **cannot** be prorated based on the amount of services delivered during the applicable period.

The IRS stated in Rev. Rul. 2007-3 that payments made for service and insurance contracts are only **deductible in the year that the services are actually provided,** and **not** in the year when the contract is signed. This is true even if the service or insurance payments are recurring tax items. In addition, as discussed later in **Issue 15,** members of a controlled group might have to delay a deduction for services provided until the other members report the related income.

Memorandum Scenario

William entered into a 12-month contract with a service provider at the end of the year and prepaid for the services to be provided during the following year. On his tax return, William deducted the prepayment as a current expense, relying on the 3½ month rule, as well as the recurring item exception.

> **Note.** The IRS indicated that this fact pattern has appeared in various industries and that the taxpayer's approach for claiming a current deduction has actually been promoted by several accounting firms.[2]

Background

Treas. Reg. §1.461-1(a)(2)(i) provides that under the accrual method of accounting, a liability is incurred and is generally deducted for tax purposes in the tax year in which:

1. All events occurred that established the fact of the liability,
2. The amount of the liability can be determined with reasonable accuracy, and
3. Economic performance occurred related to the liability.

Economic performance occurs for a liability related to future services when the services are actually provided.[3] Under the 3½ month rule, the taxpayer "must reasonably expect the person to provide the services or property within 3½ months after the date of payment."[4] Under the recurring item exception, a liability is treated as incurred for a tax year if:

1. At the end of the tax year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy;
2. Economic performance occurs on or before the **earlier** of:
    a. The date that the taxpayer files a return (including extensions) for the tax year, or
    b. The 15th day of the 9th calendar month after the close of the tax year (8½ months);

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1. IRC §461
2. AM 2007-009 (September 1, 2006)
3. Treas. Reg. §1.461-4(d)(2)
4. Treas. Reg. §1.461-4(d)(6)(ii)

3. The liability is recurring in nature; and

4. Either the amount of the liability is **not** material, or accruing the liability in the tax year results in better matching against the income than accruing the liability in the tax year when economic performance occurs.[5]

Applying Accrual Accounting Exceptions

In AM 2007-009, the IRS concludes that **neither** the 3$^1/_2$ month rule nor the recurring item exception allows a deduction for prepayments when all the services are **not** actually provided within the applicable 3$^1/_2$ or 8$^1/_2$ month period. For the 3$^1/_2$ month rule, no deduction is allowed for year-end prepayments made for services performed in the first 3$^1/_2$ months of the following year if the contract extends beyond the 3$^1/_2$ month period. No deduction is allowed under the recurring item exception for prepayments made at the end of one year for services performed in the first 8$^1/_2$ months of the following year if the contract extends beyond that 8$^1/_2$ month period.

While the language of the 3$^1/_2$ month rule[6] and the recurring item exception[7] does **not** specifically state that economic performance must be completed within the 3$^1/_2$ month or 8$^1/_2$ month period, the IRS reasoned "they implicitly require it." Unlike the 2$^1/_2$ month rule for deferred compensation[8] that applies to the extent that compensation is received within the 2$^1/_2$ month period, the 3$^1/_2$ month rule and the recurring item exception do **not** allow economic performance for a pro rata amount or a portion of the liability. Both these exceptions to the general accrual accounting rules require that economic performance actually occur. Thus, William would not be allowed to deduct the expense for the contract until the following taxable year.

The IRS concluded that an all-or-nothing approach applies for a liability under **both** the 3$^1/_2$ month rule and the recurring item exception. Therefore, deductions must be delayed until the subsequent tax year when the services are actually provided.

Treas. Reg. §1.461-4(d)(6)(iv), which deals with economic performance, provides that liability is **not divisible** unless **different services** are required under a **single contract.** In this case, economic performance occurs and any applicable economic performance exception applies separately for each service. Therefore, taxpayers may be able to currently deduct prepayments under the 3$^1/_2$ month rule and the recurring item exception **either** by:

1. Using a **multiple contract approach,** so that one contract covers only services provided within the applicable 3$^1/_2$ or 8$^1/_2$ month period and are currently deductible, and another contract covers services outside this period which are **not** currently deductible; or

2. Using a **single contract approach,** so that different services are separated into those performed within the applicable 3$^1/_2$ or 8$^1/_2$ month periods, and those that are not.

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Note. Commissioner consent is needed to change the treatment of liability for services or insurance to comply with Rev. Rul. 2007-3. See Rev. Proc. 2007-14.

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5. IRC §461(h)(3) and Treas. Reg. §1.461-5(b)(1)

6. Treas. Reg. §1.461-4(d)(6)(ii)

7. IRC §461(h)(3) and Treas. Reg. §1.461-5

8. Temp. Treas. Reg. §1.404(b)-1T(b)(1)

ISSUE 2: RECHARACTERIZATION OF RENTAL INCOME[9]

It is very common for a closely-held business to keep real estate in a separate entity to protect the assets from creditor claims. A separate entity can allow generation of nonFICA rent dollars, which are passed to the company's owners. Typically, the entity is an LLC owned by the same individuals as those involved with the day-to-day business. Occasionally, outside investors are members of the real estate LLC. In a recent case outlined below, the 9th Circuit affirmed that if the owners materially participate in the underlying operations of a trade or business, any net rental income is **recharacterized as nonpassive income.** This is opposed to the net rental income automatically being passive income which can be used to offset any current or suspended passive losses as is normally the case.

Nonpassive income is a separate type of income, distinguished from active (W-2 wages or S/E income), portfolio (dividends, interest, net capital gains, or royalties), or passive income. Consequently, nonpassive income is not available as a source of investment income to be used on Form 4952, *Investment Interest Expense Deduction,* to allow the deduction of investment interest expense.

Case Facts

In *Beecher v. Comm'r,* the 9th Circuit joined with other courts and affirmed the validity of the passive loss recharacterization rules.[10] The court precluded a married couple from applying losses from their rental properties to offset rental income derived from leases of their residential property as office space to their wholly-owned lessee corporations.

The Beechers each owned 100% of two different C corporations. The husband's company repaired automobile interiors, and the wife's business removed dents from cars. Both spouses worked full-time in the corporations and both businesses were operated out of their home. The corporations paid rent for the use of this space. In addition to renting a portion of their home to the businesses, the couple also owned five other rental properties. For three consecutive tax years, they sheltered the net rental income paid to them from their corporations with the rental losses on their other properties. The IRS recharacterized the rental income from their corporations as nonpassive under the self-rental rule[11] because the couple materially participated in the business operations of the lessee corporations. The Beechers, under their company name (California Interiors, Inc.), petitioned the Tax Court, where they lost. On appeal to the 9th Circuit, they presented the following arguments:

- The rule, as applied to C corporations, is arbitrary.
- Congress' grant of regulatory authority to the IRS "is so vague and uncertain as to be invalid."
- Even if the self-rental is valid, it should **not** apply to them since §469(l) was enacted specifically to combat abusive tax shelters and does **not** apply "when the motivation is a bona fide business purpose."

Appeals Court Decision[12]

The 9th Circuit rejected all three arguments and joined the 1st, 5th, and 7th Circuits in upholding the regulation in finding that the rule is **not** arbitrary or capricious, and the IRS's legislative regulatory authority was not unconstitutional in this area. Furthermore, there is nothing in the statute or legislative history that indicates that the taxpayer "must lack a bona fide business purpose to fall within the scope of §469."

The IRS alerted auditors to look for this issue. It is very common to keep real estate outside the operating business in a separate LLC for liability and creditor claim purposes, and then rent it back to the corporation. Though it may produce nonFICA rent dollars, these same dollars do **not** result in passive income available for offsetting passive losses. Michael Grace, the author of these regulations, probably had a valid reason for their issuance. Specifically, preventing a closely-held business from paying inflated rents, free of both employment and income tax (to the extent the rents can be offset by other passive losses), and avoiding payment of compensation subject to SE tax.

9. IRC §469

10. *Beecher v Comm'r,* 481 F.3d 717 (9th Cir. 2007), *aff'g Calif. Interiors, Inc. v. Comm'r,* TC Memo 2004-99, April 7, 2004

11. Treas. Reg. §1.469-2(f)(6)

12. *Beecher v. Comm'r,* 481 F.3d 717 (9th Cir. 2007)

Note. Recharacterization rules only apply to materially participating owner/employees when the company is a closely-held corporation. A closely-held corporation has five or fewer owners who control more than 50% of the stock anytime during the last six months of the tax year. Also, they would not impact owners who were merely investors and who did not otherwise materially participate in the underlying trade or business to which the property was rented.

Note. Some practitioners fail to note the existence of IRC §280A(c)(6) which denies deductions on a Schedule E, *Supplemental Income and Loss*, when an employee rents a home office to his employer. Otherwise allowable deductions, such as home mortgage interest and real estate taxes are reported on Schedule A as itemized deductions. The rent paid by the corporation is listed on Schedule E; however, the schedule is blank except for the gross receipts. **As a planning option to avoid this restriction, the rental agreement can require the company to reimburse or directly cover its allocable share of the home office expenses such as utilities and homeowner's insurance.** Consequently, there is no need to list these expenses on the Schedule E. If this approach is used, the only type of expense precluded by §280A(c)(6) is the noncash expenditure for depreciating the home office percentage, which is treated as MACRS 39-year commercial property.

ISSUE 3: GROUPING RENTAL ACTIVITIES TO AVOID PASSIVE LOSS RULES[13]

Treas. Reg. §1.469-4(d)(1)(i)(C) permits certain groupings in which there is **identical** ownership of both activities. Many businesses choose to keep real estate outside the company and rent it back. This creates a passive activity for the landlord(s) who usually materially participate in the underlying day-to-day operations. With the recharacterization rules discussed in **Issue 2, net rental income** is treated as **nonpassive**, however, **net rental loss** is considered **passive** income.

A grouping election treats two activities as one under the passive loss rules. Net rental income is nonpassive because rent is paid from an activity in which the owners materially participate. The advantage comes when a net rental loss is expected for a particular tax year. This might occur when the company is doing poorly and must use any available cash to pay creditors, leaving little money to pay rent to the owners who also own the real estate. Another common situation involves the business choosing to do a cost segregation study with the hope of finding misclassified assets and catching up on the missed depreciation associated with them. Because this deduction is taken all in one year,[14] it can sometimes create a net rental loss.

Consulting Scenario

The taxpayer owns 100% of a building held in a single-member LLC (SMLLC) and also owns 100% of an S corporation that conducts a profitable restaurant business. Depreciation of $200,000, created by a catch-up adjustment, results in a current tax year net rental loss for the normally profitable rental activity. By grouping the activities, the rental loss can be offset by the K-1 income shown on the same Schedule E, page 2 (assuming this combination is an "appropriate economic unit"). In this situation, the rental is no longer regarded as a **separate** activity that is automatically passive. Instead, it becomes part of the overall trade or business activity in which the taxpayer is materially participating.

13. IRC §469

14. Rev. Proc. 2002-19, 2002-1 CB 696

Consultant's Advice

With regard to the consistency requirement outlined in Treas. Reg. §1.469-4(e), the fact that net rental income shown on all prior years' tax returns was recharacterized as nonpassive does **not** affect the ability to make a grouping election for the current tax year. To make the election, a statement is submitted with the tax return which includes the taxpayer's name, EIN, and the affected tax year. The statement indicates that an election is being made to group activities pursuant to Treas. Reg. §1.469-4(c), and should contain language similar to the following:

> *The taxpayer hereby elects to group the following activities, so the grouped activities are treated as a single activity under the passive loss rules for the year ending __________, and all years thereafter.*

The election must state that the activities are grouped together and treated as one activity. A listing of the grouped activities should be included.

> **Note.** Once the election is in effect, practitioners should make sure their tax preparation software does **not** allow this rental loss to flow to Form 8582, *Passive Activity Loss Limitations*. Without this election, this is what the software program would normally do. Instead, it should flow directly from Schedule E to Form 1040, page 1.

In the view of the IRS, Schedule E rental activities with few expenses and significant net income could be indicative of a self-rental situation. If the income is reflected on Form 8582, line 1, the IRS is likely to inquire as to the identity of the lessee and if the taxpayer renders material participation in the entity. The self-rental regulation is only a concern if the taxpayer has other passive losses which could have been absorbed by the rental income if it were passive.

ISSUE 4: NONACCOUNTABLE EXPENSE REIMBURSEMENT ARRANGEMENTS USING FEDERAL PER DIEM RATES[15]

Many companies use accountable plan arrangements. Employees are reimbursed for expenses without having to submit receipts for specific expenses. Instead, employees use the standard rates permitted under the federal per diem guidelines for meals and incidentals and lodging costs.[16] The IRS is intensifying efforts to audit employers who provide employee reimbursements in excess of per diem allowances without requiring detailed accounting to justify higher levels of reimbursement. The IRS granted a certain level of amnesty for situations occurring before January 1, 2007, and taxed only the excess of the reimbursement over the federal per diem rate. **After 2006, all amounts received by the employee in these situations are treated as additional wages, subject to normal withholding rules.**

To implement these guidelines, the IRS issued a memorandum for their field auditors that clarifies guidance originally issued in Rev. Rul. 2006-56.

IRS Ruling

Rev. Rul. 2006-56 provides guidance for the proper employment tax treatment of expense allowance payments "when an employer routinely fails to treat amounts exceeding the federal per diem rate as wages." In these instances, the ruling holds that the **entire** reimbursement for business travel-related meals and incidental expenses must be treated as paid under a nonaccountable plan. Therefore, they are treated as wages if the employer does **not** track expenses and does **not** require employees to either actually substantiate expenses or pay back amounts in excess of the federal per diem rates.

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15. IRC §162

16. Treas. Reg. §1.162-2(e)(2)

Periods Ending before January 1, 2007. The memorandum notes that most taxpayers who did not comply with Rev. Rul. 2006-56 after its November 2006 release "needed time to update or secure accounting software enabling them to compute the proper amount of additional wages." As a result, for taxable periods ending on or before December 31, 2006, the IRS advised its examiners **not** to treat a plan "as entirely nonaccountable" solely because excess per diem payments were **not** treated as wages. Instead, the examiner should only treat "the excess amounts over the federal per diem limit as wages." However, the IRS noted that there might be egregious circumstances, or evidence of intentional noncompliance, that would require different treatment.

Periods Ending after December 31, 2006. Effective January 1, 2007, IRS examiners are required to determine if the plan is abusive based on:

1. The extent of the excess payments that are **not** treated as wages, and
2. Whether a system for tracking excess payments is being utilized.

If the employer utilizes a system for tracking excess payments, then the fact that it routinely pays excess allowances that are **not** treated as wages due to errors in its system generally "does **not** on its own evidence a pattern of abuse." However, the IRS notes that each case stands on its own, and a determination is made based on the facts and circumstances of each particular case. Nevertheless, if a plan indicates a pattern of abuse, **all** per diem payments made under the plan are treated as taxable wages. On the other hand, if a plan does **not** evidence a pattern of abuse, but an employer has paid excess allowances without treating them as wages, only the **excess** per diem payments are treated as taxable wages.

ISSUE 5: CONTRIBUTIONS VERSUS SALES OF ASSETS TO CONTROLLED ENTITIES[17]

A sale or exchange of assets to an entity normally results in immediate tax consequences, measured by the difference between the basis of the assets sold[18] and the fair market value (FMV) of the consideration received in exchange. If a taxpayer wishes to defer gain recognition on the transfer, and prevent gain from being recharacterized as ordinary income, assets can be transferred in exchange for an ownership interest in the underlying entity. For transfers to corporations, the operative provision is IRC §351. If the transfer is made to a partnership or LLC, IRC §721 applies. The following discusses various tax issues that can arise and tax planning strategies, especially when the overall tax ramifications are permanently reduced.

Trade or Business Property

Gain or loss is normally determined by the difference between the asset's adjusted basis and the FMV of the property received in the exchange. The character of gain or loss reflects the character of the asset while held by the transferor. For instance, §1231 governs gain for trade or business assets held long-term by the transferor. These assets are subject to the allowance for depreciation or are real estate used in the taxpayer's business. Therefore, it is reported on Form 4797, *Sale of Business Property*. The gain has the possibility of being recharacterized as ordinary income due to depreciation deductions. This normally occurs on the disposition of tangible personal property. Generally, any excess gain above §1245 or §1250 recapture or all gain related to real property transfers is treated as capital gains. However, this is not the case when there are §1231 losses in the current tax year, or unrecaptured §1231 losses for the prior five years. If a loss occurred on the transfer, §1231 treats this as an ordinary loss which flows to page 1 of the taxpayer's return.

17. IRC §§351 and 721

18. Normally determined under IRC §1001

Example 1. Marco sold a rental property. It had an adjusted basis of $100,000 and was sold for $250,000 to an unrelated third party. The original cost of the building was $150,000 and S/L depreciation of $50,000 was taken. The $150,000 gain ($250,000 – 100,000) is divided into two parts.

1. To the extent of the $50,000 S/L depreciation, the gain is separately reported on Form 4797, *Sale of Business Property,* and is taxed at a rate not exceeding 25% (as unrecaptured §1250 gain).

2. IRC §1231 controls the remaining $100,000 of gain. This is treated as capital gain, absent any §1231 losses for the current or prior five tax years. The entire $150,000 gain flows from Form 4797 to the Schedule D worksheets. Because Marco is an individual, the gains offset any capital losses. In addition, the $150,000 gain simultaneously goes to Form 8582, *Passive Activity Credit Limitations,* where it is available for use against any current or suspended passive losses.

Note. This is a rather straightforward example. It demonstrates a situation in which some or all gain can be offset for **both** passive losses and/or capital losses. Therefore, it might make sense to have a taxable sale rather than a tax-deferred transfer in exchange for an ownership interest. However, if the taxpayer has significant §1231 losses from the current year or an unrecaptured carryover from any of the prior five tax years, a tax-deferred transfer might make more sense. This is also the case if the property is depreciable in the hands of the corporate transferee. This is discussed in more detail later.

Investment Property

If the property being sold was held for investment, such as raw land, it results in either an overall capital gain or loss. However, if the taxpayer wants to avoid immediate gain recognition on the exchange and wants to secure an entity ownership interest to which the asset was being transferred, consideration should be given to the following provisions.

1. Depreciable Property Is Sold to a Controlled Corporate Entity. IRC §1239 stipulates that if the taxable sale or exchange is made to a controlled corporate entity[19] and the property sold is depreciable in the hands of the transferee, then all the gain is recharacterized as ordinary income.

Example 2. Use the same facts as in **Example 1.** The entire $150,000 gain is recharacterized as ordinary income. Therefore, it does **not** matter whether §1245 results in depreciation recapture or whether there are unrecaptured §1250 25% gains due to S/L depreciation. IRC §1239 takes precedence over these rules, and this gain is reported as "other income" on the transferor's tax return.

Note. Arguably, it is still treated as passive income given that a rental activity was sold. Therefore, it is not entirely disadvantageous to the extent that some or all of the gain can be sheltered by allowing the current or suspended passive losses. However, it definitely is **not** §1231 gain that flows to Schedule D to offset any capital losses that the taxpayer might otherwise have.

Example 3. If the property Marco sold was **raw investment land** instead of rental property, **§1239 would not apply, and all the gain is capital gain.**

2. Transfers To Corporations For Stock. Whether the transfer is to an S or C corporation, IRC §351 possibly applies, given that the transferor is only receiving company stock in the exchange. However, if the transferor receives securities (of any given maturity), cash, or other property, this boot causes the exchange to be at least partially recognized for tax purposes.

19. Defined as when the transferor owns directly or indirectly more than 50% of the entity

Gain can also result when liabilities secured by the property being transferred are in excess of the property's basis.[20] One major precondition to having §351 apply is that the transferor(s) must control at least 80% of the corporation immediately after the transfer. This requirement can be difficult to meet when the transfer is to an existing corporation and no other transfers are simultaneously made. However, for purposes of this discussion, when the transfer is to a controlled corporate entity, §351 applies.

Note. Keep in mind that the nonrecognition provisions of §351 are **mandatory** when the transferor controls the corporate entity to which the property is being transferred and only stock is received. Therefore, if a need exists to have gain recognized, there should be an outright sale to the controlled entity or enough boot to create the recognized gain necessary to utilize these tax attributes.

3. Sale To Controlled LLC Taxed as Partnership. A common situation with appreciation in land values is an attempt to lock in capital gains by selling the real estate to a development entity. This produces ordinary income on future sales of these lots or finished homes to the extent of post-sale appreciation. It is critical to understand the tax trap inherent in selling property that will become inventory in the hands of the LLC transferee, given that the transferor is in direct or indirect control of the LLC to which the property is sold. This is property which is not a capital asset. IRC §707(b)(2)(A) mandates that if the asset in the hands of the LLC transferee is other than a capital asset[21] (e.g., inventory lots or land used in the LLC's trade or business), the transfer results in an automatic characterization of any gain as ordinary income.

Example 4. Gabby sells raw land to a development LLC that he controls. It has a basis of $100,000 and an FMV of $250,000. The LLC plans to make site improvements, subdivide the land, and sell the lots for home construction. Because Gabby owns **more than 50% of the LLC,** all the gain is characterized as **ordinary** income.

Example 5. Use the same facts as **Example 4,** except the LLC decides to build a hotel on the land. It plans to lease it to a national franchise. Because this land will be used as a §1231 asset (i.e., rental property) and **not** as a capital asset, all the gain on the sale is treated as **ordinary** income to Gabby.

Note. The transferor is allowed capital gains treatment if he otherwise owns 50% or less of the development LLC. However, if the transferor controls the entity to which the property is sold, then use of an S corporation should be seriously considered.

IRC §1239, unlike §707(b)(2)(A), **does not apply** since inventory lots (or even §1231 land on which a constructed building will sit) is **not depreciable** in the hands of a corporate transferee. Moreover, to simply contribute the appreciated land to a controlled LLC in return for an ownership interest under §721 might not be a viable option because the land will be converted into ordinary income property (i.e., inventory lots upon the completion of the development activities). As a result, **all** the precontribution capital gain, in addition to any gain from appreciation due to improvements, is converted to ordinary income.

ISSUE 6: BUYOUT OF CLOSELY-HELD BUSINESS INTERESTS IN LLC AND S CORPORATION

The sale of a business has numerous tax issues. Since it is more common to sell assets versus an owner's stock or LLC interest, the first issue to address is how to allocate the purchase price. Frequently, the buyer and seller are at odds about how Form 8594, *Asset Acquisition Statement,* should be completed. The buyer typically wants the bulk of the monies allocated to shorter-lived assets. The seller wants most of the sales price allocated to goodwill resulting in capital gain. Provided the two parties are unrelated, the IRS generally respects the allocation of the purchase price as shown on the form.

20. IRC 357(c)

21. As defined under IRC §1221

If a sale of stock or a member's LLC interest is involved, questions arise. How does this situation differ from a sale of assets? What are the responsibilities of the tax preparer for the entity's return? How do the responsibilities vary with a Form 1065 for an LLC?

The following illustrates a sale of S corporation stock and a simultaneous purchase of an LLC interest. The LLC owns the real estate that the S corporation rents for use in its business.

Consulting Scenario

A restaurant/catering business, 19th Hole Catering, is operated by an S corporation. The S corporation holds a liquor license in a township that severely restricts the issuance of new licenses. The other business, a golf course, is operated as an LLC. The LLC owns the real estate, inventory in the pro shop, all the golf course equipment, and carts. Both businesses are owned in a 40%/40%/20% ratio by Wally, Mabel and Arthur, respectively. Wally purchased Mabel's 40% interest in both companies for a total of $275,000. Originally, he sought to allocate $1 as being paid for the S corporation stock, and $274,999 being paid for the LLC interest. Mabel also received an additional $232,000 due to the relief of her share of the LLC's debt.

Tax Professional A prepares the entities' returns. Tax Professional B prepares Wally's return.

Consultant's Analysis

Following are some tax issues to consider:

1. The allocation of $1 paid for the S corporation stock is **not** likely to withstand IRS scrutiny, considering the valuable liquor license that it holds and that it is in the process of expanding its restaurant/catering business. Tax Professional A prepares both Form 1120S and Form 1065. In his opinion, he recommends that at least $50,000 be allocated to the purchase of the S corporation stock.

> **Note.** Considering that there is no step-up in basis with the purchase of the S corporation stock, a blatant attempt (in the scenario) was being made to allocate as much of the purchase price toward the LLC interest (which could be stepped-up with a §754 election) as possible.

2. Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*, must be filed whenever there is an ownership change in the LLC. Instructions should be reviewed for what specifically to include. Supplemental information must be supplied to the selling member, especially related to hot assets that are deemed sold because of the transfer. The transferor is required to attach a statement to his tax return for the year of the sale listing all pertinent information.[22]

3. The S corporation has no equivalent to the §751 hot asset provisions when stock is purchased. The only thing that needs to be taken into account is the potential 28% tax on collectibles that the S corporation might hold. As a result, the ownership change is only noted in the appropriate section of the Form 1120S. No supplemental K-1 information must be supplied to the selling shareholder.

4. A supplemental statement should be filed with the Schedule K-1 detailing what the exiting LLC member is considered to have received for total proceeds. This includes the relief from $232,000 of recourse debt. This also includes details about the character of the proceeds, considering she relinquished 40% in every LLC asset. It must be determined to what extent the §751 hot asset rules apply for the deemed disposition of ordinary income assets. This includes the pro shop inventory and assets eligible for §1245 depreciation, such as golf course equipment. Unrecaptured §1250 gain and gain due to S/L depreciation for structures sold at a price above their current adjusted basis are also included.

22. Treas. Reg. 1.751-1(a)(3)

Note. It is likely there is little appreciation on either the pro shop inventory or the golf course equipment, unless they were recently purchased and a large portion was immediately expensed. The real estate might have appreciation potential if the buyer of the golf course was a residential real estate developer who kept the club house/restaurant standing. However, it is possible that a developer would tear down the maintenance sheds in addition to the club house. In this situation, it might be reasonable to conclude that all the value is in the land and no 25% gain is expected due to the disposition of the structures.

5. The §754 step-up applies to the $457,000. This is true because $50,000 of the $275,000 total consideration, as mentioned in item 1, was allocated to the S corporation stock purchase. The mechanics of making this election are covered under Treas. Reg. §1.755.

   If a §754 election is **not** in place when the purchase is made, the taxpayer has until the extended due date of the Form 1065 to make the election. Under Treas. Reg. §301-9100-2, there is an automatic 12-month extension if this initial deadline is missed.

Note. In this situation, the buyer controls 80% of both entities, so assuring that a §754 election existed was not a problem. However, when minority owners buy into an LLC, this election may be considered and possibly included in the purchase negotiation.

   A purchase of S corporation stock does **not** normally present an opportunity for stepping up the inside bases of the underlying assets being indirectly purchased. However, the equivalent of a §754 election can be accomplished if an **S corporation** purchases the assets, rather than an **individual**. IRC §338 makes this possible since it allows a step-up to the inside bases of the corporate assets equal to the price paid for recently purchased stock. Because an S corporation is now allowed to own 100% of another S corporation when a proper QSub election has been made, this can effectively result in the same step-up as a §754 election with little or no additional tax cost. More on this subject is included in the "S Corporations" section later in the chapter.

6. Each of the owners' capital accounts are reflected on the Schedule K-1 received from the LLC. When one member buys another member's interest, the exiting member's inside basis for his capital account is merged with the purchasing member's current inside basis.

ISSUE 7: IMPUTED INTEREST RULES AND LOANS BY CLOSELY-HELD BUSINESS OWNERS[23]

Most owners of smaller companies are required to guarantee their entity's debts. Occasionally, even the owner's promise to pay if the company becomes insolvent is inadequate to obtain outside financing. As a result, owners must contribute their own monies. How to best arrange this transfer of funds is considered in the following two options:

1. The payment can be treated as a contribution to the entity's capital. This results in a corresponding increase in the basis of the owner's interest for tax purposes. This allows distributions, the deduction of K-1 losses, and a recovery of basis upon the sale or exchange of his investment in the business.

2. The payment can also be reported as a loan on the company's books. In this situation, there are a number of tax issues. (1) How is the interest being paid treated for tax purposes? (2) How is interest imputed if no interest is paid related to the outstanding loan balance?

23. IRC §183

IRS Notice 89-35, Sec. IV, deals with interest expense treatment when the owner of a flow-through entity borrows money to either purchase an ownership stake in the business or contribute to the company's capital. In such instances, the interest expense is listed on Schedule E, page 2 (along with any other K-1 information). **If borrowed monies are used to make a loan to a flow-through entity, then the interest expense is treated as investment-related.** This expense must be deducted on Form 4952, *Investment Interest Expense Deduction*, where it flows to Schedule A as an itemized deduction to the extent of any net investment income. The interest expense is considered investment-related because it is incurred to produce interest income (i.e., portfolio income) which is otherwise reported on the owner's Schedule B. This interest income to the owner is deemed received even if the company has **not** actually paid any interest related to the loan.

Imputed Interest Rules

Certain types of loans, such as below-market loans, do not have an adequate interest rate stated in the contract. These loans are treated as loans bearing a deemed market rate of interest that is treated as paid by the borrower to the lender. At the same time, there is a deemed transfer of funds from the lender to the borrower which pays the interest.[24] A loan is considered below-market if the charged interest rate is lower than the current applicable federal rate (AFR).[25] The AFR is tied to the rate the U.S. government pays on securities with maturities comparable to the loan in question. For **demand** loans, the interest paid is at a rate less than the AFR. For **term** loans, the amount loaned exceeds the present value of all payments otherwise due under the loan (i.e., original issue discount).

Applicable Federal Rate (AFR)

The AFR is an annual stated interest rate based on semiannual compounding. However, the IRS provides equivalent rates based on annual, quarterly, and monthly compounding periods. This allows taxpayers to apply the imputed interest rules to loans other than those involving semiannual payments or compounding. Consequently, loans providing for annual payments or interest compounding over the entire life of the loan use the AFR based on annual compounding. Alternatively, quarterly or monthly payments/compounding use applicable AFR based on quarterly or monthly compounding.

The **shorter** payment/compounding period determines the applicable rate. Loans providing for interest payments/compounding at other intervals, such as daily, weekly, or bi-monthly may use the AFR published by the IRS based on the shortest compounding period that is longer than the shorter of the actual payment/compounding period. For example, loans providing for daily or weekly payments/compounding may use the AFR based on monthly compounding. Loans providing for bi-monthly payments/compounding use the AFR based on quarterly compounding.

Note. The AFR is published monthly by the IRS for the ensuing calendar month. The IRS believes a loan has a sufficient stated interest rate if it provides for interest on the outstanding loan balance at a rate no lower than the AFR based on a compounding period appropriate for that loan.

There are AFR tables in Chapter 16, "Tax Rates and Useful Tables."

There are several exceptions related to the imputed interest rules. One exception relates to de minimis loans between a shareholder and his corporation **that do not** exceed $10,000.

24. IRC §7872

25. IRC §7872(e)(1)

Computing Imputed Interest

Imposition of the imputed interest rules occurs when a demand loan between the entity and the owner exists, and no interest rate is stated or paid. Imputed interest also applies if the loan's interest rate is **not** at least equal to the AFR specified at the time the loan is initiated. Normally, the AFR is an annual rate based on **semiannual** compounding.[26] However, equivalent rates based on other compounding periods enable the application of the AFR to various types of loans. For instance, a demand loan that includes a 5% interest rate, compounded **monthly**, should be compared with the AFR for monthly compounding to determine if it is considered below market rate. For a loan originating in June 2007, on which interest is paid either annually, semi-annually, quarterly, or monthly, the taxpayer refers to the APR tables for that particular time period[27] and finds the following short-term adjusted AFRs:

- Annual = 3.52%
- Semi-annual = 3.49%
- Quarterly = 3.49%
- Monthly = 3.46%

In the case of a demand loan, the AFR for a semiannual period, January 1 through June 30, or July 1 through December 31, is normally the federal statutory short-term rate in effect for the semiannual period. However, the alternate federal short-term rate in effect on the day the loan is made may be used.[28] Obviously, if the loan calls for the payment of interest that **equals or exceeds** the AFR, then the imputed interest rules do **not** apply.

Example 6. Dan makes a demand loan to his corporation for $100,000, with interest compounded semi-annually. At the initiation of this loan, the AFR is 3.49%. In order to avoid the imputed interest rules, the loan calls for semi-annual interest payments of $1,745. Because the interest payments reflect a rate at least equal to the AFR, the imputed interest rules do **not** apply.

Example 7. Use the same facts as **Example 6**, except the loan provides for no interest payment to Dan. IRC §7872 treats the company as having made semi-annual payments of $1,745 for as long as the loan is outstanding. The company receives an interest deduction on its tax return equal to this amount. In addition, Dan must include the same amount of interest income on his Schedule B. Dan is deemed to have made a capital contribution to the corporation each year for $3,490 (2 × $1,745). This correspondingly increases his stock basis.

The loan recipient is required to report any imputed interest deemed paid on Form 1099-INT, *Interest Income*.

ISSUE 8: HYBRID ACCOUNTING METHOD WHEN $10 MILLION GROSS RECEIPTS EXCEEDED[29]

IRC §448 requires C corporations to use the accrual method of accounting when its average gross receipts exceed $5 million, unless they are "qualified personal service corporations." Other entities can continue to use the cash method until their average gross receipts, within the most recent 3-year period, exceed $10 million. Even under either of these instances, the **hybrid** method must be used whereby inventoriable costs are capitalized until they can be applied against the cost of goods sold. All other items of expense and income can be calculated using the cash method.

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26. IRC §7872(f)(2)

27. By going to the IRS website and simply typing in the words "applicable federal rate" a reference to Rev. Rul. 2007-36 (www.irs.gov/irb/2007-23_irb/ar07.html) will appear. Table 2 outlines the AFRs necessary for compounding the interest otherwise due depending on the period involved.

28. Treas. Reg. §1.7872-3(b)(3(ii)

29. IRC §448

Consulting Scenario

An S corporation operates a large construction business that usually has average gross receipts of less than $10 million, until the current tax year. The two main segments of the business are (1) doing site work for real estate developments, such as putting in roads and curbs and laying utility and sewer lines and (2) excavating and grading work for specific home sites. Both services are separately contracted for with either the developer, individual home site owners, or builder. The company is forced to use the accrual method of accounting because its average gross receipts exceed $10 million for the current year. Can the taxpayer (1) use the **hybrid** method for the site work business, by keeping its separate books and records on an **accrual** basis or (2) keep the excavation and grading portion of the business on the **cash** basis? This latter treatment is important because there is a $1 million balance in receivables for this segment of the business.

Consultant's Advice

Although a taxpayer's principal business activity may require use of the accrual method, when a taxpayer is **not** required to keep inventories, he may use the cash method for this separate and distinct activity. However, a trade or business is **not** considered separate and distinct unless it keeps "a complete and separate set of books and records."

Therefore, a **hybrid** accounting method can be used in conjunction with the **accrual** method. This is permitted when the accrual method is used for the taxpayer's trade or business that involves inventory-type items, and the cash method is used for the service business, assuming separate books and records are maintained.

> **Note.** Because this issue is controlled by a specific revenue procedure that details the $10 million exception and the proper method of accounting to use, an automatic consent is granted when the taxpayer is required to file Form 3115 for the change in accounting for the current year. Because this is an "automatic change," no user fee is required.

Question. With the significant downturn in the real estate and construction industry, the taxpayer only expects to have over $10 million of average gross receipts for the current tax year. Should he even bother to make the switch in accounting method knowing that he will be going back to the cash method in the following year?

Answer. The taxpayer is required to make the change. When a taxpayer changes to the accrual method of accounting because his average gross receipts exceed $10 million, he can spread the tax effect over four years if it exceeds a positive adjustment of $25,000. On the other hand, if receipts decrease so that a taxpayer now meets the exception under $10 million test in a later year; any negative adjustment is taken into income in one tax year.[30]

ISSUE 9: PROPER TAX TREATMENT OF CONSTRUCTION ALLOWANCES PAID TO LESSEE[31]

Especially with new rental retail space, it is common practice for the lessor to provide certain funds for leasehold improvements to the lessee. The tax treatment of these advances depends on whether they are properly used for "qualified long-term real property." As demonstrated in the following Chief Counsel memorandum, if they are not properly used, the monies are included in the lessee's gross income. Therefore, the excess of a construction allowance from a lessor over the lessee's actual cost of constructing or improving qualified long-term real property becomes gross income to the lessee.[32] This is in spite of the fact that lessees sometimes attempt to treat the amounts **not** spent in this fashion in several alternative ways. They may argue that this excess constitutes an excludible "nonshareholder capital contribution."

30. Rev. Proc. 2002-19, 2002-ICB 696

31. IRC §118

32. AM 2007-003 (January 24, 2007)

Background

A lessor is allowed to advance funds to the lessee in order to assist the lessee in his payment of any leasehold improvements. The lessee's gross income either does **not** include any of these amounts received in cash or is treated as a rent reduction by a lessee from a lessor, if they are received under the following conditions:

1. Under a short-term (15 years or less) lease of retail space, and
2. For the purpose of the lessee's constructing or improving qualified long-term real property for use in the lessee's trade or business at the retail space.[33]

The exclusion **cannot** exceed the amount actually spent by the lessee for the construction or improvement. For capital contributions, a corporation generally does **not** include these contributions in its gross income.[34] This rule applies whether the contribution is made by a shareholder or a nonshareholder.[35]

Administrative Memorandum Facts

A lessee and lessor enter into a qualified short-term lease of retail space. The agreement expressly allows the lessor to give the lessee a $70,000 construction allowance to build or improve qualified long-term real property for use in the lessee's trade or business at the retail space. Under the agreement, the lessee receives the $70,000 construction allowance. In the same year, the lessee spends $100,000 for construction or improvement of the retail space. This includes $60,000 for qualified long-term real property and $40,000 for lessee-owned property. The lessee notified the lessor that it had only spent $60,000 of the $70,000 construction allowance on qualified long-term real property. Nevertheless, the lessee did **not** include any of the $70,000 construction allowance in its gross income. Instead, it used one of the following two methods to account for this amount:

1. The lessee netted the $70,000 construction allowance against its $100,000 build-out costs. First, it applied the $70,000 construction allowance against its $60,000 cost of the qualified long-term real property. Then, it applied the remaining $10,000 ($70,000 – $60,000) construction allowance against its $40,000 cost for the property it owned. The taxpayer took a $0 tax basis in the qualified long-term real property and a $30,000 tax basis in the property it owned.
2. The lessee treated the $70,000 construction allowance as an asset, deferred rent, and amortized it into income as an offset to rent expense over the lease term using the straight-line method. It took a $60,000 tax basis in the qualified long-term real property and a $40,000 tax basis in the property it owned.

33. IRC §110(a) and Treas. Reg. §1.110-1(b)(3)
34. IRC §118(a)
35. Treas. Reg. §1.118-1

Chief Counsel Administrative Memorandum

The IRS concluded that neither of the methods used for accounting for the $10,000 excess was correct for tax purposes. Instead, the lessee **must** include $10,000 in its gross income in the tax year it received the $70,000 construction allowance. Consequently, the lessee had no tax basis in the qualified long-term real property, which was owned by the lessor.[36] In addition, the lessee had a $40,000 basis in the owned property.[37] The IRS concluded that this particular transfer of money did **not** qualify as a nonshareholder contribution to capital under §118 "if the transferor is motivated by a desire to obtain specific, quantifiable benefits." On the other hand, "if the transferor expects to receive only vague, uncertain, or incidental benefits, a transfer is likely to be a contribution to capital" if it satisfies five factors:

1. It must become a permanent part of the transferee's working capital structure.
2. It cannot be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee.
3. It must be bargained for.
4. The asset transferred must predictably result in benefit to the transferee in an amount commensurate with its value.
5. The asset ordinarily, if not always, is employed in or contributes to the production of additional income, and its value is assured in that respect.

The IRS stated that an example of a classic §118(a) contribution is a transfer in furtherance of a transferor's goal of benefiting the community at large. In this instance, the IRS determined that the construction allowance provided by a lessor to the lessee "was motivated by the lessor's desire to have the lessee operate a retail store in the lessee's retail property." Additionally, the lessor received rental payments. The existence of a lease under which rent was payable to the lessor is considered "a sufficient direct benefit to take a construction allowance outside the scope of §118(a)."

Note. Remember that certain leasehold improvements can qualify for a special 15-year deduction through the end of 2007, if they meet the definition of qualified leasehold improvements used for the bonus depreciation rules or otherwise meet a special rule for certain restaurant improvements. Even if the lessee pays for the improvements, they are **not** considered gross income to the landlord should the lessee terminate or otherwise not renew its lease and then abandon the leasehold improvements. However, the lessee receives a §1231 loss for the remaining unrecovered basis of the improvements at the point at which they were abandoned.[38]

ISSUE 10: BAD DEBT RESULTING FROM SALE OF BUSINESS[39]

Occasionally, a successful business owner sells his ongoing business using an installment sale. Unfortunately, the new owner may not be able to manage the business successfully and may default on the payments to the seller. This is frequently seen in the sale of a restaurant or tavern.

The sale may only consist of fixtures and goodwill. Occasionally, it includes the land and building. If only the fixtures and goodwill are sold, they are the only property of value to recover. Goodwill is lost when the business fails. If the land and building were also sold, the buyer probably used it as added security to borrow operating funds. Consequently, the original owner recovers little of his installment note in a foreclosure. Following is an example of this type of situation.

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36. IRC §110(b)

37. IRC §1012

38. IRC §168(i)(8)(B)

39. IRC §165

Consulting Scenario

In November 2005, Roxie sold various assets comprising a supper club/restaurant business including the underlying real estate to Arnold. At the time of sale, Roxie received a down payment and properly reported that part of the installment gain on Form 4797. In order to complete the sale, Roxie agreed to a $100,000 **second** mortgage on the real estate. Subsequently, Arnold defaulted. The property was sold, and Roxie received no payments on the $100,000 installment note. Unfortunately, due to the decline in realty values, the first mortgage absorbed what remained of the underlying value in the property. Because Roxie held a second mortgage, there was nothing left to satisfy her debt. Roxie wondered whether the 2005 return should be amended in order to adjust the original selling price, or whether she should report a business or a nonbusiness bad debt. A business bad debt results in ordinary loss, and a nonbusiness bad debt results in a short-term capital loss.

Consultant's Advice

The 2005 tax return **cannot** be amended to change the selling price. This was correctly reported under Roxie's method of accounting for the 2005 return. If Roxie repossessed the real estate, its basis would adjust upward to reflect any gain recognized on the installment sale to date. If Arnold continued making payments and asked for a "purchase price adjustment," this would be reflected in the contract terms of the sale and would impact the gross profit percentage on the installment contract for tax reporting purposes.

Under the current circumstances, Roxie is **not** going to receive any of the $100,000 due on the outstanding note. Yet, she did **not** loan money to Arnold so as to create a "bad debt" situation. Instead, under the Supreme Court's decision in *Arrowsmith*[40] (which created the relation-back doctrine), one looks to how the original sale would have been reflected had Roxie received $100,000 less in consideration for the assets she sold. Since this decrease in proceeds relates to the sale of real estate used in a trade or business and it would have resulted in an underlying loss, this loss would have been reported as an IRC §1231 loss on Form 4797. This loss would offset any §1231 gains. Because an overall §1231 loss results, this flows to page 1 of Roxie's tax return as an ordinary loss. Therefore, even though the 2005 tax return is **not** amended, the relation-back doctrine is used to produce the **same** result that would have occurred if these circumstances happened in 2005.

> **Note.** Actually, one might **not** have to utilize the *Arrowsmith* relation-back doctrine. Instead, the **same** conclusion might be reached simply by applying the provisions of IRC §§453(b) and (f) (installment sales), as well as **Rev. Rul. 64-178.**

ISSUE 11: APPLICABILITY OF §179 TO ASSETS USED IN CONNECTION WITH LODGING OR TO AIR CONDITIONING OR HEATING UNITS[41]

Although IRC §179 provides a generous deduction for certain assets ($125,000 for 2007), it is **not** always available for assets used in connection with providing lodging (absent certain exceptions) or for air conditioning or heating units.

Property Used to Furnish Lodging

IRC §179(d)(1) defines property eligible for the immediate expensing deduction by explaining that it is **not** property described in §50(b). Looking to §50(b), for property used for lodging, this includes "any property which is used predominantly to furnish lodging or **in connection** with the furnishing of lodging."[42] An exception exists for hotels and motels that provide lodging to transient dwellers, defined as those who stay an average of 30 days or less at the premises.

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40. *Arrowsmith v Comm'r,* 344 U.S. 6 (1952)

41. IRC §168

42. IRC §50(b)(2)

Consequently, this definition excludes items such as appliances, rugs, and furnishings used in a residential apartment complex. Unfortunately, this also excludes items such as pick-up trucks, lawn mowers, or snow blowers that are also used with residential units. This exclusion applies even though the assets are depreciated as 5-year MACRS property within ADR Class 57.0 "Distributive Trades and Services."

Observation. Practitioners should be careful when reading certain tax research services which simply state that only property "used in furnishing lodging" is §179 property eligible for immediate expensing. This appears to limit the prohibition to only those assets actually found within residential units. However, a literal reading of §50(b) specifically states that "any asset used in connection with lodging" such as a pick-up truck, is disqualified.

Heating and Air Conditioning Units

Window air conditioning units used either in a residential apartment unit or a business office and free-standing hot-air heating units located on the floor of a warehouse are examples of property that is **ineligible** for §179 immediate expensing. Although these assets are **not** considered part of the building's structure and they can be depreciated as either 5- or 7-year MACRS assets, it is unclear whether they are eligible for immediate expensing. Under §179 definitions and special rules, the law specifically states that such property "shall **not** include air conditioning and heating units."[43]

In 1990, the definition of qualifying §179 property changed. Originally, it was defined using the old investment tax credit (ITC) rules,[44] whereby the **same** property that qualified for the ITC also qualified for immediate expensing. Currently, qualifying property is defined under IRC §1245(a)(3).

In fact, the old IRC §38 was repealed for years beginning after December 31, 1983. It is now the code section used for the general business credit. However, in making the change, Congress inadvertently opened the door for more property to qualify for immediate expensing. This included residential rental furniture, fixtures, and **free-standing HVAC assets.** Therefore, this property could arguably be classified as §1231 property used in a trade or business and its disposition properly reported on Form 4797. The issue was whether this property was used in the active conduct of a trade or business, even though no self-employment tax was paid on net rental income reflected on Schedule E.

In 1996, Congress enacted a change. They inserted language now found at the end of §179(d)(1). The intent was to correct the inadvertent inclusion of such property and restore pre-1990 restrictions.

Note. Taxpayers should reference back to determine what HVAC assets such as window air conditioners and free-standing hot-air heaters might have qualified under the old ITC. This will help them determine how strictly the prohibition listed in §179(d)(1) must be construed.

Unfortunately, the definitions under Treas. Reg. §1.179-4, last updated July 13, 2005, are not much help. They still refer to "qualified Section 38 property, as defined in §48(a), and the regulations there under," even though these sections have long been repealed.

However, the new language contained at the end of §179(d) is fairly clear. The IRS seized upon this language to specifically state in IRS Pub. 946, *How to Depreciate Property*, in Chapter 2, "Electing the Section 179 Deduction" that "even if the requirements explained earlier under **'What Property Qualifies'** are met, you **cannot** elect the section 179 deduction for the following property: **Air conditioning or heating units**."

Note. Given the fact that regulation writers chose to retain the former "Section 38 property" language, and that the old ITC rules would have allowed ITC for stand-alone (nonstructural) heating and air conditioning not used in lodging, one might take the position that §179 immediate expensing should be allowed for such assets, even though this would be contrary to the IRS position stated above in IRS Pub. 946.

43. IRC §179(d)(1)

44. IRC §38

ISSUE 12: CALCULATING THE TAXABLE INCOME LIMITATION FOR §179 WITH A FLOW-THROUGH ENTITY[45]

With the proliferation of S corporations and LLCs, it is important to understand the limits on claiming a §179 immediate expensing deduction. This is especially important since this amount was recently increased to $125,000 for 2007, with the phaseout threshold commencing at $500,000. The taxable income limit applies at **both** the entity and owner levels. Therefore, the deduction is limited even before it is separately stated on the owner's Schedule K-1. Once the entity threshold is met, the same limit is applied at the owner level. However, an issue might arise when the owner has losses from other businesses on his personal return. The following scenario highlights an aggregate approach. This is used to determine whether the taxpayer has sufficient taxable income on page 2 of his Form 1040 to cover the expensed amount.

Unlike the $125,000 ceiling and the phaseout rules from $500,000 to $625,000, the taxable income limit allows excess §179 amounts to be carried over to succeeding tax years if an insufficient amount of taxable income to cover the current deduction exists.

Consulting Scenario

Chad is the sole shareholder of an S corporation in which he actively participates for purposes of the §179 deduction. In addition to the S corporation, he owns and operates a Schedule F farm operation. He wants to take a §179 deduction for $108,000 of farm equipment that he purchased. Chad is unsure how to calculate his taxable income limitation. The following information comes from his Schedule K-1 and Form 1040.

Consultant's Analysis

	Total Income	Trade or Business Income
Wages	$ 43,500	$ 43,500
§1231 gain	8,500	8,500
Rental income	27,500	0
S corporation income	85,000	85,000
Farm loss	(36,000)	(36,000)
Total	$128,500	$101,000

This calculation allows Chad to claim a maximum §179 deduction of $101,000.

If Chad is only an investor in the S corporation and **does not actively participate** in at least one of the underlying trades or businesses of the company, none of the $85,000 of the S corporation's income could be used for the §179 taxable income limitation even though it is still reported on his Schedule E, page 2. This limits his maximum §179 deduction to $16,000 or $7,500 depending on whether the §1231 gain is from the S corporation. The **same** rule applies for Form 1065 entities. However, with a partnership/LLC, there are **no** wages reported to its owners. To calculate the limitation on Form 1040, they add guaranteed payments to the Schedule K-1 trade or business income and any net §1231 gains.

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> **Note.** For 2007, Chad could claim a $108,000 §179 deduction. However, $7,000 must be carried to a succeeding tax year in which additional trade or business taxable income existed in order to use the remainder of this deduction. In addition, this assumes that the cost of the equipment Chad placed into service for 2007 did **not** exceed the beginning point of the phaseout rules ($500,000).

45. IRC §179

ISSUE 13: NEXUS AND STATE TAXATION ISSUES

The recent deficits in many state operating budgets pushed governmental entities to look to increase revenue sources. One approach is to insure that nonresident business owners located within the states' borders are paying their fair share of taxes. For instance, states have been aggressive in ensuring trucking companies purchase certain licenses or pay fees for merely passing through their borders. State sales and use tax divisions have asserted themselves in collecting from out-of-state entities. With advances in record keeping and computer technology and the sharing of information with the IRS, states search for taxpayers who are not paying the appropriate taxes for sales and exchanges of goods and services, as well as real property, occurring within their boundaries.

> **Note.** Finding delinquent tax filers is often as easy as matching payroll, sales, or property tax forms against required income tax filings. Even if a contractor denies, or otherwise ignores the existence of nexus within a state, they normally file payroll, sales, or property tax returns when required. If the state fails to find a match on the income tax side, it usually begins an investigation of the entity in order to discover whether a reason exists for the failure to file state income taxes.

Background

To ascertain whether an out-of-state corporation must pay state income tax, the state must determine if the company has "nexus" within that state. **Nexus** is defined as sufficient contact within a state to require the filing of an income tax return. Even though nexus is defined on a state-by-state basis, certain activities or circumstances usually guarantee that nexus exists. Generally, nexus is present in the following situations:

- Domestication within a state
- Having legal domicile or a principal place of business within a state
- Employment of capital or property within a state
- Maintaining an office or other facility within a state
- Rendering services within a state
- Solicitation of orders within a state

> **Note. 15 U.S.C. §381 et Seq.** prohibits states from claiming nexus if the only contact within the state is limited to the employment of salespersons or independent contractors whose only function is to solicit sales for out-of-state approval and fulfillment. Nevertheless, this very limited exception can dramatically restrict the activities of the salesperson or agent operating within that state. In order to comply, all decisions and customer support must be handled outside the state in which the salesperson operates.

When confronted with a determination of nexus, contractors often attempt to argue that state taxes are **not** due because the contractor's employees' work is being performed on federal property. However, since nexus is established by factors other than the mere existence of employees, such as the rendering of services, the fact that the performance site is on federal property usually is irrelevant.

Even with the very narrow exception for in-state solicitation, minimal activity in a given state usually triggers a filing requirement and possibly a tax liability. If the liability is ignored, it continues to grow and compound as a result of penalties and interest.

> **Note.** Contractors who pretend that a filing obligation does not exist are at high risk. The statute of limitations is of little help in such instances, because it does **not** begin until a required return is filed.

Multi-State Tax Apportionment

States are required to fairly allocate or apportion the income among each other. Apportionment is defined as the process by which business entities divide their income between two or more states to determine what tax exposure they have, if any. Although each state might have its own method of apportioning income, most states use a variation of the 3-factor formula. The three factors normally used to apportion income are gross receipts, property, and payroll.

Example 8. Widgets, Inc., has federal taxable income of $50,000 for the current year. Income is divided between the three factors and the two states as follows:

	Total	Wisconsin	Illinois
Gross receipts	$800,000	$600,000	$200,000
Payroll	400,000	200,000	200,000
Property	600,000	400,000	200,000

The apportionment factor for Illinois is calculated by dividing Illinois gross receipts, payroll, and property each by total gross receipts, payroll, and property, respectively. The three factors are then summed and divided by three to calculate the Illinois apportionment factor as follows:

$$((200{,}000 \div 800{,}000) + (200{,}000 \div 400{,}000) + (200{,}000 \div 600{,}000)) \div 3 = 1.08 \div 3 = .36$$

Illinois' apportioned taxable income is $18,000 ($50,000 × 36%). Conversely, Wisconsin's apportioned taxable income is $33,000 ($50,000 × 64%).

Example 8 is fairly straightforward and may not apply to every state. Some states vary dramatically in their definitions of gross receipts, payroll, and property, as well as how they apply this 3-part formula.

For instance, some states include rent in the property factor. They may value rented property at eight times the annual rent paid if a business rents instead of owns the real property used in its operations.

Gross receipts considered by a particular state can also vary. For example, some states allocate dividends directly to the state in which the company is domiciled. Other states allocate based on an overall gross receipts allocation. As a result, the allocation of federal taxable income to various states does not always equal 100%. It can be slightly more or less depending on the allocation formula used for each state. If a state does not have an income tax, a taxpayer could be highly motivated to allocate as much income as possible to that state.

Note. Even though the impact of a state's income taxes is not the only factor in deciding where to do business, it certainly should be considered.

ISSUE 14: MISUSE OF COMPLETED CONTRACT METHOD[46]

Although the real estate market has cooled off considerably in some parts of the country, there is still a significant amount of construction occurring. An issue that arises in the construction industry concerns which taxpayers are allowed to use the completed contract method of accounting. Although the proper use of the **completed contract method** is appropriate when dealing with certain construction deals, the **accrual method** should be used for other costs and items of income other than the recognition of income on the completed contracts. Thus, the taxpayer is really using a **hybrid method** in these instances. The gross contract price for a long-term contract is included in the year the contract is complete under the completed contract method of accounting. In this regard, the IRS commenced an audit effort specifically targeting companies abusing the use of this method. This can delay the recognition of income from various types of construction contracts for years.

46. IRC §460

Background

A **long-term contract** is any contract for the manufacture, building, installation, or construction of property, if the work is **not** completed in the tax year in which the contract is entered. Generally, with some exceptions, taxpayers must account for long-term contracts under the **percentage-of-completion method.**[47] A contract is considered completed under the **long-term contract rules** on the **earlier** of when:

- The contract's subject matter is used by the customer for its intended purpose, and at least 95% of the total allocable contract costs have been incurred by the taxpayer; or
- There is final completion and acceptance.[48]

Home construction contracts and other real property construction contracts that satisfy a 2-year test and a $10 million gross receipts test do **not** have to use the percentage-of-completion method. Instead, they can use the completed contract method.[49] However, for AMT purposes, if the contract involves other than "home construction contracts," the taxpayer must use the percentage-of-completion method or a simplified look-back method.[50]

Under the **completed contract method,** a taxpayer does **not** report income until a contract is complete, even though payments are received in years before completion.[51] A home construction contract is one in which 80% or more of the estimated total contract costs are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of dwelling units contained in buildings containing four or fewer units and to improvements to real property directly related to the units.[52] Furthermore, the IRS ruled that land sale contracts are **not** considered home construction contracts eligible for the completed contract method, if the land developer is **not** performing the construction contract activities on the dwelling units.[53]

IRS Audit Program

In the large and mid-size business (LMSB) directive,[54] the IRS notes that the **completed contract method** is generally the preferred tax accounting method used in the construction industry since it allows the taxpayer to defer recognition of income and expenses until the contract is complete.[55] However, the IRS notes that "there is a growing trend in which taxpayers in the construction industry misuse this accounting method by either applying it when it should not be used, or using it to inappropriately defer income recognition."

The current LMSB position is that as each home is sold, the contract is considered complete and income is recognized. The IRS identified abuse of the tax law for sales of homes in large master-planned communities that may take many years to complete. In these situations, taxpayers are deferring income 5, 10, or 15 years into the future. The later sale of one of these homes could be a taxable transaction long before the builder even recognizes income from the home's initial sale. In this regard, the IRS provides five scenarios illustrating **improper** treatment under the completed contract method:

1. A land developer enters into a sales/construction contract to provide improved lots. The taxpayer sells the lots and is contractually obligated to provide a future common improvement such as a clubhouse, pool, or roads. The taxpayer treats the contract as a home construction contract and defers income recognition until the future common improvement is completed.

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47. Ibid.

48. Treas. Reg. §1.460-1(c)(3)

49. Treas. Reg. §1.460-1(a)(2)

50. IRC §460(b)(2)

51. Treas. Reg. §1.460-4(d)

52. IRC §460(e)(6)(A)

53. TAM 200552012 (September 27, 2005)

54. The directive can be found at www.irs.gov/businesses/article/0,,id=169122,00.html.

55. Treas. Reg. §1.460-4(d)

2. The taxpayer is a subcontractor hired by the land developer to construct roadways, sidewalks, utilities, grading, or other common improvements within a residential community. The taxpayer treats the contract as a home construction contract and defers the progress payments until the entire contract is completed.

Note. The audit issue in Situations 1 and 2 is whether the contract even qualifies as a home construction contract. The LMSB directive concludes that in these situations, the taxpayer is using the completed contract method in circumstances in which it is **not** an allowable method. To address this abuse, the LMSB directive notes that a team from the IRS's industry issue resolution (IIR) program is currently working to clarify the definition of a home construction contract. This will help determine whether a land developer's sales/construction contracts meet the criteria.

3. The taxpayer establishes two partnerships to separate land development from home construction. The land developer enters into one contract for the homebuilder to build all the homes in the development. The homebuilder defers the income on homes it builds until the entire contract is completed. Meanwhile, the land developer may be deferring the lot sales in the same way as Situation 1.

4. A homebuilder adopts the project-by-project use of the alternative cost method to determine when completion occurs. None of the home sales are recognized until the **entire** development/project is finished and common improvements are completed.

5. The land developer/homebuilder is required to provide a future common improvement to a development. As the homes are sold, the developer/homebuilder's position is that the home is **not** 95% complete because the allocable portion of the future common improvement keeps the completion factor for that particular home less than 95%.

Note. The audit issue in Situations 3, 4, and 5 focuses on when the contract is considered complete for income tax recognition purposes. The LMSB directive concludes that in these situations, the taxpayer is improperly deferring completion under the completed contract method. Depending on the scenario, the severance rules[56] are applied segregating each individual home into a contract. The final result is that the LMSB directive is adamant that the project-by-project method is an improper aggregation of individual contracts.

Mandatory Audit Issue

The LMSB directive says that "this is a mandatory audit issue that needs to be pursued to ensure consistency and prevent widespread use of an improper method." It can be identified by examining the taxpayer's Schedule M-3, *Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More*, Form 8886 *Reportable Transaction Disclosure Statement*, and the Annual Report or SEC 10-K. In the cases reviewed so far, the IRS says "the taxpayer's position has been egregious." In addition, depending upon the materiality of the issue, it advises that penalties should be considered and applied.

ISSUE 15: DEDUCTIBILITY OF ACCRUED LIABILITIES BETWEEN MEMBERS OF A CONTROLLED GROUP

A **controlled group** exists when there is either a parent-sub corporate combination or a brother-sister arrangement, such as when an individual owns 100% of two or more corporations. When services are provided or liabilities are incurred among the members of a controlled group, the tax law may preclude a current deduction until the other member reports the related income.

56. IRC §460

Consulting Scenerio

An individual owns two companies: 100% of a C corporation that has a fiscal year-end of May 31, and 100% of an S corporation that has a calendar year-end. As of May 31, 2007, the C corporation wants to accrue a management fee for current services performed and take a corresponding deduction on its Form 1120. The cash-method S corporation will be paid by August 15, 2007, which is within 2½ months of the C corporation's fiscal year-end. The S corporation includes the payment in its income for the calendar year ending December 31, 2007. Is it permissible to allow the deduction for the accrual method C corporation?

Analysis

For these payments, IRC §267(a)(2) effectively puts the C corporation on the **cash** method because they are paid to another member of a controlled group.[57] Therefore, the deduction **cannot** be taken on the C corporation's tax return for the fiscal year ending May 31, 2007. It must wait until the following year to take the deduction.

> **Note.** In the *Weaver* decision,[58] the IRS dropped its argument which was originally based on the related-party rule contained in IRC §267(a)(2). Instead, it relied on §§461(h) and 404(d). Even though economic performance was found to have occurred by the end of the accrual method corporation's tax year, the payments in *Weaver* were **not** made to the cash basis corporation within the 2½ month window after year-end as required by §404(d).

PARTNERSHIP/LLCs

ISSUE 1: SELF-INSURED MEDICAL REIMBURSEMENT PLANS[59]

Normally, fringe benefits paid to or on the behalf of partners or LLC members are taxable and treated as guaranteed payments. Fringe benefits are also taxable for more than 2% owners of an S corporation.[60] However, in the case of accident and health insurance premiums and premiums paid for long-term care, there is a corresponding income tax deduction. The owner may take this deduction against his AGI on his personal return even though the premium is a taxable payment subject to self-employment tax.

However, if the company is large enough to institute a self-insured fund to cover its health insurance needs, different rules apply. The IRS approved a self-funded arrangement established by a partnership to provide group insurance to its partners and employees and ruled it is "an arrangement having the effect of accident or health insurance."[61] Payments made by partners for coverage/premiums are deductible, and payments from the plan for the benefit of partners can be excluded from their incomes. This is treated the same as if they received reimbursements for claims from their insurance carrier.

Revenue Ruling Facts

A partnership offers a group health plan to its eligible partners and nonpartner employees. The plan is self-funded for the benefit of both the entity's owners and eligible employees. Seventy-two partners and 380 employees are eligible to participate in the plan.

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57. As defined in IRC §1563

58. *Jimmy Weaver v. Comm'r,* 121 TC 273 (2003)

59. IRC §104(a)(3)

60. Rev. Rul. 91-26, 1991-1 CB 184, dictates that the premiums paid be treated as wages on the owner's Form W-2. They are then included in the owner's gross income on his personal return with a corresponding deduction for AGI. However, these wages are not subject to employment tax withholding.

61. Letter Ruling 200704017 (October 26, 2006)

The plan offers two benefit options that differ in the level of deductibles and out-of-pocket maximums the plan participants pay. Within each benefit option, levels of coverage are offered for the employee only, the employee plus one, or family coverage. Eligible medical expenses of partners and nonpartner employees are reimbursed by the plan from a general account funded with premium payments made by the participants and contributions from the partnership.

The amount of the premium for each benefit option and for each level of coverage is determined by the partnership **before** the beginning of each plan year. This is done in consultation with the plan's independent third-party administrator. Premiums are calculated by adding the cost of projected claims plus 25%, the cost of stop-loss insurance, the cost of an administrative service charge, and a consulting service fee. The partnership then charges each participating partner and nonpartner employee a pro rata share of the projected and actual costs.

Partners and nonpartner employees are charged the **same** premium depending on their benefit option and type of elected coverage. The partnership subsidizes a portion of the premium on behalf of its nonpartner employees. All premium payments are paid into the partnership's general account. The plan administrative expenses and eligible medical expenses under the plan are paid from this same account. If the total premium payments exceed the claims and expenses incurred for a plan year, the excess is used to pay claims and expenses for the following year. This results in reduced premium payments for all participants in the following year. Conversely, if the total premium payments are less than the claims and expenses of the plan for a year, the partnership makes a contribution to the general account to cover the deficiency. To cover the partnership's excess risk for catastrophic health claims, the partnership contracts with an insurer.

IRS Ruling

The IRS ruled as follows:

1. The plan is treated as "an arrangement having the effect of accident or health insurance;"
2. Payments from the plan, made for the benefit of partners, are excludable from the partners' income; and
3. Premium payments made by individual partners for coverage under the plan are deductible by them.

Key to the IRS's decision is the fact that a self-employed individual is permitted to deduct payments to a self-funded health plan, but only if the plan has the characteristics of insurance. In addition, according to the IRS, "an essential characteristic of accident or health insurance is the shifting of risk." Insurance must shift the risk of economic loss from the insured and the insured's family to the insurance program and must distribute the risk of this economic loss among the program participants.

Under the facts presented, the IRS said that in return for the payment of a premium, the risk of economic loss in the event of personal injury or sickness is shifted from the partner and the partner's family to the plan. It is then distributed among the plan's participants. Therefore, the plan is "an arrangement having the effect of accident or health insurance." A self-employed person, such as the partners in this situation, is entitled to a deduction equal to 100% of the premiums that are paid under the plan pursuant to §162(l).

> **Note.** Spouses of Form 1065 owners can instead be hired as legitimate employees and receive the same benefits tax free since the attributions are ignored for this purpose.

ISSUE 2: CIRCUMVENTING THE CASH DISTRIBUTION RULES[62]

The rules are fairly straightforward when it comes to liquidating distributions made to an exiting LLC member. If cash or the FMV of distributed marketable securities exceed the outside basis of the member's interest, the excess is taxable. Otherwise, the member simply substitutes the basis that he had in his interest for the property being distributed without any immediate recognition of gain.

> **Note.** This is true with regard to the substituted basis requirement, even if the aggregate of inside bases of the assets being distributed is greater than the outside basis of the member's interest. However, if there is "disappearing basis," the LLC can elect to step up the bases in the assets that it still owns by making an IRC §754 election. If the exiting member receives property that qualified to receive a §754 step-up within the prior two years, but the entity failed to make or otherwise have an election in effect, then he can effectively receive the **same** step-up at the time of the liquidating distribution.[63]

CCA Facts

An LLC member decides to retire and is offered a cash payment of $500,000 as a liquidating distribution for his interest. He intends to use the cash to purchase a vacation home for his retirement years. Realizing that this cash distribution will be in excess of the outside basis of his interest and will result in sizable gain, he asks the entity to purchase the property even though it has nothing to do with the firm's business. Subsequently, the ownership of the property is deeded to him from the LLC. Therefore, the retiring member takes a substituted basis equal to that which he has for his ownership interest.

IRS Ruling

The IRS issued a legal memorandum on this issue. It concluded that the nonrecognition provision of §731 and the substituted basis rule of §732(b) do **not** apply when a partnership acquires residential real estate that has no relation to its business activities and is solely for purposes of immediately distributing it to a partner in liquidation.[64] In addition, the CCA concludes that the partnership anti-abuse rules,[65] judicial doctrines of step-transaction rules, and economic substance over form may be applied to attack and recharacterized the transaction. The result is the LLC member is treated as receiving the cash used to purchase the property that was in excess of his basis which results in immediate gain.

> **Note.** The member is entitled to a basis in the property equal to its FMV since he is forced to report the underlying gain.

ISSUE 3: APPLICABILITY OF AT-RISK RULES TO SMLLCs[66]

A sole proprietor filing a Schedule C or F can become a victim of the at-risk rules. This is possible if he is a single-member LLC (SMLLC), with the result that some or all of a current year's tax loss **cannot be claimed** because the proprietor is **not** considered **at-risk.**

This issue first surfaced when the IRS limited a Schedule C loss deduction until the owner proved that he was at risk for the amount. The IRS issued final regulations under IRC §752 regarding the rules that consider certain obligations of a disregarded entity (SMLLC) for purposes of the partnership liability rules. The regulations clarify the existing regulations concerning when a partner may be treated as bearing the economic risk of loss for a partnership liability based on an obligation of a disregarded entity.

62. IRC §731
63. IRC §732(d)
64. ILM 200650014 (September 7, 2006)
65. Treas. Reg. §1.702-1
66. IRC §465

> **Note.** The IRS is now auditing Schedule C and F proprietorships (SMLLCs or disregarded entities) and finding that some owners are **not at risk** for at least part of the liabilities being incurred in the normal course of business operations. This is because under state law such entities are considered separate from their owners, similar to a wholly-owned corporation.
>
> There can be instances in which the proprietor might **never** face the economic risk of loss for the ultimate repayment of the underlying loan. As a result, the Schedule C or F could have a loss for a particular tax year, but the proprietor might **not** be able to deduct part or all of it when calculating his overall taxable income on Form 1040, page 2. The loss must be suspended until such time that the proprietor has sufficient at-risk basis.
>
> This might occur when the proprietor pledges S corporation assets (as opposed to his personal assets) for debt being carried by the business, and he does not act as a guarantor on the loan. The cases of this actually occurring are rare. However, one audit resulted in the current denial of a Schedule C loss exceeding $1 million until the owner has sufficient at-risk basis, either as a guarantor or by pledging personal assets as collateral for the loan.

Background

IRC §752 provides that a partner's basis in his partnership interest includes the partner's share of partnership liabilities. The corresponding regulations provide rules relating to the determination of a partner's share of partnership liabilities. How the rules are applied depends on whether the liability is characterized as recourse or nonrecourse and who ultimately bears economic risk of loss. Treas. Reg. §1.752-2 states that a partner bears the economic risk of loss for a partnership liability to the extent that the partner has an obligation to make a payment to any person. This includes a partnership contribution if the partnership were to constructively liquidate. In making this determination, all statutory and contractual rights relating to a partnership liability and reimbursement rights are taken into account in determining whether a partner has a payment obligation.[67]

Final Regulations

The final regulations clarify the existing regulations. They explain when a partner may be treated as bearing the economic risk of loss for a partnership liability based on a payment obligation of a business entity that is disregarded as separate from its owner.

Because of statutory limitations on liability, a disregarded entity owner may **not** be obligated to satisfy payment obligations undertaken by the entity. The regulations clarify that only the assets of a disregarded entity may be available to satisfy payment obligations undertaken by the disregarded entity. Therefore, a partner should be treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entity's assets.[68]

The final regulations provide that the "net value of a disregarded entity" is determined by subtracting all obligations of the disregarded entity, regardless of priority, that do **not** constitute payment obligations from the FMV of the entity's assets.[69] This is a change from the proposed regulations. They specified that after the initial determination of net value, the net value of the disregarded entity is **not** redetermined unless the disregarded entity's obligations change "by more than a de minimis amount or there is more than a de minimis contribution to, or distribution from the disregarded entity."

67. Treas. Reg. §1.752-2(b)

68. Treas. Reg. §1.752-2(k)(1)

69. Treas. Reg. §1.752-2(k)(2)

Effective Date

The final regulations apply to liabilities incurred or assumed by a partnership on or after October 11, 2006. They do not apply to liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect before October 11, 2006.

ISSUE 4: USING REFINANCING TECHNIQUES TO EASE THE ADMISSION OF NEW MEMBERS OR PARTNERS[70]

By utilizing the IRC §752 rules, a partnership or LLC can refinance property that it currently owns in order to distribute the asset's inherent appreciation. This correspondingly lowers its net FMV so that new owners can more readily afford to buy into the entity.

Consulting Scenario

An LLC with three equal members owned a commercial building valued at $600,000. The property was free of debt and liens. Each member had a basis in his LLC interest of $80,000. Two additional individuals wished to buy into the LLC but could not afford to pay $120,000 (20% × $600,000). Therefore, the LLC secured a mortgage on the property for $300,000. Using the loan proceeds, the LLC made a current nonliquidating distribution of $100,000 to each of the original three members.

The two new members could now purchase their LLC interests for $60,000 (($600,000 – $300,000) × 20%) by making a $6,000 down payment and executing a note to the LLC for the remainder to be paid over the ensuing nine years. Payments would be made with their anticipated share of the future annual rents.

Effect of Liabilities on Member Basis

From a tax standpoint, §752(a) serves to increase the outside bases of the original three members from $80,000 prior to the mortgage, to $180,000 (($80,000 + ($300,000 ÷ 3). When the cash distributions were made, their bases returned to their original level of $80,000 ($180,000 – $100,000) each. With the admission of the two new members, §752(b) requires the debt to be shared in five equal portions. As a result, it reduces the original basis of the three members by $40,000 ($100,000 – ($300,000 ÷ 5)). The original members now have a basis of $40,000 ($80,000 – $40,000). There is no tax effect when the decrease in the sharing of the liability caused by §752(b) occurs since it only serves to lower the bases of the three original members by $40,000. This is treated as a deemed cash distribution. They had sufficient basis in their respective interests at that point to absorb the decrease. However, it enabled the two new members to afford to buy a 20% interest in the LLC.

Note. This refinancing strategy points out one of the potential advantages of a partnership/LLC when it comes to the effect of liabilities on an owner's basis. In comparison, S corporation debt has no effect on a shareholder's basis unless it represents a **direct loan** from that particular shareholder to the entity. Mere guarantees do **not** qualify until that owner must actually make payment on the debt. In this example, refinancing the property for $300,000 and then making a $100,000 distribution results in an immediate capital gain to each of the original shareholders. The gain is $20,000 because the debt could **not** be used to increase their respective bases. This is true even if the lender required the shareholders to guarantee the debt.

70. IRC §752

C CORPORATIONS: QUALIFIED PERSONAL SERVICE CORPORATIONS[71]

An advantage to being a qualified personal service corporation (PSC) is that it can retain the cash method of accounting even if gross receipts exceed $5 million. A disadvantage is the PSC **cannot** use the graduated tax rates under §11(b)(1). Instead, any taxable income is taxed at a flat rate of 35%.[72] Nevertheless, there are a number of recent cases in which the taxpayer decided that either one of the "tests" outlined below were **not** met, and tax was calculated using the graduated rates. This saved approximately $13,000 ($35,000 – 22,250) on the first $100,000 of taxable income. Sometimes, an amended return was filed when the taxpayer sought almost $40,000 of refunds based on the 3-year statute of limitations period. The IRS has been fighting this approach in which the taxpayer incorrectly argued that although they performed personal services for their customers, they were otherwise **not** a "qualified" PSC.

> **Note.** Remember, only a C corporation can be a PSC, qualified or not. Therefore, once an S election is made, this argument is irrelevant.

Background

Qualified personal service corporation is defined in §448(d)(2). A corporation is considered a qualified PSC if it meets two tests: (1) **a function test** and (2) **an ownership test.**[73]

IRC §448(d)(2)(A) defines the **function test** as being met when **substantially all** the activities which involve the performance of services are in the fields of health, law, engineering, architecture, accounting, performing arts, actuarial science, or consulting. The regulations state that the **substantially all test** is met if "95% or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field."[74]

The **ownership test** is defined in §448(d)(2)(B) as being met when **substantially all** the stock (by value) is held directly or indirectly by:

1. Employees performing services for the corporation in connection with activities involving one of the fields mentioned above;
2. Retired employees, who had performed such services for the corporation;
3. The estate of any individual described in 1 or 2; or
4. Any other person who inherited stock of an individual described in 1 or 2, but only for the 2-year period beginning on the date of the individual's death.

Temp. Treas. Reg. §1.448-1T(e)(5)(i) states that the term **substantially all** means an amount equal to or greater than 95%. Some application of these rules follow.

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71. IRC §448
72. IRC §11(b)(2)
73. IRC §§448(d)(2)(A) and (B)
74. Temp. Treas. Reg. §1.448-1T(e)(3)

ARCHITECTURAL FIRM — OWNERSHIP TEST

In a summary opinion,[75] the Tax Court held that the **treasury shares** of an architectural firm should be disregarded in applying the ownership test. As a result, because **all the outstanding shares were held by architects** who currently worked at the company, the **corporation was a qualified PSC** and was subject to the flat 35% tax rate.

> **Note.** If the treasury shares were counted in the equation, the ownership of the firm would have been: Lawrence Apgar 35.5%; James Oliver 14.5% and Treasury shares 50%. The ownership test would have failed since more than 5% was held by other than the owner/employees. However, without their inclusion, the ownership was 71% and 29%, respectively.

LAW FIRM WITH SOLE OWNER/EMPLOYEE — OWNERSHIP TEST

A professional corporation which had a single shareholder/attorney operating a law practice was treated as a PSC under §448 and was therefore subject to the 35% flat tax rate imposed on qualified PSCs.

Case Facts

In this case,[76] the taxpayer was an attorney who had practiced law since 1978. In 1987, she incorporated Regina Felton, PC as a professional corporation under New York state law. Since its incorporation, Regina was the sole shareholder and the corporation's sole activity was the rendering of legal services. Regina was the corporation's sole practitioner/employee providing those services. The corporation also employed minimal secretarial and clerical staff. For 2001 and 2002, a CPA prepared the corporation's tax returns and calculated the tax based on the graduated tax rate for corporations under §11.

In a notice of deficiency, the IRS determined that Regina Felton, PC was a qualified PSC and was subject to a special flat income tax rate of 35%. The corporation filed a petition with the Tax Court challenging the determination. There was never a question that the **function test** was satisfied because the corporation's sole activity was the performance of services in the field of law. However, there was a disagreement as to whether the corporation satisfied the **ownership test,** which requires that **substantially all** the corporation's stock be held directly by the employees actually performing the corporation's services. Here, the corporation argued that it did not satisfy the ownership test, claiming that all of its stock was held by a nonemployee, Regina.

Tax Court Decision

The Tax Court agreed that the firm should be treated as a qualified PSC and was subject to the flat tax rate of 35%. In making its decision, the court noted that §448(d)(2) "did **not** adequately define the term 'employee' for purposes of the PSC ownership test." Nevertheless, the court believed that "when Congress has used the term without defining it, it intends to describe the conventional relationship as understood by common law." In addition, both the courts and the IRS have adopted common-law rules to distinguish employees from independent contractors. The primary feature in this analysis is control over the manner and means by which an employee performs his services.

In this instance, as the sole stockholder and owner of the corporation, Regina controlled the business and controlled which clients to represent. She also had control over how that representation was undertaken. Moreover, it was Regina, the corporation's only attorney, who performed all its legal services. Thus, the court concluded that "common experience under these facts leads to the conclusion that the corporation and Regina were one and the same for purposes of control." Therefore, since she was the corporation's employee and because all of the corporation's stock was held directly by its employee, it satisfied the ownership test and was a qualified PSC.

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75. *Robertson Strong & Apgar Architects,* TC Summ. Op. 2007-48, March 26, 2007

76. *Regina Felton PC v. Comm'r,* TC Summ Op. 2006-153, September 18, 2006

Comment. Some practitioners recommend a transfer of a sufficient number of shares (6%) to another qualified shareholder, such as another attorney not employed by the firm, in order to deliberately fail the ownership test. This is done so that the stock is **not** held by an employee who would own at least 95% of the corporation's shares. In such instances, the first professional, in turn, would also own 6% of the other professional's firm meaning that **both** corporations would arguably be eligible for the graduated tax rates. If gross receipts were **not** expected to exceed $5 million, it would **not** matter that these PSCs were **not** qualified for purposes of the cash method of accounting under §448.

NONLICENSED ACCOUNTING FIRM — FUNCTION TEST

The Tax Court held that a solely-owned corporation that prepared tax returns and performed bookkeeping services was engaged in the field of accounting for purposes of the qualified PSC rules.[77] It did **not** matter that the services were performed by nonCPAs and that the staff did not perform services requiring a CPA license. In essence, the taxpayer treated only those services that actually require a CPA license as accounting services and treated other tax return preparation and bookkeeping services as nonaccounting services.

Case Facts

Rainbow Tax Service, Inc., a solely owned Nevada corporation, prepared clients' federal and state individual, corporate, partnership, and transfer tax returns. It also performed bookkeeping services such as preparing profit and loss statements and various other reports relating to clients' federal payroll, state unemployment, and sales use taxes. However, Rainbow was **not** a public accounting firm. None of its services required that its employees become CPAs. Neither its principal, nor its employees were CPAs. On its 2002 and 2003 returns, Rainbow computed its tax liability using the graduated rates applicable to regular corporations. The IRS countered that Rainbow was a qualified PSC and should have calculated its tax using the flat 35% rate.

Tax Court Decision

There was no question that the PSC ownership test was met. Therefore, the key issue was whether it met the PSC function test. The Tax Court concluded that it met the function test because tax return preparation and bookkeeping services are regarded as within the field of accounting. It stated that tax return preparation, "which requires extracting information relating to financial transactions, analyzing that information, and then summarizing and reporting that information on a tax return, fits within the general definition of accounting." In doing so, the Tax Court set aside Rainbow's argument that "it wasn't in the business of accounting since Nevada required CPAs to perform 'accounting services.'" It emphasized that this argument "failed to appreciate the difference between public accounting, which must be performed by CPAs, and accounting in general." It also noted that under Nevada law, public accounting includes the preparation of income tax returns. As for Rainbow's bookkeeping services, the court said that "not only does bookkeeping constitute a 'branch' of accounting, but our system of double-entry bookkeeping undergirds modern financial accounting." As a result, because Rainbow met the PSC function test and ownership test, it was subject to tax at the flat 35% rate.

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77. *Rainbow Tax Service, Inc.*, 128 TC 42 (2007)

> **Note.** It is important to note that Rainbow did **not** raise the argument found in *Alron*,[78] that more than 5% of its gross receipts were generated by employees who did not have professional credentials. For instance, in the accounting field, some practitioners have argued that services such as payroll preparation, write-up work, and reconciling a client's bank account might be outside the field of accounting. If the logic in *Alron* was followed, it could be argued that based on state law these particular tasks would have to be performed by a professional accountant licensed with the state who must also meet certain minimum education, experience, and examining board requirements. Alternatively, could the reconciliation of bank statement or the preparation of payroll forms be accomplished by someone with, perhaps, a high school education? In this regard, the Tax Court confirmed that the Nevada statute, at least, would include payroll preparation and write-up work within the "field of accounting" regardless of the credentials of the individuals performing the services.

BUSINESS VALUATION EXPERTS — FUNCTION TEST

The IRS ruled that a full-service business valuation firm was **not** engaged in the field of consulting for purposes of the §448 qualified PSC exception.[79] As a result, it was **not** allowed to use the cash method of accounting.

> **Note.** In reaching its conclusion, the IRS used an analogy between the business valuation firm and a taxpayer that sells insurance which, therefore, is **not** a qualified PSC under an example in the §448 regulations. Unless a C corporation has average gross receipts in excess of $5 million, **not** being a qualified PSC might not be a bad result. In a recent audit of an accounting firm, the owners successfully argued that its payroll work performed for clients was **not** in the field of accounting. As a result, it secured a sizable refund for three open tax years for the difference in taxes paid based on a flat 35% rate versus the graduated rates. This also meant that for future tax years it did **not** have to assure that only minimal taxable income was reported on Form 1120.

Performing services in the consulting field is defined as "the provision of advice and counsel, but **not** including sales or brokerage, or economically similar services." In making this determination, all facts and circumstances are examined, including how the taxpayer is compensated for provided services. The IRS looks at whether the compensation for the services is contingent on the consummation of the transaction that the services were intended to effect.[80]

Temp. Treas. Reg. §1.448-1T(e)(iv)(B) presents 10 examples of businesses that do and do not qualify as providing consulting services. The regulations also indicate that "the determination of whether activities **not** specifically addressed in the examples qualify as 'consulting' is to be made by comparing the service activities in question to the types of service activities in the examples."

Letter Ruling Facts

The taxpayer in this instance was a C corporation that provided opinions of valuation or appraisals for closely-held interests in a wide variety of industries for use by business owners and their advisors for many purposes such as:

- Transactions in minority and controlling interests,
- Estate and gift tax planning and filing,
- Corporate recapitalizations,
- Restricted stock,
- Sale/merger transactions,

78. *Alron Engineering,* TC Memo 2000-335, November 1, 2000, and *Lykins v. Comm'r,* TC Memo 2006-35, May 2, 2006

79. Letter Ruling 200606020 (November 9, 2005)

80. Temp. Treas. Reg. §1.448-1T(e)(4)(iv)(A)

- Litigation,
- Fairness opinions, and
- Purchase price allocations.

The company gathered data, did research and data analysis, determined the valuation conclusion, compiled a valuation report, and delivered it to the client who usually paid a flat fee for the appraisal. Providing determinations of value, including the preparation of valuation reports, represented at least 95% of the work performed by the taxpayer. Most of its clients were professionals, such as attorneys, accountants, and financial institutions which used the conclusions contained in valuation reports to advise their own clients on business and legal matters. The taxpayer also provided expert testimony on the assessments made in one of its reports and a few of its senior employees did consulting work such as reviewing someone else's valuation report. The taxpayer's staff consisted of professional valuation analysts, sales people, and support staff.

IRS Ruling

While acknowledging that none of the examples in Temp. Treas. Reg. §1.448-1T(e)(iv)(B) describe a situation similar to this particular taxpayer, the IRS still proceeded to disqualify it from qualified PSC status on the ground that "its situation is analogous to the taxpayer in Example 10." This example involved a taxpayer that studied a client's financial situation, made recommendations on the types of insurance and annuities he should purchase, and then sold him the recommended products. Most importantly, the taxpayer's compensation was typically based on the purchases made by the client. Thus, the regulations concluded that the taxpayer was engaged in performing brokerage or sales services and was **not** a qualified PSC. As do a number of other examples of nonqualifying businesses, Example 10 states that "relevant to this determination was the fact that the taxpayer's compensation was contingent on the consummation of the transaction the services were intended to effect (here, the purchase of insurance products by its clients)."

> **Note.** Unlike the insurance seller in **Example 10,** or in a number of other similar examples, the taxpayer's remuneration was **not** based on a product that it sold. Nevertheless, the IRS concluded the two businesses were similar. Like the taxpayer in **Example 10,** the IRS apparently felt that "at the direction of its clients, the taxpayer in this ruling composes and delivers a written product that represents the culmination of the services provided (the ascertainment of value)." However, that could also be interpreted as "saying nothing more than the fact that [the taxpayer] did **not** get paid until it delivered its work product."

So, how does a firm avoid being classified as a PSC? There are several options:

- Elect S corporation status,
- Have enough other business activity conducted by the employees to fall below the 95% threshold, or
- Distribute all corporate income in the form of salary and bonuses.

> **Note.** If the corporation is going to distribute all the income, it would be best to elect S corporation status.

S CORPORATIONS

ISSUE 1: EFFECT OF OPEN ACCOUNT DEBT ON BASIS[81]

In response to the Tax Court's decision in *Brooks*,[82] the IRS issued proposed regulations.[83] These limit open account debt and basis adjustments for an S corporation's debt to its shareholder under IRC §1367(b)(2) for shareholder advances and repayments on open account debt advances. An open account debt is defined as S corporation shareholders' advances **not** evidenced by separate written instruments.

Comment. The proposed regulations significantly alter the reporting responsibilities of S corporation shareholders. To avoid some of the issues presented by these new regulations, shareholders who make loans on open accounts should consider making contributions to capital instead. In this way, shareholders can avoid being caught by the $10,000 threshold limit of Prop. Treas. Reg. §1367(a)(2). While utilizing the capital account approach requires extensive bookkeeping to track the advances and repayments to prevent deficits in the capital account, there would be no danger of crossing the $10,000 threshold and creating potential gain.

Background

A shareholder can deduct his pro rata share of S corporation losses only to the extent of his total basis in:

1. The S corporation stock, and
2. Debt owed him by the S corporation.[84]

If an S corporation repays a debt owed to a shareholder after his basis is reduced by pass-through losses and deductions, the shareholder realizes income to the extent of any repaid amounts on a pro rata basis.[85]

Example 9. Alex is an S corporation shareholder. Under a separate written agreement, he loaned $100,000 to his S corporation. Subsequently, $20,000 of this debt basis is used to take K-1 losses in excess of stock basis.

As a result, the direct shareholder loan has a reduced basis of $80,000. If $10,000 is repaid on the principal balance of this loan, $2,000 of it will be taxable (($80,000 ÷ $100,000) × $10,000). The remaining $8,000 is applied against the basis of the debt resulting in a new basis of $82,000 ($90,000 – $8,000). If this loan is in writing, the $2,000 is characterized as capital gain. If it is not in writing, it is ordinary income.

Note. As discussed below, open account debt repayments are treated differently. Repayments made in the **same** year as the original advances are netted against the outstanding balance of such loans and only the excess is recognized as income. There is no pro rata approach as is the case with a written instrument. The character of that income is ordinary, because none of the debt was evidenced by a written instrument.

81. IRC §1367

82. *Brooks v. Comm'r*, TC Memo 2005-204, August 25, 2005

83. Issued April 12, 2007, and corrected May 8, 2007

84. IRC §1366(d)

85. *Smith v. Comm'r*, 424 F.2d 219 (9th Cir. 1970) *aff'g* 48 TC 872 (1967)

Under existing regulations, open account debts and repayments are treated as a **single** debt.[86] There is no reduction for debts that are satisfied by the corporation or disposed of or forgiven by the shareholder during the year.[87] Adjustments to an S corporation shareholder's debt basis are generally determined as of the close of the S corporation's tax year and are effective at that time. If any part of a debt is disposed of or repaid before the close of the tax year, the basis of that debt is restored, effective immediately before the disposition or first repayment.[88]

Tax Court Decision in *Van Wyk*

In *Van Wyk*,[89] an S corporation shareholder borrowed money from a family member with whom he farmed (and who was also a shareholder of the S corporation), paid off the corporate debt, and then contributed the balance to the S corporation as a loan. The Tax Court held that the taxpayer's share of the S corporation losses was disallowed because they were not at risk. Had he simply borrowed the funds personally and then loaned them to the S corporation, he would have been able to increase his stock basis and deduct the losses.

Tax Court Decision In *Brooks*

In *Brooks*,[90] a shareholder made a series of open account advances to his S corporation and received repayments of the advances during the **same** year. The Tax Court treated the advances as an open account debt and repayments of the shareholder advances were netted against advances during the year. The shareholder in *Brooks* borrowed money from a bank and advanced it as open account debt to his S corporation in one tax year. This reduced his basis in that open account debt for losses passed through to him at the end of that same year. In a later tax year, the S corporation repaid the open account debt and the shareholder then repaid his debt to the bank. Late in that **same** year to avoid the recognition of gain from repayment of the debt, the shareholder again advanced money borrowed from the bank in an amount that offset the repayment of advances. As a result, the shareholder's advances increased his basis in the debt and allowed losses for that year to pass through to him. More importantly, the repayments and advances allowed the shareholder to indefinitely defer the recognition of income on a repayment of his open account debt.

Proposed Regulations

The IRS issued proposed regulations to narrow the definition of open account debt and modify the rules for adjusting basis in indebtedness for that debt. The IRS believes that Treas. Reg. §1.1367-2(a) was **not** intended to allow the deferral permitted in *Brooks*. Under the proposed regulations, **open account debt** is defined as shareholder advances **not** evidenced by separate written instruments for which the principal amount of the aggregate advances, net of repayments on the advances, does **not** exceed $10,000 at the close of **any** day during the S corporation's tax year. Open account debt therefore includes separate advances under a line-of-credit agreement if the advances are **not** evidenced by a separate written instrument. Open account debt is also treated as a **single** debt.

The proposed regulations provide that a shareholder must maintain a "running balance" of the advances and repayments, as well as the outstanding principal amount of the open account debt. This requirement helps to determine whether shareholder advances and repayments on advances exceed the $10,000 aggregate principal threshold on any day during the S corporation's tax year. If the resulting aggregate principal of the running balance does **not** exceed $10,000 at the close of any day during the S corporation's tax year, the advances and repayments are open account debt. They are treated as a single debt and are **not** accounted for until the close of the tax year. However, if the running balance exceeds $10,000, the **entire** principal amount of that debt is no longer open account debt. This is effective at the close of the day in which the amount of the running balance exceeds $10,000.

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86. Treas. Reg. §1.1367-2(a)

87. Treas. Reg. §1.1367-2(b)

88. Treas. Reg. §1.1367-2(d)

89. *Van Wyk v. Comm'r,* 113 TC 440 (1999)

90. *Brooks v. Comm'r,* TC Memo 2005-204, August 25, 2005

The principal amount is treated as debt, evidenced by a written instrument for that tax year, and is accounted for according to the timing rules in Treas. Reg. §1.1367-2(d) for that and later tax years. Any new shareholder advances **not** evidenced by a written instrument and repayments on those advances within the $10,000 aggregate principal threshold amount during the tax year are considered new open account debt. Under the proposed regulations, at the end of the S corporation's tax year, each shareholder determines if he made a net advance, or received a net repayment on open account debt for that tax year. He must net all advances and repayments made during the year without regard to the outstanding principal amount of the open account debt. A net repayment is taken into account, effective at the close of the S corporation's tax year under the general basis adjustment rules in Treas. Reg. §1.1367-2.

A net advance is combined with the outstanding aggregate principal balance of the existing open account debt and that amount is carried forward to the beginning of the later tax year as the outstanding aggregate principal amount of the open account debt. If at any time during the tax year the $10,000 threshold is exceeded, the running balance must be reconciled. This reconciliation is effective at the close of the day the balance exceeds $10,000 and determines the aggregate principal amount of the debt. For the remainder of the tax year, that principal amount is treated in the **same** manner as debt evidenced by a written instrument.

Effective Date

The proposed regulations will apply to shareholder advances to the S corporation made on or after the date the regulations are published as final regulations.

Had the regulations been in effect at the time of the *Brooks* case, the results would have been dramatically different. Instead of having one loan with balances measured at the end of the year, there would have been two loans — an $800,000 loan paid off in 2000 and a $1,100,000 loan made at the end of 2000.

The results are compared below.

	Outcome Under Tax Court's Opinion	Outcome Under Proposed Regulation	
		Debt #1	Debt #2
1999 open account advance	$ 800,000	$800,000	
1999 loss applied to open account loan basis	(441,293)	(441,293)	
Repayment in 2000	(800,000)	(800,000)	
Additional open account advanced in 2000	1,100,000		$1,100,000
S corporation losses in 2000	(413,944)		(413,944)
Basis in open account debt, December 31, 2000	$ 244,763		$ 686,056
(Gain) recognized on debt repayment in 2000		($441,293)	
Net Income and Loss			
Deductible S corporation loss, 1999 and 2000	($ 855,237)	($855,237)	
Capital gain on loan repayment	0	441,293	
Net income and loss, S corporation and loan	($ 855,237)	($413,944)	
Balance in loans at end of 2000	$ 244,763		$ 686,056

Under the proposed regulations, the losses would have been fully deductible, but the shareholders would have also had a $441,293 gain on the repayment of the deemed separate debt paid off during 2000 — in effect, recapturing the 1999 loss that the 1999 year-end loan enabled them to take.

If the regulations become final (which is likely), S corporation shareholders will have to determine whether their advances and repayments exceed the $10,000 aggregate principal threshold. Probably the best way to do that is to maintain a running balance of those advances and repayments and the principal amount of the open account debt.

ISSUE 2: PROPERLY TERMINATING OWNERSHIP INTEREST IN A FLOW-THROUGH ENTITY[91]

A key tax principle in the ownership of an interest in a flow-through entity is that the owner is taxed whether or not he actually receives any distribution of the company's profits for the tax year. Furthermore, if the taxpayer is officially listed as being an owner for any part of the year, he is taxed on at least some portion of the entity's profits. A question arises when there are marital difficulties or owner disputes resulting in an owner leaving mid-year and thinking he is no longer part of the enterprise.

The owner may truly believe that he exited the business, but due to the lack of formality, proper notice is not given about the ownership change. The S corporation owner in the case discussed below was taxed on his share of the entity's profits even though there was no chance that he would ever see any money. The IRS insisted that the taxpayer was required to include as income his proportionate share of undistributed S corporation income in which he was a shareholder with his former wife. This was despite the fact that he had absolutely no involvement with the business during the tax year in question.[92]

Case Facts

In 2000, Thomas and Cheryl Sweeney incorporated Lake Vista Billing Services, Inc. Thomas was listed as the registered agent for the corporation. Cheryl was the president and Thomas was vice president and a stockholder. The stated purpose for the corporation was medical billing for physicians' practices. Thomas and Cheryl each owned 50% of the corporation. The corporation was a collection service that obtained fees charged by doctors to their patients for medical services. Cheryl performed all the activities of the corporation by visiting doctors' offices weekly, picking up their billing invoices, collecting payment of these invoices from primary and secondary insurers, and collecting directly from each patient the portions not covered by insurance. During this time period, Thomas was **not** involved in this activity. He was employed as an insurance instructor for an unrelated employer. For 2002, Form 1120S was filed showing the corporation's taxable income of $18,627. A Schedule K-1 was issued to Thomas showing $9,314, his 50% of the S corporation profit. However, Thomas did **not** include the K-1 income from the corporation on his 2002 return. Both Thomas and Cheryl filed income tax returns as married filing separately. Cheryl reported one-half of the taxable income of the S corporation on her return. The IRS determined a deficiency against Thomas for the unreported $9,314 in flow-through income from Lake Vista Billing Services, Inc. Thomas claimed that he received none of the proceeds of the corporation's profitable activity for 2002. He also testified that he and his wife had serious marital problems during that year. During the second week of January 2002, Thomas testified that Cheryl "proceeded to throw him out of his home," which is where the business was located. She changed the locks. She stripped the corporate bank accounts, personal bank accounts, charged up all the cash she could on his credit cards, and she "physically, lock, stock, and barrel, locked him out of the corporation."

91. IRC §1366

92. *Sweeney v. Comm'r*, TC Summ. Op. 2006-169, October 19, 2006

Tax Court Decision

The Tax Court held that "all formalities of the code had been followed with respect to the S corporation for the year 2002." Therefore, the distributive share of its income to Thomas had to be treated as taxable income. The court stated that "although it was obvious that Thomas and his spouse had serious differences, the Tax Court is **not** the proper forum for the resolution of those differences."

In *Burke,* a similar situation occurred with an LLC when the owners fell into a dispute regarding how the profits of the firm should be split.[93] While the litigation was pending, these monies were placed into an escrow account. Therefore, the owner felt justified that none of these profits needed to be reported on his Schedule E until such time as the matter was resolved and he would learn what, if any, of these profits he was entitled to.

Unfortunately, the IRS's matching program discovered that he had listed zero with regard to his K-1 information even though the other owner, who prepared the business tax return, had listed his allocable share in spite of the dispute. In reaching its decision, the 1st Circuit cited the "well settled" rule that "partners' K-1 distributions are taxed in the year the partnership receives its earnings, regardless of whether the partners actually receive their share of partnership earnings. Consistent with this long-standing principle, courts have uniformly held that partners must currently recognize in their individual incomes their proportionate shares of partnership income, even if the partnership income was **not** actually distributed to them for any reason, including disputes, consensual arrangements, ignorance, concealment, or force of law."

Observation. While the IRS suspended the Schedule K-1 matching program several years ago, the revised Schedules K-1 (1065, 1120S, and 1041) were designed to enhance the matching of the information with the taxpayer's returns. Practitioners should expect CP2000 letters from the IRS to include Schedules K-1 soon.

ISSUE 3: RESTRUCTURING GUARANTEED LOANS TO CREATE DEBT BASIS FOR DEDUCTING K-1 LOSSES

Almost every small- to medium-size business faces the prospect of having some or all of its owners guaranteeing its debts or lines-of-credit if it is going to secure needed capital for operating purposes. One of the advantages of being an S corporation is that it is a flow-through entity, whereby owners can deduct start-up (or on-going) losses on their personal returns. However, unlike partnerships and LLCs, an S corporation is more similar to a regular C corporation if the owners do **not** have sufficient basis to realize the tax benefit of these K-1 losses. If they can be forced to repay the debts of the entity if the company is unable to do so, they should receive additional debt basis for taking losses from these guarantees.

In this regard, a recent Tax Court decision offers an excellent blueprint on this restructuring process. After a debt restructuring, an S corporation shareholder had the necessary basis to deduct losses when he became a fully recourse obligor on an enforceable debt held by an independent, third-party lender and then reloaned the proceeds of this debt to his S corporation.[94]

Note. This important case illustrates the ability of an S corporation shareholder to carry out a novation before year-end for a bank loan that originally was made directly to the entity. Instead, the shareholder replaced the business as the primary obligor. Therefore, he created debt basis for taking losses instead of being a mere guarantor.

Note. Of course, if the owners do not materially participate in the day-to-day operations, they face the prospects of having the passive loss rules prevent utilization of any pass-through K-1 losses, despite the presence of adequate debt or stock basis.

93. *Burke v. Comm'r,* 485 F.3d 171 (1st Cir. 2007)

94. *Miller v. Comm'r,* TC Memo 2006-125, June 15, 2006

Background

Deductions and losses of an S corporation are passed through to shareholders and are claimed on their own returns with the exception of those limited by the basis, at-risk, and/or passive loss rules. However, under IRC §1366(d)(1) and Treas. Reg. §1.1366-2, a shareholder may deduct his pro rata share of these pass-through items only to the extent of his adjusted basis in the S corporation stock. This is determined by taking into account the increases in basis for his share of the S corporation income during the year and the decreases in basis for nondividend distributions for the year, plus any debt owed directly to the shareholder by the corporation. A deduction or loss that is disallowed due to the lack of basis may be carried over and used in the future to the extent the shareholder then has basis. Also, §465 limits the amount of losses from certain activities that may be subject to the at-risk rules. Despite the existence of sufficient basis that is considered to be at-risk, the passive loss rules can curtail the deduction if there is not enough passive income to cover the loss amount.

Facts

Timothy Miller incorporated MMS as an S corporation. MMS was in the business of manufacturing mobile and modular medical diagnostic facilities. In a restructuring transaction, Miller gave his fully recourse $1 million promissory note to Huntington National Bank (Huntington) to replace MMS's $1 million promissory note on which Miller had formerly served as guarantor. Huntington then advanced $750,000 under Miller's note and recorded MMS's note as satisfied by virtue of the payment of its $750,000 outstanding balance. In turn, MMS gave a promissory note to Miller that mirrored the terms of Miller's note to Huntington. A principal motivation for the note substitution was to generate basis for purposes of §1366(d)(1)(B). Two later $250,000 increases in the respective credit lines extended by Huntington to Miller and by Miller to MMS followed the format of back-to-back loans that had been held to create basis. In other words, Miller borrowed the additional amounts from Huntington and immediately reloaned them to MMS, with the indebtedness between Miller and Huntington and between MMS and Miller fully documented.

Tax Court Decision

The Tax Court concluded that Miller had actually "made an economic outlay, which left him poorer in a material sense, by becoming the fully recourse obligor on an enforceable debt held by an independent third-party lender." Miller, who then reloaned the proceeds of the indebtedness to MMS, created direct indebtedness of his S corporation to him, within the meaning of §1366(d)(1)(B). As a result, he was considered to have sufficient basis to cover the losses he claimed. The key was that the restructuring transaction, in which Miller borrowed from Huntington on a recourse basis and reloaned the borrowed amounts to MMS, was that both loans were fully documented so as to create enforceable legal obligations. They also "contained adequate substance" so as "not to be disregarded." After the restructuring, MMS was directly indebted to Miller and he had enforceable creditor's rights against MMS. Consequently, there was indebtedness of MMS to Miller so that the outstanding indebtedness under the MMS-Miller loan at the close of the years in issue generated basis in those amounts. In reaching its decision, the court rejected as "unpersuasive" the IRS's argument that Miller's "status as borrower from Huntington and lender to MMS should be disregarded, and the transaction treated in substance as a loan from Huntington to MMS, with the result that Miller obtained no basis." The court also rejected the IRS's argument that Miller should not be considered at-risk under §465 for the borrowed amounts. Depending on the circumstances, Miller could have been required to satisfy all or part of the Miller-Huntington loan, even if MMS ceased making payments to him under the MMS-Miller loan.

> **Note.** It is surprising the IRS insisted on pursuing this case. Here, the taxpayer actually went to the trouble of fully documenting what was being done. In other words, it was **not** just the mere substitution of his name on the original loan document in place of his S corporation. Also, consider the costs that the taxpayer incurred to defend himself in the IRS audit and in Tax Court.

EMPLOYMENT TAXES: OWNERS OF SMLLCs HELD LIABLE FOR UNPAID PAYROLL TAXES[95]

Business owners who decide to pay creditors ahead of the federal government should study IRC §6672 and the 100% trust fund penalty. A recent case dealt with the limited liability status of LLC members when the entity failed to pay employment taxes. Managing members who work in the business on a day-to-day basis and decide which outstanding liabilities to pay first can be held responsible for the trust fund penalty. However, do other members have the same liability shield as their corporate counterparts?

> **Observation.** This case was **not** litigated based on the trust fund penalty. If it was, the proprietor of this SMLLC would probably have lost because he ultimately decided how funds were disbursed in his company. Instead, he attempted to attack the validity of the check-the-box regulations. It did **not** matter that local (Kentucky) law stated that owners of SMLLCs had limited liability status for outside creditor claims, including taxes owed by the business to the federal government. Had this been a multi-member LLC, the owners would have been subject to the levy powers of the IRS, given that the business was now bankrupt, and personal assets of the owners could have been seized.

Case Facts

Frank Littriello was the sole member of several Kentucky LLCs (SMLLCs). He did **not** elect to have them treated as corporations for tax purposes and instead reported their income on separate Schedules C. However, the LLCs failed to pay their employment taxes, and the IRS notified him of its intent to levy on his property. Littriello sought relief in the district court.

District Court Decision

In the district court, Littriello argued that the IRS's issuance of the check-the-box regulations "was an invalid exercise of its authority to issue interpretive regulations under IRC §7805(a)." According to the taxpayer, the regulations should be held unenforceable. The IRS should only be allowed to tax the LLC as a separate legal entity for the unpaid taxes, and it should **not** be permitted to tax Littriello individually. The district court rejected Littriello's argument and found that the regulations were valid.

Appeals Court Decision

Littriello appealed to the 6th Circuit Court of Appeals. In a case of first impression,[96] the court agreed with the district court and rejected Littriello's attempt to escape a levy to satisfy unpaid employment taxes by claiming that the check-the-box regulations are invalid. As stated previously, the taxpayer was the sole member of the SMLLCs and the check-the-box regulations treat these as disregarded entities under its default rule. As a result, the individual taxpayer was responsible for the LLCs' employment taxes.

> **Note.** It is important to note that no election was made on Form 8832, *Entity Classification Election,* to check a box to be treated as a corporation. Therefore, the default rule is that an SMLLC is disregarded for federal income tax purposes and is treated as a sole proprietorship.

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95. Treas. Reg. §301.7701

96. *Littriello v. U.S.*, 484 F.3d 372 (2007). See also *McNamee v. U.S.*, 488 F.3d 100 (2nd Cir. 2007); *Stearn & Co., LLC, v. U.S*, 100 AFTR 2d 2007-5039 (DC MI, June 29, 2007)

The court stated that §7701 "was ambiguous with regard to hybrid business entities, such as LLCs, and the regulations, which filled the statutory gap in dealing with hybrid entities, were eminently reasonable." Furthermore, Littriello's failure to make an election under the check-the-box regulations resulted in his companies being treated as disregarded entities under the regulations, and **not** as corporations. Accordingly, he was individually liable for the businesses' employment taxes because the businesses were treated as sole proprietorships under §7701 and he was the proprietor.

The court also rejected Littriello's contention that the IRS "is required to recognize the separate existence of his LLCs as a matter of state law." The court acknowledged that state laws of incorporation control various aspects of business relations. However, while they "may affect federal tax provisions, they do **not** control them." The court found that Littriello's SMLLCs were entitled to whatever advantages state law may extend, but state law could **not** eliminate his federal tax liability. In reaching its decision, the appeals court also rejected Littriello's reliance on proposed regulations.

In October 2005, after Littriello filed his appeal in this case, the IRS issued proposed regulations that would treat single-owner entities that are disregarded entities (SMLLCs) as separate entities for employment tax purposes. Littriello argued that the proposed amendments "should be taken as reflecting current IRS policy" and thus applied to his case. However, the court reasoned that "proposed regulations do **not** represent the IRS's considered interpretation of the statutes" and that the IRS "is entitled to consider alternative interpretations before settling on the view it considers most sound."

Note. Rev. Rul. 2004-41 makes it clear that the IRS is **not** permitted to collect a multi-member LLC's unpaid employment taxes from its members "because they are **not** liable for the LLC's debts under state law." This is the case even though the LLC is classified as a partnership for federal tax purposes, and general partners are normally liable for partnership obligations under state law under the doctrine of joint and several liability. Nevertheless, the LLC members, as responsible persons, may still be liable for the unpaid employment taxes under the §6672 trust fund penalty tax rules.

This is probably how this case should have been decided, without having to go into the question of limited liability status or the effect of the state law on a federal tax liability. Under this approach, would it have made a difference if the taxpayer and his spouse had decided jointly to own the LLC, thus making it a multi-member LLC? The key is that this sole proprietor had complete discretion as to which creditors were paid. And, the taxpayer decided to shirk his responsibility to pay the federal government its share of employment taxes. That is probably why he did **not** even attempt to argue the trust fund penalty issue. Instead, he tried to dispute the validity of the check-the-box regulations.

A Kentucky law stating that an LLC owner **cannot** be held personally liable for the entity's debts was ignored in this case. The rule is different for SMLLCs that choose to be taxed as corporations and for multi-member LLCs that are taxed as partnerships. In these instances, the IRS does **not** automatically pursue the owners for unpaid payroll taxes, unless the taxpayers are responsible for the shortfall because they have the discretion to decide which creditors, including the government, were paid.[97]

Background

Under the check-the-box system of classifying entities for tax purposes, eligible entities may choose their federal tax classification. Multi-owner eligible entities may elect to be classified as corporations or partnerships, or to retain their default classifications in the absence of an election. Single-owner eligible entities may elect to be classified as corporations or may choose to have their status as entities separate from their owners ignored. An SMLLC that does **not** elect to be treated as a corporation under the check-the-box regulations is considered a disregarded entity for federal tax purposes. As such, its activities are treated in the **same** manner as a sole proprietorship.[98]

97. In a federal district court opinion that would be appealable to the 6th Circuit (the circuit that decided *Littriello*), the court ruled that an owner of a SMLLC was not shielded from payroll tax liability when an election to treat the LLC as a separate entity was not made. *Stearn & Co., LLC v. U.S.,* 100 AFTR 2d 2007-5039 (DC MI, June 29, 2007)

98. Treas. Reg. §301.7701-3(b)(1)(ii)