Chapter 1: S Corporations

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Corrections were made to this workbook through January of 2011. No subsequent modifications were made.

HISTORY OF THE S CORPORATION

Subchapter S of the Internal Revenue Code was enacted in 1958 as part of the Technical Amendments Act of 1958.[1] The creation of S corporations allowed small business corporations to have the liability protection afforded to C corporations while avoiding the corporation income tax. While the S corporation might appear to be a partnership with corporate characteristics, it is substantially different from both.

Subchapter S was amended many times until the Subchapter S Revision Act of 1982 was enacted. This act completely revised existing S corporation laws. The Subchapter S Revision Act of 1982 has also been amended many times since its enactment.

With passage of the Tax Reform Act of 1986 (TRA), many C corporations decided to elect S corporation status. This occurred because the TRA reversed the top tax rates. Before 1986, the individual income tax rates were higher than the corporation income tax rates. This continued for seven years until the rates reversed in 1993. Consequently, it became advantageous to elect S corporation status because under those flow-through provisions, corporate profits were taxed at the individual shareholders' income tax rates.

TRA repealed the General Utilities Doctrine.[2] The General Utilities Doctrine had allowed a corporation to transfer property from the corporation to a shareholder without being subject to double taxation — once at the corporate level and again at the shareholder level. This allowed C corporations to liquidate with a single level of taxation. As a result, many C corporations elected S corporation status to retain the one level of tax. However, the TRA also enacted the built-in gains (BIG) provisions. The BIG provisions are discussed later in this chapter.

While later acts continued to revise and refine the S corporation provisions, the next major revision came with the Small Business Job Protection Act of 1996 (SBJPA).[3] SBJPA increased the maximum number of shareholders from 10 to 75. When counting the number of shareholders, an employee stock ownership plan (ESOP) is counted as just one shareholder, although many individuals can be part of the ESOP. The act also permitted S corporations to have tax-exempt shareholders, such as trusts. SBJPA also made it possible for an S corporation to own both C corporation and S corporation subsidiaries.

1. P.L. 85-866.

2. *General Utilities & Operating Co. v. Helvering,* 296 U.S. 200 (1935).

3. P.L. 104-188.

Before 2002, if the S corporation experienced financial difficulties resulting in debt discharge income, the S corporation could exclude recognition of the income, but the shareholder was allowed to increase stock basis and consequently deduct suspended losses.[4] The Job Creation and Worker Assistance Act of 2002 (JCWAA) closed this loophole.

The next major change occurred with the American Jobs Creation Act of 2004 (AJCA).[5] This act increased the number of allowable shareholders to 100. In addition, it includes attribution rules that allow many more than 100 shareholders in certain situations. For example, all family members are treated as one shareholder.

An important change to S corporation law was enacted in the Pension Protection Act of 2006 (PPA).[6] This provision allowed shareholders to reduce their stock basis by their pro-rata share of the basis of property the corporation donated to charity for 2006 and 2007. Prior to this change, the shareholder's basis was reduced by his pro-rata share of the fair market value (FMV) of the donation. The PPA change was later extended through 2009 by the Emergency Economic Stabilization Act of 2008 (EESA).[7]

In an attempt to increase government revenue, a change was made by the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA).[8] This change increased the penalty for late filed S corporation returns to $89 per month per shareholder. The new penalty applies to returns required to be filed after December 31, 2008. The penalty was next increased to $195 by the Worker, Homeownership, and Business Assistance Act of 2009.[9]

The American Recovery and Reinvestment Act of 2009 (ARRA)[10] also made a change to S corporation law. This was a special-interest change that reduced the BIG recognition period from ten to seven years for S corporations that were formerly C corporations and elected S status between 2000 and 2003. The 7-year recapture period only applies in tax years beginning in 2009 and 2010. This is discussed later in the chapter.

GROWTH OF S CORPORATIONS

Next to the sole proprietorship, the S corporation is the most popular type of entity.[11] The number of S corporations increased by 35% between 2000 and 2006 and accounted for nearly 4 million businesses in 2006. As a percentage of all businesses, S corporations grew from 11.4% in 2000 to 12.6% in 2006.

Between the same years, S corporation income grew by 67%, or $106 billion, and total assets grew by 46%, or $1.0 trillion.[12]

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4. *D. A. Gitlitz v. Comm'r,* S.Ct., 2000-1 USTC ¶50,147, 531 U.S. 206, 121 S.Ct. 701 (June 9, 2001).

5. P.L. 108-357.

6. P.L. 109-280.

7. P.L. 110-343.

8. P.L. 110-458.

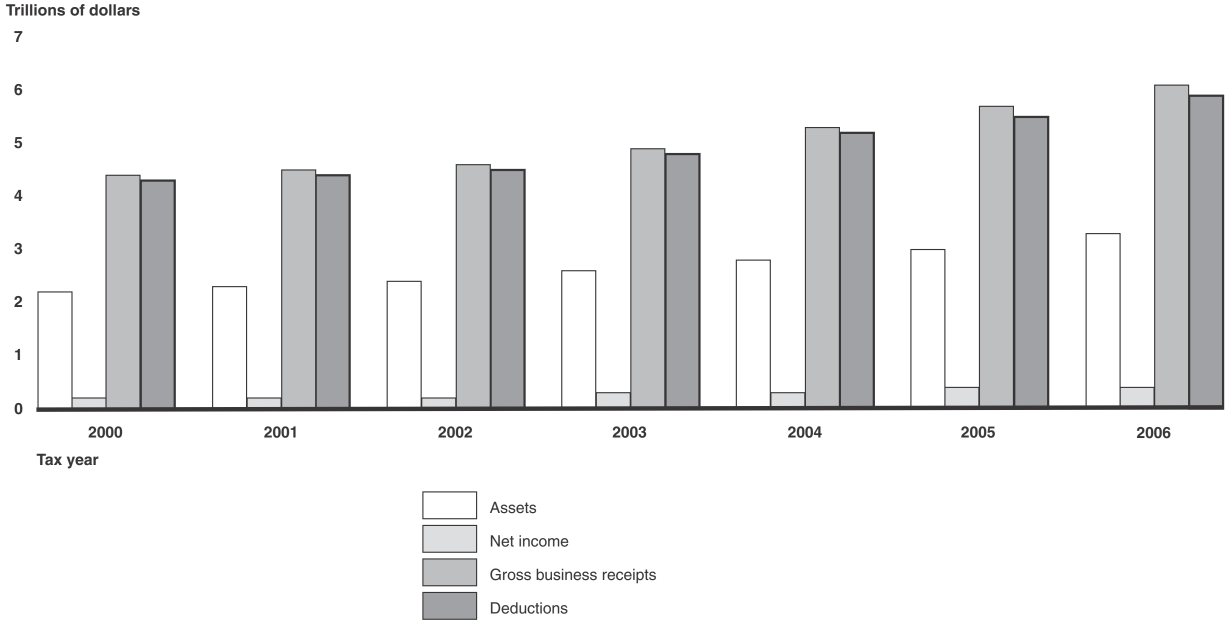
9. P.L. 111-92.

10. P.L. 111-5.

11. GAO-10-195, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules* (Dec. 2009), p. 3.

12. Ibid, p. 4.

Total S Corporation Assets, Net Income, Gross Business Receipts, and Deductions, Tax Years 2000 to 2006



Source: GAO analysis of IRS's SOI data.

Between 78,000 to 97,000 C corporations converted to S corporations each year between 2000 and 2006. This represents 23% to 31% of new S corporations each year.[13]

There is no data available on the conversion of S corporations to C corporations. This type of conversion would more likely occur if the individual income tax rate became higher than the corporation income tax rates or S corporation profits became subject to SE tax. The 2010 Patient Protection and Affordable Care Act, which imposes a Medicare tax (3.8%) on unearned income of individuals, estates, and trusts for tax years beginning after December 31, 2012, may also impact the decision to convert from S status to C status.

RECENT GOVERNMENT REPORTS

As Congress attempts to reduce the tax gap, they have prompted various government agencies to study the S corporation.

TIGTA REPORT[14]

A 2005 report by the Treasury Inspector General for Tax Administration (TIGTA) highlights the lack of reported compensation taken by S corporation shareholders. If a shareholder does not receive a salary or wage but instead takes distributions from the corporation, he does not contribute to the social security system. The report shows that 36,000 single-shareholder corporations had profits of $100,000 or more and passed through profits of $13.2 billion but paid no payroll taxes.

The report estimates shareholders underreported $23.6 billion of compensation in 2003 and 2004. The report calls this an "employment tax shelter" and estimates its closure would increase social security and Medicare employment tax revenues by $30.8 billion and $30.2 billion, respectively, between calendar years 2006 and 2010.

13. Ibid.

14. Treasury Inspector General for Tax Administration, *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations,* Reference Number 2005-30-080 (May 2005).

The Government Accountability Office (GAO) blames the lack of reported compensation on Rev. Rul. 59-221.[15] The revenue ruling was issued because the S corporation statute was silent on the employment tax treatment of corporate profits. The GAO theorized that the IRS assumed the majority of S corporations would involve multiple shareholders when it released the ruling. In a multiple-shareholder environment, it would be reasonable to assume that the salary of the business operator would be set by a consensus of shareholders at a level reflecting the market value of the operator's services. The IRS apparently did not anticipate that most S corporations would eventually consist of sole proprietors who chose to incorporate without expanding ownership to include additional shareholders.

In 2000, 78.9% of all S corporations were owned by either a single shareholder or a greater-than-50% owner. This allows the shareholder to make compensation decisions. Unfortunately, the IRS does not have the agents to enforce reasonable salary issues on a case-by-case basis.

Rev. Rul. 59-221 was issued in response to a request asking whether S corporation profits fell under IRC §1372. This code section states that for employee fringe benefit purposes, the S corporation is treated as a partnership and any 2% shareholder of the S corporation is treated as a partner of such partnership. While §1372 only deals with fringe benefits, taxpayers assume the S corporation, like the partnership, does not have a salary requirement. Consequently, the ruling places the burden on the IRS to prove that the salary chosen by the owner of a single-shareholder corporation is not "reasonable" (commensurate with the services the shareholder provides to the S corporation).

The 2005 TIGTA report recommends Rev. Rul. 59-221 be revised through the issuance of new regulations or through drafting of new legislation. TIGTA believes all ordinary operating gains of an S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50% of the stock in the S corporation should be subject to employment taxes.

The IRS disagrees with the TIGTA report but agrees that differences exist between the employment tax liabilities of sole proprietorships and single-shareholder S corporations. The IRS does not believe Rev. Rul. 59-221 is the cause of these problems. The IRS has expressed its belief that, since it was based upon corporate employment taxation statutes and regulations in effect prior to the creation of S corporations, Rev. Rul. 59-221 confirms that SECA taxes do not apply to S corporation shareholders. The IRS believes legislative rather than regulatory changes could help reduce the problems it experiences in relation to the employment taxes of single-shareholder S corporations and believes any such legislation should also address possible similar inequities in other types of business structures.

The TIGTA report resulted in the IRS making S corporations the focus of the National Research Program (NRP) audits of 2003 and 2004.

GAO REPORT[16]

The IRS has not issued a public report on the results of the NRP audits of S corporations. However, the GAO used these results to issue its 2009 report to the Senate Committee on Finance.

The GAO was asked to:

1. Describe the reasons businesses choose to become S corporations;
2. Analyze types of S corporation noncompliance, what the IRS has done to address noncompliance, and options to improve compliance; and
3. Analyze the extent of shareholder compensation noncompliance and identify options for improving compliance.

15. Rev. Rul. 59-221, 1959-1 CB 225.

16. GAO-10-195, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules* (Dec. 2009).

The first statistic the GAO reported from the IRS data was that approximately 68% of S corporation returns filed for tax years 2003 and 2004 misreported at least one item. This resulted in a tax advantage to the corporation and/or shareholder nearly 80% of the time. Deducting ineligible expenses was the item most frequently misreported, which could decrease the tax liability of the shareholder. The research showed that paid tax preparers were used by the majority of S corporations and 71% of those returns were incorrect. The GAO compares this with 70% of sole proprietorships that misreport income.

The error rate is higher on corporations with assets under $250,000 than those with $1 million to $10 million of assets. The highest percentage of errors was due to the corporation deducting personal expenses. This included taxes, tax preparation fees, insurance, vehicles, and other personal expenses. Automobile, insurance, telephone, and travel expenses were most commonly misreported.

The report focuses on two major issues in the S corporation misreporting. The first issue is the errors shareholders make in determining the basis of their shares. This is important when determining whether pass-through losses from the corporation are deductible or must be suspended until more basis is available. The second issue is the failure of shareholder-employees to take a reasonable amount of compensation for services rendered to the corporation.

Basis Reporting

The GAO report analyzed S corporation losses for 2003. It was found that many of these corporations reported losses in other years as well. Of the sample returns with losses in 2003, 61% had losses in four or more of the six years and 51% had losses in four or more consecutive years. The shareholders offset 16.6% of their income with the pass-through losses. Furthermore, 11% of the taxpayers were shareholders in multiple corporations. The GAO estimated 42% of the shareholders used an S corporation loss to offset other income.

The GAO believes one option for improving basis rules compliance is for Congress to require S corporations to calculate and report each shareholder's basis on Schedule K-1. This could improve compliance to the extent that recordkeeping and expertise in basis calculations are better at the entity level than at the shareholder level. IRS officials said that during examinations some shareholders are not aware of the basis calculations requirement. This option would most likely help bring some S corporations into compliance by requiring that the calculation be explicitly reported to both shareholders and the IRS. In addition, it likely would be most useful for S corporations with multiple shareholders since the business and the shareholder are essentially the same in single-shareholder S corporations.

The GAO believes the least burdensome way for S corporations to calculate basis for their shareholders is to limit the required calculation to information already possessed by the S corporation. The shareholder would be required to be aware of and track the information missing from the S corporation's calculations. Another way is to require S corporations to obtain as much missing information from each shareholder as possible in order to calculate stock and debt basis more fully. While this would place more of a burden on S corporations, it would be helpful to shareholders, especially if shareholders are less likely than S corporations to know the information needed. The additional burden on the S corporation is minimized by some tax return software programs that already compute S corporation shareholders' stock and debt basis.

The information missing at the S corporation level is primarily the shareholder's initial cost to buy stock from another shareholder and the value of inherited stock on the date of death.

Another option suggested by the GAO is that the IRS provide information on basis calculations to newly-elected S corporations. While the determination of stock basis is an issue, the IRS indicated determining debt basis was also a major challenge in calculating shareholder basis. The IRS has a worksheet to assist shareholders in determining stock basis, but there are no aids to assist in determining debt basis.

Compensation Reporting

The second target of the GAO report is the compensation issue. The report emphasizes the same issues as reported by TIGTA. The NRP data showed that 13% of corporations paid inadequate wages resulting in $23.6 billion of underpaid compensation. This resulted in $3 billion of lost employment tax revenue.

Unlike other types of business entities, S corporations have a possible avenue, whether used intentionally or unintentionally, to avoid employment taxes on payments made to shareholders. S corporation shareholders can receive both wages and distributions, but only wages are subject to employment taxes that are to be paid by both the S corporation and those receiving wages. As a result, corporations that improperly pay lower shareholder wages while increasing other payments such as distributions to shareholders, underpay employment tax liabilities.

Generally, an officer of an S corporation is considered an employee of the corporation for federal employment tax purposes. The employment taxes are paid on an estimate of "reasonable" or adequate shareholder wage compensation. Because "adequate wage" is subjective and difficult to determine, some corporations may inadequately compensate for labor provided by officers and instead compensate through higher amounts of distributions, payments of personal expenses, and/or loans.

The NRP results show S corporations with the fewest shareholders make up the largest portion of shareholder compensation net underpayments. Single-shareholder corporations accounted for $14.2 billion of adjustments, and two or three shareholder corporations accounted for $8.3 billion of adjustments.

TIGTA blamed Rev. Rul. 59-221 for creating the compensation problem. However, IRC §1402(a)(2) states, "there shall be excluded dividends on any share of stock." Were it not for this provision, the S corporation shareholder would be subject to SE tax on the trade or business income of the corporation just as the partner is taxed on the trade or business income of the partnership.

The compensation issue is further complicated by IRC §1372. IRC §1372 provides that a shareholder must include in gross income the amount he would have received as a dividend had the corporation distributed pro rata to shareholders its undistributed taxable income for the year.

IRS Compliance

The IRS enforces compliance with the S corporation rules through a document matching and examination program. The automated underreporter program (AUR) matches individual tax returns with information return documents and assesses taxes on those with significant discrepancies. For S corporations, AUR matches pass-through income reported on Form 1040, Schedule E with amounts shown on Schedule K-1. For tax year 2006, AUR found mismatch errors on almost 5,200 taxpayers and assessed over $49 million. This number includes partnerships as well as S corporations. The issue ranked 14 out of 56 additional tax AUR categories in terms of dollars assessed.

Examinations are used to check reporting compliance on tax returns, but due to limited resources, the IRS examines only a small portion of S corporations. In fiscal year 2008, the IRS examined over 16,000 S corporation returns, which represents less than 0.5% of all S corporations filing tax returns.

REASONABLE COMPENSATION

Unfortunately, the IRS has given no guidance on the amount of distributions to shareholders that should be included as compensation, nor have they established a mechanism to determine reasonable compensation.

Treas. Reg. §31.3121(a)-1(b) states:

> *The term "wages" means all remuneration for employment unless specifically excepted under section 3121(a).*

IRC §3121 exempts such things as certain fringe benefits.

REVENUE RULINGS

Two revenue rulings provide some guidance in determining reasonable compensation. Rev. Rul. 74-44[17] dealt with shareholders that performed services for the S corporation who elected to receive dividends from the corporation rather than wages. The IRS determined the dividends were reasonable compensation for the services provided and were subject to payroll taxes.

Compensation was also discussed in Rev. Rul. 73-361.[18] In this ruling, an officer-shareholder of an S corporation performed substantial services as an officer and received a salary. It was determined that he was an employee of the corporation for purposes of FICA, FUTA, and income tax withholding. The ruling also stated that a corporate officer that does not perform services or performs only minor services and neither receives nor is entitled to receive remuneration, whether direct or indirect, is not an employee.[19]

COURT CASES

Reasonable compensation has been the primary issue of numerous court cases. Several factors are used to determine reasonable compensation. These include:

- Training and experience,
- Duties and responsibilities,
- Time and effort devoted to the business,
- Dividend history,
- Payments to nonshareholder employees,
- Timing and manner of paying bonuses to key people,
- What comparable businesses pay for similar services,
- Compensation agreements, and
- The use of a formula to determine compensation.

Radtke[20]

Joseph Radtke was the sole employee-shareholder of a legal service corporation. Radtke received no wages, only dividends. His employment contract specified no salary would be paid. Radtke received all the profits of the company in the form of dividends. This amounted to $18,225 on which he paid income tax, but no payroll taxes.

The IRS determined, and the court agreed, that all the payments were wages. The decision was based on IRC §§3121(a) and 3306(b). The court did agree that not all income could be categorized as wages. Whether it is compensation or dividend is a substance versus form issue.

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17. Rev. Rul. 74-44, 1974-1 CB 287.

18. Rev. Rul. 73-361, 1973-2 CB 331.

19. 26 C.F.R. §31.3121(d)-1(b).

20. *Joseph Radtke, S.C. v. U.S.*, 89-2 USTC ¶9466, East. Dist. Wis. (Apr. 11, 1989).

Migliore[21]

Not all cases are ruled in favor of the IRS. Mr. and Mrs. Migliore were the sole owners of R&G Sales, Inc., an S corporation. In *Migliore*, the IRS contended that the entire corporate profit constituted earned income. The taxpayers reported $61,058 as salary and asserted this was a reasonable amount. However, the IRS determined that the remaining profit of $68,607 was also earned income and subject to the maximum tax limitations of §1348. The court ruled that Migliore did receive a reasonable salary, and the remainder was not subject to payroll tax. The court noted the corporation had six other employees that were not shareholders. Therefore, all the profit was not the result of the shareholders' efforts and consequently should not be attributed to them.

> **Note.** This is a §1374 case rather than a case in which the IRS tried to assess payroll taxes. IRC §1374 was repealed in 1981. However, the arguments about the definition of reasonable compensation are still valid.

Boles Trucking[22]

This case has two different issues. One pertains to Boles Trucking employing truck drivers and treating them as independent contractors, which is outside the context of this chapter. The second issue pertains to sole shareholder David Boles failing to take reasonable compensation. He received no salary from the S corporation during the year. Instead, he received interest-free shareholder loans and paid personal expenses with corporation funds. David Boles was the president, secretary, and treasurer of the corporation. He alone ran the corporation. Because the truck drivers were treated as independent contractors, the corporation operated with no employees.

David Boles conceded that he was an employee but argued the corporation should not be assessed penalties for failure to file employment returns, as he had reasonable cause. The argument was that he relied on the advice of his tax preparer. Unfortunately for him, a taxpayer is required to use common sense. He knew he was running a company with no employees. Consequently, the court agreed with the IRS, and the loans and personal expenses were deemed wages.

Spicer Accounting[23]

Mr. and Mrs. Spicer were the only shareholders of Spicer Accounting, Inc., an S corporation. Mr. Spicer was the only accountant working for the firm. He performed substantial services, and his work was crucial to the business.

Mr. Spicer was never paid a salary or wages during the existence of the corporation. He had no employment contract with the corporation and contended that he donated his services and, as a shareholder, he could withdraw earnings in the form of dividends. The IRS did not agree with Mr. Spicer and deemed the dividends to be wages.

The court agreed with the IRS. It based its decision on Mr. Spicer's testimony that his services were necessary for the success of the business. He testified that he would be required to pay someone else $16,000 to $17,000 to perform the same services.

In trying to avoid a penalty for failure to file payroll tax returns, the corporation made a Section 530 argument. However, the court determined that Mr. Spicer was not an independent contractor. The corporation provided him with supplies and a place to work and he did not perform accounting services for any other accounting firm.

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21. *Gregory P. Migliore v. Comm'r,* U.S. Tax Court, TC Memo 34,545(M), 36 TCM 1004, TC Memo 1977-247 (July 28, 1977).

22. *Boles Trucking, Inc. v. U.S.,* 77 F.3d 236 (8th Cir. 1996).

23. *Spicer Accounting v. U.S.,* 91-1 USTC ¶50,103 *aff'd* 918 F.2d 90 (9th Cir. 1990).

Dunn & Clark, PA[24]

Attorneys Mr. Dunn and Mr. Clark were the only shareholders of Dunn & Clark, P.A., an S corporation. They were the only two individuals that performed legal services for the corporation. The case facts are similar to other deemed wage cases in that all payments made to the shareholders were treated as dividends. The court ruled in favor of the IRS and used *Spicer* as precedent.

Joseph M. Grey[25]

This is a case in which an accountant followed the same advice that he gave to his clients. Grey was the sole shareholder of the corporation. Grey operated the business out of his principal residence and was paid $500 per month as office rental. Grey performed the following services for the corporation:

1. Solicitation of business on behalf of the corporation;
2. Ordering the corporation's supplies;
3. Entering into verbal and/or written agreements on behalf of the corporation;
4. Overseeing the finances of the corporation;
5. Collecting monies owed to the corporation;
6. Managing the corporation;
7. Purchasing the corporation's supplies;
8. Obtaining clients for the corporation;
9. Maintaining customer satisfaction;
10. Bookkeeping for the corporation; and
11. Performing all accounting, bookkeeping, and tax preparation services for the corporation on behalf of the corporation's clients.

Mr. Grey made all deposits to the corporate bank account and wrote checks to himself when he needed money. The corporation did not distribute dividends to Grey during the years in question nor did it classify any payment made to Grey as a dividend.

The corporation reported a portion of its expenses as payments to an independent contractor and issued a Form 1099-MISC. The remaining profit of the corporation was reported on Schedule K-1.

The IRS contended Grey was an employee of the corporation. It based its decision on Treas. Reg. §31-3121(d)-1(b).

> *Corporate officers. — Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation. A director of a corporation in his capacity as such is not an employee of the corporation.*

Based on the duties Grey performed, his services were more than minor.

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[24] *Dunn & Clark, P.A. v. Comm'r,* U.S. District Court, Dist. Ida. CV 93-0108-E-EJL (Mar. 25, 1994), 853 F.Supp 365, 365.

[25] *Joseph M. Grey Public Accountant v. Comm'r*, 119 TC 5, 119 TC 121 (2002) *aff'd* 93 Fed Appx. 473 (3rd Cir. 2004).

Mr. Grey made the following arguments that he was not an employee:

- Because the S corporation passed its net income through to the shareholder pursuant to §1366, there can be no employer-employee relationship.
- A corporate officer is not an employee for employment tax purposes unless he is an employee under common law. Because the corporation never exercised control over Grey in the performance of his services, he is not an employee.

The court did not agree with Grey on either argument and upheld the IRS determination that the payments to him were wages. The court also ruled the corporation did not qualify for Section 530 relief from penalties for failure to file employment tax returns.

Mr. Grey was such a firm believer that his categorization of payments was not subject to payroll taxes that he promoted the idea to his S corporation clients. The IRS was convinced he was wrong; consequently, many of the clients were audited, went to court, and found that the court agreed with the IRS. These cases include:

- *Nu-Look Design, Inc. v. Comm'r,* 356 F.3d 290 (3rd Cir. 2004)
- *Water-Pure Systems, Inc. v. Comm'r,* 85 TCM 934, TC Memo 2003-53 (2003) *aff'd* 93 Fed. Appx. 473 (3rd Cir. 2004)
- *Mike J. Graham Trucking, Inc. v. Comm'r,* 85 TCM 908, TC Memo 2003-49 (2003) *aff'd* 93 Fed. Appx. 473 (3rd Cir. 2004)
- *Specialty Transport & Delivery Services, Inc. v. Comm'r,* 85 TCM 920, TC Memo 2003-51 (2003) *aff'd* 91 Fed. Appx. 787 (3rd Cir. 2004)
- *Veterinary Surgical Consultants, P.C. v. Comm*'r, 85 TCM 901, TC Memo 2003-48 (2003) *aff'd* 90 Fed. Appx. 669 (3rd Cir. 2004)
- *Superior Proside, Inc. v. Comm'r*, 85 TCM 914, TC Memo 2003-50, (2003) *aff'd* 86 Fed. Appx. 510 (2004)
- *Bradley M. Cohen and Kathy A. Cohen v. Comm'r,* 85 TCM 861, TC Memo 2003-42 (2003)

Carol Davis[26]

Carol Davis and her husband Henry Adams were the only shareholders of an S corporation. Adams was the corporation president but did not actively participate in the company business. Davis only worked 12 hours per month and was paid $8 per hour for her services. When the company experienced financial problems, the shareholders loaned their personal funds to the company.

When the company recovered, it repaid the loans and the shareholders deposited the money in their personal bank account and reported it as nonsalary income on their tax return. Upon audit, the IRS ruled the payments were salary to Mr. Adams. In addition, the IRS assessed $39,221 in employment taxes, penalties, and interest.

The court looked at all the facts of the case and ruled the IRS erred in deciding the loan repayments to Davis and Adams were wages. In a later suit, the court ruled the taxpayers were entitled to reimbursement for reasonable costs, expenses, and professional fees.

DETERMINING REASONABLE COMPENSATION

There are no definitive guidelines from cases to answer the question, "What is a reasonable salary?" If the IRS determines a reasonable salary was not paid to a shareholder-employee, it will likely deem all payments were salary. Analyzing C corporation cases in which the court determined reasonable compensation may provide an answer to the question. The courts have looked at several factors, but none were determinative in all cases.

26. *Carol Davis, dba Mile High Calcium, Inc. v. U.S.,* 95-2 USTC (1994).

In a 1981 case,[27] the court looked at 21 factors to determine reasonable compensation. These were:

1. Employee's qualifications and training;
2. Nature, extent, and scope of employee's duties;
3. Responsibilities and hours involved;
4. Size and complexity of the business;
5. Results of the employee's efforts;
6. Prevailing rates for comparable employees in comparable businesses;[28]
7. Scarcity of other qualified employees;
8. Ratio of compensation to gross and net income (before salaries and federal income tax) of the business;
9. Salary policy of the employer to its other employees;
10. Amount of compensation paid to the employee in prior years;
11. Employee's responsibility for employer's inception and/or success;
12. Time of year the compensation was determined;
13. Whether compensation was set by corporate directors;
14. Correlation between the stockholder-employee's compensation and his stockholdings;
15. Corporate dividend history;
16. Contingent compensation formulas agreed on prior to the rendition of services and based upon free bargaining between the employer and employee;[29]
17. Undercompensation in prior years;
18. Compensation paid in accordance with a plan that has been consistently followed;
19. Prevailing economic conditions;
20. Whether payments were meant as an inducement to remain with the employer; and
21. Examination of the financial condition of the company after payment of compensation.

Note. A court of appeals decision[30] took a contrary approach. The case involved a C corporation in which the issue was disallowance of excessive salary as being a disguised dividend. The appeals court reversed the tax court's use of a 7-factor test (similar to the 21 factors listed above) holding the factors as inappropriate.

It appears one primary question is whether the payment is for services. If little or no service is provided to the corporation, an argument can be made that the payment is a return of investment rather than compensation.

A possible argument for a low salary is the independent-investor test. Would a third party invest in the business if he did not anticipate a return on his investment?

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27. *H.L. Foos v. Comm'r*, 41 TCM 863, 878–79, Dec. 37,687(M), TC Memo 1981-61.

28. Treas. Reg. §1.162-7(b)(3).

29. Treas. Reg. §1.162-7(b)(2).

30. *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833 (7th Cir. 1999).

EXAMPLES

The following situations are for discussion purposes. The situations are not taken from court cases, so there is no definitive answer.

1. Ted is a sole shareholder of Tax Guru, Inc., an S corporation. He has a $60,000 investment in Tax Guru, Inc. The corporation employs one CPA and one clerical staff member, who were paid $50,000 and $40,000, respectively. The corporation had a profit of $95,000 in 2010. Ted and the CPA are the only individuals who interview clients and sign tax returns. What is a reasonable salary for Ted?

2. Zoe is the sole shareholder-employee of I Like Tax, Inc., an S corporation. Zoe works from her home and nets $40,000 from her tax preparation business. Zoe's investment in business assets totals $3,000. What is a reasonable salary for Zoe?

3. George and Martha are distributors for a well-known product. They operate the business through their S corporation, Buy From Us, Inc. George and Martha are 50-50 owners of the corporation stock. They keep an inventory of $80,000 of product in their garage. George travels four days per week in his leased car to market the product. The corporation has one part-time employee that accepts product orders and ships the product. The employee was paid $25,000 of wages in 2010. Martha occasionally accepts orders when the employee takes time off but is never involved in the shipping or other aspects of the business. In 2010, the business nets $150,000. The corporation distributes $60,000 to George, $60,000 to Martha and retains $30,000 for business expansion. What is a reasonable salary for George? What is a reasonable salary for Martha?

4. Aaron is the sole shareholder-employee of We Lose Money, Inc., an S corporation. The business has a net loss of $45,000 in 2010. The corporation increased its loans by $80,000 during the year, and Aaron borrowed $30,000 from the corporation to meet his living needs. Should any of the loans be recharacterized as salary?

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5. Ben formed an S corporation, Sales Pro, Inc., and is the sole shareholder. Sales Pro has a contract with an unrelated company, Widgets, Inc., to sell its products. In addition to receiving a commission, Sales Pro also receives travel and expense reimbursements from Widgets. Sales Pro receives $200,000 of commissions in 2010 and $30,000 for travel reimbursements. Ben receives $200,000 of distributions from Sales Pro in 2010. What is a reasonable salary?

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CURRENT IRS ACTIVITY

In attempting to create more compliance with shareholder-employee reasonable compensation expectations, the IRS is giving notice to all new S corporations. When the IRS sends the acceptance acknowledgement (Notice CP 261) of the new corporation, they also include a notice that shareholder-employees are subject to payroll taxes. The notice states that if a shareholder provides services to the corporation, he must be paid a reasonable amount of compensation. The notice also states that the IRS can recharacterize distributions as compensation. In addition, distributions other than dividends may also be recharacterized.

SHAREHOLDER BASIS

A major issue in the GAO report mentioned earlier pertains to shareholders deducting losses in excess of their stock and debt basis. For fiscal years 2006 through 2008, IRS examinations showed taxpayers deducted over $10 million of losses in excess of their bases. This averages $21,600 per taxpayer. The GAO report suggests that the IRS require S corporations to report shareholder basis. This is currently impossible in many situations, because the corporation may not know what a shareholder paid for his stock if he purchased it from another shareholder. In addition, if the shareholder inherited the stock, the corporation would be unaware of the stock's date of death FMV.

Besides stock basis, a shareholder may also have debt basis. This exists if the shareholder personally loans money to the corporation. Debt basis is important when a shareholder uses his entire stock basis but has additional pass-through losses from the corporation.

There are three instances in which the amount of shareholder basis is needed by the shareholder:

1. When determining whether a current year and/or prior year loss is deductible to the shareholder when preparing their individual return
2. When determining the tax implications of a distribution to the shareholder
3. When determining any gain or loss to the shareholder when all or part of their interest in the S corporation is disposed of in a sale or gift

A tax preparer cannot solely rely on a Schedule K-1 from the S corporation for all of the information needed to compute basis for a shareholder-client. The computation of shareholder basis must be computed and maintained at the shareholder level.

> **Note.** There are different rules for computing basis for AMT purposes which are not discussed in this chapter. In addition, state law may require additional computations.

COMPUTING INITIAL STOCK BASIS

Formation

The beginning stock basis consists of the basis of property contributed to the corporation, plus any gain recognized by the contributor, minus any boot received.[31] The basis is also reduced by any debt assumed by the corporation.[32] The debt assumed is treated the same as boot received. Additional contributions by the shareholder increase basis.

Purchased Stock

If stock is purchased from a shareholder, the beginning basis is the price paid for the shares.

Stock Acquired by Gift

The beginning basis of stock received from a donor is the basis of the stock in the hands of the donor.[33] The basis is increased by the amount of any gift tax paid by the donor.[34] For purposes of deducting losses, if the donor's basis is greater than the FMV of the stock, the donee's basis is the FMV on the date of the gift. Any suspended loss at the time of the gift is lost and no longer available to either the donor or the donee.[35]

Stock Acquired by Inheritance

The beneficiary's beginning basis is the FMV of the stock in the deceased shareholder's estate.[36] The basis is reduced by any net income in respect of decedent (IRD) in the corporation on the date of death.[37]

> **Caution.** IRC §1022 states that basis of property acquired by inheritance after December 31, 2009, follows the rules of property acquired by gift. The personal representative may elect to increase the basis of property up to FMV by an aggregate increase of $1.3 million. Qualified spousal property shall be increased by a maximum of $3 million.

31. IRC §351.
32. IRC §358(d)(1).
33. IRC §1015(a).
34. IRC §1015(d)(1)(A).
35. Treas. Reg. §1.1366-2(b)(2).
36. IRC §§1014 and 1022.
37. IRC §1367(b)(4)(B).

Stock Received Due to Divorce

If a shareholder's stock in an S corporation is transferred to a spouse, or to a former spouse incident to a divorce, any suspended loss or deduction associated with that stock is transferred with the stock.[38]

BASIS ADJUSTMENTS

> **Note.** Basis issues were covered in more detail in the 2009 *University of Illinois Federal Tax Workbook* in Chapter 5, Calculating Basis; and in Chapter 10, C Corporation Issues, in Issue 2, Contribution of Property of a Corporation. This information can be found on the accompanying CD.

Because the S corporation is a flow-through entity, any gains or losses of the corporation affect the stock and debt basis of the shareholders. The corporate gains, losses, and deductions are reported pro rata to each shareholder based on their ownership-interest percentage. Any additional capital contribution made by the shareholder increases basis and any distributions of property or money decreases basis. Since losses are not deductible if they exceed the stock and debt basis of the shareholder, it is important to understand the ordering rules for stock and debt basis adjustments. The rules were changed by the Small Business Job Protection Act of 1996 and were later amended in 1999.

The beginning-year stock basis is increased by:

1. Any money and/or adjusted basis of property contributed to the corporation;
2. The shareholder's portion of the corporation's separately-stated income (including tax-exempt income);
3. The shareholder's portion of nonseparately-stated income; and
4. Other increases to basis, including the shareholder's portion of the excess of the deductions for depletion (other than oil and gas depletion) over the basis of the property subject to depletion.

Stock basis is then decreased by:

5. Distributions of money and the FMV of property (excluding dividend distributions reportable on Form 1099-DIV and distributions in excess of basis);
6. The shareholder's portion of nondeductible expenses and the depletion deduction for any oil and gas property held by the corporation (but only to the extent that the shareholder's portion of the property's adjusted basis exceeds the depletion deduction); and
7. The shareholder's portion of the corporation's deductions and losses (including IRC §179 expense deduction even if the shareholder's §179 deduction is limited) adjusted, if the corporation made a charitable contribution of property, by subtracting the shareholder's portion of the excess of the property's FMV minus adjusted basis.

38. IRC §1366(d)(2).

Example 1. Trevor owns stock in an S corporation. His stock basis at the beginning of 2009 is $5,000. He has no debt basis. In 2009, he receives a cash distribution of $10,000. His 2009 Schedule K-1 from the corporation reports his share of loss as $25,000. In addition, it shows $12,000 tax-exempt income and $4,000 of nondeductible expenses.

If Trevor does not make the Treas. Reg. §1.1367-1(g) election he reports:

Beginning stock basis	$ 5,000
Money and property contributions	0
Flow-through net income	0
Tax-exempt income	12,000
Subtotal	$17,000
Money and property distributions	(10,000)
Flow-through net losses if election made	(0)
Nondeductible expenses	(4,000)
Subtotal	$ 3,000
Flow-through net losses	(25,000)
Ending stock basis	0
Deductible loss	(3,000)
Suspended basis deductible loss	(22,000)

A shareholder can make the Treas. Reg. §1.1367-1(g) election to alter the order of basis adjustments. If the election is made, the shareholder can reduce the stock basis by his portion of the deductible losses (item 7 in the prior list) before reducing the stock basis by his portion of the nondeductible expenses (item 6). Once this election is made, it becomes irrevocable unless approved by the IRS.

Note. This election is important if the shareholder has limited stock basis and will not be able to deduct his entire portion of the flow-through losses. However, because it is an irrevocable election, the shareholder should consider the impact on future years.

Example 2. Use the same facts as **Example 1.** Trevor decides to make the Treas. Reg. §1.1367-1(g) election. The result is:

Beginning stock basis	$ 5,000
Money and property contributions	0
Flow-through net income	0
Tax-exempt income	12,000
Subtotal	$17,000
Money and property distributions	(10,000)
Subtotal	$ 7,000
Flow-through net losses if election made	(25,000)
Subtotal	($18,000)
Nondeductible expenses	(4,000)
Subtotal	($22,000)
Ending stock basis	0
Deductible loss	(7,000)
Suspended basis deductible loss	(18,000)
Suspended basis nondeductible loss	(4,000)

Note. Once stock basis is zero, any remaining deductible and nondeductible losses reduce debt basis.

Any suspended deductible losses become deductible when the shareholder increases his stock or debt basis.

Example 3. Continuing with **Example 2,** at the end of 2009, Trevor has $0 stock basis, a suspended deductible loss of $18,000, and a suspended nondeductible loss of $4,000. In 2010, Trevor's share of the corporation tax-exempt income is $12,000 and his nondeductible expenses are $2,000. His share of the deductible loss is $6,000, and he makes a $30,000 capital contribution. This allows him to utilize both the deductible and nondeductible losses, and he ends the year with a stock basis of $12,000. His tax deduction for the year is $24,000 ($18,000 suspended loss utilized + $6,000 deductible expenses).

	With Election		Without Election	
Beginning basis	$ 0		$ 0	
Money and property contributed	30,000		30,000	
Flow-through income	0		0	
Tax-exempt income	12,000		12,000	
Subtotal	$42,000		$42,000	
Money and property distributed	0		0	
2010 flow-through loss	(6,000)	($ 6,000)	N/A	
2010 nondeductible	N/A		(2,000)	
2010 flow-through loss	N/A		(6,000)	($ 6,000)
2009 prior-year loss	(18,000)	(18,000)	(22,000)	(22,000)
2009 prior-year nondeductible	(4,000)		N/A	
2010 nondeductible	(2,000)		N/A	
Basis	$12,000		$12,000	
2010 allowable loss		($24,000)		($28,000)
2009 allowable loss		(7,000)		(3,000)
Total losses allowed for 2-year period		($31,000)		($31,000)

Example 3 assumes that without the election, nondeductible losses carry over. However, the regulations do not specifically address the issue of whether the nondeductible expenses carry over or disappear. The regulations address only the carryover of deductible losses and expenses.[39]

DISTRIBUTIONS

If a shareholder receives a distribution in excess of his stock basis, he reports a capital gain. Whether the capital gain is long-term or short-term depends on how long he held the stock.

Example 4. Shanda owns stock in an S corporation. In 2009, she has a beginning basis in her shares of $5,000. Her share of the income is $25,000 and she received a cash distribution of $50,000. Shanda has owned her shares for at least 12 months. She reports a long-term capital gain of $20,000.

Beginning basis	$ 5,000
Money and property contributions	0
Flow-through net income	25,000
Tax-exempt income	0
Subtotal	$30,000
Money and property distributions	(50,000)
Excess distribution taxed as long-term capital gain	($20,000)

Note. If the S corporation has earnings and profits (E&P) that existed when it converted from a C corporation, the shareholder will not be able to recover all of the shareholder's stock basis without recognizing dividend income. See Chapter 10, S Corporations, in the 2007 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

DEBT BASIS

Unlike a partnership in which a partner's basis for loss deductions includes his share of the partnership recourse loans, a shareholder in an S corporation can only include debt basis for loans personally made to the corporation. The guarantee of a loan is not sufficient. Initially, the basis of a loan made by a shareholder to the corporation is the face amount of the loan. When payments are made on the loan, the basis decreases by the payment amount.

Debt basis is only significant if the shareholder has losses in excess of his stock basis. In this case, debt basis is used to determine the amount of excess loss that is deductible.

Example 5. Lisa has stock basis of $12,000 at the beginning of 2009. She also loaned the corporation $10,000 in 2009, which gave her a combined stock and debt basis of $22,000. In 2009, her share of the corporate loss is $18,000. Because this is less than her combined basis, she can deduct the entire $18,000 loss. Her stock basis of $12,000 is first reduced to zero leaving a loss of $6,000 ($18,000 – $12,000), and her debt basis is then reduced to $4,000 ($10,000 – $6,000).

January 1, 2009 stock basis	$12,000
2009 loan	10,000
Combined stock and loan basis	$22,000
2009 loss	($18,000)
Stock basis	$12,000
Remaining loss	($ 6,000)
Loan basis	10,000
Remaining loan basis	$ 4,000

39. Straum, Sydney S., *The Tax Advisor,* Apr. 1, 2010.

Once debt basis is reduced below the face amount of the loan, then:

- Any subsequent gains or income restores the debt before increasing stock basis.
- Any principal payments made to the shareholder results in taxable income.
- The basis in the debt may never exceed the amount of the principal due.

Adjustments to debt basis are determined at yearend and are generally effective as of the close of the S corporation's taxable year. If debt is disposed of or repaid before the close of the taxable year, the basis of that indebtedness is restored effective immediately before the first repayment on the debt during the taxable year. To the extent any debt of the S corporation to the shareholder is repaid during the taxable year and the shareholder's basis in that debt has been reduced, the repayment is a recognition event immediately before the debt is repaid. Therefore, the debt recognition is not chronological.

Example 6. Carmen loaned her S corporation $100,000 in 2008. At the beginning of 2009, she has a stock basis of zero and a debt basis of $40,000. During 2009, the corporation has a profit of $80,000. On April 1, 2009, the corporation repays Carmen $60,000 on the loan. The debt basis is restored to $100,000 and her stock basis becomes $20,000. Consequently, Carmen does not report any income because of the loan repayment. She reports $80,000 of pass-through income. If the profits could not restore debt basis before gain recognition from the debt repayment, Carmen would recognize $20,000 of gain on the repayment, $80,000 from the pass-through profit and her stock basis at the end of 2009 would be $80,000.

	Gain Recognized	Principal	Stock Basis	Debt Basis
Debt basis restored chronologically				
Beginning of year amounts		$100,000	$ 0	$40,000
Debt repayment		(60,000)		(60,000)
Gain recognized from repayment	$ 20,000			($20,000)
Current-year profit	80,000		80,000	
End-of-year amounts	$100,000	$ 40,000	$80,000	$ 0
Debt basis restored per regulations				
Beginning of year		$100,000	$ 0	$40,000
Debt repayment		(60,000)		(60,000)
Current-year profit	80,000		20,000	60,000
End-of-year amounts	$ 80,000	$40,000	$20,000	$40,000

The basis rules become more complicated if the shareholder made multiple loans to the corporation. If the shareholder holds more than one instrument of indebtedness at the close of the corporation's taxable year, the reduction in basis is applied to each item of indebtedness in the same proportion that the basis of each item of indebtedness bears to the aggregate bases of the indebtedness to the shareholder.

Example 7. Use the following facts:

- The corporation is a single-shareholder S corporation.
- The shareholder loaned the corporation $1,000 on January 1, 2000.
- The shareholder loaned the corporation $5,000 on December 31, 2008.
- At the end of 2008, the basis of loan #1 was $0.
- At the end of 2008, the basis of loan #2 was $1,000.
- The shareholder loaned the corporation $4,000 on January 1, 2009.
- The corporation lost $4,000 in 2009.

At the beginning of 2009, the debt basis is:

Debt	Principal	January 1, 2009 Basis
January 1, 2000 debt #1	$ 1,000	$ 0
December 31, 2008 debt #2	5,000	1,000
January 1, 2009 debt #3	4,000	4,000
	$10,000	$5,000

At the end of 2009, the debt basis reduction is computed as follows:

Debt #1 reduction = (debt #1 basis ÷ basis of all beginning-year debt) × net loss

Debt #1 reduction = ($0 ÷ ($0 + $1,000 + $4,000)) × $4,000 = $0

Debt #2 reduction = ($1,000 ÷ ($0 + $1,000 + $4,000)) × $4,000 = $800

Debt #3 reduction = ($4,000 ÷ ($0 + $1,000 + $4,000)) × $4,000 = $3,200

Debt	Principal	January 1, 2009 Basis	December 31, 2009 Reduction	January 1, 2010 Basis
January 1, 2000 debt #1	$ 1,000	$ 0	$ 0	$ 0
December 31, 2008 debt #2	5,000	1,000	800	200
January 1, 2009 debt #3	4,000	4,000	3,200	800
	$10,000	$5,000	$4,000	$1,000

A shareholder loan can be one of two types. The first is **term debt** for which there is a formal loan agreement. The agreement includes a payment schedule and an interest rate. The other is called **open-account debt.** Open-account debt is defined as advances shareholders make to their S corporations without any formal documentation. The amount can increase or decrease within the same year. There may be numerous transactions made to the account throughout the year.

A shareholder may anticipate that he will have insufficient basis at yearend to allow the deduction of pass-through losses. Consequently, the shareholder may consider classifying some distributions as loans from the corporation or advancing money to the corporation before yearend.

A shareholder can increase stock basis by making additional capital contributions. However, debt basis can only be restored by pass-through income. If additional money is loaned to the corporation, it is treated as an additional loan unless it is an open-account loan. Debt basis is restored only if the debt is still owed at yearend.

If a shareholder terminates his S corporation ownership midyear, the basis reduction rules apply immediately prior to termination. If the shareholder continues to hold the debt after terminating ownership, he does not have any opportunity to increase his debt basis. Consequently, when the debt principal is repaid, payments in excess of debt basis are taxable.

The IRS considers open-account debt to be a loophole in S corporation law. It was utilized by some shareholders to allow them to deduct pass-through losses when they did not have adequate basis. The Tax Court decision in *Brooks*[40] caused the IRS to rewrite the regulations on open-account debt.

Example 8. These are the amounts of open-account debt from the *Brooks* case.

	Loss	Advance	Payment	Loan Balance
1997 advance		$ 500,000		$ 500,000
January 2, 1999 repayment			($500,000)	0
December 31, 1999 net loss	($ 800,000)			0
December 31, 1999 advance		800,000		800,000
January 3, 2000 repayment			(800,000)	0
December 29, 2000 advance		1,100,000		1,100,000
December 31, 2000 net loss	(1,100,000)			1,100,000

The open-account debt allowed Brooks to deduct $1.1 million of losses without any outlay of cash ($800,000 loss in 1999 + (1,100,000 loss – 800,000 repayment in 2000). The initial advance of $500,000 was made to utilize a prior-year loss. However, if Brooks ceased to be a shareholder, the corporation would need to repay the $1.1 million open-account balance and Brooks would recognize income of $1.1 million.

The regulations on open-account debt[41] were changed in October 2008. If the amount of open-account debt to a shareholder is more than $25,000 at yearend, the open-account debt balance is deemed a term debt and the multiple-debt rules apply on repayments. If the balance is $25,000 or less, it carries into the next year as open-account debt.

AT-RISK LIMITATIONS

Even when a pass-through loss has cleared the basis hurdle, other factors may prevent the shareholder from deducting the loss. The next factor is the at-risk limitations. The amount at risk is the amount the shareholder would lose if the S corporation terminated without returning any money or property to the investor.[42] Typically, this is the amount of basis the shareholder has in his S corporation stock. However, it is possible that a shareholder has basis but is not at risk.

Example 9. Sheila owns 50% of the stock of S&S, Inc., an S corporation. To purchase her partner's stock, Sheila borrows $100,000 from her bank using the stock as collateral for a nonrecourse loan. While Sheila's basis in the new stock is $100,000, her at-risk amount is zero.

The following year, the corporation repays $10,000 on the bank loan. The repayment does not increase Sheila's at-risk amount.[43]

40. *Brooks v. Comm'r*, TC Memo 2005-204 (Aug. 25, 2005).

41. Treas. Reg. §1.1367-2(a).

42. IRC §465.

43. Treas. Reg. §1.465-25(b)(2)(ii).

An S corporation may be involved in multiple activities. Consequently, each activity has its own at-risk amount and may result in a suspended at-risk loss. The suspended at-risk amount for each S corporation investment is separate unless the activities of the corporation constitute a trade or business and 65% or more of the losses for the year are allocable to shareholders who actively participate in the management of the business. In that case, the losses can be aggregated and treated as one activity.[44] Aggregation does not apply to S corporations involved in motion picture films, farming, leased §1245 property, and exploring for, or exploiting, oil and gas resources or geothermal deposits.

> **Example 10.** Marvin is the sole shareholder of an S corporation. The corporation operates a dairy farm and a farm equipment dealership. This is considered two separate activities, and Marvin must determine his at-risk amount separately in each activity.

Losses for any of the activities can be used against stock basis. Therefore, a loss may be suspended because of at-risk limitations but still reduce stock basis. Suspended at-risk losses can be carried forward but not backward. The stock-basis limitation rules apply before the at-risk limitation rules.

PASSIVE LOSSES

The passive-loss rules[45] are the third leg in the trifecta of loss limitations. The passive-loss limitation falls after the stock-basis limitation and the at-risk loss limitation.

A passive activity is defined as a trade or business in which the taxpayer does not materially participate. Material participation is sometimes hard to determine. According to the code:

> *A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis which is regular, continuous, and substantial.*[46]

This means a shareholder may be an investor in an S corporation but not have the degree of participation to deduct pass-through losses because of the passive-loss limitation rules.

A shareholder is treated as materially participating in the S corporation for the year if he meets at least one of the following requirements:

1. He participates in the activity for more than 500 hours during the year.
2. His participation in the S corporation for the year constitutes substantially all of the participation in the corporation of all individuals (including individuals who are not owners of the corporation) for the year.
3. He participates in the corporation for more than 100 hours during the year, and his participation is not less than the participation of any other individual (including individuals who are not owners of the corporation) for the year.
4. The activity is a significant participation activity for the year and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours. (An individual is treated as significantly participating in an activity if and only if the individual participates for more than 100 hours during the year.)
5. He materially participates in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.
6. The activity is a personal service activity and the individual materially participates in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.
7. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year.

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44. IRC §§465(c)(3)(A) and (B).

45. IRC §469.

46. IRC §469(h)(1).

Example 11. Ed is the sole shareholder of Johnston Electric, Inc., an S corporation. As part of his estate plan, he gifts 25% of the shares to his two grandsons. The grandsons are in college and never participate in the business. In 2009, Johnston loses $25,000 due to the downturn in housing construction. If Ed has stock and/or debt basis, he can deduct his 75% of the loss. However, the grandsons are considered passive shareholders and their loss is suspended until they become active in the business or the business shows a profit that passes through on their Schedules K-1.

Like the at-risk rules, the S corporation is not subject to the passive loss limitations. However, the rules are imposed on the taxpayer at the shareholder level. Nevertheless, the corporation must report on its activities to allow the shareholders to determine the passive activity and properly report the income and deductions related to the corporation.

Normally, if the S corporation has a rental real estate activity, the shareholder can use the loss as part of his $25,000 passive-loss allowance.[47] This is not the case in all situations.

In *Carlos v. Comm'r,*[48] the taxpayers owned two commercial real estate properties and rented them to two separate, wholly-owned businesses in which they materially participated. One of the properties produced a positive net income and the other generated a net loss. They were not allowed to treat their combined net income from the two properties as nonpassive self-rental income. The income from the profitable rental property was treated as self-rental income and was therefore excluded from passive-loss-activity computations. The loss property was treated as a separate passive activity. The IRS relied on the self-rental rule[49] in making its decision.

When a taxpayer disposes of his entire interest in a passive activity involving a fully-taxable transaction, he is released from the passive-loss rules and can deduct suspended passive losses.[50]

CONVERSIONS

The Tax Reform Act of 1986 (TRA) repealed the General Utilities Doctrine. This meant a corporation could no longer distribute property to a shareholder without the burden of double taxation. TRA of 1986 provides that a corporation recognizes gains and losses when distributing property to a shareholder in a complete liquidation. The corporation is treated as if the liquidated property were sold to the shareholder at its FMV.[51]

Under old law, if the corporation was an S corporation at the time of the distribution, there would only be a single level of taxation. Consequently, Congress was concerned that C corporations would convert to S corporations to achieve the tax savings. To prevent the savings, Congress enacted the built-in gains (BIG) tax.[52]

If the distributed asset is sold within 10 years after the conversion, the BIG is taxed at the highest corporation tax rate (currently 35%). For the first 10 years after conversion, it is assumed that all income from the S corporation is subject to the BIG tax. This assumption is easy to refute, though. Much of the S corporation income is associated with ongoing operations rather than the sale of transferred assets. However, in the earliest years, part of the income may be from converted assets, such as accounts receivable. In a cash-basis farming S corporation, grain and livestock inventory could have a substantial built-in gain due to lack of basis.

Note. The 10-year period was reduced to seven years for gains recognized in 2009 and 2010 if the conversion occurred in 2000–2002.[53] Corporations converting in 1999 or earlier years are exempt because they are beyond the 10-year period.

47. IRC §469(i).

48. *Tony R. Carlos and Judith D. Carlos v. Comm'r,* 123 TC 16, 123 TC 275 (Sep. 20, 2004).

49. Treas. Reg. §1.469-2(f)(6).

50. IRC §469(g).

51. IRC §336(a).

52. IRC §1374.

53. American Recovery and Reinvestment Act of 2009, P.L. 111-5.

NET UNREALIZED BUILT-IN GAINS

The net unrealized built-in gain (UBIG) is the excess of the FMV of the assets in the corporation minus their bases at the time of conversion. The value of goodwill must be considered when calculating the UBIG. Normally, goodwill does not have basis. Built-in losses (BIL) are also considered at the time of conversion. They consist of assets with an FMV less than their bases and of liabilities transferred. The UBIG may also be calculated as the excess of the BIG minus the BIL.

The UBIG is also calculated for each asset at the time of conversion. Any BIG tax is paid by the S corporation. This is in addition to any tax the shareholder pays on his pass-through share of corporation profits.

The net recognized built-in gain (NRBIG) is taxed in the year an asset is sold. The NRBIG is the smallest of the following three amounts:

1. The taxable income a C corporation would have recognized if it disposed of the assets sold (This consists of the current year's recognized built-in gains (RBIG), minus any recognized built-in losses (RBIL), plus any RBIG carryover from prior years. This is called the "pre-limitation amount.")
2. The taxable income of the S corporation
3. The excess of the net unrecognized built-in gain (NUBIG) less the NRBIG for all prior years (This is the upper limit on the amount of gain that will ever be recognized.)

Example 12. Avatar Corporation, a cash-basis taxpayer, has the following assets, liabilities, and basis when it elects S corporation status on January 1, 2009. The BIG is calculated as follows:

	FMV	Basis	Built-In Gain/Loss
Cash	$ 1,000	$ 1,000	$ 0
Accounts receivable	39,000	0	39,000
Building	120,000	70,000	50,000
Total assets	$160,000	$71,000	$89,000
Accounts payable	25,000	0	(25,000)
NUBIG			$64,000

Avatar can never pay the BIG tax on more than $64,000 of gain.[54] Any future appreciation in FMV of assets after the conversion will not be a part of BIG.

Example 13. Avatar has a successful year in 2009 and has a net profit of $40,000. They collect all of the carryover January 1, 2009 receivables and pay all of the carryover payables. Avatar pays the BIG tax of $4,900 (35% × ($39,000 – $25,000)). At the end of 2009, Avatar has a remaining BIG of $50,000. The net profit of $40,000 is shown on the shareholder's Schedule K-1 and is taxed at his individual tax rate.

Current-year RBIG	$39,000		
Current-year RBIL	(25,000)		
NRBIG "pre-limitation amount" (#1)	$14,000	$14,000	
Taxable income (#2)		40,000	
NUBIG at beginning of year (#3)		64,000	
Smallest of #1, #2, or #3			$14,000
Multiply by BIG tax rate			× 35%
BIG tax			$ 4,900

Regardless of the amount of BIG realized at the end of the year, the corporation never pays the BIG tax on more than the yearend profit.[55] The $4,900 BIG tax paid reduces the taxable income as an operating expense in 2009.

54. Treas. Reg. §1.1374-2(a)(3).

55. Treas. Reg. §1.1374-2(a)(2).

Example 14. Use the same facts as **Example 13,** except Avatar's net profit for the year was $10,000. The BIG tax is $3,500 (35% × $10,000). Avatar still has a $54,000 BIG at yearend ($64,000 – $10,000).

Current-year RBIG	$39,000			
Current-year RBIL	(25,000)			
NRBIG "pre-limitation amount" (#1)	$14,000	$14,000		
Taxable income (#2)		10,000		
NUBIG at beginning of year (#3)		64,000		$64,000
Smallest of #1, #2, or #3			$10,000	
Multiply by BIG tax rate			× 35%	
BIG tax			$ 3,500	
NRBIG				(10,000)
NUBIG carryover				$54,000

If a BIG asset is sold and the gain realized is less than the BIG, tax is assessed on no more than the gain realized. The NUBIG is reduced by the BIG on the asset sold.

Because the amount of gain subject to the BIG tax was limited by taxable income in a year, the NUBIG continues to be subject to BIG tax in any year remaining in the ten year period after conversion.[56]

Example 15. Use the same facts as **Example 14.** In 2010, Avatar's net profit is $80,000. It sold its building for $100,000. Therefore, the gain realized on the building was only $30,000 ($100,000 – $70,000 basis) but the BIG on the building at the time of conversion is $50,000. The BIG tax is $10,500 (35% × $30,000). The total carryover BIG is reduced by $50,000, the amount of BIG on the building, even though the RBIG was $30,000.

Current-year RBIG	$30,000			
Current-year RBIL	(0)			
NRBIG "pre-limitation amount" (#1)	$30,000	$30,000		
Taxable income (#2)		80,000		
NUBIG at beginning of year (#3)		54,000		$54,000
Smallest of #1, #2, or #3			$30,000	
Multiply by BIG tax rate			× 35%	
BIG tax			$10,500	
BIG on building at time of conversion				(50,000)
BIG not recognized because of income limitation from 2009			$ 4,000	
BIG tax rate			× 35%	
BIG tax			$ 1,400	
BIG on receivables				(4,000)
NUBIG carryover				$ 0

If the BIG asset is sold and the gain is more than the BIG, the BIG tax is only assessed on the original BIG. If the asset is sold and the gain is less than the BIG, the BIG tax is only assessed on the actual gain.

56. IRC §1374(d)(2)(B).

Example 16. Use the facts from **Example 15,** except Avatar sells the building for $160,000 realizing a gain of $90,000. The BIG tax is $17,500 (35% × $50,000 building's original BIG).

Current-year RBIG	$50,000			
Current-year RBIL	(0)			
NRBIG "pre-limitation amount" (#1)	$50,000	$50,000		
Taxable income (#2)		80,000		
NUBIG at beginning of year (#3)		54,000		$54,000
Smallest of #1, #2, or #3			$50,000	
Multiply by BIG tax rate			× 35%	
BIG tax			$17,500	
BIG on building at time of conversion				(50,000)
BIG not recognized because of income limitation from 2009			$ 4,000	
BIG tax rate			× 35%	
BIG tax			$1,400	
BIG on receivables				(4,000)
NUBIG carryover				$ 0

One method of avoiding the BIG tax is showing no net profit in the year a BIG asset is sold and the remainder of the 10-year BIG period (seven years for corporations converting from C to S status in 2000–2002). This can often be accomplished with skillful tax planning.

Note. In today's depressed real estate market, a C corporation contemplating a sale of real estate might consider making an S election if the asset has a BIL.

If the converting C corporation has assets with both built-in gains and built-in losses, the gains and losses are netted.[57] Consequently, the BIG tax will never be more than the net BIG. If an asset with a BIG is sold in the same year as an asset with a BIL, the two assets are netted when computing the BIG tax for the year.

If a BIG asset is part of an IRC §1031 like-kind exchange, the amount of BIG transfers to the replacement property.[58]

57. Treas. Reg. §1.1374-2(a)(1).

58. IRC §1374(d)(6).

SMALL BUSINESS JOB PROTECTION ACT OF 1996

There were beneficial changes made to S corporation law by the Small Business Job Protection Act of 1996 (SBJPA).[59] Some of these changes deal with the termination of an S corporation and some with the death of a shareholder.

TRUST AS SHAREHOLDER

At one time, only individuals and estates were allowed to be shareholders of an S corporation. Any other type of shareholder terminated the S election. Congress, however, began to ease this rule and gradually allowed some types of trusts to become shareholders. One of these entities is the grantor trust.[60]

Prior to the SBJPA, if a shareholder held his S corporation shares in a grantor trust, the trust could only remain as a shareholder for 60 days after the death of the grantor. This was extended to two years by the SBJPA.[61]

POST-TERMINATION DISTRIBUTIONS

Prior to the SBJPA, if an S corporation election was terminated, any undistributed pass-through income to a shareholder was frozen. A later distribution of this income was treated the same as a C corporation distribution. This resulted in double taxation to the shareholder because he was previously taxed on the income as a pass-through and the later distribution was treated as a C corporation dividend.

The SBJPA allows a distribution of this frozen income as a reduction of stock basis in the post-termination transition period as long as it does not exceed the balance of the accumulated adjustments account (AAA).

The post-termination transition period means either:

1. The period beginning on the day after the last day of the corporation's last tax year as an S corporation and ending on the later of one year after the last day or the due date of the last S corporation tax return (including extensions);[62]
2. The 120-day period beginning on the date of determination pursuant to an audit of the taxpayer which follows the termination of the corporation's election and which adjusts an S corporation item of income, loss, or deduction of the corporation arising during the S period;[63] or
3. The 120-day period beginning on the date of a determination that the corporation's election had ended for a previous tax year.[64]

ACCOUNTING PERIOD OF TERMINATION YEAR

The SBJPA also added a provision for shareholders who terminate their interest in the S corporation. If all the affected shareholders agree, the S corporation year is treated as if the taxable year consisted of two taxable years.[65] The first taxable year ends on the date of the termination, and the second begins the day after the termination.

Affected shareholders are defined as shareholders whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the taxable year. If the terminating shareholder has transferred shares to the corporation, the "affected shareholders" are all persons who are shareholders during the taxable year.

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59. P.L. 104-188.
60. A grantor trust is any trust that meets the requirements of IRC §§671–678.
61. IRC §1361(c)(2)A(ii).
62. IRC §1377(b)(1)(A).
63. IRC §1377(b)(1)(B).
64. IRC §1377(b)(1)(C).
65. IRC §1377(a).

Example 17. Jerry owns 100% of an S corporation. He sells his S corporation shares to Tom on June 30, 2009. At that time, the corporation has a net loss of $25,000. Jerry estimates the corporation profit will be approximately $100,000 by yearend, and his estimate turns out to be correct. Unless both Jerry and Tom agree to elect two taxable years, Jerry's final Schedule K-1 reports income of $50,000. If the election is made, Jerry's Schedule K-1 reports a net loss of $25,000. Tom's Schedule K-1 reports a net income of $125,000.

		With Election		Without Election	
Corporation Income from...	**Corporation**	**Jerry**	**Tom**	**Jerry**	**Tom**
January 1, 2009 to June 30, 2009	($ 25,000)	($25,000)	$ 0	($12,500)	($12,500)
July 1, 2009 to December 31, 2009	125,000	0	125,000	62,500	62,500
Total	$100,000	($25,000)	$125,000	$50,000	$50,000

Note. A stock purchase agreement involving S corporation stock should address the two taxable years issue. The stock purchase agreement should either contractually obligate the parties to make the election or stipulate that no election will be made.

AT-RISK SUSPENDED LOSSES

Normally, a suspended at-risk loss is lost when an activity is terminated. However, the SBJPA added IRC §1366(d)(3), which allows the shareholder to treat any gain from the disposition of his stock as income from the at-risk activity. Therefore, the shareholder can utilize any suspended at-risk losses to the extent of the gain.

INHERITED STOCK

Income in respect of a decedent (IRD) generally consists of items of gross income that accrued during the decedent's lifetime but were not includible in the decedent's income before death under his method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to such person.[66] The cost or basis of property acquired from a decedent is its date of death FMV (or alternate valuation date if that date is elected for estate tax purposes). This basis is often referred to as a "stepped-up basis." Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD.[67] This rule ensures that the items of IRD held by a partnership are not later offset by a loss arising from a stepped-up basis. Although an S corporation and its shareholders generally are taxed in a manner similar to the taxation of a partnership and its partners, no comparable regulation existed that required a reduction in the basis of stock in an S corporation acquired from a decedent when the S corporation holds items of IRD.

In order to clarify the treatment of IRD for an S corporation, Congress modified IRC §1367(a) and added a provision making the treatment of IRD in the S corporation setting similar to a partnership setting. This provision causes a person acquiring stock in an S corporation from a decedent to treat as IRD his pro-rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. When an item is treated as IRD, a deduction for the estate tax attributable to the item generally is allowed under the provisions of IRC §691(c). The stepped-up basis in the stock of an S corporation acquired from a decedent is reduced by the extent to which the value of the stock is attributable to items consisting of IRD.[68] This basis rule is comparable to the current law partnership rule.

66. IRC §691(c).

67. Treas. Reg. §1.742-1.

68. IRC §1367(b)(4).

DISSOLVING OR LIQUIDATING THE S CORPORATION

Eventually, a shareholder terminates his S corporation interest or the S corporation dissolves or liquidates. The income tax results from these transactions vary. A taxpayer that is the sole owner of an S corporation must decide whether he will sell his corporate stock, or will sell the corporation's assets and then liquidate the corporation. This is not necessarily an easy decision because of the adverse results for the buyer and seller.

SALE OF STOCK

Seller's Analysis

The sale of stock is normally the most advantageous to the exiting shareholder. He reports a capital gain on the difference between the sale price of the stock and its basis. The gain is either long-term or short-term depending on how long it was held. In some situations, the seller obtains a better tax result from selling the S corporation's assets. If the value of the assets is depressed, an asset sale can result in an ordinary loss. However, a loss on the sale of stock is a capital loss subject to the capital-loss limitation.

If the stock is sold, the seller is relieved from any corporation liabilities unless he has personally guaranteed the debt. If assets are sold, the seller must use the sale proceeds to repay the corporation debts.

A stock sale could be structured as an installment sale. While an asset sale could also be an installment sale, the §1245 recapture rules could require substantial income to be recognized in the year of sale.

Before the shareholder decides to terminate his shareholder interest, he should evaluate some other tax consequences. If the S corporation terminates its S election, the shareholder can receive post-termination tax-free distributions. This is not the case for a shareholder that terminates his ownership interest in the S corporation. There is no post-termination transition period.

If the seller has a balance in his AAA when he terminates his stock interest, the balance will transfer with the stock and provide for a tax-free distribution to the new stockowner.

Example 18. Candy has stock basis in her S corporation stock of $100,000, which includes a $60,000 AAA balance. Tex offers to pay Candy $150,000 for her stock. Candy must decide whether to take a $60,000 distribution from the corporation prior to the sale or leave the $60,000 in the corporation and sell her stock for a higher price. She bases her analysis on the following:

With Distribution		Without Distribution	
Stock basis	$100,000	FMV (selling price)	$150,000
AAA distribution	(60,000)	Stock basis	(100,000)
Adjusted stock basis	$ 40,000	Gain recognized	$ 50,000
FMV of stock before distribution	$150,000		
Distribution	(60,000)		
New FMV (selling price)	$ 90,000		
Stock basis	(40,000)		
Gain realized	$ 50,000		

By leaving the $60,000 in the AAA, Candy gives Tex the option to immediately withdraw the money to offset the additional $60,000 he paid for the stock or leave the money in the corporation to be distributed later.

Many times when a shareholder considers selling stock, he has a suspended loss because he lacks stock basis. Consequently, he should consider whether to increase the stock basis to utilize the loss, since the loss cannot be used after the sale. He can increase the stock basis by making an additional contribution to the S corporation.

Example 19. Troy is considering selling his S corporation stock for $200,000. However, he has zero stock basis and $60,000 of suspended losses. Troy analyzes the transaction as follows:

Without Contribution		With Contribution	
January 1, 2010 stock value	$200,000	December 30, 2009 stock value	$200,000
Stock basis	0	December 30, 2009 stock contribution	60,000
Gain recognized	$200,000	December 31, 2009 stock value	$260,000
Suspended loss used	0		
Net income recognized	$200,000	December 30, 2009 stock basis	$ 0
		December 30, 2009 stock contribution	60,000
		December 31, 2009 stock basis	$ 60,000
		December 31, 2009 suspended loss utilized	(60,000)
		December 31, 2009 stock basis after loss	$ 0
		December 31, 2009 stock value	$260,000
		January 1, 2010 stock basis	0
		December 31, 2010 gain on sale	$260,000
		December 31, 2009 loss utilized	(60,000)
		2009/2010 combined gain recognized	$200,000

Without the additional stock contribution, Troy recognizes a capital gain of $200,000 in the year of sale. However, by making the $60,000 contribution in 2009 and increasing the sale price to $260,000, he recognizes a $60,000 ordinary loss in 2009 and a capital gain of $260,000 in 2010.

Buyer's Analysis

When a buyer purchases stock, the purchase price becomes the basis of his stock. He is not able to increase the basis of the corporation assets and benefit from additional depreciation and amortization deductions. The corporation remains responsible for its corporate liabilities. This includes known and unknown liabilities. For example, if the corporation is a manufacturer and a product liability suit is settled in favor of the plaintiff, the corporation is responsible for the payment.

Any existing tax implications (including BIG) remain. The sale of stock has no effect on the corporation's AAA or E&P accounts.

SALE OF ASSETS WITHOUT LIQUIDATION

Seller's Analysis

If the seller sells all or a portion of the assets and retains the S corporation, it is possible future income will be passive investment income. The corporation loses its S election if 25% or more of its income is passive investment income for three years. The election is terminated at the beginning of the fourth year. Once the election is terminated, the corporation becomes a C corporation. Consequently, there could be a problem with the personal holding company rules under which the income is subject to the top corporate tax rate.

In situations in which the corporation has liabilities in excess of the FMV of its assets and the shareholder has personally guaranteed the debt, it could be advantageous to retain the corporation. It is likely the shareholder has substantial suspended losses from the corporation. If the corporation is dissolved, these losses are lost. By retaining the corporation, any debt payment made by the shareholder increases his stock basis and consequently allows an equal amount of loss to be deducted.

If the assets sold constitute all of the corporation's passive activity, any suspended passive losses become deductible. If the shareholder's basis in his stock is higher than the value of the assets, he may be eligible for an IRC §1244 loss deduction.

Buyer's Analysis

When a buyer purchases the assets of the corporation, he can form a new S corporation and the basis of the assets is the same as the purchase price. If the value of the assets is lower than the basis, the buyer may want to retain the old corporation to take advantage of higher depreciation amounts.

A portion of the asset purchase price may be for goodwill, which allows for an amortization deduction.

LIQUIDATING THE CORPORATION

Sometimes, corporate shareholders no longer want to be in business. They may not have a buyer for the business and, consequently, decide to dissolve the corporation. In this situation, there are two choices. One is to sell the corporation's assets, repay all debts, and distribute the remaining cash to the shareholders pro rata to their stock ownership. The second option is to distribute the assets to the shareholders for their use or future sale.

Sale of Assets by Corporation

The corporation recognizes gain on the sale of each asset, and the tax consequences of the gain or loss on the sale is passed through to the shareholders on their Schedules K-1. Any depreciation taken on the assets is recaptured to the extent of the gain realized.

After all expenses and debts are paid, any remaining money is distributed to the shareholders. The distribution is tax-free to the shareholder to the extent he has stock basis. If he does not have stock basis, the gain is a short- or long-term capital gain, depending on the time the stock was held.

Distribution of Assets to Shareholders

If the corporation distributes assets to the shareholder, the assets are deemed sold at their FMVs.

Example 20. Handy, Inc., an S corporation, owns a building with an FMV of $125,000 and a basis of $80,000. Handy transfers the building to its shareholder. Handy is deemed to sell the building for $125,000 and recognizes a gain of $45,000 ($125,000 – $80,000.) The pass-through gain increases the shareholder's stock basis by $45,000.

Caution. If the distributed property is subject to BIG, the corporation may have to recognize a BIG tax liability.

If liabilities are transferred to the shareholders along with the assets, the sale price is deemed to be no less than the amount of the liabilities. Gain or loss recognized by the corporation is reported to the shareholders on their Schedules K-1.

Example 21. Use the same facts as **Example 20,** except the building has a $130,000 mortgage that is assumed by the shareholder. Handy (S corporation) recognizes an additional $5,000 gain ($130,000 – $125,000). Total gain equals $50,000 ($45,000 + $5,000).

When an S corporation liquidates, any property received by the shareholders is treated as full payment for the shareholder's stock. Any property received by the shareholder when an S corporation liquidates is treated as a taxable event. The shareholder's basis in the asset is its FMV when received.[69] If liabilities are received that exceed the FMV of the asset, the shareholder's basis in the asset is the amount of the liability.

69. See IRC §358(d)(1) for a discussion of basis when debt exceeds FMV.

S CORPORATION AS PART OF AN AFFILIATED GROUP

IRC §1561 was designed to prevent taxpayers from establishing multiple corporations in order to take advantage of certain tax benefits. These include the corporate graduated tax brackets, the $250,000 accumulated earnings credit, the $40,000 exemption used when computing the alternative minimum tax, and the alternative minimum taxable income over $2 million threshold when computing the IRC §59A environmental tax.[70] These benefits must be apportioned to component members of a controlled group.

A controlled group can be either a parent-subsidiary group or a brother-sister group. A parent-subsidiary group is one or more chains of corporations connected through stock ownership with a common parent corporation if:[71]

- Stock possessing at least 80% of the total combined voting power of all classes of stock of each corporation or at least 80% of the total value of all classes of stock of each of the other corporations, except the parent corporation, is owned by one or more other corporations; and
- The common parent owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of at least one of the other corporations.

A brother-sister group is two or more corporations in which five or fewer persons who are individuals, estates, or trusts own:[72]

- More than 50% of the total combined voting power of all classes of stock entitled to vote, or
- More than 50% of the total value of shares of all classes of stock of each corporation.

To determine whether more than 50% is owned, only the stock ownership that is identical within each corporation is taken into account.

Example 22. Lynda and Ainsley own 100% of two corporations, A and B. Their ownership is as follows:

	Corporations		
Shareholder	**A**	**B**	**Identical Ownership**
Lynda	60%	40%	40%
Ainsley	40%	60%	40%
Total	100%	100%	80%

Lynda and Ainsley own all of the stock of both corporations and meet the first 50% test. Lynda's identical ownership of the two corporations is 40%, as is Ainsley's. Because their identical ownership is 80%, they meet the second more-than-50% test. The corporations constitute a brother-sister affiliated group.

While an S corporation can be a member of a controlled group, it can only be a component member if it is subject to the BIG tax or is subject to the passive investment income tax because of accumulated earnings and profits at the time of making the S election.

70. IRC §1561(a).

71. IRC §1563(a)(1).

72. IRC §1563(a)(2).

IRC §179 DEDUCTION

While IRC §1561(a) causes component members of a controlled group to allocate certain tax benefits, allocation of the §179 deduction applies to all members of the controlled group. These members are treated as a single taxpayer for purposes of the §179 deduction. The definition of a controlled group changes for the §179 deduction, however. The "at least 80%" test is changed to "more than 50%."[73]

While an S corporation cannot have a C corporation shareholder, an S corporation may own a C corporation. Consequently, they could be subject to the allocations required for controlled groups.

> **Note.** For more information on controlled groups and apportionment of benefits and taxes, see Chapter 8 in the 2009 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

ESTATE PLANNING WITH THE S CORPORATION

Many of today's small businesses are family owned and operated. As the elder family member nears retirement, he may be looking for a way to transition the business to the next generation. While estate tax savings is important, he may also be looking for a seamless transition. The use of an S corporation can be a good entity to accomplish this transition. In many regards, an LLC taxed as a partnership offers the same benefits as an S corporation. However, there is one major difference in the estate planning aspect. If 50% or more of the partnership interests transfer within 12 months, the partnership terminates and a new partnership is formed. There is no similar rule for an S corporation.

BENEFITS OF THE S CORPORATION

Without the use of an entity that allows for partial transfers of the business, it is very difficult to transfer the business to the next generation over an extended period. Typically, the transfer is all or nothing.

Example 23. Maude owns a service station/convenience store, and her daughter Adrienne works for her full time. Maude wants to retire and sell/gift the business to Adrienne over a 5-year period. The business is composed of many types of assets. These include:

- Land,
- Building,
- Equipment,
- Inventory, and
- Franchise.

It will be cumbersome for Maude to transfer one category of assets each year. Likewise, transferring an undivided one-fifth interest is also difficult. However, if Maude transfers all of the business assets to an S corporation, she can easily transfer one-fifth of the stock each year.

Valuation of Transferred Assets

Prior to transferring shares of the S corporation, it is important to have the shares valued. A determination of FMV is a question of fact. It depends upon the circumstances in each case. There is no generally-accepted formula because of the multitude of valuation issues arising in estate and gift tax cases. Different appraisers may arrive at widely different valuations for the same company.

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73. IRC §179(d)(7).

When valuing stock in the closely-held corporation, the values will also depend on the economy at the time the stock is evaluated. As economic conditions change from "normal" to "boom" or "depression," the value changes. It depends on the degree of optimism or pessimism of the individual performing the valuation.

The IRS provides eight factors to consider in valuing a closely-held corporation:[74]

1. The nature of the business and the history of the enterprise from its inception
2. The economic outlook in general and the condition and outlook of the specific industry in particular
3. The book value of the stock and the financial condition of the business
4. The earnings capacity of the company
5. The dividend-paying capacity
6. Whether or not the enterprise has goodwill or other intangible value
7. Sales of the stock and the size of the block of stock to be valued
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter

For many closely-held businesses, the FMV of the underlying assets is the biggest factor in the valuation process. This value needs to be adjusted to account for marketability and minority discounts.

FMV is defined as what a willing buyer will pay a willing seller in an arms-length agreement with neither being obligated to buy or sell. This then raises a question: If a person owns 60% of the stock and the remainder is held by family members, is the stock worth 100% of the value of the assets?

In one court case involving a marketability discount, the appraiser defended the discount by using a pyramid principle. He defined the pyramid principle as follows:[75]

> *In the pyramid there is a large number of people that could buy one of the groves, one of the lots, or one parcel, even the larger parcel of pasturage, but the likelihood, as you proceed upward in the pyramid of finding one person who would be interested in buying on the one hand a ranch, on the other hand six thousand eight hundred sixty-one acres of pastureland, lots, groves, is in the pyramid, in the upper end of the pyramid, and for this reason, any time you reduce the size of the market, you, without exception, encounter a discount in order to effect the sale.*

The IRS argued that if the stock interest was a majority interest, no discount should be allowed as the majority owner could cause the sale of the assets.

Some practitioners consider a marketability discount to be the same as a minority interest. This is not true. In some court cases, the court has allowed both marketability and minority discounts.

A minority discount is based on the fact that the seller does not have control of the company. This is especially relevant in a family-owned business when a nonfamily member has little interest in purchasing stock because he has no control. A revenue ruling stated that in a 100% family-owned corporation with a single class of stock, a minority discount was still appropriate. The share of stock held by the family members was not aggregated.[76]

The amount of the minority discount generally is greater than the marketability discount. Based on the facts and circumstances of the case, the amount of discounts upheld by the courts varies greatly. The likelihood of the IRS challenging stock valuation is proportional to the amount of discount taken.

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74. Rev. Rul. 59-60 (Jan. 1, 1959).

75. *Estate of Maxcy v. Comm'r*, U.S. Tax Court, Docket Nos. 376-65, 5869-67, 28 TCM 783, TC Memo 1969-158 (July 31, 1969).

76. Rev. Rul. 93-12, 1993-1 CB 202.