# Chapter 1: S Corporation



Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

An S corporation is formed by first establishing a corporation under state law. If the corporation meets certain requirements, an election can be made to have the corporation taxed under subchapter S of the Code.

The S corporation has three distinct advantages over a C corporation.

- Distribution amounts that exceed reasonable compensation are not subject to payroll taxes.
- There is no corporate-level double taxation.
- Corporate profits and losses to shareholders can be passed through.

**Note.** IRC §§1361 through 1379 comprise subchapter S of the Code.

## S CORPORATION REQUIREMENTS

An entity must meet certain prerequisites to qualify as a "**small business corporation** (S corporation)."[1] If all the prerequisites are met, the corporation can obtain subchapter S tax treatment by making the appropriate election. The following are prerequisites to qualify for the S election.

- The corporation must be a **domestic corporation.**
- There can be **no more than 100 shareholders.**
- The corporation **cannot have more than one class of stock.**
- All shareholders must be **qualified shareholders.**[2]

The above prerequisites must be satisified at the time the corporation files its S election. In addition, once S status is obtained, these prerequisites must be **continually maintained** or the corporation risks losing its S status. The tax election and the maintenance of these prerequisites are discussed later in this chapter.

**Note.** An LLC that meets the above requirements may elect to be taxed as an S corporation.

1. IRC §1361(a)(1).
2. IRC §1361(b)(1).

## DOMESTIC CORPORATION

Generally, an S corporation must meet the **domestic corporation** requirement of IRC §1361(b). A "domestic corporation" is a corporation created or organized in the United States or under federal or state law.[3] A state or federal corporate charter meets this requirement.

Entities that are not traditional state law corporations may also meet the domestic corporation requirement. The term "corporation" includes any domestic entity classified as an association under the "check-the-box" rules of Treas. Reg. §301.7701-3. These rules provide that any unincorporated entity may elect to be an "association," which qualifies it for corporate tax treatment. If the association meets all the prerequisites for an S corporation, a timely election can be made to obtain subchapter S status. Examples of entities that are not traditional state law corporations but are eligible for subchapter S status include the following.

- An Arizona "statutory close corporation"[4]
- A Massachusetts business trust[5]
- A limited liability company (LLC)

The Code specifically prohibits some types of corporations from becoming S corporations.[6] **Ineligible** corporations include the following.

- A bank or other financial institution that uses the reserve method of accounting for bad debts, as described in IRC §585
- An insurance corporation
- A corporation electing a Puerto Rico and possessions tax credit under IRC §936
- A domestic international sales corporation as defined in Treas. Reg. §1.992-1

## 100 SHAREHOLDER LIMIT

An S corporation cannot have more than 100 shareholders at any time during the tax year.[7] For S corporation purposes, the determination of shareholder status is a question of federal law rather than state law. Ordinarily, a person who would be required to include in gross income dividends distributed from the stock (if the corporation were a C corporation) is considered a shareholder of the S corporation. As a matter of federal law, **beneficial ownership** in the corporation is determinative of shareholder status as opposed to being listed as a shareholder of record or having shareholder rights under applicable state law.[8] "Beneficial ownership" exists when an individual or entity enjoys the rights of share ownership, such as the receipt of distributions or the ability to exercise control over the S corporation, without actual share ownership.

> **Example 1.** Sherman Yachts, Inc., is an S corporation with 98 shareholders. Additional shares are sold to James and Bryan during 2012. James and Bryan own their shares jointly. Because James and Bryan each must report their respective share of any dividends, they are considered two shareholders. This results in the S corporation reaching the maximum of 100 shareholders.

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3. Treas. Reg. §301.7701-5(a).
4. Ltr. Rul. 7918056 (Jan. 30, 1979).
5. Ltr. Rul. 8342088 (Jul. 20, 1983).
6. IRC §1361(b)(2).
7. IRC §1361(b)(1)(A).
8. *Kean v. Comm'r,* 469 F.2d 1183 (9th Cir. 1972).

**Example 2.** Guido and Francesco are brothers who each own half of the stock in Bellissimo Italian Foods, Inc., a C corporation. They purchase shares in Mezzo Scales, Inc., an S corporation, but they pay for their shares using a Bellissimo Italian Foods corporate check. The purchase was charged to their shareholder loan accounts. Guido and Francesco can demonstrate a repeated, recurring pattern of making purchases together in this fashion without any written agreements or other documentation. This history of conduct will likely make the brothers the beneficial owners of the S corporation shares instead of the C corporation, which is not an eligible shareholder.[9]

**Note**. Eligible shareholders are discussed later in this section.

### Related Party Share Ownership

Under IRC §1361, there are special rules relating to **spousal** share ownership and **family** share ownership.

**A husband and wife** who own shares count as one shareholder.[10] If one or both spouses die, this share attribution extends to their estates.

**Example 3.** Creative Bakeries, Ltd. is an S corporation with 99 shareholders. During 2012, the corporation issues shares to Harvey Slotnick. Later in 2012, the corporation issues shares to Harvey's wife, Inga Slotnick. Neither Harvey nor Inga were shareholders prior to 2012. Under the spousal share ownership rules, Harvey and Inga count as only one shareholder. Creative Bakeries has not exceeded the 100-shareholder limitation and continues to qualify as an S corporation.

All **family shareholders** are treated as one shareholder.[11] The term "family shareholders" is defined **broadly** to include:

- Individuals with a common ancestor,
- The lineal descendants of the common ancestor, and
- The spouses (or former spouses) of the lineal descendants or common ancestor.[12]

**Example 4.** Use the same facts as **Example 3,** except that before the end of 2012, Mr. and Mrs. Slotnick are divorced. After the divorce, the spouses are still considered one shareholder under the family shareholder attribution rules. These rules continue to treat a former spouse as a family shareholder. Creative Bakeries continues to have 100 shareholders after the Slotnick divorce.

Family share ownership attribution only applies with a common ancestor that is not more than six generations removed from the youngest generation of shareholders[13] as of the **earliest** of the following dates.

- The effective date of the subchapter S election
- The earliest date that a family member became a shareholder in the S corporation
- October 22, 2004[14]

Under the family ownership rule, spouses are considered of the same generation.[15] Moreover, the estate or trust of a family shareholder may also be considered a family shareholder in connection with the application of these rules.[16]

9. Ibid.
10. IRC §1361(c)(1)(A)(i).
11. IRC §1361(c)(1)(A)(ii).
12. IRC §1361(c)(1)(B)(i).
13. IRC §1361(c)(1)(B)(ii).
14. IRC §1361(c)(1)(B)(iii).
15. IRC §1361(c)(1)(B)(ii) and Treas. Reg. §1.1361-1(e)(3)(i).
16. IRC §1361(c)(2).

## ONE CLASS OF STOCK

In order to qualify as an S corporation, the corporation cannot have more than one class of stock. Generally, the one-class-of-stock requirement is met as long as all outstanding shares have identical **distribution** and **liquidation** rights. **Governing provisions** such as the corporate charter or articles, bylaws, applicable state laws, and any binding agreements comprise the principal sources of information that determine whether all outstanding shares meet this requirement.[17] Even when such documents indicate that identical distribution and liquidation rights exist for all outstanding shares, actual distributions that are not equal among all shares may cause a violation of the one-class-of-stock requirement.[18] Commercial contracts such as leases, employment agreements, and loan agreements are not considered as governing provisions unless a principal purpose of the agreement is to deliberately create a second class of stock in order to disqualify the corporation from meeting this requirement.[19]

Differences in voting rights are disregarded in determining whether a corporation has more than one class of stock.[20] Distribution or liquidation rights on stock that is not outstanding, such as treasury stock or other unissued stock, are irrelevant.

**Example 5.** Somerset Corporation has Class A voting shares and Class B nonvoting shares. All outstanding Class A and Class B shares have the same liquidation and distribution rights. Somerset meets the one-class-of-stock requirement and may qualify as an S corporation if all other prerequisites are met.

**Example 6.** Use the same facts as **Example 5,** except that during the 2012 taxation year, Somerset issues a $0.10 per share dividend on its Class A shares. Two months later, it issues a $0.05 per share dividend on its Class B shares. Even if the governing provisions of Somerset indicate equal distribution and liquidation rights exist for all outstanding shares of both classes, the difference in the amount and timing of these actual dividends suggests that this is not really the case. The dividends likely trigger a violation of the one-class-of-stock requirement.

### Restricted Stock

Restricted stock issued to employees as compensation does not constitute outstanding stock unless the employee elects to include the stock in gross income in the year it is received under IRC §83(b). If an §83(b) election is made (which directs the IRS to tax the transaction at the time the stock is granted), the stock is considered outstanding stock and the employee is considered a shareholder.[21]

### Deferred Compensation Arrangements

A deferred compensation plan arrangement does not constitute outstanding stock if it:

- Does not give voting rights,
- Constitutes a promise to pay in the future that is unfunded and unsecured,
- Is provided to a worker in connection with the performance of services to the corporation, and
- The worker is not currently taxed on the income.[22]

17. Treas. Reg. §1.1361-1(l)(2)(i).
18. Ibid.
19. Ibid.
20. Treas. Reg. §1.1361-1(l)(1).
21. Treas. Reg. §1.1361-1(b)(3).
22. Treas. Reg. §1.1361-1(b)(4).

### Other Instruments, Obligations, or Arrangements

Instruments, obligations, or arrangements of the corporation, such as corporate debt, **are** treated as a second class of stock if they:

- Constitute equity **or** the holder is treated as a shareholder, and
- Have a principal purpose of circumventing distribution or liquidation rights **or** circumventing the 100-shareholder limit.

**Debt Safe Harbors.** A debt safe harbor stipulates that short-term, unwritten advances are not considered a second class of stock if the following conditions are met.

- The shareholder's advances are collectively less than $10,000 at all times during the corporation's tax year.
- The parties involved in the transaction treat the advances as debt.
- It is expected that the debts will be repaid in a reasonable time.[23]

Similarly, **straight debt** is not considered a second class of stock. "Straight debt" is an unconditional obligation to pay on demand or at a future due date that:

- Does not use interest rates or payment dates that are based on the borrower's discretion, on profits, or dividend distributions on stock or similar aspects;
- Is not convertible into any equity of the S corporation; and
- Is held by a qualified S corporation shareholder.[24]

An additional safe harbor applies to other types of debt instruments, which are not considered a second class of stock if the debt is owned:

- Exclusively by the owners of the corporation, and
- In the same proportion as the owners hold the class of corporate stock.[25]

### Call Options and Similar Arrangements

A call option or similar arrangement constitutes a second class of stock if, under all the facts and circumstances, it is substantially certain that it will be exercised, and

- The exercise price is substantially below the fair market value (FMV) of the corporation's stock at the time the option is issued,
- It is transferred by an eligible S corporation shareholder to someone who is ineligible, or
- The option has been materially modified.[26]

When an option and loan arrangement are issued together, an option time extension consistent with an extension on the loan does not result in a material modification.[27]

> **Caution.** A disproportionate distribution is a common mistake that creates more than one class of stock. This occurs when one shareholder receives a distribution or benefit that is not on a pro rata per-share basis.

23. Treas. Reg. §1.1361-1(l)(4)(ii)(B)(1).
24. Treas. Reg. §1.1361-1(l)(5).
25. Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2).
26. Treas. Reg. §1.1361-1(l)(4)(iii).
27. Ibid.

## QUALIFIED SHAREHOLDERS

Under subchapter S, only certain types of individuals and entities are permitted to hold shares in the S corporation.

### Individuals as S Corporation Shareholders

Shareholders that are **individuals** must be U.S. citizens or U.S. residents. A corporation with a nonresident alien shareholder does not qualify as an S corporation.[28] However, a U.S. citizen with a nonresident alien spouse can make a joint spousal tax election[29] to have the nonresident spouse treated as a resident alien for tax purposes. This subjects the nonresident alien spouse to the same "worldwide income" reporting requirement as the U.S. citizen spouse. If this tax election is made, the nonresident alien spouse is eligible to hold shares in an S corporation.[30]

### Entities as S Corporation Shareholders

**Decedents' Estates.** A **decedent's estate[31]** can hold S corporation shares without any time limit. The receipt of shares by a decedent's estate does not cause termination of the S election. This is true even if an individual who is a beneficiary of the estate is not eligible to hold S corporation shares. However, if the administration of the estate is extremely prolonged, the estate may be disregarded and the beneficiaries may be viewed as shareholders.[32]

**Bankruptcy Estates.** When an individual declares Chapter 11 bankruptcy, property of the individual is placed in a **bankruptcy estate,[33]** which ultimately may serve to distribute some or all of the property to creditors. A bankruptcy estate is an eligible S corporation shareholder.[34] When the S corporation shares are held by the bankruptcy estate, the corporation's S status remains intact. However, if any of the shares are ultimately transferred to a creditor who is not an eligible shareholder, the corporation's S status terminates.

**Grantor Trusts and Deemed Grantor Trusts.** A **grantor trust** is generally a trust created by an individual who transfers property into the trust and who subsequently retains a large degree of control over the trust arrangement. The grantor is considered the owner of the trust property for federal tax purposes.

However, a trust may be sufficiently controlled by a beneficiary such that the beneficiary is considered the owner of the trust property. This type of beneficiary-controlled trust is a **deemed grantor trust.**

> **Note.** A grantor or deemed grantor trust is also referred to as a "subpart E" trust. Within the Code, subchapter J outlines the various tax rules associated with certain trusts that have beneficial owners who are treated as owners of their respective portions of the trust upon which they are taxed.

With grantor and deemed grantor trusts, the trust is eligible to hold S corporation shares if the grantor or controlling beneficiary is either a U.S. citizen or U.S. resident who is directly eligible to hold S corporation shares as an individual.[35] No special election is required by the grantor or deemed grantor trust for S corporation shareholder eligibility.

After the death of the grantor or controlling beneficiary, the trust can generally continue to hold the S corporation shares for the 2-year period that begins on the date of death.[36] Before the expiration of the 2-year post-death period, the stock must either be transferred to a qualified shareholder or an asset election must be made.

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28. IRC §1361(b)(1)(C).
29. See Treas. Reg. §1.6013-6.
30. See Ltr. Rul. 199939029 (Jul. 6, 1999).
31. IRC §1361(b)(1)(B).
32. *Old Virginia Brick Company, Inc. v. Comm'r,* 367 F.2d 276 (4th Cir. 1966). (The shareholder was an ineligible shareholder because part of his shares were held by an estate that was a testamentary trust at the time of election; the estate was administered for approximately 23 years).
33. IRC §1361(c)(3).
34. Ibid.
35. IRC §1361(c)(2)(A)(i).
36. IRC §1361(c)(2)(A)(ii).

**Testamentary Trusts.** A testamentary trust is created by the decedent's will and comes into existence at death. A testamentary trust may hold S corporation shares for a period of two years commencing with the date the trust receives the S corporation shares from the estate.

**Other Entities.** Other entities that qualify as S corporation shareholders are as follows.

| Qualified Shareholder Entity | Description | Initial Reference or Guidance |
|---|---|---|
| Qualified subchapter S trust (QSST) | A trust with one current income beneficiary who receives all income each year. The trust cannot accumulate income but must distribute it. | IRC §1361(d)<br>Treas. Reg. §1.1361-1(j) |
| Electing small business trust (ESBT) | A trust with one or more current income beneficiaries. The trust is allowed to accumulate income. | IRC §1361(e)<br>Treas. Reg. §1.1361-1(m). |
| Voting trust | A trust holding the S corporation shares that the trustee votes in connection with S corporation business operations. | IRC §1361(c)(2)(A)(iv)<br>Treas. Reg. §1.1361-1(h)(1)(v) |
| Charitable organization | An organization meeting the requirements of IRC §501(c)(3). | IRC §1361(c)(6) |
| Qualified retirement plan | A retirement plan, such as a pension plan, §401(k) plan, or SEP-IRA that meets the requirements of IRC §401(a). | IRC §1361(c)(6)(A) |
| Employee stock ownership plan | A qualified retirement plan that holds shares of the S corporation and allocates them among S corporation owners and employees as compensation. | Small Business Job Protection Act of 1996, PL 104-188 |

## Ineligible Shareholders

The following individuals and entities are **not eligible** to hold S corporation shares.

- Nonresident aliens
- Foreign trusts
- IRAs
- C corporations
- Partnerships
- Limited liability partnerships (LLPs)
- Limited liability companies (other than a single-shareholder LLC)

> **Note.** A multi-member LLC cannot own S corporation shares. However, multi-member LLCs, like single-member LLCs, **can** make a subchapter S election to be taxed as an S corporation. For comprehensive information on the subject of LLCs taxed as S corporations, see *Limited Liability Companies: Electing Partnership vs. S Corporation Status* (Gary Hoff, ed., University of Illinois, 2011).

## MAKING THE SUBCHAPTER S ELECTION

The S election is made by filing Form 2553, *Election by a Small Business Corporation*. The election must be made no later than two months and 15 days after the beginning of the tax year in which the election is to take effect, or it can be made at any time during the tax year preceding the tax year that the election is to take effect.[37] All existing shareholders must consent to the election to obtain status as an S corporation.[38]

**Example 7.** George forms a new corporation with the first tax year commencing January 1, 2013. If George wishes to obtain S corporation status beginning with the first taxable year, he must file Form 2553 by March 15, 2013.

**Example 8.** General Corporation's tax year begins January 1. It operated for several years as a C corporation. Its shareholders agree that they want to switch to S corporation tax status beginning on January 1, 2013. They can file Form 2553 to elect S corporation status any time during the 2012 calendar year or before March 15, 2013.

**Observation.** Although a timely S election can be made at any time during the preceding tax year, it is best to file as early within the year as possible. If the IRS denies S corporation status, there may be time to take corrective action to address the reason for the IRS denial and submit another Form 2553 before the end of the 1-year period.

Form 2553 is filed with an IRS office in either Cincinnati, Ohio, or Ogden, Utah, depending on the state in which the electing corporation must file its annual return.[39]

**Note.** An LLC entity electing S corporation tax status is not required to file Form 8832, *Entity Classification Election,* to become an association treated as a corporation.[40] Only Form 2553 must be filed.

### LATE ELECTIONS

IRC §1362(b)(5) allows the IRS to accept late S corporation elections.[41] A corporation requesting relief for filing a late election can use the "automatic relief" provision under Rev. Proc. 97-48 if the narrow grounds are met. Otherwise, the broader scope of Rev. Proc. 2003-43 can be used.

#### Automatic Relief under Rev. Proc. 97-48

Automatic relief under Rev. Proc. 97-48 applies if all the following circumstances exist.

- The corporation fails to timely file Form 2553 to make a valid S election.
- The corporation filed a Form 1120S, *U.S. Income Tax Return for an S Corporation,* without realizing that a valid S election was not made.
- The corporation and all shareholders report income consistent with S corporation status for the tax year in which the election is made (and all subsequent years, if any).
- Within six months of filing the Form 1120S, the IRS **does not** notify the corporation about any problems regarding the S corporation status.

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37. IRC §1362(b)(1).

38. IRC §1362(a)(2).

39. See IRS Instructions for Form 2553, *Election by a Small Business Corporation.*

40. Treas. Reg. §301.7701-3(c)(v)(C) provides for a "deemed election" as an association, eliminating the need to elect as an association using Form 8832. The deemed election is granted as long as the corporation meets S corporation requirements.

41. As added to the Code by the Small Business Job Protection Act of 1996, PL 104-188.

To obtain automatic relief for the late filing, the corporation must file a completed Form 2553 that:

- Indicates at the top of the form that it is "filed pursuant to Rev. Proc. 97-48,"
- Is signed by an officer of the corporation and by all persons that were shareholders at any time during the period that the corporation intended to be an S corporation, and
- Is accompanied by a statement, signed by the same individuals required to sign the Form 2553, attesting under penalty of perjury that the corporation and shareholders reported income consistent with S corporation status.[42]

After filing a properly completed Form 2553, the corporation **automatically** obtains its S election, which is effective at the time the election was intended.[43] No further communication with the IRS is necessary.

Rev. Proc. 97-48 only applies to the late filing of S elections for corporations. It does not apply to late S elections for QSSTs or ESBTs.

> **Note**. Rev. Proc. 97-48 has another automatic relief provision for a corporation that **did** receive IRS notice within six months of a tax return filing. However, because this second provision only applies to tax years prior to 1997 for which the statute of limitations period has not closed, it is unlikely to apply to most present-day late election filing situations.

### Relief under Rev. Proc. 2003-43 (as supplemented by Rev. Proc. 2007-62)

Relief from a late S election is available to a corporation only if the following conditions are met.

- The sole reason for not having a valid S election in place is the failure to timely file Form 2553.
- The request for relief is made **within 24 months of the original due date** of the election.

This procedure cannot be used for a corporation that had its previously valid S election terminated.

**If No S Corporation Tax Return Was Filed.** If the corporation has **not yet filed a Form 1120S,** relief may be granted by the IRS if:

- The application for relief is made no later than six months after the due date for the Form 1120S (excluding any extensions), and
- No taxpayer reports income inconsistent with the S corporation election on any return filed for the year the S election was intended and all subsequent years.

***Procedure.*** A corporation that meets the above requirements must use the following procedure to obtain relief.

- File a properly completed Form 2553 with the IRS office (Cincinnati or Ogden) with which a timely election should have originally been filed.
- The late Form 2553 must be filed within 18 months of the original due date of the election but no later than six months after the due date of the first Form 1120S (excluding extensions).
- Indicate at the top of the Form 2553 that it is being "filed pursuant to Rev. Proc. 2007-62."
- Attach an accompanying statement explaining the reasonable cause for failure to timely file the election.

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42. Rev. Proc. 97-48, 1997-2 CB 521.

43. Ibid.

**If the First S Corporation Return Was Filed.** If the corporation **filed a Form 1120S** for the first year of the intended election under subchapter S, relief may be granted by the IRS if:

- The first Form 1120S was filed within six months of its due date (excluding extensions), and
- All taxpayers report income consistent with the S election on any return filed for the first year of the intended S election and all subsequent years.

***Procedure.*** A corporation that already filed a Form 1120S for the first year it desires an S election to be effective must use the following procedure to obtain relief.

- File a properly completed Form 2553 with the IRS office (Cincinnati or Ogden) with which a timely election should have originally been filed.
- The late Form 2553 must be filed within 24 months of the original due date for an S election (the original election date).
- The Form 2553 must be signed by an officer of the corporation and all persons who were shareholders from the original election date to the date the election is actually made (applicable shareholders).
- The Form 2553 must indicate at the top of the document that it is being "Filed pursuant to Rev. Proc. 2007-62."
- An accompanying statement must explain the reasonable cause for failure to timely file the election.
- Statements must be attached from each applicable shareholder indicating that their income was reported consistent with an S election for all tax years since the original election date.
- A corporate officer's declaration as to the truthfulness and correctness of the facts presented in all submitted documents for the election, under penalty of perjury, must also accompany the submitted documents.

> **Note.** When a shareholder filed a previous individual tax return that reports income in a manner **inconsistent** with the S corporation election, it appears that filing an amended return brings that shareholder into compliance with the requirements of Rev. Proc. 2003-43 (as supplemented).

## IRS Leniency with Late S Elections

The provisions of Rev. Procs. 97-48 and 2003-43 (as supplemented) are methods of obtaining relief from the failure to timely make an S election without the need to obtain a private letter ruling. IRC §1362(b)(5) provides the IRS with authority to treat a late election as being timely made if reasonable cause exists for the late election or for the failure to make an election.[44] However, a private letter ruling may be used to request relief if the corporation is not eligible for relief under Rev. Proc. 97-48 or 2003-43. The IRS has shown **substantial** leniency with finding sufficient reasonable cause and with granting late S elections when requested to do so in private letter rulings. The following letter rulings provide examples of IRS leniency in this regard.

**Letter Ruling 9735008.** A new corporation was formed on October 5, 1995, with a sole shareholder. The new corporation's CPA prepared Form 2553 for the corporation and forwarded it to the sole shareholder to sign and file "as soon as possible." The CPA failed to indicate to the shareholder that the Form 2553 was due December 19, 1995 (two months and 15 days after the beginning of the tax year), in order for the election to be effective for the 1995 taxation year. Unaware of the deadline, the sole shareholder did not file the form until January 2, 1996. The IRS granted the request to make the S election effective for 1995.[45]

44. IRC §1362(b)(5).

45. Ltr. Rul. 9735008 (May 23, 1997).

**Letter Ruling 9743036.** A new corporation was formed with a sole shareholder. The shareholder wanted the corporation to be treated as an S corporation and retained an accountant to file the necessary election. The shareholder completed and signed Form 2553 and forwarded it to the accountant to file with the IRS. The accountant failed to file the Form 2553 and incorrectly advised the shareholder that no corporate tax returns were required but instead, all information was to be reported on Schedule C of the shareholder's personal return. The IRS granted the request to make the S election effective as of the date of incorporation.[46]

**Letter Ruling 9652016.** A corporation was established and the shareholder was unaware that any election was required to have the corporation treated as an S corporation. The IRS granted a late S election effective retroactively to the date of incorporation.[47]

## TERMINATION OF S ELECTION

Termination of a corporation's S election can occur in the following ways.

- Revocation
- Deliberate or inadvertent termination

### Revocation

There is no specific IRS form created for the purpose of revoking an S election. Revocation is accomplished by filing the following items with the IRS.

- A statement, signed by anyone authorized to sign the corporate tax returns, indicating a desire to revoke the election and an effective date of revocation
- A statement from holders of more than 50% of the shares (including nonvoting shares) of the corporation consenting to the revocation[48]

> **Note**. Additional details on the revocation of an S election can be found in Treas. Reg. §1.1362-2(a)(3). A revocation may also be **rescinded** under Treas. Reg. §1.1362-2(a)(4).

The two statements described above are sent to the same IRS office where the corporation's S election was originally filed.[49]

**Effective Date of Revocation.** A revocation filed within the first two months and 15 days of the S corporation's tax year is effective the first day of that same tax year.[50] Revocations filed after this period are effective the first day of the following tax year.[51]

A revocation may also specify a **prospective date** on which the revocation becomes effective. Any prospective date on or after the filing of the statement may be selected. A prospective revocation must specify an actual date and not an event or contingency on which revocation is to occur.[52] If no such prospective date is specified, the revocation is effective on the first day of the following tax year.

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46. Ltr. Rul. 9743036 (Jul. 28, 1997).
47. Ltr. Rul. 9652016 (Sep. 30, 1996).
48. IRC §1362(d)(1)(B) and Treas. Reg. §1.1362-2(a)(1).
49. Treas. Reg. §1.1362-2(a)(3).
50. IRC §1362(d)(1)(C)(i).
51. IRC §1362(d)(1)(C)(ii).
52. Treas. Reg. §1.1362-2(a)(2)(ii).

**Example 9.** Marissa is the sole shareholder of her S corporation, Marissa's Muffins, Inc. At the end of February 2012, Marissa decides that she would like to revoke her S election. Marissa decides that the best day of the year to select as the effective date of revocation is February 15, 2012. If Marissa files a revocation on or before March 15, 2012, the revocation will become effective January 1, 2012, even if she indicates a desired effective date of February 15, 2012. The only retroactive date available is the first day of the current tax year (typically January 1 of each year). Marissa could file a revocation at any time during 2012 with a prospective date of February 15, 2013, if she desires.

### Deliberate or Inadvertent Termination

The same initial ownership qualifications required to make the corporation eligible for S corporation status are also **ongoing** requirements that must be maintained in order for the S corporation's tax election to remain in effect. Therefore, if the S corporation violates one or more of these requirements (inadvertently or deliberately), its subchapter S status ceases to exist and its tax treatment reverts to C corporation status. This rule also applies to an LLC that has elected S corporation tax treatment.

There may be circumstances under which S corporation shareholders may no longer desire pass-through tax treatment, instead preferring C corporation taxation. Although an S election revocation can be used to invoke C corporation tax treatment, this can also be accomplished by **deliberately** violating any one of the initial requirements that were necessary to qualify the corporation for subchapter S status. S corporation status ceases on the date that the disqualifying event occurs.

**Example 10.** Ben, Riley, and Lynn are the three shareholders of Patriotic Products, Inc., an S corporation. The three shareholders agree that effective July 4, 2012, they want to begin tax treatment as a C corporation. On July 4, 2012, Riley transfers his shares in the business to his IRA. Because an IRA is not an eligible S corporation shareholder, Riley's action causes the S election to terminate. The termination is effective on July 4, 2012, the date that shares were transferred to the ineligible shareholder. The corporation is taxed as a C corporation beginning on July 4, 2012.

Violation of one of the prerequisites of S corporation eligibility may occur **inadvertently** because of the actions of one or more shareholders.

**Example 11.** Eva and Larry establish a new corporation and meet all the requirements to make an S election. The S corporation's tax year begins January 1. They file Form 2553 and obtain IRS approval for subchapter S status. Several years later, Eva and Larry agree that their friend Craig should have some shares in the business. The corporation issues shares to Craig on June 1, 2012. Eva and Larry find out later that Craig is a nonresident alien. As of June 1, 2012 (the date the S corporation requirements were violated), the corporation's S election terminates because Craig is not a qualifying shareholder. The corporation's **termination year** is 2012, which is divided into two parts for tax purposes. The final S corporation return is filed for the period from January 1 to May 31, 2012. The corporation is taxed as a C corporation from June 1, 2012, to December 31, 2012. It is also treated as a C corporation for 2013 and subsequent years.

**Note**. Although all shareholders must initially consent to obtaining S corporation status, it takes only one shareholder to violate the qualifications and cause C corporation tax treatment to apply. A **shareholder agreement,** which restricts the transfer of shares only to other persons or entities that qualify as S corporation shareholders, can prevent the corporation from losing its S status because of a nonqualifying shareholder.

**Example 12.** MegaPolytechnical, Inc., is an S corporation. Abe, Barb, and Carl are the only three shareholders. Abe owns a Class A share, Barb owns a Class B share, and Carl owns a Class C share. Because all classes of shares have identical distribution and liquidation rights, the one-class-of-stock requirement is met.

On September 15, 2012, Abe and Barb contribute property to the S corporation. The three shareholders agree that Abe and Barb will receive an additional "special dividend" in 2012 because of their property contribution. The special dividend to Abe and Barb violates the one-class-of-stock requirement and the corporation's S election terminates on September 15, 2012, the date of the shareholder's agreement on the special dividend.

**Relief from Inadvertent Termination.** If the shareholders inadvertently terminate the corporation's S election, relief may be possible.[53] Granting relief is at the discretion of the IRS; however, relief is frequently granted. Relief can be granted in two ways.

1. Relief can be retroactive to the date of the inadvertent termination so that the corporation is treated as if the inadvertent termination never happened.
2. The corporation is treated as a C corporation from the date of inadvertent termination to the date the IRS grants prospective relief.[54]

**Application Procedure for Relief.** Under the applicable regulation,[55] the corporation makes its request by applying for a private letter ruling. The request is drafted to include:

- The relevant facts that led to the inadvertent termination,
- How it was discovered, and
- The steps that were taken to obtain the necessary consents from all shareholders within a reasonable time.[56]

All shareholders must submit a signed consent statement with the request if any adjustments are required by the IRS. These statements provide relevant identifying information on each respective shareholder and must state that the shareholder agrees to any adjustments the IRS may require in granting relief.[57]

## CONTRIBUTION OF ASSETS AND SHAREHOLDER BASIS

When a corporation makes an S election, it becomes an S corporation and is taxed in accordance with the pass-through taxation treatment of subchapter S as long as the election remains valid. The tax rules (IRC §351 and related provisions) associated with contributions of capital to corporations apply to both C and S corporations.

IRC §351 governs the transfer of property to a corporation, including an S corporation. It states:

> *. . . no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control. . . of the corporation.*[58]

53. Treas. Reg. §1.1362-4(f).
54. Ibid.
55. Treas. Reg. §1.1362-4(c).
56. Ibid.
57. Treas. Reg. §1.1362-4(e).
58. IRC §351.

Following is a description of the basic elements that must be satisfied in order to obtain **nonrecognition** treatment under IRC §351.

## PROPERTY

For nonrecognition treatment, property must be transferred. The definition of "property" has been interpreted very broadly. Virtually anything can be considered property that falls within IRC §351(a). Given the broad leeway provided on what constitutes property under this provision, it is easier to identify established exceptions.

Services (i.e., working for the corporation) do **not** constitute property for purposes of §351(a).[59] In essence, this exception to property is necessary to prevent a shareholder from receiving tax-free employment income under the guise of §351(a) nonrecognition.[60]

Debt obligations of the transferee corporation qualify as property as long as the debt is evidenced by a security. Debt not evidenced by a security or "open account" indebtedness does not qualify as property.[61] This exclusion is necessary in order to prevent the use of §351 to turn taxable interest into nontaxable interest. In addition, any accrued interest on the debt up to the time of the transfer does not qualify.[62]

## TRANSFER

A transfer of property constitutes a change in ownership. This can occur through a sale, gift, or inheritance. It is typically easy to determine whether a transfer has taken place. However, issues can arise if something less than a full conveyance of property appears to have taken place. Courts have provided significant leeway. For example, the transfer of a lease was held to qualify.[63] Additionally, a transfer for IRC §351 purposes does not encompass the same requirements as the term "sale or exchange" of property under IRC §1001.[64]

## SOLELY IN EXCHANGE FOR STOCK

The "solely in exchange for stock" requirement of IRC §351 ensures that there is a continuity of interest between the shareholder contributing property to the corporation and the property itself.

> **Example 13.** Grady files articles of organization to form a new corporation. Once the new corporation exists, he then transfers commercial real estate into the corporation in exchange for stock. Grady still maintains an ownership relationship with the property transferred into the corporation. However, instead of directly owning the property, he owns shares in the corporation that now owns the property. There is a continuity of interest between Grady and the property he transferred into the corporation.

This provision appears to suggest that **only** stock can be received by the contributing shareholder to obtain nonrecognition treatment. However, shareholders **can** receive other property (such as a note payable or money) from the corporation (referred to as "boot"). Nonrecognition treatment still prevails when boot is received, but the contributing shareholder is taxed on any realized gain to the extent of the value of the boot received.[65]

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59. Rev. Rul. 64-56, 1964-1 CB 133.

60. Sometimes the line between services and property is blurred. For two cases that have addressed this area, see *U.S. v. Frazell,* 335 F.2d 487 (5th Cir. 1964) and *U.S. v. Stafford,* 727 F.2d 1043 (11th Cir. 1984).

61. IRC §351(d)(2).

62. IRC §351(d)(3).

63. *R&J Furniture Co. v. Comm'r*, 20 TC 857 (1953), *rev'd on other grounds,* 221 F.2d 795 (6th Cir. 1955).

64. *E.I. DuPont de Nemours & Co., Inc. v. U.S.,* 471 F.2d 1211 (Ct. Cl. 1973).

65. IRC §351(b)(1).

## CONTROL IMMEDIATELY AFTER THE EXCHANGE

For nonrecognition treatment after the transfer of property under §351, the transferor shareholder(s) must own:

- Stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote, and
- At least 80% of the total number of shares of all other classes of stock.[66]

Both components of the above test are generally referred to as "the 80% control test." In order to meet the second part of this control test, the transferor must own at least 80% of the total number of shares of **each** class.[67]

The length of time the shareholders must retain control after the transaction is not specified. It seems that as long as the shareholders are reasonably diligent in executing an integrated plan with continuity of interest in the overall transaction and the transaction represents a mere change in form, only a minimal time frame (perhaps only a moment) suffices.[68]

## CORPORATE NONRECOGNITION AND BASIS RULES

Providing a shareholder with nonrecognition treatment makes little sense if the transferee corporation was taxed on capital contributions. Accordingly, IRC §1032(a) states that "no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock."

> **Note. Realized** gain or loss refers to the actual gain or loss that a taxpayer receives in a transaction based on that taxpayer's cost basis in the asset and in relation to the proceeds received. This amount may be different than the amount of gain **recognized** for tax purposes under the particular tax rules that apply. For example, a taxpayer may realize a substantial capital gain on the sale of a residence but none of that gain is recognized for tax purposes if the sale qualifies for the applicable exemption.

IRC §362(a) further provides the corporation with the same basis in the property after the transfer that the shareholder had. Technically, this is called a **"transferred basis."** This transferred basis is increased by the gain the shareholder recognized in the transaction.[69]

> **Note**. Upon the transfer of capital property to a corporation, the corporation can include or "tack" the **holding period** of the transferor shareholder onto its own holding period.[70]

IRC §358(a) provides the shareholder with an initial basis in the shares acquired that is equal to the basis in the property transferred. Technically, this is referred to as an "exchanged basis."

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66. IRC §368(c).

67. Rev. Rul. 59-259, 1959-2 CB 115.

68. Two early cases involving issues about the length of time of control are *American Bantam Car Co. v. Comm'r,* 11 TC 397 (1948), *aff'd per curiam,* 177 F.2d 513 (3d Cir. 1949), *cert. denied,* 339 U.S., 920 (1950), and *Intermountain Lumber Co. v. Comm'r*, 65 TC 1025 (1976).

69. .IRC §362(a).

70. See IRC §1223(2).

**Example 14.** Samantha files articles of organization to form a new corporation. Once the new corporation is established, she contributes property to the corporation with a $20,000 adjusted cost basis (ACB) and a $100,000 FMV in exchange for the corporation's stock, which also has a value of $100,000. In transferring the property to the corporation, the following occur.

1. Samantha **realized** a gain of $80,000 ($100,000 FMV − $20,000 ACB).
2. Samantha meets all the elements of IRC §351. Immediately after the exchange, she meets the **80% control test** because she received 100% of the shares outstanding, which meets both components of the 80% control test. Samantha benefits from §351(a) **nonrecognition** treatment. Consequently, even though she realized a gain of $80,000, none of it is recognized for income tax purposes.
3. Samantha's basis in her shares under IRC §358(a) is an exchanged basis of $20,000 (the same basis that she had in the property she transferred).
4. IRC §362(a) provides the corporation with a transferred basis in the property of $20,000 (the same as Samantha's basis in the property).
5. IRC §1032(a) indicates that the corporation likewise recognizes no gain in the transaction.

Samantha still owns property in which her basis is $20,000, but she owns it now through her corporation indirectly as a shareholder. Her cost in the property is now reflected in her shares. Presumably, the share value reflects the $100,000 value of the property in the corporation.

Samantha could later sell her shares to someone else. Upon the sale of her shares, she would recognize gain or loss on the difference between the sale price and her $20,000 exchanged basis. If Samantha simply sold the property initially, without the transfer, her position would be the same.

**Caution.** The question of whether an actual transfer occurred is best avoided by obtaining appropriate documentation that shows the corporation as the new owner of the property. For example, vehicles should actually be deeded to the corporation. A detailed bill of sale should be used for non-titled assets showing the corporation as the new owner.

It is common to refer to this type of transaction as "tax-free." This reflects the immediate outcome because nonrecognition treatment means no tax is paid on the accrued capital gain on the asset in the year of the transaction. However, what actually occurs is tax deferral. The gain is preserved in the shareholder's shares and the shareholder recognizes the gain if the shares are sold at a later date. The gain is also preserved in the corporation because IRC §362(a) provides the corporation with a transferred basis equal to the shareholder's original basis.

### Taxation of "Boot Gain"

As noted earlier, the solely-in-exchange-for-stock requirement should not be taken literally. Nonrecognition treatment is still available if a transferor shareholder receives property or money (boot) from the corporation in the transaction. However, §351(b)(1) requires the shareholder to recognize gain, if any, up to the amount of boot received.

The next example illustrates IRC §351(b)(1).

**Example 15.** Use the same facts as **Example 14,** except Samantha receives corporate stock worth $95,000 and $5,000 in cash in exchange for her contribution of property. The property has a $100,000 FMV. Samantha's adjusted cost basis in the property is $20,000. In transferring the property to the corporation, the following occurs.

1. Samantha has **realized** gain of $80,000 ($100,000 FMV – $20,000 ACB).
2. The elements of IRC §351 are met and she benefits from nonrecognition treatment.
3. IRC §351(b)(1) requires Samantha to recognize gain, if any, up to the amount of boot received. Of the $80,000 of realized gain, she must recognize $5,000, which is taxable in the year of the transaction.
4. Samantha's share basis is calculated using her IRC §358(a) exchanged basis of $20,000 minus the amount of boot received ($5,000) plus the amount of gain recognized ($5,000). Therefore, the basis in her shares is $20,000.
5. IRC §362(a) provides the corporation with a $20,000 transferred basis. This is increased by the amount of gain Samantha recognized in the transaction. The corporation's basis is therefore $25,000 ($20,000 + $5,000). IRC §1032 provides the corporation with nonrecognition treatment on the difference between the $25,000 basis the corporation receives and the $100,000 value of the property the corporation now owns.

In the preceding example, the upward and downward adjustments to share basis are the same and simply negate one another. In the following example, the boot Samantha receives is larger than her realized gain.

**Example 16.** Use the same facts as **Example 14,** except Samantha transfers property into the corporation with an adjusted cost basis of $90,000 and an FMV of $100,000 in exchange for the corporation's stock worth $70,000 and $30,000 in securities (i.e., note payable to the shareholder).

**Note.** The shareholder's boot can consist of assets or cash. When boot consists of a note payable to the shareholder and the shareholder receives periodic payments, the shareholder may benefit from the installment rules.[71] The property must be of a type that qualifies for the installment rules.

1. Samantha's realized gain is $10,000 ($100,000 FMV − $90,000 ACB).
2. IRC §351(b)(1) requires Samantha to recognize gain, if any, up to but not in excess of the amount of boot. She recognizes gain of $10,000. She is not required to recognize more gain than is actually realized in the transaction. Although $30,000 is the amount of boot and the maximum gain to recognize, Samantha only realizes $10,000 of gain for tax purposes.
3. Her share basis starts with her §358(a) exchanged basis of $90,000 minus the boot received ($30,000) plus the gain she recognized ($10,000). Her share basis is $70,000.
4. The calculation of the corporation's basis begins with its transferred basis of $90,000. This is increased by the amount of gain Samantha recognized in the transaction, which is $10,000. Therefore, the corporation's basis in the property is therefore $100,000.
5. If Samantha's basis were $60,000, she would have realized gain of $40,000 ($100,000 − $60,000). IRC §351(b)(1) requires her to realize gain up to but not in excess of the $30,000 of boot received. She therefore would recognize the full $30,000 of boot gain. The remaining $10,000 of realized gain goes unrecognized. Her $60,000 total basis equals her IRC §358(a) exchanged basis of $60,000 less the $30,000 boot received plus the $30,000 gain recognized.

71. See IRC §453(f)(6) and Prop. Treas. Reg. §1.453-1(f)(3)(ii).

### Built-In Loss Rule

The §358(a) exchanged basis rule preserves the realized gain in the shareholder's share basis. Consequently, it is taken into account upon a later sale of the shares. In addition, the §362(a) transferred basis rule for the corporation preserves that same appreciation in the asset within the corporation, and this gain is recognized by the corporation upon a later sale of the asset.

> **Observation**. The same gain is preserved in the share basis and in the corporation's property basis.

When property with a built-in loss is contributed to the corporation, §362(e)(2) limits the corporation's transferred basis to its FMV. The shareholder still receives the usual exchanged basis under §358(a).[72]

**Example 17.** Millie contributes equipment to her corporation. She paid $20,000 for the equipment and it has a $5,000 FMV. There is a built-in loss on this property. IRC §362(e)(2) gives the corporation a transferred basis of $5,000. Millie's exchanged basis in her shares is $20,000 under IRC §358(a).

Millie's shares are worth $5,000 (the value of the equipment transferred into her corporation). If Millie sold her shares, she would recognize a $15,000 loss. This is the same result that would occur if she sold the equipment directly to someone else. Therefore, the loss is preserved in her shares but not in the corporation. If the corporation sells the assets for the $5,000 FMV, its basis is also $5,000 and no loss is recognized.

> **Note.** IRC §362(e)(2)(C) provides a special joint election for the shareholder and the corporation that allows the loss to be preserved in the corporation instead of in the shareholder's shares.

More complex provisions exist for situations involving multiple transferors and/or multiple assets when aggregate cost bases and FMVs are used and applied using a transferor-by-transferor method.[73]

## CONTRIBUTION VERSUS A SALE

IRC §351 and related provisions provide the shareholder with nonrecognition treatment on the contribution of capital to a corporation. However, this nonrecognition applies to both gains and losses.[74] There may be situations in which a shareholder has a loss and wants to recognize it for tax purposes.

The shareholder might be able to accomplish this through a sale of the asset to the corporation rather than through a contribution of the asset in exchange for shares under §351. Instead of taking corporate shares in consideration for the asset, a promissory note or even cash is taken.

IRC §267 imposes limitations on such sales of loss property to corporations which circumvent §351 nonrecognition. Under §267, a loss is denied in a sale or exchange of property between related parties. Related parties include an individual directly or indirectly owning more than 50% of the value of the outstanding stock in a corporation.[75]

## CAPITAL CONTRIBUTIONS WITH LIABILITIES

Originally, the Supreme Court held that when a liability was transferred into a corporation, it was treated as boot.[76] The notion of forcing shareholders to report boot gain in connection with business liabilities transferred into corporations was viewed by Congress as an unacceptable hurdle for business owners. Subsequently, Congress legislatively overruled this early court decision.

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72. IRC §362(e)(2) was enacted to prevent the preservation of the same loss at both the shareholder and corporate levels.

73. See Prop. Treas. Reg. §1.362-4(b)(2).

74. Note that IRC §351(b)(2) specifically prohibits the recognition of losses.

75. IRC §267(b)(2).

76. *U.S. v. Hendler*, 303 U.S. 564 (1938).

Today, transferred liabilities do not prevent a transaction from qualifying under §351.[77] They are governed by the following rules.

- The liability assumed by the corporation **is not** treated as boot for tax purposes.[78] No recognition by the shareholder occurs.
- The liability **is** treated as boot in calculating share basis[79] and that basis is reduced by the boot received.

**Example 18.** Roderigo incorporates his retail business, Roderigo's Collision, Inc., and elects treatment under subchapter S. He contributes the following to the new corporation.

| | |
|---|---|
| Pickup truck's ACB | $ 3,000 |
| Pickup truck's FMV | 10,000 |
| Outstanding loan balance on pickup truck | 2,000 |

Roderigo transfers the pickup truck and the corresponding loan into the corporation. The corporation becomes the owner of the pickup truck and assumes the loan debt. The analysis of the transaction is as follows.

**Roderigo's realized gain.**

| | |
|---|---|
| Value of stock | $ 8,000 |
| Loan assumed by corporation | 2,000 |
| Total value received | $10,000 |
| Less: basis in the pickup truck | (3,000) |
| Realized gain | $ 7,000 |

**Roderigo's recognized gain.** Normally under §351(b)(1), Roderigo has recognized gain amounting to any boot received. However, under §357(a), the loan of $2,000 is not treated as boot for tax purposes and Roderigo has zero recognized gain.

**Roderigo's share basis.** Under §358(a), Roderigo's exchanged share basis is $3,000. This is reduced by any boot and increased by any recognized gain. Under §358(d)(1), the loan is treated as boot and it reduces the share basis, even though §357(a) provides Roderigo with nonrecognition of the "loan boot" for tax purposes. Accordingly, Roderigo's exchanged basis of $3,000 is reduced by the $2,000 debt and is not increased because there is no recognized gain. Roderigo's share basis is therefore $1,000 ($3,000 – $2,000).

**The corporation's basis.** Under §362(a), the corporation's basis is the transferred basis of $3,000.

The above example demonstrates how §357(a) provides for the nonrecognition of a debt amount transferred into the corporation for a business owner. The transfer of a debt does not cause any immediate tax liability for the business owner. However, because the business owner's share basis is reduced by the amount of the debt, the tax liability is deferred until a later sale of those shares.

## Exceptions to §357 Nonrecognition

There are some exceptions to IRC §357(a) nonrecognition. Recognition of the debt is required when:

- Tax avoidance is the reason for the debt transfer,
- There is no bona fide business purpose for the transfer,[80] or
- The debt amount exceeds the shareholder's cost basis in the property transferred.

77. IRC §357(a).

78. Ibid.

79. IRC §358(d)(1).

80. IRC §357(b)(1)(B).

Tax avoidance and lack of business purpose are most often found in instances in which a personal loan was transferred into the business.

When the transferred debt exceeds the shareholder's basis in the property, the liability assumed by the corporation **is** treated as boot for tax purposes.[81] Recognition of the amount by which the debt exceeds basis is required.

The **entire** amount of the liability **is** treated as boot in calculating the shareholder's share basis.[82] The amount reduces that basis by the **entire** liability.

**Example 19.** Paul incorporates his retail business, Paul's Collision, Inc., and contributes property to the new corporation. The following details apply to the contribution.

| | |
|---|---|
| Property's original cost basis | $ 30,000 |
| Depreciation claimed on property | 25,000 |
| Property's FMV | 100,000 |
| Loan on property | 20,000 |

Paul's basis in the property prior to the transfer is his original cost less the depreciation claimed. His basis is therefore $5,000 ($30,000 – $25,000). Paul's realized gain is $95,000 ($100,000 – $5,000).

Paul's recognized gain is the excess of the debt over the basis amount, or $15,000 ($20,000 – $5,000).

Paul's share basis is calculated starting with his §358(a) exchanged basis of $5,000, minus the entire amount of the liability assumed ($20,000) plus the gain Paul must recognize ($15,000). Therefore, his share basis is $0 ($5,000 – $20,000 + $15,000).

The corporation's basis in the property is the transferred basis of $20,000 ($5,000 transferred basis increased by the $15,000 gain Paul recognized in the transaction).[83]

## MULTIPLE-ASSET TRANSFERS

Frequently, a shareholder has more than one asset to transfer into the corporation. IRC §351(b)(2) prohibits losses from being recognized on a transfer of assets into a corporation. A particular protocol exists to address multiple asset situations in accordance with this loss nonrecognition.

**Example 20.** Kim transfers the following three assets into her corporation, each having the adjusted cost basis (ACB) and FMV indicated.

| | Vehicle | Stamping Press | Forklift | Total |
|---|---|---|---|---|
| FMV | $22,000 | $33,000 | $55,000 | $110,000 |
| ACB | (40,000) | (20,000) | (25,000) | (85,000) |
| Gain/(loss) position | ($18,000) | $13,000 | $30,000 | $ 25,000 |

Kim receives corporate stock and $10,000 cash. The total FMV of assets transferred into the corporation is $110,000 ($22,000 + $33,000 + $55,000). Because Kim receives stock and $10,000 cash, the value of the stock portion of her consideration is $100,000 ($110,000 – $10,000).

Kim **cannot** combine the total cost basis amounts and use that total as an overall cost basis amount under §351. This represents a netting of the vehicle loss with the gain positions of the other assets. This would allow her to take into account the $18,000 loss on the vehicle that §351(b)(2) was designed to prevent.[84]

81. IRC §357(c).

82. IRC §358(d)(1).

83. IRC §362(a).

84. IRC §351 provides nonrecognition for such losses as well as gains.

Kim must allocate to each asset the value of the stock and boot received according to each asset's percentage FMV compared to the total FMV of all assets transferred. For example, the total FMV of all assets is $110,000. The vehicle's percentage FMV relative to the total asset FMV is 20% ($22,000 ÷ $110,000). Similar calculations are required for the other two assets. Using the methodology required by Rev. Rul. 68-55, the final analysis under §351 is as follows.

| | Vehicle | Stamping Press | Forklift | Total |
|---|---|---|---|---|
| FMV | $22,000 | $33,000 | $55,000 | $110,000 |
| ACB | (40,000) | (20,000) | (25,000) | (85,000) |
| Realized gain/(loss) | ($18,000) | $13,000 | $30,000 | $ 25,000 |
| % Total FMV | 20.00% | 30.00% | 50.00% | 100.00% |
| Boot allocation | $ 2,000 | $ 3,000 | $5,000 | $ 10,000 |
| Gain/(loss recognized) | 0 | 3,000 | 5,000 | 8,000 |
| Lower of FMV or ACB | $22,000 | $20,000 | $25,000 | $ 67,000 |
| Recognized gain | 0 | 3,000 | 5,000 | 8,000 |
| Basis of stock received | $22,000 | $23,000 | $30,000 | $ 75,000 |
| Plus: loss not recognized | 18,000 | | | 18,000 |
| Less: boot received | (2,000) | | | (2,000) |
| Adjusted basis of stock | $38,000 | $23,000 | $30,000 | $ 91,000 |
| Asset basis to corporation | $22,000 | $23,000 | $30,000 | $ 75,000 |

Using this approach, §351(b)(2) prevents recognition of the $18,000 loss on the vehicle. IRC §351(b)(1) states that the amount of realized gain that must be recognized for tax purposes is the amount of realized gain, if any, up to the amount of boot received. The amount of boot allocated to the stamping press was $3,000 ($10,000 total boot × 30%). Accordingly, of the $13,000 of realized gain on the stamping press, $3,000 of that gain is recognized by Kim. Similarly, of the $30,000 realized gain on the forklift, the $5,000 boot amount ($10,000 total boot × 50%) represents the maximum amount of gain recognized.

Using this methodology prevents Kim from obtaining recognition of the $18,000 loss on the vehicle in an IRC §351 transfer.

## TAXATION OF S CORPORATION INCOME

The S corporation is a **pass-through** entity. The S corporation typically does not pay corporate-level income tax.[85] Instead, shareholders are taxed as if they earned the income directly. Each shareholder is taxed on their pro-rata share of earnings, whether or not those earnings are actually distributed.

> **Note.** Generally, S corporations only pay corporate-level tax when there is built-in gain, LIFO recapture, or excessive passive income tax. These situations arise when the S corporation was previously a C corporation. Each of these situations is discussed later in this chapter.

85. IRC §1366.

## TAXATION OF SHAREHOLDERS

### OVERVIEW

The first step in arriving at the correct tax amounts to pass through to S corporation shareholders is to separate income and expense items into two categories — **separately stated** and **nonseparately stated.**

It is necessary to place separately stated items within their own category because these items of income or expense are subject to special tax rules or limitations once passed through to the shareholder. Nonseparately stated income and expense items are not subject to such limitations and can be combined to arrive at an overall net income or loss (similar to a typical income statement).

### SEPARATELY STATED ITEMS

There are several items falling into the category of separately stated items. Among these are the following.

- Combined net amount of any gains or losses from the sale or exchange of corporate capital assets that are subject to regular capital gains tax rules (categorized by applicable holding periods, tax rates, or other classification relevant to the shareholder's tax liability)
- Combined net amount of gains or losses to the corporation on the sale or exchange of IRC §1231 property (categorized by applicable holding periods, tax rates, or other classification relevant to the shareholder's tax liability)

> **Observation.** When a §179 deduction on property was passed through to shareholder(s) and that property is subsequently sold, the sale of the property is reported in box 17, Other Information, of Schedule K-1, using code K, which specifically denotes the sale of §179 property.

- Corporate charitable contributions (categorized by the percentage limitations)[86]

> **Note.** An S corporation must report and claim charitable contributions on a cash basis (whether or not the S corporation has elected to use cash or accrual basis for tax accounting purposes).

- Amount of taxes the corporation paid to foreign countries that qualify for the foreign tax credit
- Income or loss items and expenses related to a corporate investment portfolio calculated under the passive loss rules
- Any items of tax-exempt income received by the corporation
- Corporate adjustments and tax preference items for alternative minimum tax (AMT) purposes
- Any other item identified through IRS guidance that is required to be stated separately

### NONSEPARATELY STATED ITEMS

The items falling into the nonseparately stated category consist of the S corporation's gross income from business activity and its business expenses. These are items typically found on a profit and loss statement. The deductible expenses are subtracted from the gross income to arrive at the S corporation's net income (or loss) for the year.

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86. Rev. Rul. 2000-43, 2000-41 IRB 333.

### Wages and Compensation

Wages are a business expense that reduces gross income of the S corporation. Wages paid to S corporation shareholders and other employees are reported on Form W-2, *Wage and Tax Statement,* showing appropriate tax and Federal Insurance Contribution Act (FICA) amounts withheld. Taxable fringe benefits are also reported in box 1 of Form W-2. These fringe benefits include accident and health insurance premiums paid by the S corporation for shareholders with interests of 2% or more in the company. An optional explanatory note can be included in box 14 of Form W-2. The shareholder deducts the amount of the insurance premiums on line 29 (self-employed health insurance deduction) of Form 1040.

**Caution.** In order to prevent a disproportionate distribution and to properly report taxable fringe benefits, the value of health insurance for a 2% or more shareholder must be included as wages on Form W-2 (not subject to social security or Medicare tax). The corporation deducts these payments as compensation.

**Note.** In order for the S corporation to deduct the health insurance premiums as shareholder compensation, the corporation must pay these premiums directly or reimburse the shareholder for premiums paid by the shareholder.

A major tax planning strategy associated with the S corporation is the ability to reduce social security and Medicare taxes. For 2012, the combined employer and employee tax rate on wages is 13.3% for social security and Medicare.[87] S corporation owners can receive income as **wages** (reported on Form W-2) and they can receive **distributions** (such as dividends) from the S corporation. This distinction is important because any wage payments are subject to tax and distributions are not.

**Example 21.** Marge is the sole shareholder of Marge's Courier Service, Inc., an S corporation. She would like to receive $50,000 in 2012 from her business. If Marge takes the entire $50,000 in the form of wages, she will incur 13.3% (or $6,650) in social security and Medicare taxes.

However, Marge decides to take only $30,000 in wages and the remaining $20,000 in dividends. Only the wages are subject to the 13.3% social security and Medicare taxes. In doing this, Marge pays $3,990 in social security and Medicare taxes. Taking distributions in the form of dividends eliminates a substantial part of her social security and Medicare tax liability and she saves $2,660 ($6,650 − $3,990) in these taxes.

## REASONABLE SALARY REQUIREMENT

To address apparent abuses with S corporation owners paying dividends instead of wages to avoid social security and Medicare taxation, the IRS requires S corporation owners to pay themselves a reasonable salary each year.[88] There is no precise definition of "reasonable salary." The IRS and the courts look to the individual facts and circumstances of each case to determine how much of the total compensation paid to the owner should constitute salary. Frequently, the IRS and the courts recharacterize some or all of the dividend distribution as salary to ensure that a reasonable salary is reported. FICA tax is accordingly assessed on the recharacterized amounts, along with any applicable interest and penalties.

87. The Middle Class Tax Relief and Job Creation Act of 2012 (PL 112-96) extended the 2011 "payroll tax holiday" through December 31, 2012.

88. IRS Fact Sheet FS-2008-25.

In each case, factors about the S corporation owner that are considered in determining what amount constitutes a reasonable salary include the following.

- 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
- The use of a formula to determine compensation[89]

The IRS first addressed the reasonable compensation issue in 1974[90] and since then, IRS challenges in this area have been successful in the courts.

In *David E. Watson, P.C. v. U.S.*,[91] the taxpayer was a CPA with 20 years of experience, a business degree, and a master's degree in taxation. After nine years of large-firm experience, he became a 25% partner in LWBE, an accounting firm. Four years later, he formed an S corporation that became the 25% shareholder in the accounting firm in his place. Mr. Watson performed accounting services for the accounting firm as an employee of his own S corporation. For the 2002 and 2003 taxation years, Mr. Watson paid himself the following amounts.

| | 2002 | 2003 |
|---|---|---|
| Wages | $ 24,000 | $ 24,000 |
| Distribution | 203,651 | 175,470 |

Focusing on Watson's 20 years of experience, his 35–45 hours of weekly work for his firm, and the firm's $2 million and $3 million of gross income in 2002 and 2003, respectively, the court agreed with the IRS's assertion that Watson's wages were unreasonably low and should be adjusted upward along with applicable social security and Medicare taxes plus penalties and interest.

The court's conclusion was aided by IRS expert witness testimony that relied on several accounting compensation studies, including AICPA survey material. The IRS's expert witness estimated that reasonable compensation for Watson's services was $91,044 in each of the two tax years at issue. Watson argued that it was the intent of the S corporation to pay him $24,000 annually with the remaining amounts distributed based on the firm's success. However, the court found this argument implausible because of Watson's extensive experience and success. Watson's wages were therefore adjusted upward to $91,044, plus applicable social security and Medicare taxes, in each of the two years.

89. Ibid.

90. See Rev. Rul. 74-44, 1974-1 CB 287.

91. *David E. Watson, P.C. v. U.S.*, 757 F. Supp. 2d 877 (S.D. Iowa 2010), *aff'd* 668 F.3d 1008 (8th Cir. Feb. 21, 2012).

Other reasonable compensation cases include the following.

- *Spicer Accounting, Inc. v. U.S.,* 918 F.2d 90 (9th Cir. 1990)
- *J. Radtke v. U.S.,* 895 F.2d 1196 (7th Cir. 1990)
- *Fred R. Esser, P.C. v. U.S.,* 750 F.Supp. 421 (DC Ariz. 1990)

**Note.** IRS auditors are aware of the reasonable salary requirement associated with S corporation compensation and have guidelines for what constitutes a reasonable salary within particular industries in various geographical locations. These guidelines are used as a starting point if a particular S corporation owner's compensation is under review.

**Observation.** Unlike income from a partnership, S corporation income is not considered self-employment income. This has been a big concern for a number of years. Both the Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO) have issued reports about this.[92]

## ALLOCATION TO SHAREHOLDERS

After the separately stated items are calculated and itemized, they are allocated to the S corporation shareholders on a pro-rata basis determined by their relative percentage ownership interests.

Moreover, once the ordinary net income or loss amounts are determined at in connection with the nonseparately stated **items,** the amount is similarly allocated to the S corporation shareholders on the same pro-rata basis according to the relative shareholder interests.

## PART-YEAR SHAREHOLDERS

For various reasons, the S corporation shareholder may cease being a shareholder during a tax year. In addition, new shareholders may obtain shares during a tax year. These part-year shareholders receive their pro-rata allocations on the basis of the **number of days** within the tax year that the shareholder owned shares.

**Note.** Treas. Reg. §1.1377-1(b) provides an election for an interim closing if a change in ownership takes place and at least one shareholder completely terminates their interest. All affected shareholders must agree in order for the election to be effective. It may be prudent to obtain the agreement of all affected shareholders before the change in ownership takes place, through an applicable buy-sell agreement or other transfer document.

92. *Actions Needed to Address Noncompliance with S Corporation Tax Rules*, GAO-10-195, Dec. 15, 2009 and *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, Treasury Inspector General for Tax Administration Reference Number 2005-30-080, May 20, 2005.

# TAX REPORTING

## OVERVIEW

The S corporation generally does not pay income tax. However, an S corporation must file Form 1120S, *U.S. Income Tax Return for an S Corporation.* An S corporation must generally use the calendar year unless it has permission from the IRS to use another year based on a business purpose.[93] Form 1120S is used to report required amounts for business operations arising from the separately stated and nonseparately stated categories of business activity. The cornerstone of the Form 1120S is Schedule K, *Shareholders' Pro Rata Share Items,* which is used to pass through all required amounts to individual S corporation shareholders.

## FORM 1120S

Once the separately stated items are placed in their own categories and any required additional calculations and schedules are completed, the relevant amounts are reported on Form 1120S. The separately stated items are generally reported within Schedule K of the Form 1120S.

The nonseparately stated items are likewise reported on Form 1120S and included in a simplified profit and loss statement (with Schedule A used to report a cost-of-goods-sold calculation, if applicable). The resulting "bottom line" profit or loss amount from business operations is also reported on Schedule K.

Although there may be other disclosures and schedules necessary with the return, this basic level of S corporation reporting serves the central function of summarizing all key amounts from the separately stated and nonseparately stated categories. These key amounts are subsequently allocated to S corporation shareholders on a pro-rata basis.

Supplementary schedules may be required for items such as depreciation and capital gains. Once Form 1120S is complete, Schedule K provides the necessary amounts for the next step: completing Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc*.

### Form 1120S Due Date and Penalties

The due date for Form 1120S is the 15th day of the third month after the end of the tax year. Accordingly, for a calendar-year S corporation, the due date is March 15 of the following year. The due date may be extended for six months by filing Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns,* by the due date of the return for which the extension is sought.

When the return is late and no tax is due, the penalty is $195 per month (or partial month) multiplied by the total number of persons who were shareholders at any time during the tax year. The penalty can be assessed for up to 12 months. This penalty can also be assessed when the return does not report all the required information.

When the Form 1120S indicates that tax is owed, an additional penalty of 5% of the unpaid tax can be assessed for each month (or partial month) that it remains unpaid. The maximum penalty is 25% of the amount of unpaid tax. When the return is more than 60 days late and tax is due, the minimum penalty assessed is the lesser of the amount of tax due or $135.

The penalty for failure to provide shareholders with their respective Schedules K-1 by the due date is $100 per Schedule K-1. However, when there is intentional disregard of the rules, the penalty is the greater of $250 per Schedule K-1 or 10% of the total amount of items required to be reported.[94]

The penalty can be waived if there is reasonable cause for the delay.

---

93. IRC §1378(b).

94. See 2011 Instructions for Form 1120S.

### Form 1120S, Schedules L and M-1

When the S corporation has less than $250,000 in total receipts and assets for the taxable year, Schedule L, *Balance Sheets per Books,* and Schedule M-1, *Reconciliation of Income per Books With Income (Loss) per Return,* are not required to be completed.

> **Note.** Because S corporation asset, liability, and equity figures are frequently required in connection with routine business transactions and must be updated each year, it is always prudent to complete Schedule L even when it is not required.

### Form 1120S, Schedule M-2

Schedule M-2, *Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed,* provides the annual update of the S corporation's accumulated adjustments account (AAA). This schedule must be completed for the S corporation each year. The AAA account is adjusted each year in a manner similar to shareholder basis adjustments and can have an impact upon the tax treatment of distributions.

### Form 1120S, Schedule M-3

For S corporations that have $10 million or more of assets at the end of the tax year, a much more detailed reconciliation of book income with tax income is required. Instead of completing Schedule M-1, this reconciliation is disclosed by completing Schedule M-3, *Net Income (Loss) Reconciliation for S Corporations With Total Assets of $10 Million or More*.

S corporations with less than $10 million of assets can voluntarily complete the more detailed Schedule M-3 instead of Schedule M-1. The S corporation cannot file both Schedules M-1 and M-3 for the same taxable year.

## PREPARATION OF SCHEDULES K-1 FOR SHAREHOLDERS

Schedule K provides a concise summary of the required amounts that are allocated to each shareholder according to their pro-rata ownership interest. The Schedule K figures are separated to arrive at appropriate pro-rata amounts for each shareholder and each shareholder's Schedule K-1 is completed with the shareholder's respective amounts.

Copies of each shareholder's Schedule K-1 are filed with the Form 1120S. The sum of all items reported on individual Schedules K-1 equals the total corporate amounts reported on Schedule K of Form 1120S. Each shareholder receives a copy of their individual Schedule K-1. The Schedules K-1 are used in the preparation of the shareholders' individual tax returns.

> **Note.** Shareholders are taxed on their respective pro-rata share of business earnings of the S corporation regardless of whether those earnings are actually distributed to the shareholder.

## PASS-THROUGH REPORTING BY S CORPORATION SHAREHOLDERS

After a shareholder receives their Schedule K-1, the information is reported on their individual Form 1040 return.

**Example 22.** Cliff and Roberta own Creative Design Solutions, Inc., which is a calendar-year S corporation. Cliff and Roberta own the S corporation on a 60/40 basis, respectively. For 2011, the corporation had the following income and expenses.

| | | |
|---|---|---|
| Receipts | | $210,000 |
| Advertising | $ 10,000 | |
| Interest | 5,000 | |
| Rents | 16,000 | |
| Repairs and maintenance | 9,000 | |
| Wages to Cliff and Roberta | 70,000 | |
| Total expenses | $110,000 | (110,000) |
| Ordinary business income | | $100,000 |
| Dividend income | | 1,000 |
| Interest | | 200 |
| Gain on sale of assets | | 10,000 |
| Net income | | $111,200 |

Cliff and Roberta each receive $35,000 of wages for the year.

The ordinary business income represents net income after the various expenses were deducted. One of those expenses was the $70,000 wage amount. Wage payments have the effect of **reducing** the amount of ordinary income remaining for pro-rata distribution among shareholders. Any wage amounts for Cliff, Roberta, and other employees are reported on Forms W-2.

The S corporation received $1,000 in dividend income of which $600 is qualified dividends.

The S corporation sold the following assets.

| | Cost | Depreciation Taken | Proceeds |
|---|---|---|---|
| Land | $ 20,000 | $ 0 | $70,000 |
| Equipment | 200,000 | 150,000 | 10,000 |

**S Corporation Reporting.** Any separately stated items are isolated from nonseparately stated items. In this case, the assets sold (land and equipment) constitute sales of IRC §1231 property and are separately stated items. These asset sales are reported on Form 4797, *Sales of Business Property,* as follows. This form is filed with Form 1120S.

**For Example 22**

Form **4797** Department of the Treasury Internal Revenue Service (99)

## Sales of Business Property

**(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))**

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184 2011 Attachment Sequence No. 27

| Name(s) shown on return | Identifying number |
|---|---|
| Creative Design Solutions, Inc. | 33-3333333 |

1 Enter the gross proceeds from sales or exchanges reported to you for 2011 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) . . . . . . . . . **1** **0**

**Part I** **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

| 2 (a) Description of property | (b) Date acquired (mo., day, yr.) | (c) Date sold (mo., day, yr.) | (d) Gross sales price | (e) Depreciation allowed or allowable since acquisition | (f) Cost or other basis, plus improvements and expense of sale | (g) Gain or (loss) Subtract (f) from the sum of (d) and (e) |
|---|---|---|---|---|---|---|
| Land | 2/02/06 | 5/31/11 | 70,000 | | 20,000 | 50,000 |
| Equipment | 8/03/07 | 7/06/11 | 10,000 | 150,000 | 200,000 | (40,000) |
| | | | | | | |
| | | | | | | |

| | | |
|---|---|---|
| 3 Gain, if any, from Form 4684, line 39 . . . . . . . . . . . . . . . . . . . . . . . . . . . . | 3 | |
| 4 Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . . . . . . . . . . . . . . . . | 4 | |
| 5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . . . . . . . . . . . . . . . . | 5 | |
| 6 Gain, if any, from line 32, from other than casualty or theft. . . . . . . . . . . . . . . . . . . . . . | 6 | |
| 7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: . . . . . . . . | 7 | 10,000 |

**Partnerships (except electing large partnerships) and S corporations.** Report the gain or (loss) following the

The income and expense items are nonseparately stated items. These are reported on page 1 of Form 1120S, which shows the gross income, expenses, and the $100,000 of ordinary (net) business income as shown next.

## For Example 22

Form **1120S**
Department of the Treasury
Internal Revenue Service

# U.S. Income Tax Return for an S Corporation

▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.
▶ See separate instructions.

OMB No. 1545-0130
2011

For calendar year 2011 or tax year beginning , 2011, ending , 20

| | | |
|---|---|---|
| A S election effective date: January 1, 2002 | Name: Creative Design Solutions, Inc. | D Employer identification number: 33-3333333 |
| B Business activity code number (see instructions): 541400 | TYPE OR PRINT — Number, street, and room or suite no. If a P.O. box, see instructions.: 406 Gingerbread Hill Drive | E Date incorporated: January 1, 2002 |
| C Check if Sch. M-3 attached ☐ | City or town, state, and ZIP code: Marblehead, MA 01945 | F Total assets (see instructions): $ 116,000 |

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☑ No If "Yes," attach Form 2553 if not already filed

H Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year ▶ 2

**Caution.** *Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.*

| | | | | | | |
|---|---|---|---|---|---|---|
| Income | 1a | Merchant card and third-party payments. For 2011, enter -0- | 1a | 0 | | |
| | b | Gross receipts or sales not reported on line 1a (see instructions) | 1b | 210,000 | | |
| | c | Total. Add lines 1a and 1b | 1c | 210,000 | | |
| | d | Returns and allowances plus any other adjustments (see instructions) | 1d | | | |
| | e | Subtract line 1d from line 1c | | | 1e | 210,000 |
| | 2 | Cost of goods sold (attach Form 1125-A) | | | 2 | |
| | 3 | Gross profit. Subtract line 2 from line 1e | | | 3 | |
| | 4 | Net gain (loss) from Form 4797, Part II, line 17 *(attach Form 4797)* | | | 4 | |
| | 5 | Other income (loss) *(see instructions—attach statement)* | | | 5 | |
| | 6 | **Total income (loss).** Add lines 3 through 5 ▶ | | | 6 | 210,000 |
| Deductions (see instructions for limitations) | 7 | Compensation of officers | | | 7 | 70,000 |
| | 8 | Salaries and wages (less employment credits) | | | 8 | |
| | 9 | Repairs and maintenance | | | 9 | 9,000 |
| | 10 | Bad debts | | | 10 | |
| | 11 | Rents | | | 11 | 16,000 |
| | 12 | Taxes and licenses | | | 12 | |
| | 13 | Interest | | | 13 | 5,000 |
| | 14 | Depreciation not claimed on Form 1125-A or elsewhere on return *(attach Form 4562)* | | | 14 | |
| | 15 | Depletion **(Do not deduct oil and gas depletion.)** | | | 15 | |
| | 16 | Advertising | | | 16 | 10,000 |
| | 17 | Pension, profit-sharing, etc., plans | | | 17 | |
| | 18 | Employee benefit programs | | | 18 | |
| | 19 | Other deductions *(attach statement)* | | | 19 | |
| | 20 | **Total deductions.** Add lines 7 through 19 ▶ | | | 20 | 110,000 |
| | 21 | **Ordinary business income (loss).** Subtract line 20 from line 6 | | | 21 | 100,000 |
| Tax and Payments | 22a | Excess net passive income or LIFO recapture tax *(see instructions)* | 22a | | | |
| | b | Tax from Schedule D (Form 1120S) | 22b | | | |
| | c | Add lines 22a and 22b *(see instructions for additional taxes)* | | | 22c | |
| | 23a | 2011 estimated tax payments and 2010 overpayment credited to 2011 | 23a | | | |
| | b | Tax deposited with Form 7004 | 23b | | | |
| | c | Credit for federal tax paid on fuels *(attach Form 4136)* | 23c | | | |
| | d | Add lines 23a through 23c | | | 23d | |
| | 24 | Estimated tax penalty *(see instructions)*. Check if Form 2220 is attached ▶ ☐ | | | 24 | |
| | 25 | **Amount owed.** If line 23d is smaller than the total of lines 22c and 24, enter amount owed | | | 25 | 0 |
| | 26 | **Overpayment.** If line 23d is larger than the total of lines 22c and 24, enter amount overpaid | | | 26 | 0 |
| | 27 | Enter amount from line 26 **Credited to 2012 estimated tax ▶** | **Refunded ▶** | | 27 | 0 |

**Sign Here** — Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer | Date | ▶ Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

| **Paid Preparer Use Only** | | | | |
|---|---|---|---|---|
| Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN |
| Firm's name ▶ | | | Firm's EIN ▶ | |
| Firm's address ▶ | | | Phone no. | |

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11510H Form **1120S** (2011)

Schedule K of Form 1120S shows the dividend and interest income that is received by the S corporation. In addition to these amounts, it also summarizes the ordinary business income and other amounts that are passed through to Cliff and Roberta in accordance with their respective 60/40 ownership interests in Creative Design Solutions, Inc. The Schedule K is shown below.

b If "Yes," did the corporation file or will it file all required Forms 1099?

| Schedule K | | Shareholders' Pro Rata Share Items | | | | Total amount |
|---|---|---|---|---|---|---|
| Income (Loss) | 1 | Ordinary business income (loss) (page 1, line 21) | | | 1 | 100,000 |
| | 2 | Net rental real estate income (loss) (*attach Form 8825*) | | | 2 | |
| | 3a | Other gross rental income (loss) | 3a | | | |
| | b | Expenses from other rental activities (*attach statement*) | 3b | | | |
| | c | Other net rental income (loss). Subtract line 3b from line 3a | | | 3c | |
| | 4 | Interest income | | | 4 | 200 |
| | 5 | Dividends: **a** Ordinary dividends | | | 5a | 1,000 |
| | | **b** Qualified dividends | 5b | 600 | | |
| | 6 | Royalties | | | 6 | |
| | 7 | Net short-term capital gain (loss) (*attach Schedule D (Form 1120S)*) | | | 7 | |
| | 8a | Net long-term capital gain (loss) (*attach Schedule D (Form 1120S)*) | | | 8a | |
| | b | Collectibles (28%) gain (loss) | 8b | | | |
| | c | Unrecaptured section 1250 gain (*attach statement*) | 8c | | | |
| | 9 | Net section 1231 gain (loss) (*attach Form 4797*) | | | 9 | 10,000 |
| | 10 | Other income (loss) (*see instructions*) . . Type ▶ | | | 10 | |

Form **1120S** (2011)

**Pass-Through of Schedule K Amounts to Shareholders.** To pass through the Schedule K amounts to shareholders Cliff and Roberta, the S corporation completes a **Schedule K-1** for each shareholder. Each shareholder's Schedule K-1 indicates that shareholder's respective pro-rata amount of all the amounts reported on Schedule K. Accordingly, Cliff's Schedule K-1 shows his 60% share of the amounts shown on Form 1120S, Schedule K. Roberta's Schedule K-1 shows her respective 40% share. The S corporation is required to distribute these Schedules K-1 to all shareholders by the deadline for the Form 1120S (March 15 or the extended September 15 deadline). Cliff's Schedule K-1 is shown on the following page.

## For Example 22

671111

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

**Schedule K-1 (Form 1120S)** 2011
Department of the Treasury
Internal Revenue Service

For calendar year 2011, or tax year beginning ____________, 2011
ending ____________, 20 ____

**Shareholder's Share of Income, Deductions, Credits, etc.** ▶ See back of form and separate instructions.

**Part I Information About the Corporation**

**A** Corporation's employer identification number
**33-3333333**

**B** Corporation's name, address, city, state, and ZIP code
**Creative Design Solutions, Inc.**
**406 Gingerbread Hill Drive**
**Marblehead, MA 01945**

**C** IRS Center where corporation filed return
**Cincinnati, OH**

**Part II Information About the Shareholder**

**D** Shareholder's identifying number
**222-22-2222**

**E** Shareholder's name, address, city, state, and ZIP code
**Cliff Devereaux**
**123 Market Street**
**Marblehead, MA 01945**

**F** Shareholder's percentage of stock ownership for tax year . . . . . . . **60** %

For IRS Use Only

**Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items**

| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) **60,000** | 13 | Credits |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | | |
| 4 | Interest income **120** | | |
| 5a | Ordinary dividends **600** | | |
| 5b | Qualified dividends **360** | 14 | Foreign transactions |
| 6 | Royalties | | |
| 7 | Net short-term capital gain (loss) | | |
| 8a | Net long-term capital gain (loss) | | |
| 8b | Collectibles (28%) gain (loss) | | |
| 8c | Unrecaptured section 1250 gain | | |
| 9 | Net section 1231 gain (loss) **6,000** | | |
| 10 | Other income (loss) | 15 | Alternative minimum tax (AMT) items |
| 11 | Section 179 deduction | 16 | Items affecting shareholder basis |
| 12 | Other deductions | | |
| | | 17 | Other information |
| | | **A** | **720** |

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. Cat. No. 11520D Schedule K-1 (Form 1120S) 2011

Cliff's Schedule K-1, box 17, uses code "A" to indicate that $720 of the income shown on the schedule is investment income ($600 of ordinary dividends plus $120 of interest income).

**Note.** Roberta also receives a Schedule K-1 from Creative Design Solutions showing her respective 40% pro-rata amount of each item.

**Observation**. Even if the shareholders **do not actually receive** a distribution of their pro-rata share of earnings, those pro-rata shares are allocated to them for tax purposes on Schedule K-1. The amounts must be reported and applicable income tax is paid on the passed through amounts. The tax treatment of a distribution to a shareholder largely depends on the shareholder's **share and debt basis** (discussed later in this chapter).

Various types of income received by Creative Design Solutions **retain their character** when passed through to Cliff and Roberta as shareholders. The net §1231 gain of the S corporation retains its character and flows through to the shareholder's Form 4797. The same is true for the qualified dividends and interest income.

**Shareholder Reporting.** Cliff reports his pro-rata share of activity in Creative Design Solutions on his 2011 Form 1040 as follows.

**For Example 22**

Form **1040** Department of the Treasury—Internal Revenue Service (99)
**U.S. Individual Income Tax Return** **2011** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2011, or other tax year beginning , 2011, ending , 20 — See separate instructions.

| | |
|---|---|
| Your first name and initial | Cliff |
| Last name | Devereaux |
| Your social security number | 222-22-2222 |
| If a joint return, spouse's first name and initial | |
| Last name | |
| Spouse's social security number | |
| Home address (number and street). If you have a P.O. box, see instructions. | 123 Market Street |
| Apt. no. | |
| City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). | Marblehead, MA 01945 |
| Foreign country name | |
| Foreign province/county | |
| Foreign postal code | |

▲ Make sure the SSN(s) above and on line 6c are correct.

**Presidential Election Campaign**
Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

**Filing Status**

Check only one box.

1 ☑ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

**Exemptions**

6a ☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
Boxes checked on 6a and 6b: 1

c **Dependents:**

| (1) First name Last name | (2) Dependent's social security number | (3) Dependent's relationship to you | (4) ✓ if child under age 17 qualifying for child tax credit (see instructions) |
|---|---|---|---|
| | | | ☐ |
| | | | ☐ |
| | | | ☐ |
| | | | ☐ |

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers on lines above ▶ 1

**Income**

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

| | | | |
|---|---|---|---|
| 7 | Wages, salaries, tips, etc. Attach Form(s) W-2 | 7 | 35,000 |
| 8a | **Taxable** interest. Attach Schedule B if required | 8a | 120 |
| b | **Tax-exempt** interest. **Do not** include on line 8a — 8b | | |
| 9a | Ordinary dividends. Attach Schedule B if required | 9a | 600 |
| b | Qualified dividends — 9b 360 | | |
| 10 | Taxable refunds, credits, or offsets of state and local income taxes | 10 | |
| 11 | Alimony received | 11 | |
| 12 | Business income or (loss). Attach Schedule C or C-EZ | 12 | |
| 13 | Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐ | 13 | 6,000 |
| 14 | Other gains or (losses). Attach Form 4797 | 14 | |
| 15a | IRA distributions — 15a — b Taxable amount | 15b | |
| 16a | Pensions and annuities — 16a — b Taxable amount | 16b | |
| 17 | Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E | 17 | 60,000 |
| 18 | Farm income or (loss). Attach Schedule F | 18 | |
| 19 | Unemployment compensation | 19 | |
| 20a | Social security benefits — 20a — b Taxable amount | 20b | |
| 21 | Other income. List type and amount | 21 | |
| 22 | Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶ | 22 | 101,720 |

**Adjusted Gross Income**

| | | | |
|---|---|---|---|
| 23 | Educator expenses | 23 | |
| 24 | Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ | 24 | |
| 25 | Health savings account deduction. Attach Form 8889 | 25 | |
| 26 | Moving expenses. Attach Form 3903 | 26 | |
| 27 | Deductible part of self-employment tax. Attach Schedule SE | 27 | |
| 28 | Self-employed SEP, SIMPLE, and qualified plans | 28 | |
| 29 | Self-employed health insurance deduction | 29 | |
| 30 | Penalty on early withdrawal of savings | 30 | |
| 31a | Alimony paid b Recipient's SSN ▶ | 31a | |
| 32 | IRA deduction | 32 | |
| 33 | Student loan interest deduction | 33 | |
| 34 | Tuition and fees. Attach Form 8917 | 34 | |
| 35 | Domestic production activities deduction. Attach Form 8903 | 35 | |
| 36 | Add lines 23 through 35 | 36 | 0 |
| 37 | Subtract line 36 from line 22. This is your **adjusted gross income** ▶ | 37 | 101,720 |

**For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11320B Form **1040** (2011)

Cliff must also report additional details on his pro-rata share of the capital gain that arises from Creative Design Solution's asset sale. Form 4797, shown below, serves this purpose.

Form **4797**
Department of the Treasury
Internal Revenue Service (99)

**Sales of Business Property**
**(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))**
▶ **Attach to your tax return.** ▶ **See separate instructions.**

OMB No. 1545-0184
**2011**
Attachment Sequence No. **27**

| Name(s) shown on return | Identifying number |
|---|---|
| **Cliff Devereaux** | **222-22-2222** |

**1** Enter the gross proceeds from sales or exchanges reported to you for 2011 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) . . . . . . . . . **1** **0**

**Part I** **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

| 2 (a) Description of property | (b) Date acquired (mo., day, yr.) | (c) Date sold (mo., day, yr.) | (d) Gross sales price | (e) Depreciation allowed or allowable since acquisition | (f) Cost or other basis, plus improvements and expense of sale | (g) Gain or (loss) Subtract (f) from the sum of (d) and (e) |
|---|---|---|---|---|---|---|
| **From Schedule K-1** | | | | | | **6,000** |
| | | | | | | |
| | | | | | | |
| | | | | | | |

| | | | |
|---|---|---|---|
| 3 | Gain, if any, from Form 4684, line 39 . . . . . | 3 | |
| 4 | Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . . . . | 4 | |
| 5 | Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . . . . | 5 | |
| 6 | Gain, if any, from line 32, from other than casualty or theft. . . . . | 6 | |
| 7 | Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: . . . . . | 7 | **6,000** |
| | **Partnerships (except electing large partnerships) and S corporations.** Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. **Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below. | | |
| 8 | Nonrecaptured net section 1231 losses from prior years (see instructions) . . . . . | 8 | |
| 9 | Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions) . . . . . | 9 | **6,000** |

**Part II** **Ordinary Gains and Losses** (see instructions)

Cliff's 2011 Form 1040 also includes Schedule D, which indicates the long-term nature of the gain.

**For Example 22**

**SCHEDULE D (Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

# Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074
2011
Attachment Sequence No. 12

| Name(s) shown on return | Your social security number |
|---|---|
| Cliff Devereaux | 222-22-2222 |

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

| Complete Form 8949 before completing line 1, 2, or 3. This form may be easier to complete if you round off cents to whole dollars. | (e) Sales price from Form(s) 8949, line 2, column (e) | (f) Cost or other basis from Form(s) 8949, line 2, column (f) | (g) Adjustments to gain or loss from Form(s) 8949, line 2, column (g) | (h) Gain or (loss) Combine columns (e), (f), and (g) |
|---|---|---|---|---|
| 1 Short-term totals from all Forms 8949 with **box A** checked in **Part I** | | ( ) | | |
| 2 Short-term totals from all Forms 8949 with **box B** checked in **Part I** | | ( ) | | |
| 3 Short-term totals from all Forms 8949 with **box C** checked in **Part I** | | ( ) | | |

| | | |
|---|---|---|
| 4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 | 4 | |
| 5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 | 5 | |
| 6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions | 6 | ( ) |
| 7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back | 7 | |

**Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year**

| Complete Form 8949 before completing line 8, 9, or 10. This form may be easier to complete if you round off cents to whole dollars. | (e) Sales price from Form(s) 8949, line 4, column (e) | (f) Cost or other basis from Form(s) 8949, line 4, column (f) | (g) Adjustments to gain or loss from Form(s) 8949, line 4, column (g) | (h) Gain or (loss) Combine columns (e), (f), and (g) |
|---|---|---|---|---|
| 8 Long-term totals from all Forms 8949 with **box A** checked in **Part II** | | ( ) | | |
| 9 Long-term totals from all Forms 8949 with **box B** checked in **Part II** | | ( ) | | |
| 10 Long-term totals from all Forms 8949 with **box C** checked in **Part II** | | ( ) | | |

| | | |
|---|---|---|
| 11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 | 11 | 6,000 |
| 12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 | 12 | |
| 13 Capital gain distributions. See the instructions | 13 | |
| 14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions | 14 | ( ) |
| 15 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (h). Then go to Part III on the back | 15 | 6,000 |

**For Paperwork Reduction Act Notice, see your tax return instructions.** Cat. No. 11338H **Schedule D (Form 1040) 2011**

**Note.** Roberta's Form 1040, Form 4797, and Schedule D report her respective 40% pro-rata share of the amounts passed through to her from Creative Design Solutions on her Schedule K-1.

## LIMITATIONS ON DEDUCTIBILITY OF SHAREHOLDER LOSSES

There are rules that may limit the amount of Schedule K-1 loss that can be reported on the shareholder's individual tax return. These rules may impact each shareholder differently. There are various factors within each shareholder's particular tax circumstances that impact their tax result.

S corporation shareholders must be aware of three different limitations for claiming business losses each year. These limitations, **in the order in which they are applied,** are as follows.

1. The **shareholder and debt basis limitation** under IRC §1366(d)
2. The **at-risk rules** under IRC §465
3. The **passive activity loss rules** under IRC §469

### SHAREHOLDER AND DEBT BASIS LIMITATION

Basis determination is a dynamic process. The amount of losses that an S corporation shareholder can deduct is limited by the amount of investment the shareholder has in the S corporation. This investment is referred to as the shareholder's basis. The shareholder's basis is composed of the following two items.

- Share basis
- Debt basis[95]

Once initial basis is determined for each shareholder, it is adjusted each year for the various business activities to arrive at an updated yearend basis. This ensures that the correct basis amount is used as an overall limit to the amount of losses that each shareholder can claim. Losses over the applicable basis limit are disallowed for that year and are carried forward for possible use in subsequent years when sufficient additional basis exists. This allows part or all of a suspended loss to be claimed.

As an initial rule, a shareholder's current loss deduction is limited to their share basis plus their basis in any debt owed by the corporation to that shareholder.[96] Any excess loss that is not deductible is carried forward and can be claimed by the shareholder once the shareholder has sufficient basis. In order for debt to provide the shareholder with basis, the debt must be bona fide.[97]

Shareholders can make additional contributions of property or personal loans to the S corporation to increase basis. The shareholder's basis is increased by their basis in the property contributed or the amount of the personal loan.

The first step in this annual process is to determine the shareholder's initial basis and apply the appropriate adjustments accordingly. This section focuses first on the concept of share basis. A discussion of debt basis then follows.

#### Shareholder Basis

**Determining Initial Basis.** The shareholder's basis must be determined because losses are only deductible up to the amount of combined share and/or debt basis. Because a shareholder's interest can be obtained in various ways, the shareholder's corresponding basis may also need to be determined in various ways.

**Basis at Formation.** When a new S corporation is formed, the shareholder's initial basis is the total of the basis in property contributed to the corporation plus any gain recognized by the contributing shareholder, less the amount of boot received.

95. Treas. Reg. §1.1366-2(a)(1).

96. Treas. Reg. §1.1366-2(a).

97. See *M.S. Kerzner v. Comm'r,* TC Memo 2009-76, and *D.L. Russell et al. v. Comm'r*, TC Memo 2009-29. When purported shareholder loans to an S corporation did not entail any true economic outlay, the loans did not constitute bona fide debt and could not be used to increase basis.

**Example 23.** Natasha establishes her new business, Natasha's Electrical Service, Inc., in 2011. She elects S corporation tax treatment. Under IRC §351, she transfers into the business a vehicle and equipment in which she has a cost basis of $15,000. IRC §358(a) provides her with a transferred basis in her shares of $15,000. Accordingly, her starting basis is $15,000. Natasha has no further activity in 2011. Natasha's 2011 yearend basis is $15,000 less any applicable depreciation taken.

**Example 24.** Use the same facts as **Example 23.** In 2012, Natasha contributes $9,000 of cash. She establishes a home equity loan at her bank and borrows $11,000. She loans this amount to the business. Natasha has no further transactions in 2012 that affect basis. Her cash and loan contribution to the S corporation increase her existing 2011 basis of $15,000 by an additional $20,000. Natasha's total 2012 basis is $35,000 less any applicable depreciation taken. This $35,000 basis is composed of shareholder interest basis of $24,000 and loan basis of $11,000.

**Purchased Shareholder Interest.** The basis of a shareholder's interest in an S corporation is the price paid by the new shareholder for the ownership interest.

**Gifted Shareholder Interest.** A shareholder's interest received from a donor retains the donor's basis.[98] When the donor pays gift tax, the basis is increased by the amount of gift tax paid.[99] If the donor's basis exceeds the FMV of the gifted share interest, the donee's basis is equal to the FMV. Any suspended losses are lost.[100]

**Inherited Shareholder Interest.** When a shareholder dies, their share interest is included in their estate. Prior to 2010, the interest was valued by determining the FMV of the corporate assets minus any corporate liabilities.[101] This was then reduced by any minority or marketability discount. The discounted value is multiplied by the deceased shareholder's percentage ownership of the S corporation. This is called a stepped-up basis.

For deaths in 2010 (before legislation enacted on December 17, 2010), no federal estate tax was assessed. The share interest was included in the shareholder's estate. Modified carryover basis rules applied, in which the estate executor was allowed to step up the basis of the estate assets by up to $1.3 million. The executor decided which assets to step up. However, the new basis of an asset could not be greater than its FMV. If the beneficiary of the estate was the surviving spouse, the executor could apply the $1.3 million step up plus an additional $3 million, for a total of $4.3 million.[102]

In late 2010, Congress passed a new law that restored the federal estate tax and stepped-up basis for 2011 and 2012 and, by election, for 2010 on a retroactive basis.[103] The new law also established a $5 million federal estate exemption and a top estate tax rate of 35%.

## Ongoing Basis Adjustments

Because the S corporation is a pass-through entity, gains, income, and losses that occur each year affect the shareholder's basis in their shares. Additional contributions and distributions of capital affect basis.

The basis in the shareholder's interest is determined at yearend using the default pro-rata rules. It is calculated using the basis at the beginning of the year, plus or minus the shareholder's share of the S corporation's profits or losses, plus or minus any additional contributions or distributions. The yearend basis determines the amount of pass-through loss the shareholder can use on their individual return. However, deductible losses may still be limited by the at-risk and passive activity rules.

98. IRC §1015(a).

99. IRC §1015(d)(1)(A).

100. Treas. Reg. §1.1366-2(b)(2).

101. IRC §1014(a)(1).

102. IRC §1022.

103. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

If the interim closing method is elected, basis calculations are required at the point immediately preceding the transfer.[104]

Based upon the nature of business activity and transactions for the year, there are several possible items that may trigger basis adjustments each year. These adjustments must be made in a particular order.[105]

The following list outlines items that require adjustments and are presented in the specific order in which they are applied.[106] Each shareholder receives respective pro-rata adjustments to their own individual basis amounts for the following items.

**Tier 1.** **Increases** in basis:

- Separately stated income items, including tax-exempt income items
- Nonseparately stated income
- Depletion deductions (only in excess of basis in any depletion property)[107] (Exception: oil or gas property, see Tier 3.)

**Tier 2.** **Decreases** in basis:

- Distributions not includible in income under IRC §1368(a)[108] because of sufficient basis

**Tier 3.** **Decreases** in basis:

- S corporation expenses that are nondeductible for tax purposes and not properly chargeable to a capital account[109]
- Depletion deductions for any oil or gas property held by the S corporation (only in excess of basis in the property)

**Tier 4.** **Decreases** in basis:

- Separately stated loss or deduction items
- Nonseparately computed loss amount

---

104. Treas. Reg. §1.1367-1(d)(1).

105. See Treas. Reg. §1.1367-1; IRC §§1366 and 1367.

106. This list is based on Treas. Reg. §1.1367-1 and IRC §§1366, 1367, and 1368.

107. Only the amount of the shareholder's deduction in excess of their individual pro-rata basis in the property itself is used for basis adjustment purposes. The same rule applies with gas and oil property depletion deductions shown in Tier 3.

108. This includes distributions made to the shareholder that were not taxable because the shareholder had basis in their share interest in excess of the distribution.

109. Such items only include those in which no loss or deduction is allowed, not those items in which a deduction is deferred to a later year. Such items include bribes, kickbacks, fines and penalties, expenses, interest in connection with tax-free income, and the disallowed portion of meal and entertainment expenses.

**Example 25.** Jenna is the sole shareholder in an S corporation. Her basis at the beginning of 2012 is $10,000. Her 2012 Schedule K-1 shows a $30,000 loss, $20,000 of tax-exempt income, and $8,000 of nondeductible expenses. During 2012, she received a $20,000 cash distribution from the S corporation.

Jenna needs to know how much of the $30,000 loss she can claim on her 2012 personal tax return. In order to determine this, her basis calculation under Treas. Reg. §1.1367-1 is computed as follows.

| | |
|---|---|
| 2012 beginning basis | $10,000 |
| Tier 1 | |
| Tax-exempt income | 20,000 |
| Basis subtotal | $30,000 |
| Tier 2 | |
| Distributions | (20,000) |
| Basis subtotal | $10,000 |
| Tier 3 | |
| Nondeductible expenses | (8,000) |
| Basis subtotal | $ 2,000 |
| Tier 4 | |
| Application of nonseparately stated loss (lesser of nonseparately stated loss or basis after Tier 3) | (2,000) |
| Remaining basis | $ 0 |

Jenna's suspended deductible loss is calculated as follows:

| | |
|---|---|
| Nonseparately stated loss | $30,000 |
| Lesser of basis or loss | (2,000) |
| Suspended deductible loss | $28,000 |

After Tier 3 items are factored into Jenna's basis calculation, she is left with basis of only $2,000 against which her $30,000 loss is applied in Tier 4 of the calculations. She can therefore deduct $2,000 of her $30,000 loss on her 2012 personal return. The remaining $28,000 is a **suspended loss** that carries forward to 2013. If Jenna has sufficient basis in 2013, she can claim the suspended loss amount at that time. Otherwise, it continues to carry forward through subsequent tax years until she has adequate basis (either share basis or debt basis) to claim the loss.

**Note.** Jenna's share basis can never be negative.

## Special Election

In a situation in which there are substantial nondeductible expenses (Tier 3 of the calculations), a shareholder should consider making a Treas. Reg. §1.1367-1(g) election. Instead of using the order listed above, the special election allows the Tier 4 adjustments to precede the Tier 3 adjustments. The effect is to allow the nondeductible expenses to be applied last after the nonseparately computed loss amount.

When substantial nondeductible expenses exist, this election might provide the shareholder with the ability to claim a larger loss amount for the year.

**Note.** This election may be made on an original or amended return.

**Example 26.** Use the same facts as **Example 25,** except Jenna makes the Treas. Reg. §1.1367-1(g) election. Her basis calculation **with** the election is compared to the calculation **without** the election, as shown in **Example 25.** Jenna's suspended losses are calculated as follows.

| | |
|---|---|
| 2012 beginning basis | $10,000 |
| Tier 1 | |
| Tax-exempt income | 20,000 |
| Basis subtotal | $30,000 |
| Tier 2 | |
| Distribution | (20,000) |
| Basis subtotal | $10,000 |
| Tier 4 | |
| Application of nonseparately stated loss (lesser of nonseparately stated loss or basis after Tier 2) | (10,000) |
| Basis subtotal | $ 0 |
| Tier 3 | |
| Lesser of nondeductible expenses or remaining basis | (0) |
| Ending basis | $ 0 |

If Jenna makes the election, she has $10,000 in basis after completing the Tier 2 calculations. The election allows her to apply her Tier 4 loss at that point (instead of the Tier 3 nondeductible expenses that she would normally apply as the next step without the election). With the election, Jenna can claim $10,000 of the $30,000 loss (more than the $2,000 she could claim without the election). After claiming $10,000 of the loss under the election, the remaining $20,000 carries forward as a suspended loss. The $8,000 of nondeductible losses are also carried forward.

**Note.** This election is **irrevocable** without the consent of the IRS. After making the election, the rules under this election must continue to be used in future tax years.[110] Accordingly, this election should be made only under circumstances in which it appears that it will provide for greater loss deductions over the long term (not merely for the short term).

**Special Rule on Basis Reductions for §179 Deductions.** The shareholder must reduce the basis in their interest by their pro-rata share of allocated §179 deduction. This reduction must be made regardless of whether there was an immediate tax benefit from the deduction. The tax treatment of the unused amount of a §179 deduction varies depending on the reason the current year deduction was limited.

110. Treas. Reg. §1.1367-1(g).

## Debt Basis

In addition to share basis, the shareholder may also have debt basis. Debt basis reflects the portion of the shareholder's investment in the form of loans made to the S corporation. Debt basis does not include any bank or third-party debt.

Generally, only bona fide direct debt constituting an actual economic outlay by the shareholder provides debt basis to the shareholder.[111] Indirect debt (guarantees, sureties, or acting as a cosigner), does not provide debt basis.[112] However, if the shareholder is called upon to pay some or all of the debt[113] or issue a note[114] as guarantor, surety, or cosigner, the debt provides basis up to the amount of the debt paid. Debt basis becomes available in the year in which the payment, note, or other satisfaction of the guarantee or surety is made. It does not "relate back" to the year the guaranty or surety was created.[115]

> **Note.** Debt basis calculations are more critical when there is an increased likelihood of losses caused by claiming large expenses such as bonus depreciation.

It is not always clear what constitutes the requisite economic outlay to provide debt basis on a loan arrangement. This has been the subject of substantial litigation.

> **Observation.** The 11th Circuit has taken the view that a shareholder loan guarantee may be enough to provide debt basis if the S corporation is thinly capitalized and the shareholder is viewed as the primary party obligated on the loan.[116] However, this minority view has been rejected by the 4th Circuit[117] (which has adhered to the general rule requiring actual economic outlay) and by the 5th[118] and 10th[119] Circuits (on other grounds).
>
> The IRS proposed new regulations regarding debt basis. These were scheduled for public hearing on October 8, 2012.
>
> The Tax Court does not agree with the 11th Circuit's view that a guarantee can provide debt basis. However, it must follow this precedent in cases from the 11th Circuit (Alabama, Georgia, and Florida).

The IRS may disallow a loss claim by a shareholder relying on debt basis in instances that include the following.

- The shareholder makes no actual outlay of cash or assets.
- Loan arrangements are manipulated among related entities controlled by the shareholder.
- The economic outlay is made by a party related to the shareholder.

For a loss claim to survive IRS scrutiny, shareholder loans to the S corporation should be appropriately documented in order to establish the requisite economic outlay and corresponding debt basis used. Financial statements indicating the presence of a shareholder loan are not sufficient.[120] Promissory notes, book entries, or other forms of documentation may be sufficient.[121]

111. *D.L. Russell et al. v. Comm'r*, TC Memo 2008-46 (Oct. 30, 2008).
112. *William H. Perry v. Comm'r*, 47 TC 159 (1966), *aff'd* 392 F2d 458 (1968).
113. Rev. Rul. 70-50, 1970-1 CB 178.
114. Rev. Rul. 75-144, 1975-1 CB 277, amplifying Rev. Rul. 70-50, 1970-1 CB 178.
115. Rev. Rul. 71-288, 1971-2 CB 319, clarifying Rev. Rul. 70-50.
116. *E.M. Selfe v. U.S.*, 778 F.2d 769 (11th Cir. 1985).
117. *Est. of D. Leavitt v. Comm'r*, 90 TC 206 (Feb. 10, 1988), *aff'd* 875 F.2d 420 (4th Cir. 1989), *cert. denied*, 493 U.S. 958.
118. *J.H. Harris v. Comm'r*, 902 F.2d 439 (5th Cir. 1990).
119. *L.R. Uri, Jr. v. Comm'r*, 949 F.2d 371 (10th Cir. 1991).
120. *C.E. Jones v. Comm'r*, TC Memo 1997-400 (Sep. 10, 1997), *aff'd per curiam* 177 F.3d 983 (Mar. 17, 1999), *D.E. Bolding v. Comm'r,* TC Memo 1995-326 (Jul. 20, 1995), *aff'd* 117 F.3d 270 (5th Cir. 1997).
121. *D.E. Bolding v. Comm'r,* TC Memo 1995-326 (Jul. 20, 1995), *aff'd* 117 F.3d 270 (5th Cir. 1997).

Moreover, some court decisions have held that the shareholder creates debt basis if another entity related to the shareholder transfers funds to the shareholder's S corporation.[122] These transactions have been characterized as a 2-step process.

1. An initial loan from the related entity to the shareholder
2. A subsequent loan from the shareholder to the S corporation

This arrangement results in an increase in debt basis only if the transaction creates a bona fide debtor-creditor relationship between the S corporation and the shareholder.[123]

> **Note.** The IRS released a proposed regulation (REG-134042-07) on June 12, 2012 to clarify the above issues relating to debt basis given the significant amount of uncertainty and litigation involving these issues. The proposed regulation was open for comment until September 12, 2012 and public hearing on the regulation was scheduled for October 8, 2012.

### Adjustment Rules for Share and Debt Basis

The following rules apply to the interaction between share and debt basis and the annual adjustment of debt basis at the end of the tax year.

**Reduction Rules.** Share basis is reduced first. It cannot be reduced below zero. Once share basis is reduced to zero, any further downward adjustments are applied against available debt basis.[124]

Debt basis is reduced in the same manner by the same items that reduce share basis **except** for distributions.[125] Distributions do not reduce debt basis.

If there is more than one debt owed to the shareholder, the basis of each debt is reduced by an amount in proportion to the shareholder's basis in each of the debts.

**Example 27.** Lisa has share basis of $12,000 at the beginning of 2012. She also loaned the corporation $10,000 in 2012, which gave her a combined share and debt basis of $22,000. In 2012, her portion of the corporate loss is $18,000. Because this is less than her combined basis, she can deduct the entire $18,000 loss. Her share 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, 2012 share basis | $12,000 |
| 2012 loan | 10,000 |
| Combined share and debt basis | $22,000 |
| 2012 loss | ($18,000) |
| Share basis | 12,000 |
| Remaining loss | ($ 6,000) |
| Debt basis | 10,000 |
| Remaining debt basis | $ 4,000 |

122. *Yates v. Comm'r,* TC Memo 2001-280 (Oct. 11, 2001); *Culnen v. Comm'r,* TC Memo 2000-139 (Apr. 13, 2000).

123. Ibid.

124. IRC §1367(b)(2)(A).

125. IRC §§1367(a)(2)(B)–(E) and Treas. Reg. §1.1367-2(b)(1).

**Example 28.** Mariana is sole shareholder of Entertainment Ticket Sales, Inc., an S corporation. In 2009, she loaned the corporation $20,000. In 2009, Mariana had share basis of $7,000. The 2009 operating loss is $12,000. The loss was applied against Mariana's existing share and debt basis as follows.

| | 2009 Loss | Share Basis Adjustment | Debt Basis Adjustment |
|---|---|---|---|
| Amount of 2009 loss | $12,000 | | |
| Share basis, beginning of 2009 | | $7,000 | |
| Amount of loss applied against share basis | (7,000) | (7,000) | |
| Remaining loss and share basis | $ 5,000 | $ 0 | |
| Debt basis | | | $20,000 |
| Remaining loss applied against debt basis | (5,000) | | (5,000) |
| Remaining loss and debt basis | $ 0 | | $15,000 |

In 2010, Mariana loaned the corporation an additional $10,000. The corporation had a 2010 operating loss of $8,000. Mariana's basis adjustments to the two debts are as follows.

| | 2009 Loan | | 2010 Loan | | Total | |
|---|---|---|---|---|---|---|
| 2010 beginning basis | | $15,000 | | $10,000 | | $25,000 |
| 2010 loss | $8,000 | | $8,000 | | $8,000 | |
| Percent of total debt basis | × 60% | | × 40% | | × 100% | |
| Loss apportioned | $4,800 | (4,800) | $3,200 | (3,200) | $8,000 | (8,000) |
| Basis after 2010 loss | | $10,200 | | $ 6,800 | | $17,000 |

**Example 29.** 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, 2011.
- At the end of 2011, the basis of loan #1 was $0.
- At the end of 2011, the basis of loan #2 was $1,000.
- The shareholder loaned the corporation $4,000 on January 1, 2012.
- The corporation lost $4,000 in 2012.

At the beginning of 2012, the debt basis is:

| Debt | Principal | January 2012 Basis |
|---|---|---|
| January 1, 2000 (Debt #1) | $ 1,000 | $ 0 |
| December 31, 2011 (Debt #2) | 5,000 | 1,000 |
| January 1, 2012 (Debt #3) | 4,000 | 4,000 |
| | $10,000 | $5,000 |

At the end of 2012, the debt basis reduction is computed as follows:

$$\text{Debt reduction} = \frac{\text{Debt basis}}{\text{Basis of all beginning of year debt}} \times \text{Net loss}$$

$$\begin{aligned}\text{Debt \#1 reduction} &= \frac{\$0}{\$0 + \$1{,}000 + \$4{,}000} \times \$4{,}000 \\ &= \frac{\$0}{\$5{,}000} \times \$4{,}000 \\ &= \$0 \times \$4{,}000 \\ &= \$0\end{aligned}$$

$$\begin{aligned}\text{Debt \#2 reduction} &= \frac{\$1{,}000}{\$0 + \$1{,}000 + \$4{,}000} \times \$4{,}000 \\ &= \frac{\$1{,}000}{\$5{,}000} \times \$4{,}000 \\ &= 0.2 \times \$4{,}000 \\ &= \$800\end{aligned}$$

$$\begin{aligned}\text{Debt \#3 reduction} &= \frac{\$4{,}000}{\$0 + \$1{,}000 + \$4{,}000} \times \$4{,}000 \\ &= \frac{\$4{,}000}{\$5{,}000} \times \$4{,}000 \\ &= 0.8 \times \$4{,}000 \\ &= \$3{,}200\end{aligned}$$

| Debt | Principal | January 1, 2012 Basis | December 31, 2012 Reduction | January 1, 2013 Basis |
|---|---|---|---|---|
| January 1, 2000 (Debt #1) | $ 1,000 | $ 0 | $ 0 | $ 0 |
| December 31, 2011 (Debt #2) | 5,000 | 1,000 | 800 | 200 |
| January 1, 2012 (Debt #3) | 4,000 | 4,000 | 3,200 | 800 |
| | $10,000 | $5,000 | $4,000 | $1,000 |

**Restoration Rules.** Restoration applies first to loans repaid during the year to prevent the shareholder from recognizing gain.[126] If multiple debts exist, remaining income amounts are then applied to each debt in proportion to the amount that each debt was reduced in prior years relative to the total amount of overall reduction for all the debts.[127]

Income items in subsequent tax years are first used to restore debt basis up to the original debt basis amount that existed at the beginning of the tax year in which the income occurs.[128]

126. Treas. Reg. §1.1367-2(c)(2).

127. Ibid.

128. IRC §1016(a).

After debt basis is fully restored, further income is applied to restore share basis.[129]

**Example 30.** Use the same facts as **Example 28.** For 2011, Mariana's S corporation has operating net income of $12,000. The 2009 and 2010 loans still exist. The operating income provides Mariana with basis. Her debt basis is restored before any share basis. The basis in the two debts is restored in proportion to the total prior reductions. The computations are as follows.

| | 2009 Loan | 2010 Loan | Total |
|---|---|---|---|
| Original amount | $20,000 | $10,000 | $30,000 |
| 2009 reductions to basis | $ 5,000 | | $ 5,000 |
| 2010 reductions to basis | 4,800 | 3,200 | 8,000 |
| Pre-2011 reductions to basis | $ 9,800 | $ 3,200 | $13,000 |
| Divided by total pre-2011 reductions to basis | ÷ 13,000 | ÷ 13,000 | ÷ 13,000 |
| Percent of total reductions applied to each debt | 75.385% | 24.615% | 100% |
| Amount of 2011 basis (income) to allocate | × $12,000 | × $12,000 | × $12,000 |
| Amount of 2011 basis applied to each debt | $ 9,046 | $ 2,954 | $12,000 |
| Basis after 2010 loss | 10,200 | 6,800 | 17,000 |
| Basis after 2011 income | $19,246 | $ 9,754 | $29,000 |

**Open-Account Indebtedness.** Although debt typically represents a formal loan agreement, open-account indebtedness represents numerous advances and repayments between a shareholder and the S corporation throughout the year that are not formally documented. When the advances to the S corporation and repayments from the S corporation are netted for the year, the net amount may be either a net advance or a net repayment.

A shareholder may realize that there will be inadequate basis at yearend to allow the deduction of a pass-through loss. Therefore, the shareholder may consider advancing additional funds to the corporation before yearend to create the needed basis. Shareholders have used open account indebtedness to deduct losses in this manner.

In the *Brooks* case,[130] the IRS challenged a taxpayer that used this strategy. The facts of the case are summarized as follows.

| | Loss | Advance | Payment | Loan Balance |
|---|---|---|---|---|
| 1997 loan 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 loan money to the S corporation to create sufficient debt basis to permit the deduction of $1.1 million of losses. 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.

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129. IRC §1367(b)(2)(B).

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

In October 2008, the IRS issued **new regulations** on the use of open-account debt. If the amount of open-account debt at the S corporation's yearend exceeds $25,000, the open-account debt is treated as a formal loan to which the normal rules, including those for multiple debts, apply. Open account debt amounts of $25,000 or less carry forward to the following year and retain their character as open-account indebtedness.[131]

### Loss Carryover Rule

If the amount of the S corporation shareholder's loss deduction is limited for a particular tax year because of insufficient share or debt basis, the amount of the loss in excess of available basis is carried forward until used by the shareholder.[132] However, if the shareholder transfers shares, this deferred deduction is lost.[133] An exception exists for transfers to a spouse incident to a divorce.[134] The transferee spouse still needs to meet all basis rules in order to claim the losses, including the at-risk and passive activity loss rules.[135]

## AT-RISK RULES

The at-risk rules are a potential limitation on each shareholder's ability to deduct a pass-through loss from the S corporation even when the losses are not limited by the general basis rules.

The at-risk rules cover any trade or business or income-producing activity. Under the at-risk rules, an S corporation shareholder can only claim a loss up to the amount at risk. The shareholder is at risk for the following.

- The amount of money plus the adjusted basis of property contributed to the S corporation
- The amounts the shareholder borrowed for use in the S corporation business activity as long as the shareholder is either:
  - Personally liable for repayment, or
  - The shareholder pledged property as security for the debt.

**Example 31.** In 2012, Larry buys Lights Out Corporation for $100,000. He purchases 50% of the shares with his own funds. He purchases the remaining 50% by pledging the shares to the bank for a loan of $50,000. Larry's basis in Lights Out Corporation is $100,000, of which only the $50,000 of his own funds is at risk.

The appropriate time to calculate at-risk basis is at the end of the tax year for the S corporation.[136] In applying the at-risk rules, ". . . **substance will prevail over form.** Regardless of the form a transaction may take, the taxpayer's amount at risk will not be increased if the transaction is inconsistent with normal offset commercial practices or is, in essence, a device to avoid section 465."[137]

### Annual At-Risk Adjustment

Each shareholder's at-risk amount is adjusted annually. It is increased by various items contributed to the business such as additional money, the basis of property, and qualified debt. It is reduced by losses allowed in prior years under the at-risk rules and by the amount of distributions made by the S corporation. The at-risk amount is reduced if previously qualifying debt subsequently becomes unqualified. This could occur if someone else guarantees the debt or if the debt becomes nonrecourse. Conversely, when debt that previously did not qualify as basis becomes qualified, the debt increases basis.

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131. Treas. Regs. §§1.1367-2 and 1.1367-3.
132. IRC §§1366(a)(1)(A) and (B).
133. Ltr. Rul. 9552001 (Aug. 31, 1995).
134. IRC §1366(d)(2).
135. IRC §469.
136. Prop. Treas. Reg. §1.465-1.
137. Ibid.

### At-Risk Recapture

If a shareholder's at-risk amount is negative for the tax year, a portion of the losses previously allowed must be recaptured. This is accomplished by increasing the year's income from the S corporation by the lesser of:

- The amount of negative at-risk amount (expressed as a positive income amount), or
- The total amount of losses deducted in previous tax years minus any amounts previously added to income under this recapture rule.

The recapture amount that must be recognized in the tax year is not used to offset a net loss that exists from the activity for that year. However, the recaptured amount can be deducted from the income from that activity in the following year.[138]

### At-Risk Aggregation Rules

When one business entity engages in more than one type of business activity, special rules determine which activities must be looked at separately and when they can be aggregated.

IRC §465(c)(2)(A) provides a general rule that film-related activities, the leasing of IRC §1245 property, farming, oil and gas property, and geothermal property must be treated separately. Therefore, the at-risk rules apply separately to each film, each item of leased property, and each individual farming activity. However, the following exceptions to this general rule apply to S corporations.

- All activity involving the leasing of IRC §1245 property must be aggregated into one single activity.[139]
- All at-risk activities constituting a trade or business can be aggregated into one activity if the taxpayer **actively participates** in the management of the business or at least 65% of the losses for the tax year are allocable to persons who actively participate in the management of the business.[140]

**Active participation** is defined differently than "material participation" for the passive activity loss rules. Indicators of active participation exist when the shareholder makes operational or management decisions for the business, performs services for the business, or makes staff hiring and termination decisions for the business. Conversely, a lack of control or management, authority to discharge only a top manager, or using independent contractors rather than employees denotes a lack of active participation.[141]

### At-Risk Filing Requirement

An S corporation shareholder is required to file Form 6198, *At-Risk Limitations,* when an amount that is not at risk is invested in a trade or business activity. This form is used to show the annual adjustments each year to at-risk basis and to disclose such adjustments to the IRS.

## PASSIVE ACTIVITY LOSS RULES

The third hurdle for an S corporation shareholder to overcome in order to deduct a loss from corporate activity is presented by the **passive activity loss (PAL)** rules. As with the general basis rules and the at-risk rules, the shareholder's ability to deduct a loss may be limited by the PAL rules.[142]

As an initial rule, when the shareholder **does not materially participate** in the S corporation's business,[143] or if the S corporation is in the business of real estate rental,[144] the PAL rules apply.

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138. IRC §465(e)(1)(B).
139. IRC §§465(c)(2)(B) and (c)(2)(B)(i).
140. IRC §465(c)(3)(B).
141. This guidance comes from the 1976 Committee Report drafted when IRC §465 was enacted.
142. IRC §469(a)(1).
143. IRC §469(c)(1)(B).
144. IRC §469(c)(1)(A).

Material participation is generally defined as regular, continuous, and substantial involvement in the operations of the business activity by the shareholder.[145] However, the shareholder is considered to materially participate if **any** of the following apply during the year.[146]

- The shareholder participates in the activity for **more than 500 hours.**
- The shareholder's participation in the activity constitutes **substantially all of the participation in the activity** by all individuals (including nonshareholders).
- The shareholder participates in the activity for **more than 100 hours** and no other individual participates in the activity more than the shareholder.
- The activity is a significant participation activity and the shareholder's aggregate participation in all significant participation activities **exceeds 500 hours.**
- The shareholder materially participated in the activity for any five of the preceding 10 tax years (not necessarily consecutive).
- The activity is a **personal service activity**[147] and the shareholder materially participated in any three preceding taxable years (regardless of whether they are consecutive).
- Based on the facts and circumstances, the shareholder **participates on a regular, continuous, and substantial basis.**

When the shareholder does not materially participate in the business activity, the resulting business loss from that activity is categorized as a PAL. The shareholder cannot deduct the PAL against other active income. Instead, the PAL carries forward to subsequent years indefinitely until it can be used against passive activity income. Unused losses can be used when the shareholder sells their interest in the passive income activity.

**Caution.** In connection with a shareholder's **state tax** situation, it should be noted that a passive loss arising from activity in one state may not be useful in providing a current year or future year deduction against passive income sourced from another state.

The general rule classifying real estate rental as passive is accompanied by two ancillary rules relating to real estate. First, real estate is not classified as passive income when the S corporation shareholder is a **real estate professional.**[148] Second, even when the real estate rental is considered passive, the taxpayer may be allowed to **deduct up to $25,000** of rental losses against other active income.[149] However, this amount is reduced if the taxpayer's MAGI exceeds $100,000. Different rules apply to taxpayers filing MFS.[150] Unused rental losses carry forward to future years.

145. IRC §469(h)(1).
146. Temp. Treas. Reg. §1-469-5T(a).
147. Defined by Temp. Treas. Reg. §1.469-5T(d).
148. IRC §469(c)(7).
149. IRC §469(i).
150. IRC §469(i)(5).

## SHARE BASIS AND S CORPORATION DISTRIBUTIONS

For an S corporation that has never previously been a C corporation, distributions are tax free to the shareholder up to that shareholder's share basis.[151] Distributions in excess of share basis are treated as capital gain.[152] A C corporation that made an S election may have accumulated earnings and profits from the time it was a C corporation. If so, some or all of a distribution received by a shareholder may be taxable as a dividend.

> **Note.** The determination of how an S corporation distribution is taxed requires accounting involving special accounts. These accounts include an AAA and other related accounts that are adjusted at the end of each year along with the shareholder's share basis. The applicable rules are found at IRC §1368 and underlying regulations.

## CHANGE OF S CORPORATION OWNERSHIP INTERESTS

### GENERAL TAX RULES

Gain or loss is recognized on the sale of S corporation shares just as with other investments. Realized gain is the excess of the proceeds received over the shareholder's basis. If there is a loss, the realized loss is the amount of basis in excess of the proceeds received. Consequently, proper determination of the selling shareholder's basis is critical in determining the amount of realized gain or loss.

The sale of S corporation shares during the tax year requires a basis calculation as of the date of sale if an interim closing election was made. Otherwise, basis is calculated using the pro-rata method at the end of the year.

To preserve the S election, care must be taken to ensure that shares are transferred to an eligible shareholder. The types of persons and entities that are permitted to hold shares in an S corporation were discussed previously.

#### Special Election on Sale of S Corporation Shares

A buyer of an ownership interest in an S corporation may wish to purchase **assets** instead of shares. With an asset purchase, the purchase price paid by the buyer is reflected in the cost of the assets, which can result in substantial additional depreciation deductions. This is not the case with a purchase of shares, which only provides the buyer with a cost basis in the shares purchased.

When a buyer seeks to purchase the interests of one or more shareholders, a special tax election is allowable under IRC §338(h)(10) that **treats the share purchase as an asset purchase.** The election is made jointly by the buyer and the shareholders. All the S corporation shareholders must agree to the election for it to become effective.

151. IRC §1368(b)(1).

152. IRC §1368(b)(2).

**Example 32.** Natalie is the sole shareholder of Natalie's Bakeshop, Inc. Following are the relevant details.

| | |
|---|---|
| S corporation basis in assets | $30,000 |
| S corporation liabilities | 4,000 |
| Natalie's share basis | 10,000 |
| FMV of Natalie's shares | 60,000 |
| Natalie's marginal tax rate | 35% |
| Natalie's capital gains tax rate | 15% |

The bakeshop was never previously taxed as a C corporation and therefore is not subject to any built-in gains (BIG) tax. In addition, no depreciation was taken on the $30,000 of assets in the S corporation. All gain on the assets is taxed as §1231 gain.

Consolidated Bakery Products, Inc., a C corporation, offers Natalie $60,000 for her shares. With this straight sale of shares, Natalie recognizes gain of $50,000 ($60,000 sale price less her $10,000 basis). She pays capital gains tax of $7,500 ($50,000 × 15%). Natalie is left with $52,500 ($60,000 − $7,500) after taxes. Consolidated Bakery Products receives a $60,000 basis in the shares that it purchases. The $30,000 of basis in the corporate assets is retained.

**Example 33.** Use the same facts as **Example 32,** except Consolidated Bakery Products, Inc., and Natalie jointly agree to a §338(h)(10) election. With the election, the straight sale of shares is treated as an asset sale. Following are the relevant details.

1. The $60,000 paid by Consolidated Bakery Products to Natalie for her shares is deemed paid to "old Natalie's Bakeshop" in exchange for its assets and assumption of its liabilities. The $4,000 liability in old Natalie's Bakeshop is assumed by Consolidated Bakery Products. This $4,000 is added to the purchase price to arrive at a modified aggregate deemed sale price (MADSP) of $64,000. The $30,000 asset basis in old Natalie's Bakeshop is deducted from the $64,000 MADSP, leaving a §1231 gain of $34,000.

2. The $34,000 gain is passed through to Natalie. She pays capital gains tax of $5,100 ($34,000 × 15%). She increases her original $10,000 share basis by the $34,000 recognized gain. Her total share basis becomes $44,000.

3. Old Natalie's Bakeshop is subsequently treated as undergoing a liquidating distribution, with the $60,000 of cash proceeds paid by Consolidated Bakery Products distributed to Natalie. Natalie deducts her $44,000 share basis in shares against the $60,000 liquidating distribution to arrive at recognized gain of $16,000. She pays 15% capital gains tax on this recognized gain, which equals $2,400 ($16,000 × 15%).

4. Consolidated Bakery Products is treated as having formed a "new Natalie's Bakeries, Inc.," which begins a new tax life just as if it were a new corporation with assets purchased by Consolidated Bakery Products. Consolidated Bakery Products has a $64,000 basis in the assets and it can use this stepped-up basis for future depreciation purposes instead of the original $30,000 asset basis that the "old" corporation had.

The following table compares Natalie's tax liability with the straight sale of shares as shown in **Example 32** to selling her interest with a §338(h)(10) election.

| | Straight Sale of Shares (Example 32) | | Sale with §338(h)(10) Election (Example 33) | |
|---|---|---|---|---|
| Recognized gain from sale of shares | | $50,000 | | |
| Recognized gain on deemed asset sale | | 0 | | $34,000 |
| Recognized gain on deemed liquidating distribution | | 0 | | 16,000 |
| Total recognized gain | | $50,000 | | $50,000 |
| Tax on sale of shares | $7,500 | | | |
| Tax on gain from deemed asset sale | 0 | | $5,100 | |
| Tax on gain from liquidating distribution | 0 | | 2,400 | |
| Total capital gains tax paid | $7,500 | (7,500) | $7,500 | (7,500) |
| Total recognized gain less taxes paid | | $42,500 | | $42,500 |

A §338(h)(10) election is favorable for the buyer. For the seller, Natalie, it is neutral because her tax picture is the same under either scenario. Typically, there are items within the seller's tax situation that cause additional tax liability to the seller under a §338(h)(10) election.

**Caution.** A sale of a group of assets that comprise a going concern may be governed by IRC §1060. This requires the use of a special method to allocate the purchase price across the assets and filing IRS Form 8594, *Asset Acquisition Statement Under Section 1060*. A §338(h)(10) election may trigger §1245 recapture for the seller.

**Example 34.** Use the same facts as **Example 32,** except the $30,000 asset basis in Natalie's Bakeshop, Inc., is reduced by $10,000 of depreciation. The net adjusted asset basis is $20,000. After properly allocating the purchase price across the S corporation assets, the accumulated depreciation subject to recapture at ordinary income tax rates is $4,000. Further, the parties agree to a §338(h)(10) election.

The following details apply:

1. The $60,000 paid by Consolidated Bakery Products, Inc., to Natalie for her units is deemed paid to "old Natalie's Bakeshop" in exchange for its assets and assumption of its liabilities. The $4,000 liability in old Natalie's Bakeshop is assumed by Consolidated Bakery Products. The $4,000 is added to the purchase price to arrive at a $64,000 MADSP. The $20,000 asset basis in old Natalie's Bakeshop is deducted from the $64,000 MADSP, leaving a $44,000 §1231 gain.

2. The $44,000 §1231 gain is reduced by $4,000 of accumulated depreciation subject to recapture. This results in $40,000 of §1231 gain.

3. The $4,000 of accumulated depreciation passes through to Natalie and is taxed as ordinary income. Natalie's tax on this ordinary income is $1,400 ($4,000 × 35%). Natalie's $10,000 original share basis is increased by $4,000 of ordinary income, resulting in a $14,000 share basis.

4. The $40,000 §1231 gain also passes to Natalie. Her tax on this gain is $6,000 ($40,000 × 15%). Natalie increases her $14,000 basis by $40,000 of gain, resulting in a basis of $54,000.

5. The "old Natalie's Bakeshop, Inc." entity subsequently undergoes a deemed liquidation. Natalie receives a liquidating distribution of $60,000 which is composed of the proceeds paid by Consolidated Bakery Products. Natalie can deduct her $54,000 basis against the $60,000 liquidating distribution. Natalie has $6,000 of taxable capital gain resulting in tax liability of $900 ($6,000 × 15%).

6. Consolidated Bakery Products is treated as having formed a "new Natalie's Bakeries, Inc." which begins a new tax life just as if it were a new corporation with assets purchased by Consolidated Bakery Products. Consolidated Bakery Products has a $64,000 basis in the assets and can use this stepped-up basis for future depreciation purposes.

Natalie's total tax is summarized as follows.

| | |
|---|---|
| Tax paid on $4,000 depreciation recapture | $1,400 |
| Tax paid on §1231 gain of $40,000 | 6,000 |
| Tax paid on $60,000 liquidating distribution | 900 |
| Total tax paid | $8,300 |
| Less: tax paid on straight sale of shares | (7,500) |
| Additional tax liability to Natalie from §338(h)(10) election | $ 800 |

Natalie pays an additional $800 of tax if she agrees to a §338(h)(10) election. The additional $800 in tax represents the difference between ordinary income and capital gains tax rates (15% and 35% respectively) on the $4,000 of accumulated depreciation recapture.

In **Example 34,** the buyer is strongly motivated to enter into a §338(h)(10) tax election in order to obtain a much higher basis in assets. However, the seller has **additional tax liability** if the election is made. The buyer assesses the present value of the additional tax savings that the election brings. Once any added tax savings are quantified, the buyer can decide if it is worthwhile to compensate the seller for any additional tax liability that the seller may encounter.

Additional compensation from the buyer to the seller can make the transaction beneficial to both parties. Shareholders that initially do not agree to the election may also require adequate compensation in exchange for their agreement. The buyer and all shareholders must jointly agree to the election or the election is not valid.

> **Note.** In addition to depreciation recapture, BIG tax and state tax rules can trigger additional tax liability for a seller with a §338(h)(10) election. State tax and nontax factors should be considered by the parties as well. Responsibility for disclosed and undisclosed liabilities of the seller's business and the disposition of assets unwanted by the buyer or both parties are additional concerns requiring attention.

## TAXATION OF S CORPORATIONS THAT WERE PREVIOUSLY C CORPORATIONS

Because the S corporation is a pass-through entity, it typically does not have tax liability. However, there are narrow circumstances under which the S corporation (which was formerly a C corporation) has corporate-level tax liability.

### EXCESS PASSIVE INVESTMENT INCOME

Tax on excess passive investment income can only occur if a C corporation makes an S corporation election and has accumulated earnings and profits. S corporations do not generate earnings and profits because they pass all income through to individual shareholders each year.

When earnings and profits exist from the past and the S corporation has passive investment income in excess of 25% of its gross receipts for the year, tax is triggered on the "excess net passive income."

**Passive investment income (PII)** is defined in IRC §1362(d) and includes interest, dividends, annuities, rents, royalties, and other forms of income not received from typical active business activity. **Net passive income (NPI)** is the amount of passive investment income minus allowable deductions that are directly connected with the production of this income (with the exception of deductions for any net operating losses or special corporate deductions from IRC §§241–248).

**Excess net passive investment income (ENPI)** is calculated using the following formula.[153]

$$\text{ENPI} = \text{NPI} \times \frac{\text{PII} - 25\% \text{ of gross receipts}}{\text{PII}}$$

The tax is calculated using the maximum corporate tax rate.[154] A waiver is available[155] but only if earnings and profits were miscalculated.

## BUILT-IN GAINS (BIG)

Similar to the excess passive investment income tax, the BIG tax also applies to situations in which a C corporation makes an S corporation election.

Unlike a C corporation that creates double taxation when it sells appreciated assets and distributes the sale proceeds to shareholders, the S corporation only has one level of tax. The tax is at the shareholder level. Consequently, before enactment of the BIG tax, corporations that wanted to dispose of assets could make an S election and save a substantial amount of tax. The BIG tax is assessed if assets are sold by the S corporation during the "recognition period,"[156] which is the 10-year period from the date the S election became effective.

> **Note.** The American Recovery and Reinvestment Act of 2009 changed the 10-year recognition period to seven years. However, this only applied to gains recognized in 2009 or 2010. The Small Business Jobs Act of 2010 went a step further. It reduced the holding period to five years if the sale of assets occurred in 2011. For 2012 and later years, the recognition period reverts to 10 years.

At the time the election becomes effective, an asset-by-asset determination of unrealized gain or loss amounts is calculated to arrive at total BIG and built-in losses (BIL). These calculations are based on the C corporation's cost basis in the assets and the FMVs at the time of the S election. To avoid BIG tax, inventory and receivables may be sold before the S election is made.

The BIG tax also encompasses inventory and receivables that the C corporation had at the time of the S election. Immediately after the S election, as the business receives income, that income is presumed to arise from the inventory and receivables. Accordingly, BIG tax is assessed on this income unless the business can establish to the satisfaction of the IRS that the income in fact did not arise from old C corporation receivables or inventory.

Therefore, within the recognition period, both income and asset sales can trigger BIG tax.

The applicable rate of tax is the maximum corporate tax rate. Consequently, without careful tax planning, the amount of tax can be rather substantial. Substantial potential BIG tax liability may make it prudent to obtain a formal, detailed asset appraisal at the time of the S election. Once the total BIL is subtracted from the total BIG, the net amount of unrealized built-in gain represents the overall maximum amount of unrealized gain that can be taxed. Future accrued gains that take place after the S election becomes effective are not subject to this tax. These post–S election gains are passed through to the shareholders.

> **Caution.** Among the states that recognize subchapter S pass-through tax treatment, there is a split of authority on whether the S corporation is taxed on BIG items. When a conversion from C to S tax treatment is being considered, it is prudent to confirm how any applicable state tax authority stands on matters involving the BIG tax.

153. IRC §1375(b)(1)(A).

154. IRC §1375(a).

155. IRC §1375(d).

156. IRC §1374(d)(7); Treas. Reg. §1.1374-1(d).

### RECAPTURE OF LIFO BENEFITS

While receivables and inventory can pose significant tax issues with the BIG tax, inventory can continue to be an issue when a C corporation used the last in, first out (LIFO) method of accounting for its inventory for the final year prior to making an S election.

Originally, the IRS ruled that, under the BIG tax, the inventory method that the taxpayer used for income tax purposes would be the method used in determining whether the inventory sold after an S conversion existed at the time of the S election.[157] Therefore, as long as the S corporation did not invade LIFO layers during the 10-year recognition period, it would not be taxed on the BIG attributable to its LIFO inventory. Congress became concerned that taxpayers using the LIFO method could avoid the BIG tax and believed that first in, first out (FIFO) and LIFO method taxpayers should be placed on more equal footing. This led to the creation of the LIFO recapture rule.[158]

The LIFO recapture amount is defined as the excess in inventory value using the FIFO method over that inventory's LIFO value. Once calculated, this amount is included in gross income of the C corporation in its last year prior to its S election.[159]

**Note.** Further details on LIFO recapture and its calculation may be found in Treas. Reg. §1.1363-2.

**Caution.** Excessive passive income tax, BIG tax, and LIFO recapture tax liabilities all arise from preexisting subchapter C tax treatment and a subsequent election under subchapter S. Accordingly, all three of these special "conversion taxes" should be taken into account in instances in which conversion from subchapter C to S tax treatment is being considered.

## STATE TAX TREATMENT OF S CORPORATIONS

An important consideration with the use of S corporations is the state-level treatment of such entities. Most states recognize for state tax purposes a federal S corporation election, but some do not. Other important considerations at the state level include how state law treats the S corporation for withholding tax purposes and whether a composite return is allowed.[160]

157. IRS Ann. 86-128, 1986-51 IRB 22.

158. IRC §1363(d)(1).

159. Ibid.

160. For further information regarding the state taxation of S corporations, see *Multistate Tax Considerations for S Corporations,* Lafond, Andrew, and Schrader, Jeffrey. *Journal of Accountancy* [wwww.journalofaccountancy.com/Issues/2011/Feb/20103307.htm] Accessed on Aug. 27, 2012.

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