Chapter 4: S Corporation Entity Issues

Please note. Corrections were made to this workbook through January of 2017. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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S CORPORATION BASICS

The designation as an S corporation reflects an election for tax purposes and does not indicate the legal form of the business. Partnerships, limited liability companies (LLCs), and corporations may elect to be taxed under the Code provisions pertaining to S corporations if all the pertinent requirements are met.

For tax purposes, S corporations are entities that elect to pass income, losses, deductions, and credits through to their shareholders. S corporation shareholders report the flow-through income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations may, however, be responsible for tax on certain built-in gains and passive income at the entity level.[1]

To qualify for S status, the entity must meet the following requirements.[2]

1. Be a domestic corporation, or a partnership or an LLC that elects to be taxed as a corporation[3]
2. Have only **allowable shareholders — individuals, certain trusts, and estates** (Ineligible shareholders include partnerships, corporations, and nonresident aliens.)
3. Have no more than 100 shareholders
4. Have only one class of stock
5. Not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations)

1. *S Corporations.* Jun. 15, 2016. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporations] Accessed on Jun. 22, 2016.
2. IRC §1361(b).
3. See Treas. Reg. §§1.1361-1(c) and 301.7701-3.

For tax purposes, any person who must report the pass-through income of the S corporation is referred to as a shareholder even though the person may technically be an LLC member, beneficiary, or deemed owner.[4]

THE 100 SHAREHOLDER LIMIT[5]

Although the Code specifies that an entity with more than 100 shareholders is not eligible to be taxed as an S corporation,[6] it also defines "one" shareholder very broadly. **All members of a family are treated as one shareholder.** In addition, **family** is defined more generously for this purpose than perhaps anywhere else in the Code.

The term **members of a family** means:

- A common ancestor,
- Any lineal descendant of the common ancestor, and
- Any spouse or former spouse of the common ancestor or of any lineal descendant.

The family that is considered one shareholder includes everyone with a common ancestor who is **not more than six generations** removed from the **youngest** generation of shareholders as of the latest of the following dates.

1. The effective date of the S election
2. The earliest date that a family member became a shareholder in the S corporation
3. October 22, 2004 (the enactment date of the American Jobs Creation Act of 2004)

The 6-generation test is only applied as of the applicable date. Lineal descendants (and spouses) more than six generations removed from the common ancestor are treated as family members if they acquire stock in the corporation after the applicable date.[7]

For the purpose of defining the six generations, a spouse (or former spouse) is treated as being of the same generation as the individual to whom the spouse is (or was) married. Moreover, the estate or trust of a family shareholder may also be considered a family member in connection with the application of these rules.

Any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by the individual, and any eligible foster child of an individual is treated as a child of that individual by blood.

4. IRC §1361(c)(2)(B).
5. IRC §§1361(c)(1)–(2).
6. IRC §1361(b)(1)(A).
7. Treas. Reg. §1.1361-1(e)(3)(i).

Example 1. The following story illustrates how a large number of people can count as one shareholder for purposes of the S corporation shareholder count.[8]

John GI and all of his family are shareholders in Motherall's Family Ventures, Inc., a C corporation. The corporation and its shareholders elect to be taxed as an S corporation effective January 1, 2016.

Generation	Who Is a Member of Each Generation	Number of Members
1	John GI was born in 1916. He married Jane Motherall in 1934.	2
2	John and Mary's first child was born in 1935.	1
	Their other nine children were born between 1936 through 1945.	9
	Each child married early in life, and 10 spouses were added to the family.	10
3	During the baby boom, each of John and Jane's children had four children.	40
	Every Baby Boomer got married, and 40 spouses were added to the family.	40
	Two of the Baby Boomers divorced and remarried.	2
4	Each Baby Boomer couple had two Generation X children.	80
	Every member of Generation X got married twice, adding a total of 160 spouses.	160
5	Each Generation X couple gave birth to one Millennial during each marriage	160
	As of the end of 2015, half of the Millennial children are married, adding 80 spouses.	80
6	Every married Millennial has three children; they are the iGen.	240
	Total	824

Note. When the first of the iGens' children becomes a shareholder in the family S corporation, everyone mentioned in the example continues to count as one shareholder.

8. For more information on generations in the U.S., see *The Six Living Generations in America*. Novak, Jill. Marketing Teacher Ltd. [www.marketingteacher.com/the-six-living-generations-in-america] Accessed on May 23, 2016.

Each family member who owns or is deemed to own stock must meet the requirements regarding permissible shareholders and each must consent to the S corporation election. Although a person may be a member of more than one family, each family (not all of whose members are also members of the other family) is treated as one shareholder.[9]

Certain entities, their owners, or their beneficiaries may be included within one family unit. The following entities and/or their beneficiaries are also included as members of a family.[10]

1. Trusts electing under §645 to be treated as part of the estate and the estate of a deceased member of the family
2. Each **potential current beneficiary** of an electing small business trust **(ESBT)**
3. The **income beneficiary** of a qualified subchapter S trust **(QSST)** who makes the QSST election
4. **Each beneficiary** of a trust created primarily to exercise the **voting power of stock** transferred to it
5. The beneficiary of a traditional IRA or a Roth IRA that owns stock in a **banking institution** that has elected S corporation status[11]
6. The **deemed owner** of a trust
7. The owner of a disregarded entity

> **Note.** For more information about trusts as shareholders of S corporations and their beneficiaries, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust and Estate Taxation.

LIABILITY PROTECTION

Often the reason that owners of a business choose to incorporate or form an LLC is because they believe the entity choice protects them from liabilities arising from the business.

> **Caution.** Competent legal advice in the state in which the entity is formed should be sought regarding liability protection issues.

Shareholders, partners, and members bear personal responsibility for the income taxes due on the income that passes through the entity to their personal returns. Owners who are responsible parties may be held liable for unpaid payroll trust fund withholding. In addition, states may require at least one owner to take personal responsibility for sales taxes, payroll taxes, and/or other obligations.

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9. Treas. Reg. §1.1361-1(e)(3)(i).
10. Treas. Reg. §1.1361-1(e)(3)(ii).
11. Traditional IRAs and Roth IRAs are permitted S corporation shareholders only when the S corporation is a banking institution and the stock was held in the IRA on October 22, 2004.

When the IRS and the courts consider whether to recognize the legal form of a business or disregard it, they look for evidence that the entity was operated in a manner consistent with its form. Evidence that a **corporation** is operated consistently with its form includes the following.[12]

1. Adequate capitalization
2. Corporate stock issued
3. Corporate formalities observed, such as:
   a. Holding meetings
   b. Keeping minutes
   c. Keeping accurate books and records
   d. Providing required notices
4. Paying dividends or making other distributions
5. Not commingling business and personal assets

MAKING AN S ELECTION

If all other requirements (mentioned earlier) are met, any domestic corporation and any other entity eligible to be taxed as a corporation may make an S election. **The election is made by filing Form 2553, *Election by a Small Business Corporation*.** Generally the election must be filed:[13]

- No more than two months and 15 days after the beginning of the tax year the election is to take effect, **or**
- At any time during the tax year preceding the tax year it is to take effect.

> **Note.** For an in-depth discussion of relief from late S corporation elections, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Entities use Form 8832, *Entity Classification Election*, to elect to be treated for federal income tax purposes as an entity other than the default tax classification for the entity. For example, a single-member LLC is taxed as a sole proprietorship by default, but it could use Form 8832 to elect to be taxed as a C corporation.[14] However, an entity electing to be taxed as an S corporation does **not** use Form 8832. **Filing Form 2553 makes both the entity election and the S corporation election.[15]**

> **Note.** The instructions for Form 2553 were last revised in December 2013. The fax number for filing Form 2553 with the IRS center in Cincinnati has changed from the number provided in the instructions. **The new number is 855-270-4081.[16]**

12. *Piercing the LLC Veil in Illinois*. Brennan, Michael. The Virtual Attorney. [thevirtualattorney.com/blog/piercing-llc-veil-illinois] Accessed on May 23, 2016.
13. Instructions for Form 2553.
14. Instructions for Form 8832.
15. Instructions for Form 2553 and Form 8832.
16. *Form 2553, Election by a Small Business Corporation*. Jan. 29, 2016. IRS. [www.irs.gov/uac/form-2553-election-by-a-small-business-corporation] Accessed on Jul. 12, 2016.

LATE ELECTIONS[17]

The Code establishes the deadline to make an S election as two months and 15 days after the beginning of the tax year in which the S election is to be effective. However, it also gives the IRS the authority to treat a late election as timely when the taxpayer had reasonable cause for missing the deadline.[18] Late S elections are so common that nearly 20% of the instructions for Form 2553 are dedicated to late S elections.

Rev. Proc. 2013-30 provides the **exclusive** simplified methods for taxpayers to request relief for a late S election. This procedure also contains provisions for taxpayers to make late elections for classification as an electing small business trust (ESBT), qualified subchapter S trust (QSST), a qualified subchapter S subsidiary (QSub), or a corporation.

To qualify for relief, all the following requirements must be met.[19]

1. The requesting entity intended to be classified as an S corporation as of the effective date.
2. The requesting entity requests relief within **three years and 75 days** after the effective date.
3. The failure to qualify as an S corporation as of the effective date was solely because the S election was not timely filed by the due date.
4. The requesting entity has **reasonable cause** for its failure to make a timely election and has acted **diligently** to correct the mistake upon its discovery.
5. The Form 2553 states "FILED PURSUANT TO REV. PROC. 2013-30" at the top.
6. The completed Form 2553 includes signatures from all shareholders that indicates that, during the period between the date the S election was to have become effective and the date the completed form is filed, they have reported their income on all affected returns consistent with the S election for the year the election should have been filed and for all subsequent years.

The completed Form 2553 must be signed by all of the following persons.

- A corporate officer with the authority to sign
- All persons who were shareholders at any time during the period that began on the first day of the tax year for which the election is to be effective and ends on the day the completed Form 2553 is filed

The shareholders must sign page 2 of Form 2553. Under previous procedures for late S elections, the shareholders were required to attach a separate signed statement declaring that they had reported their income consistent with the election for all affected periods. This statement is now incorporated into the fine print over the lines for the shareholders' signatures on Form 2553.

> **Note.** Practitioners must inquire to make sure that all of the shareholders affected by the late S corporation election **actually** reported the entity activity appropriately on their personal returns. If any of the shareholders did not, the corporation is not allowed to make a late S election.

17. Rev. Proc. 2013-30, 2013-36 IRB 173.
18. IRC §1362(b)(5).
19. Rev. Proc. 2013-30, 2013-36 IRB 173 (§§4.02, 5.02).

LLCs TAXED AS S CORPORATIONS

The check-the-box regulations permit LLCs and other state-law partnerships to elect to be classified as corporations, including S corporations. Reasons that an entity may want to form an LLC instead of a corporation include the following.

- Reduced formation and operating costs (annual report and/or franchise taxes) under state law for LLCs
- Protection of members' ownership interests from foreclosure by creditors, unlike shareholder stock
- Flexibility in organizational structure

Reasons that a taxpayer may not want to form an LLC before electing S status include the following.

- Increased formation and operating costs under state law
- Amendments to the operating agreements necessary to comply with the S corporation single class of stock requirement.

LLC is a legal designation that has no corresponding definition under tax law. LLCs by default are taxed as partnerships if there are multiple members and as sole proprietorships if there is only one member. However, an LLC may elect to be taxed as an S corporation or as a C corporation.

A single-member or multiple-member LLC that already has an employer identification number (EIN) does **not** need to obtain a new one when it elects to be taxed as a corporation. However, if it has not yet acquired an EIN, it must obtain one prior to making an election to be taxed as a corporation.[20]

An LLC taxed as an S corporation faces the same shareholder restrictions as any entity electing to be taxed as an S corporation. Consequently, it may have no more than 100 members; no owners who are partnerships, corporations, or nonresident aliens; and only one class of stock. LLC members planning to make the S election must be very careful to change any provisions in the LLC member agreement that would cause their interests to be treated as multiple classes of ownership. If the LLC has no operating agreement, it must adopt one that satisfies subchapter S because the default rules of state LLC acts may cause violations of the single class of stock requirement. Partnerships and LLCs frequently have complicated provisions regarding rights and obligations that could be construed as multiple classes of ownership, such as the following.

- Special allocations of income or loss to be passed through to members disproportionately
- Voting
- Liquidations
- Deficit restoration obligations

It is very important that risks involving multiple classes of stock be resolved prior to the effective date of the S election.

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20. *Do You Need a New EIN?* May 6, 2016. IRS. [www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein] Accessed on Jul. 12, 2016.

TRANSFER OF ASSETS

Generally, if a partnership wishes to contribute assets to a corporation, there are three ways of making a contribution.

1. The partnership assigns the actual partnership units to the corporation solely in exchange for stock in the corporation, which is distributed to the members in a redemption. The corporation liquidates the target partnership assets into the corporate entity.
2. The partnership assets are distributed to the members, and the members directly contribute the assets to the corporation, solely in exchange for stock. This method allows dissenting partners to not continue ownership in the new corporation.
3. The partnership contributes all the partnership assets directly to the corporation in exchange for corporation stock.

This third method is the overriding standard. When a single- or multiple-member LLC elects S status for tax purposes, it is **deemed** to have contributed all of its assets and liabilities to the corporation in exchange for the corporate stock.[21] Immediately thereafter, the LLC-partnership is deemed to have liquidated by distributing the stock to its partners.

Because the S election is a deemed transfer in exchange for stock, IRC §351 governs the transaction. 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.*

ASSET BASIS

The S corporation property has the same basis and holding period after the transfer as it had in the LLC.[22] In essence, the S corporation "steps into the shoes" of the LLC.

> **Example 2.** On March 10, 2016, Harriet Tubman formed Underground RR LLC under the laws of Maryland. On March 11, she applied for an EIN online and then filed Form 2553 to elect S status as of the formation date.
>
> Underground RR LLC was established to operate a Civil War museum memorializing the relics of the time. Prior to opening the museum, Ms. Tubman acquired a number of antiques and display units. She paid $10,000 for these items. For tax purposes, she is treated as having exchanged these items for S corporation stock. She received $10,000 in stock basis, and the S corporation has $10,000 in basis for the assets.

ASSUMED DEBT

Debt assumed by the S corporation can cause tax difficulties for LLCs and partnerships electing S status because debt often exceeds the basis of the underlying partnership assets. Despite the general rule that transfers in exchange for corporate stock are not taxable events, careful consideration must be given to the debt in relation to the pre-contribution asset basis. The fair market value (FMV) often exceeds the debt amount, but the basis often is less that the debt. Before an S corporation assumes debt as part of an exchange for corporate stock, the tax consequences to the shareholder should be considered.

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21. Treas. Reg. §301.7701-3(g)(1).
22. IRC §§362(a) and 1223(2).

A taxpayer must recognize income to the extent that debt transferred to the S corporation exceeds the taxpayer's basis in the property transferred.[23] Furthermore, the entire amount of debt is treated as boot in calculating the shareholder's basis.[24] The corporation's basis is equal to the shareholder's basis plus any gain recognized by the shareholder.[25]

Example 3. In 2014, John Brown transferred his commercial rental property to a single-member LLC, Harpers Ferry LLC. He elected to have the LLC taxed as an S corporation as of July 1, 2016. Although the transfer occurred in 2014, the election made in 2016 must satisfy the rules under §§351 and 357. From 2014 through June 30, 2016, the LLC was disregarded for tax purposes, and he reported the income and expenses on Schedule E, *Supplemental Income and Loss,* which he filed with his Form 1040, *U.S. Individual Income Tax Return*.

As of July 1, 2016, the following facts applied to the property.

Original cost of real estate plus improvements	$ 50,000
Depreciation claimed	45,000
FMV of real estate	200,000
Mortgage on real estate	20,000

John's basis in the property prior to the transfer is his original cost less the depreciation deductions he was allowed. His basis is therefore $5,000 ($50,000 − $45,000).

John must recognize a gain equal to the excess of the mortgage debt over his basis. Therefore, his recognized gain is $15,000 ($20,000 − $5,000). John is not required to recognize a gain for any of the excess of the $200,000 FMV of the real estate over the $20,000 mortgage.

His tax basis in the S corporation is calculated as follows.

Basis in property exchanged	$ 5,000
Less: liability assumed by corporation	(20,000)
Plus: gain recognized	15,000
John Brown's basis in Harpers Ferry LLC	$ 0

The LLC's basis in the property is $20,000: John's $5,000 basis prior to the transfer plus the $15,000 gain he recognized.

The basis of ownership interests for partners and members in LLCs taxed as partnerships include the owners' proportionate share of recourse and nonrecourse debt. This is not true with S corporations; being liable for the company debt does not establish basis for the S corporation owner. Thus, when an S corporation assumes the debt of the entity converting to S status, the owners receive a constructive dividend of the proportionate amount of debt assumed. If the constructive dividend exceeds basis, the owners will have a taxable event from the conversion to S status.

> **Note.** If facts and circumstances show that recourse debt is not assumed by the corporation, then §351 is not applicable. Nonrecourse debt is generally deemed to be assumed by the corporation.

23. IRC §357(c).
24. IRC §358(d)(1).
25. IRC §362(a).

CAPITAL ACCOUNTS

An LLC that elects to be taxed as a corporation does not actually issue shares of stock to its members. The members' capital accounts are converted to additional paid-in capital (APIC) on the corporate tax return balance sheet. If the members' capital accounts are disproportionate to their ownership percentages at the time of the conversion **and if the rights to dissolution proceeds are tied to the capital account balances,** the entity has in essence more than one class of stock.[26] This could create a situation in which the entity's S status is terminated for failure to qualify as an S corporation.[27]

Several mechanisms can be used to rectify this situation. However, these corrections should be made **prior** to the effective date of the S election.

1. Members whose capital accounts are proportionately less than the other members could add to their capital accounts to bring the accounts in proportion to their ownership percentage.
2. The LLC could make a distribution to the members whose accounts are higher than their ownership percentage.
3. The excess in the capital accounts could be converted to loans. However, the LLC must be careful to structure and document these loans properly in order to qualify for the straight-debt safe hardbor discussed later. If the loans do not meet these standards, the IRS can treat them as disguised capital accounts.

Example 4. Charlotte Woodward Pierce and Harriot Stanton Blatch each owned 50% of NAWSA, LLC. In 2010, they each provided initial funding of $10,000 for the LLC. The rights to dissolution proceeds are tied to their capital account balances according to their operating agreement.

From 2010 through 2015, the LLC was taxed as a partnership. It generated modest profits each year.

Charlotte's earnings share each year was distributed to her, but Harriot chose to leave her share in the company. At the end of 2015, Charlotte's capital account was still $10,000, but Harriot's was $15,000.

Projecting significant profits for 2016, they decided to save self-employment taxes on company profits by electing to be taxed as an S corporation. In December 2015, they elected S status effective January 1, 2016.

To make their capital accounts proportionate to their ownership interests, they consider four options.

1. Charlotte could make capital contributions of $5,000 to the company, increasing her capital account to $15,000.
2. Harriot could take a distribution of $5,000 from the company, reducing her capital account to $10,000.
3. They could each adjust their accounts, with Charlotte making a contribution of $2,500, increasing her capital account to $12,500 ($10,000 + $2,500) and Harriot taking a distribution of $2,500, reducing her capital account to $12,500 ($15,000 − $2,500).
4. The LLC could sign an interest-bearing demand note payable to Harriot for $5,000 and reclassify $5,000 of her capital account to debt, leaving only $10,000 in her capital account.

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26. Ltr. Rul. 201351017 (Aug. 16, 2013).
27. Ibid; Treas. Reg. §1.1361-1(l)(1).

C CORPORATIONS ELECTING S STATUS

The default method of corporate taxation is found under Subchapter C, Chapter 1, of the Code — hence the designation "C" corporation.[28] Many of the C corporation rules are not relevant when a corporation elects to be taxed as an S corporation effective as of the day of incorporation. However, if the C corporation was in business for a period of time prior to making the election, several very important factors must be considered.

1. The built-in gains (BIG) tax
2. Passive investment income (PII)
3. Last-in-first-out (LIFO) inventory recapture rule
4. Accumulated earnings and profits (AEP)
5. Accumulated adjustments account (AAA)

BIG TAX[29]

The BIG tax was created to close a loophole that allowed C corporations with appreciated assets to elect S status just prior to selling or distributing their assets and thereby avoid the double taxation of the C corporation. Under the BIG tax regime, the S corporation may be liable for tax at the maximum corporate tax rate (currently 35%) on the net unrealized gain that existed at the time of the S election **if assets owned on the conversion date** are disposed of in taxable transactions within the **recognition period.**

Through various temporary and permanent Code changes, the recognition period's length has varied from five to 10 years. For tax years beginning after 2010, **the recognition period is five years.**

The net unrealized BIG must be determined as of the effective date of the S election. It equals the difference between the balance sheet based on FMV and the balance sheet tax basis. Each year, the taxpayer must disclose the remaining net unrealized BIG on Schedule B of Form 1120S, *U.S. Income Tax Return for an S Corporation*.

Most assets are subject to the BIG tax. There are some exceptions. For example, timber, coal, and iron ore are not considered separate assets held by the S corporation on the conversion date. Instead, they are considered part of the land. The sale of these assets is not considered a disposition of land subject to the BIG tax. These commodities receive special capital gains treatment under IRC §631, but the income derived from the commodities is classified as rent or royalties. The receipt of normal operating business income in the nature of rents and royalties is not subject to BIG tax under IRC §1374.[30]

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28. *Choosing a Business Structure.* Aug. 17, 2012. IRS. [www.irs.gov/uac/choosing-a-business-structure] Accessed on Jun. 17, 2016.
29. IRC §1374.
30. Rev. Rul. 2001-50, 2001-2 CB 343.

Example 5. Cady Inc. was taxed as a C corporation from its inception through December 31, 2014. As of January 1, 2015, the corporation elected S status. At the time of the conversion, the corporation owned the following assets.

	Basis	Value	Unrealized Gain Per Acre
40 acres farm land (per acre)	$2,000	$10,000	$8,000
60 acres of timberland (per acre)	2,000	6,000	4,000

On July 1, 2016, the corporation sold five acres of the farm land for $12,000 each. Because the S election was effective less than five years prior to the sale, the unrealized gain of $8,000 per acre as of the time of the election is subject to the BIG tax. The remaining $4,000 of gain ($12,000 − $8,000) is not. Assuming the corporate taxable income is at least as much as the total gain, the BIG tax is $14,000 ($8,000 × 5 acres × 35% BIG tax rate).

In addition to the farm acres the corporation sold on July 1, it sold the right to cut 10% of its timber to a logging company. The timber is **not** subject to the BIG tax under §631.

Assets subject to the BIG tax include **inventory and receivables** that a cash basis C corporation holds on the effective date of the S election. Immediately after the S election, the corporation's income is presumed to arise from inventory and receivables. Accordingly, BIG tax is assessed on this income unless the business can establish to the IRS's satisfaction that the income in fact did not arise from old C corporation receivables or inventory.[31]

Example 6. Doctor Delany, Inc., is an S corporation that was formerly a cash-basis C corporation. The company had the following assets and liabilities when it elected S status on December 31, 2014.

	Basis	Value	Unrealized Gain/(Loss)
Cash in bank	$5,000	$ 5,000	$ 0
Accounts receivable	0	400,000	400,000
Equipment	5,000	30,000	25,000
Goodwill	0	250,000	250,000
Accounts payable	0	(20,000)	(20,000)

In 2015, the corporation collected 85% of the accounts receivable that it had at the beginning of the year. Therefore, it realized $340,000 (85% × $400,000) of previously untaxed income generated while the entity was a C corporation. It also paid the $20,000 of accounts payable that were incurred while it was a C corporation. Therefore, the net excess of recognized built-in gains over recognized built-in losses in 2015 was $320,000 ($340,000 A/R receipts less $20,000 A/P payments).

On its 2015 Form 1120S, the corporation reported this $320,000 profit on Schedule D, *Capital Gains and Losses and Built-in Gains*, line 16, as shown on the following form. A separate statement is attached to the return that shows the calculation of this amount.

The corporation's net profit was $375,000 in 2015. The $112,000 BIG tax (35% highest corporate rate × $320,000), was carried to page 1 of Form 1120S, which follows.

31. Robert Jamison, *S Corporation Taxation,* ¶1104.02, pp. 880-881 (CCH, 2016).

For Example 6

Schedule D (Form 1120S) 2015 Page 2

Part III	Built-in Gains Tax (See instructions **before** completing this part.)		
16	Excess of recognized built-in gains over recognized built-in losses (attach computation statement)	16	320,000
17	Taxable income (attach computation statement)	17	375,000
18	Net recognized built-in gain. Enter the smallest of line 16, line 17, or line 8 of Schedule B	18	320,000
19	Section 1374(b)(2) deduction	19	
20	Subtract line 19 from line 18. If zero or less, enter -0- here and on line 23	20	320,000
21	Enter 35% of line 20	21	112,000
22	Section 1374(b)(3) business credit and minimum tax credit carryforwards from C corporation years	22	
23	**Tax.** Subtract line 22 from line 21 (if zero or less, enter -0-). Enter here and on Form 1120S, page 1, line 22b	23	112,000

Schedule D (Form 1120S) 2015

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Note. The Schedule D for Form 1120S is different than the Schedule D for other tax returns. Part III of the Schedule D is designed specifically for S corporations.

The BIG tax is limited to net taxable income if net taxable income from the S corporation operations does not exceed the net profit from the sale of assets that the corporation owned prior to making the S election.[32] In addition, the taxpayer may deduct net operating loss (NOL) carryforwards and certain credits that arose during C corporation tax years.[33]

Example 7. Use the same facts as **Example 6,** except the S corporation has a net profit of $8,000 in 2015 and $3,000 of NOL carryforwards from 2014. In this situation, the 2015 BIG tax is only $1,750 as shown on the corporation's 2015 Schedule D, which follows.

Schedule D (Form 1120S) 2015 Page 2

Part III	Built-in Gains Tax (See instructions **before** completing this part.)		
16	Excess of recognized built-in gains over recognized built-in losses (attach computation statement)	16	320,000
17	Taxable income (attach computation statement)	17	8,000
18	Net recognized built-in gain. Enter the smallest of line 16, line 17, or line 8 of Schedule B	18	8,000
19	Section 1374(b)(2) deduction	19	3,000
20	Subtract line 19 from line 18. If zero or less, enter -0- here and on line 23	20	5,000
21	Enter 35% of line 20	21	1,750
22	Section 1374(b)(3) business credit and minimum tax credit carryforwards from C corporation years	22	
23	**Tax.** Subtract line 22 from line 21 (if zero or less, enter -0-). Enter here and on Form 1120S, page 1, line 22b	23	1,750

Schedule D (Form 1120S) 2015

The BIG tax is paid by the corporation and is **in addition** to any tax the shareholder pays on their pass-through share of corporate profits. However, a deduction for the BIG tax is treated as a loss sustained by the S corporation. The deduction's character is determined by allocating it proportionately among the recognized built-in gains giving rise to such tax.[34]

32. IRC §1374(a).

33. IRC §1374(b).

34. IRC §1366(f)(2).

PASSIVE INVESTMENT INCOME — A TAX AND A TRAP

Congress's intent for initiating the S corporation status was to give small businesses a way to operate under the legal protections of corporation law while also avoiding the double taxation of the C corporation tax structure.[35] However, members of Congress were concerned that the S corporation rules would be abused by C corporations seeking to replace active business ventures with passive investments. To address this concern, the Code includes two provisions regarding passive investment income (PII) earned by S corporations. One provision assesses an additional tax on excessive passive income; the other terminates the S status when the excessive passive income is an ongoing issue.

The term "passive" as used in these provisions is defined differently than it is in the individual income tax provisions. This is because the original S corporation provisions were added to the Code in 1958,[36] long before the Tax Reform Act of 1986 added the mechanisms to limit passive losses.

PII Tax[37]

The PII tax only applies in cases when PII exceeds 25% of the S corporation's gross receipts for the year **and** the C corporation had accumulated earnings and profits (AEP) at the tax yearend. Income subject to the BIG tax is exempt from the PII tax.

> **Note.** AEP and the election to reduce AEP before AAA are discussed later in the chapter. This tool may be very valuable for S corporations facing the PII tax.

PII includes tax-exempt interest,[38] taxable interest, dividends, annuities, rents, royalties, and other forms of income received outside typical active business activity.[39] However, the term "rents" for PII purposes does **not** include rents derived in the **active trade or business** of renting property. Whether the corporation is treated as being in the rental business or not is based on all the facts and circumstances. These include, but are not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation). A similar exception exists for royalties.[40] Likewise, an exception exists for interest earned on accounts receivable from inventory sales.[41]

The taxable amount of PII is the **excess net passive income** (ENPI) realized by the S corporation for the year. This is calculated using the following formula.[42]

$$\text{ENPI} = \text{Net passive income} \times (\text{PII} - (.25 \times \text{gross receipts})) \div \text{PII}$$

Net passive income is PII less the deductions directly connected to the production of the income.[43] If expenses are attributable in part to PII and in part to income other than PII, the deduction is allocated between the two types of items on a reasonable basis.[44]

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35. Sicular, David R. Subchapter S at 55 — Has Time Passed This Passthrough By? Maybe Not. (2014, Fall). *Tax Lawyer,* Vol. 68, No. 1 pp. 185–238. [www.americanbar.org/groups/taxation/publications/tax_lawyer_home/14fal.html] Accessed on Jul. 13, 2016.
36. Ibid.
37. IRC §1375.
38. Treas. Reg. §1.1375-1(f), Example 2.
39. IRC §1362(d)(3)(B).
40. Treas. Reg. §1.1362-2(c)(5)(ii)(B).
41. IRC §1362(d)(3)(C)(ii).
42. Treas. Reg. §1.1375-1(b)(1)(i).
43. Treas. Reg. §1.1375-1(b)(2).
44. Treas. Reg. §1.1375-1(b)(3).

Gross receipts include ordinary revenues and the **net** gains from the sales of capital assets. Gross receipts do not include net losses.[45]

Example 8. ACME Fireworks Inc. was taxed as a C corporation until its S election became effective on January 1, 2016. At the end of 2016, it has AEP remaining from the C corporation years.

ACME has the following income and expenses for 2016.

	Total	PII
Tax-exempt interest income	$10,000	$10,000
Taxable interest income	4,000	4,000
Qualified capital gain distributions	6,000	6,000
Short-term gains from stock sales [a]	3,000	3,000
Gross income from services	50,000	0
Total gross income	$73,000	$23,000
Operating expenses	(45,000)	0
Investment management fees on tax-exempt income	(2,000)	(2,000)
Investment management fees on taxable income	(4,000)	(4,000)
Net income	$22,000	$17,000

[a] The stock sold was not held at December 31, 2015, and is therefore not subject to the BIG tax.

ACME's $1,229 of PII tax is calculated using the worksheet in the instructions for Form 1120S.

Excess Net Passive Income Tax Worksheet for Line 22a *Keep for Your Records*

1. Enter gross receipts for the tax year (see section 1362(d)(3)(B) for gross receipts from the sale of capital assets)*	73,000	4. Excess passive investment income—Subtract line 3 from line 2	4,750	8. Excess net passive income—Multiply line 6 by line 7	3,511
2. Enter passive investment income as defined in section 1362(d)(3)(C)*	23,000	5. Enter deductions directly connected with the production of income on line 2 (see section 1375(b)(2))*	6,000	9. Enter taxable income (see instructions for taxable income below)	22,000
3. Multiply line 1 by 25% (0.25). (If line 2 is less than line 3, stop here. You aren't liable for this tax.)	18,250	6. Net passive income—Subtract line 5 from line 2	17,000	10. Enter smaller of line 8 or line 9	3,511
		7. Divide amount on line 4 by amount on line 2	20.65 %	11. Excess net passive income tax—Multiply line 10 by 35% (0.35). Enter here and on Form 1120S, line 22a	1,229

*Income and deductions on lines 1, 2, and 5 are from total operations for the tax year. This includes applicable income and expenses from page 1, Form 1120S, as well as those imported separately on Schedule K. See section 1375(b)(4) for an exception regarding lines 2 and 5.

Line 9 of Worksheet—Taxable Income

Taxable income, for this purpose, is defined in Regulations section 1.1374-1A(d)(1). Figure this income by completing lines 1 through 28 of **Form 1120**, U.S. Corporation Income Tax Return. Include the Form 1120 computation with the worksheet computation you attach to Form 1120S. You don't have to attach the schedules, etc., called for on Form 1120. However, you may want to complete certain Form 1120 schedules, such as Schedule D (Form 1120), if you have capital gains or losses.

The PII tax is calculated using the maximum corporate tax rate (currently 35%).[46] However, a deduction for the PII tax paid passes through to the shareholders. This deduction is allocated proportionately among the passive income items.[47]

45. IRC §1362(d)(3)(B).

46. IRC §1375(a)(2).

47. IRC §1366(f)(3).

Waiver of PII Tax[48]

The PII tax may be waived if the following conditions are satisfied.

- The S corporation determined in good faith that it had no AEP at the close of a tax year.
- The AEP was distributed within a reasonable period after it was subsequently discovered.

A request for waiver of the tax must be made in writing to the IRS service center where the return is filed. The request must contain the following.[49]

1. A description of how and on what date the S corporation in good faith and using due diligence determined that it did **not** have AEP at the close of the tax year
2. A description of how and on what date it was subsequently discovered that the S corporation **did** have AEP
3. A description (including dates) of any steps taken to distribute such earnings and profits **or,** if the earnings and profits have not yet been distributed, a timetable for distribution and an explanation of why the timetable is reasonable

ENPI Trap[50]

If the S corporation has ENPI for **three consecutive years**, the corporation's S status is terminated. The termination is effective on the first day of the tax year that begins after the third consecutive year.

However, the S corporation may request relief from the inadvertent termination. The IRS may grant relief when steps were taken within a reasonable time after the discovery of the circumstances resulting in the termination.

Relief may only be obtained through a **private letter ruling**. The request should describe all the relevant facts pertaining to the event or circumstance that caused the inadvertent termination. It must include enough information to demonstrate that the termination was **despite the due diligence** practiced by the corporation.[51] In addition, it should include the S election's effective date, a detailed explanation of the event or circumstance causing the termination, when and how the event or circumstance was discovered, and the steps taken to rectify the situation.[52]

> **Note.** For information on submitting a private letter ruling, see Rev. Proc. 2016-1.[53] A user fee is assessed for private letter ruling requests.

LIFO INVENTORY RECAPTURE[54]

When a C corporation that used the LIFO inventory method elects S status, a recapture adjustment must be made on the final C corporation tax return.[55] The LIFO recapture amount is defined as the excess in inventory value using the first-in-first-out (FIFO) method over that inventory's LIFO value.[56]

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48. IRC §1375(d).
49. Treas. Reg. §1.1375-1(d).
50. Treas. Reg. §1.1362-2(c); IRC §1362(f).
51. Treas. Reg. §1.1362-4.
52. Ibid.
53. Rev. Proc. 2016-1, 2016-1 IRB 1.
54. IRC §1363(d).
55. IRC §1363(d)(1).
56. IRC §1363(d)(3).

The tax attributable to the LIFO inventory recapture is equal to the net tax difference with and without the recapture. The entire recapture amount is taxed at the corporation's highest marginal rate on the final tax return.

The tax is payable in equal installments over four tax years. The first installment is payable with the final return as a C corporation (without regard to extensions). The total tax due on the final C corporation return is reduced by the three installments to be paid with subsequent returns. This reduction is shown on the tax return by reporting 75% of the tax attributable to the LIFO recapture as a subtraction from line 11 ("total tax") of Schedule J, *Tax Computation and Payment*. On the dotted line next to line 11, the description of the adjustment and the adjustment amount are reported as "Section 1363-Deferred Tax-$X,XXX." A statement is attached showing the computation of each item included in, or subtracted from, the total for line 11.[57]

The remaining three payments are made with the S corporation returns for the three succeeding years.[58] They are reported on line 22a of Form 1120S, *U.S. Income Tax Return for an S Corporation*.

Example 9. The Liberator Booksellers Inc. uses the LIFO method of valuing inventory. It was taxed as a C corporation until its S election became effective on December 31, 2014. On that date, the cost of its inventory was **$30,000 under the LIFO method** and **$50,000 under the FIFO method.** The excess $20,000 is reported as other income on the corporation's 2014 tax return.

The corporation's net taxable income for 2014 was $70,000 including the $20,000 LIFO recapture. Its tax **without** the recapture would have been $7,500. With the recapture, the tax was $12,500; therefore, the tax attributable to the recapture was $5,000 ($12,500 − $7,500).

Only 25% of the tax on the recapture was payable on the 2014 return. The remaining 75% was deferred. On its **2014** Form 1120, *U.S. Corporation Income Tax Return*, Liberator deducted 75% of $5,000 ($3,750) from line 11 ("total tax") of Schedule J. On the dotted line next to line 11, the tax preparer entered "Section 1363-Deferred Tax-$3,750."[59]

On its **2015** Form 1120S, the corporation reported 25% of the recapture tax ($1,250) on line 22a ("excess net passive income or LIFO recapture tax"). It continues to do this for two more years.

Note. For more information on the procedures to adjust the basis of inventory to reflect the LIFO recapture, see Rev. Proc. 94-61.

ACCUMULATED EARNINGS AND PROFITS

AEP is a measure of the accumulated **distributable** earnings of a C corporation. It is not intended to measure retained earnings or cumulative net income but instead it quantifies the **economic** wealth retained by the corporation.[60]

By definition, income earned by S corporations does not add to the corporation's accumulated earnings. Thus, the AEP balance only consists of the C corporation's previously undistributed earnings as adjusted.

Distributions from AEP are taxable as dividends to the shareholders.[61] The corporation must issue Form 1099-DIV, *Dividends and Distributions*, to each shareholder to report dividends paid from AEP of $10 or more.[62]

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57. Instructions for Form 1120.
58. IRC §1363(d)(2).
59. Instructions for Form 1120.
60. Gary Hoff & Marc Lovell, *Limited Liability Companies: Electing Partnership vs. S Corporation Status* (Univ. of Illinois, 2011).
61. IRC §316.
62. 2016 Instructions for Form 1099-DIV.

If a C corporation that never tracked AEP converts to an S corporation, it is necessary to calculate the AEP as of the day prior to the S election's effective date. This amount is used both to determine whether the corporation might be subject to PII rules and whether distributions are taxable to shareholders.

> **Note.** The PII rules are discussed earlier in the chapter. Distributions are discussed later.

AEP is calculated using the accounting method that the corporation uses for tax purposes. The following adjustments are made to taxable income to arrive at AEP. [63]

1. Tax-exempt income is added.
2. Any amount subtracted from income in connection with the dividends-received deduction[64] is added.
3. The difference between accelerated depreciation and straight-line depreciation is added/subtracted.
4. The IRC §179 deduction is added back, and the asset is depreciated ratably over five years.
5. Federal income tax and applicable penalties[65] are subtracted.
6. Changes to LIFO recapture for inventory cost are added/subtracted.
7. Income reported under the installment sale method[66] is adjusted to the accrual method.
8. In the case of a taxpayer who uses the completed-contract method of accounting, earnings are computed as if such taxpayer used the percentage-of-completion method of accounting.
9. Construction period carrying costs are excluded from AEP, added to the basis of the constructed assets, and included in depreciable costs.
10. Intangible drilling costs and mineral exploration and development costs are capitalized and amortized over 60 and 120 months, respectively.
11. Amortization of circulation and organizational costs are subtracted.
12. Allocations are made for certain corporate acquisitions, separations, and reorganizations.[67]
13. Adjustments related to bankruptcy filings may be necessary when there is a deficit in AEP.[68]
14. Distributions of money and property from the time when the corporation was a C corporation are subtracted.[69] However, this reduction must be adjusted for debt and unrealized gains.

> **Note.** Providing examples of how to calculate these adjustments is beyond the scope of this chapter. The list is intended to alert the reader to situations that require additional research.

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63. IRC §312; Treas. Reg. §1.312-6; Gary Hoff & Marc Lovell, *Limited Liability Companies: Electing Partnership vs. S Corporation Status* (Univ. of Illinois, 2011).
64. Under IRC §243.
65. Rev. Rul. 57-332, 1957-2 CB 231.
66. Under IRC §453.
67. IRC §312(h).
68. IRC §312(l)(2).
69. IRC §§312(a), (b), and (c).

ACCUMULATED ADJUSTMENTS ACCOUNT

When a corporation has AEP, it is essential to track the AAA balance. The purpose of the AAA is to serve as a limit on distributions that are not treated as dividends.

AAA does not necessarily tie to the shareholders' aggregate inside basis. It is not adjusted for tax-exempt income or related expenses. In addition, the AAA is reduced for all losses that pass through to members, including losses that reduce membership basis, debt basis, and even suspended losses resulting from insufficient basis.

The following table shows the order that adjustments are applied to AAA.

Step	Effect on AAA	Items	Notes
1	Increase	• Separately stated income amounts • Nonseparately computed income • Depletion deductions in excess of basis in depletion property (except for oil and gas properties with a §613A(c)(11)(B) allocated basis)	• No adjustment to AAA for tax-exempt income
2	Decrease	• Separately stated loss amounts • Nonseparately computed losses • Expense items not deductible and not properly chargeable to a capital account (other than C corp's federal taxes and expenses relating to tax-exempt income) • Member depletion deductions for oil and gas property (to the extent deductions do not exceed basis allocated under §613A(c)(11)(B))	• No adjustment to AAA for expenses relating to tax-exempt income • Ignore any net negative adjustment (decreases in excess of increases from Steps 1 and 2). • AAA is reduced by net negative adjustment after the decrease for distributions (see Step 4).
3	Decrease	• Amount of ordinary distributions	
4	Decrease	• Net negative adjustment	
5	Decrease	• Redemption distributions, if any	

OTHER ADJUSTMENTS ACCOUNT

As discussed previously, the activity prior to electing S status is reflected by the AEP account. Most of the adjustments affecting shareholder basis after the S election are reflected in the AAA. The OAA is where tax-exempt income and related expenses are tracked.

DISTRIBUTIONS IN GENERAL

Distributions from an S corporation with **no AEP** are taxed to the shareholders using the following rules.[70]

1. Distributions are a nontaxable return of each shareholder's basis as long as they do not exceed the shareholder's basis. The shareholder's basis is reduced by the amount of distributions received.
2. Once a shareholder's basis is reduced to zero, further distributions are treated as a gain from the sale of stock.

When the S corporation has no AEP balance, the AAA is not used in determining how a member's distribution is taxed. However, tracking the AAA is recommended and will be necessary information to shareholders in the event of a future termination or reorganization.

When the S corporation has AEP, there is a 4-part hierarchy of rules for distributions.[71]

1. Distributions first reduce AAA. Distributions not in excess of AAA are treated in the same manner as S corporations with no AEP.
2. After AAA is fully utilized, distributions come from pre-1983 previously taxed income.
3. After items 1 and 2 are fully utilized, distributions from AEP are characterized as dividends and have no effect on stock basis.
4. After the AEP balance is fully utilized, distributions reduce stock basis and OAA.
5. Any additional distributions are taxed as a sale of stock.

However, an S corporation may elect to have distributions come from AEP first, rather than from AAA.[72] The distributions attributable to AEP are then treated as dividends to the shareholders. This election is an important tool for eliminating PII tax and avoiding the ENPI trap.

Making the Election to Distribute AEP First[73]

A corporation makes the election to distribute AEP first by attaching a statement to a timely filed (including extensions) original or amended return for that tax year. In the statement, the corporation must identify that it is making the election under Treas. Reg. §1.1368-1(f). It must also state that each shareholder consents to the election. It is not necessary that the statement be signed by the shareholders or a corporate officer. The proper signature on the return is sufficient to verify the election.

The election is **irrevocable.** Furthermore, it is only effective for the tax year for which it is made.

Election to Make a Deemed Dividend Distribution[74]

An S corporation may elect to distribute all or part of its AEP through a **deemed** dividend. If an S corporation makes this election, the S corporation is also deemed to have made the election to distribute earnings and profits first. Each affected shareholder must consent to this election.

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70. IRC §1368(b).
71. IRC §1368(c); Also see the instructions for Form 1120S regarding OAA.
72. IRC §1368(e)(3).
73. Treas. Reg. §1.1368-1(f)(5).
74. Treas. Reg. §§1.1368-1(f)(3) and (5).

The deemed dividend amount may not exceed the corporation's AEP on the last day of the tax year, reduced by any actual distributions of AEP made during the tax year. The deemed dividend is treated as if all of the following actions took place on the last day of the corporation's tax year.

- Distributed money to the shareholders in proportion to their stock ownership
- Dividends received by the shareholders
- Amount of dividends immediately contributed by the shareholders to the corporation

The contribution increases each shareholder's basis.

The election to make a deemed dividend election is made on a timely filed (including extensions) original or amended return for that tax year. The election statement must include the amount of the deemed dividend that is distributed to each shareholder. In addition, it must state that the corporation is making the election under Treas. Reg. §1.1368-1(f). It must also state that each shareholder consents to the election. It is not necessary that the statement be signed by the shareholders or a corporate officer. The proper signature on the return is sufficient to verify the election.

The election is **irrevocable.** It is only effective for the tax year for which it is made.

Example 10. Manum Inc. was incorporated in 1963. This closely held corporation was taxed as a C corporation from 1963 through December 31, 2013. In 2013, Manum sold a significant portion of its assets as part of an attempt to overhaul the company's strategic focus and revenue sources. The shift in strategy was expected to take several years to implement.

Because of the new business model's nature, the shareholders determined that being taxed as an S corporation would be more beneficial in the future. The S election was effective January 1, 2014.

On December 31, 2013, the corporation's AEP was $200,000. In 2014, the corporation had no operating income but earned $40,000 in qualified dividends on investments it was holding for future use in their new operations. This was its only income. The corporation's net income after deductible expenses was $20,000. On their 2014 returns, the shareholders claimed their prorated shares of the net income, which was classified as qualified dividends. The corporation paid $7,000 PII tax ($20,000 × 35%). At the end of 2014, the S corporation had $200,000 in AEP and $13,000 in AAA ($20,000 net income − $7,000 in federal taxes).

In 2015, the corporation had exactly the same results as in 2014. At the end of 2015, the S corporation had $200,000 in AEP and $26,000 in AAA.

Alternative 1: Election to distribute AEP before AAA. In 2016, construction was nearly complete on new facilities. Because all the construction costs to date were capitalized, the taxable activity is the same as it was in 2014 and 2015. Because the corporation will lose its S corporation status if it realizes ENPI for a third consecutive year, the corporation borrows $200,000. The shareholders vote to distribute $200,000 and elect to treat the distribution as being made from AEP. Because there will be no AEP as of December 31, 2016, the S corporation is not subject to PII tax and does not lose its S corporation status.

Alternative 2: Deemed dividend election. In 2016, the corporation borrows $40,000 and distributes that to the shareholders as a dividend. The corporation then makes a deemed dividend election in the amount of $160,000. The corporation is treated as having first distributed $40,000 of AEP before distributing AAA. The remaining AEP is now $160,000, for which the corporation makes a deemed dividend election. The $40,000 cash dividend is intended to enable the shareholders to pay their personal income tax liabilities on the $160,000 deemed dividend (increased, if necessary, for additional state income taxes). The shareholders also increase their stock basis by the $160,000 deemed dividend because it is treated as both a constructive distribution to the shareholders and a simultaneous contribution to capital by the shareholders. The corporation is therefore required to borrow significantly less money to eliminate AEP.

Under each alternative, the shareholders receive Form 1099-DIV reporting their shares of the dividend and deemed dividend distributions.

PROPERTY DISTRIBUTIONS

An S corporation must treat any appreciated property distributed as if the property were sold at FMV.[75] Thus, the gain from the sale is prorated among the shareholders. However, the corporation is not allowed to recognize any losses from the distribution of property other than in a complete liquidation.[76]

If there is any debt assumed by the shareholder as part of the distribution, the value of the distribution is reduced by the debt assumed.[77] The shareholder receiving the property must do all of the following.

1. Reduce their basis in the S corporation to the extent of AAA.
2. Report taxable dividends if the distribution is treated as AEP.
3. Report taxable gain as a constructive sale of stock if the value of property exceeds stock basis.

The following table summarizes the various adjustments to basis, AEP, and AAA for distributions of gain and loss property. It also shows the distribution's impact on the shareholders and the S corporation.

	Distribution of Gain Property	Distribution of Loss Property
Corporation tax treatment	• Gain recognized (§311(b)) • Nature of property determines character of gain • Gain flows through to members on pro-rata basis	• No loss recognized (§311(a))
Effect on AEP	• Deemed disposition: AEP increases by amount of gain (§312(b)(1)) • Distribution: AEP decreases by FMV of property (§312(b)(2))	• Decreased by cost basis in the property (§312(a))
Effect on AAA	• Deemed disposition: increases by the gain • Distribution: decreases by FMV of property	• Deemed disposition: no decrease from loss (because of §311(a)) • Distribution: decreases by FMV of property [a]
Effect on shareholder basis (if shareholder basis exists)	• Deemed disposition: increases by gain • Distribution: decreases by FMV of property	• Deemed disposition: no decrease (due to §311(a)) • Distribution: decreases by FMV of property (§301(c)(2))

[a] Very limited IRS guidance exists on proper accounting for the distribution of loss property. Treas. Reg. §1.1368-2(c)(2) indicates an FMV reduction is made to AAA on loss property when the limited conditions of §1.1368-2(c)(1) exist.

75. IRC §311(b).
76. IRC §311(a).
77. IRC §301(b)(2).

TRANSACTIONS WITH SHAREHOLDERS

Shareholders in closely held corporations often need regular and rigorous guidance from their tax practitioners to structure their transactions in ways that benefit taxpayers and are acceptable under the Code, regulations, and rulings. It is especially imperative that transactions between shareholders and S corporations do not violate S corporation provisions or raise unnecessary flags with the IRS.

This section focuses on four areas of concern: compensation issues, loans to and from shareholders, reimbursements to shareholders, and disproportionate distributions.

COMPENSATION ISSUES

There are many ways to financially reward an employee and an investor. Because S corporation shareholders often fill both roles, payments must be reasonably allocated between wages, fringe benefits, and distributions of profits. It is important to keep adequate documentation of how the allocation was determined. A shareholder-employer may also be paid for reimbursements, rents, etc., and these payments should be adequately documented.

Reasonable Compensation

Distributions are **not** subject to employment taxes but salaries and wages are. Reasonable compensation is an issue when the S corporation is paying dividends or providing excessive fringe benefits to shareholder-employees. However, it is not unreasonable for shareholder-employees to take low or even no wages during the start-up years when the company is not generating sufficient funds to adequately compensate them.

To address perceived abuses, the IRS requires S corporation shareholder-employees to take reasonable wages. However, there is no concise definition of reasonable compensation. Therefore, the individual facts and circumstances of each situation determine how much is reasonable.[78]

The IRS first addressed the reasonable wage issue in 1974.[79] Subsequently, many IRS challenges to unreasonable wages have been successful in the courts.[80]

> **Note.** While S corporations are scrutinized for unrealistically low wages compared to distributions, C corporations are often examined for excessively high salaries compared to dividends. The truly reasonable salary is one that falls into a range that could pass both tests.

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78. *Wage Compensation for S Corporation Officers.* Aug. 18, 2012. IRS. [www.irs.gov/uac/wage-compensation-for-s-corporation-officers] Accessed on Jun. 27, 2016.

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

80. See, e.g., *Radtke v. U.S.,* 712 F.Supp. 143 (E.D. Wis. 1989), *aff'd* 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting v. U.S.,* 918 F.2d 90 (9th Cir. 1990); *Veterinary Surgical Consultants, P.C. v. Comm'r,* TC Memo 2003-48, *aff'd* 90 Fed Appx 669; *Joseph M. Grey v. Comm'r,* 119 TC 121 (2002), *aff'd* 93 Fed Appx 473; *Nu-Look Design, Inc. v. Comm'r,* TC Memo 2003-52 (Feb. 26, 2003), *aff'd* 356 F.3d 290; *Joly v. Comm'r*, 211 F.3d 1269 (6th Cir. 2000); *Veterinary Surgical Consultants, P.C. v. Comm'r*, 117 TC 141 (2001); *David E. Watson, PC v. U.S.*, 668 F.3d 1008 (8th Cir. 2012).

Factors considered by the IRS and the courts in determining what constitutes reasonable compensation include the following.[81]

- 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

The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation. Sources of the S corporation's gross receipts are an important factor. The three major sources are the following.[82]

1. Services of shareholder
2. Services of nonshareholder employees
3. Capital and equipment

If most of the corporation's gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation. However, if a significant portion of gross receipts and profits come from items 2 and 3, then it is reasonable that the shareholder would receive distributions along with compensation.[83]

Note. The 7th Circuit Court of Appeals rejected the use of the factors previously listed in determining whether compensation is reasonable. Instead, it adopted an independent-investor test. This test asks whether a hypothetical independent investor would consider the rate of return on investment in the corporation higher than would be reasonably expected. If that is the case, a high level of compensation paid to the corporation's chief executive officer (CEO) is presumptively reasonable. The presumption is rebuttable if an extraordinary event is responsible for the company's profitability or the executive's position was merely titular.[84]

The corporation in the 7th Circuit case was a C corporation. In addition to the highly compensated CEO, there were other shareholders who had approved the CEO's salary. This fact was significant to the court. It is not clear how the independent-investor test would be applied to S corporation shareholder-employees who receive extremely high rates of return and low salaries.

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81. *Wage Compensation for S Corporation Officers.* Aug. 18, 2012. IRS. [www.irs.gov/uac/wage-compensation-for-s-corporation-officers] Accessed on Jun. 27, 2016.

82. *S Corporation Compensation and Medical Insurance Issues.* Jun. 15, 2016. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues] Accessed on Jun. 27, 2016.

83. Ibid.

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

In addition to compensation for gross receipts directly generated by the shareholder-employee, the shareholder-employee should also be compensated for administrative work performed. For example, a manager may not directly produce gross receipts but may assist the other employees in producing the day-to-day gross receipts.[85] Administrative work performed as a corporate officer should also be compensated.[86]

> **Note.** The IRS has internal guidelines for what constitutes a reasonable salary within particular industries in various geographic locations. These guidelines are often used as a starting point when the IRS reviews a particular taxpayer's compensation.
>
> Public libraries may have reference sources that provide averages of compensation paid for various types of services. There are also a number of websites that purport to give regional salary ranges based on experience and industry, but because the methodology of determining the salaries may be unknown, tax practitioners are cautioned to not rely on these too heavily.
>
> However, one question to the shareholder-employee can frequently determine if a salary is **unreasonably low:** "Would you work this hard for this level of pay if you did not own the company?" If the answer is no and the shareholder has been taking distributions, then it may be prudent to reclassify some of the distributions as salary.

Fringe Benefits[87]

> **Caution.** Attribution rules apply to fringe benefits provided to family members of 2% shareholders.[88] Thus, the rules explained in this section also apply to spouses, children, grandchildren, and parents of the S corporation's 2% shareholders. However, they do not apply to a spouse who is legally separated from a shareholder under a decree of divorce or separate maintenance.

In general, shareholders who own (or who are deemed to own)[89] **more** than 2% of the S corporation's outstanding stock must include the value of fringe benefits in their wages. Although the term is technically inaccurate, shareholders who own more than 2% of the stock or voting power of the S corporation's stock are often referred to as "2% shareholders."

IRC §1372(a) controls the taxation of fringe benefits for 2% shareholders. It states that, for these purposes, such **shareholders are taxed under the rules applicable to partners in a partnership.**

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85. Ibid.

86. *Wage Compensation for S Corporation Officers.* Aug. 18, 2012. IRS. [www.irs.gov/uac/wage-compensation-for-s-corporation-officers] Accessed on Jun. 27, 2016.

87. IRC §1372(a).

88. IRC §1372(b) referencing IRC §318(a)(1).

89. Under IRC §318.

In general, all fringe benefits **must be included** in 2% shareholder wages.[90] The most common benefits include the following.

- Group term life insurance premiums[91]
- Amounts received under accident and health plans (not subject to FICA taxes)[92]
- Premiums on employer-paid accident and health insurance (not subject to FICA taxes)[93]
- Voluntary contributions to health savings accounts (HSAs) (not subject to FICA taxes)[94]
- Meals and lodging provided by the employer[95]
- Parking and transit passes provided by the employer[96]

The following fringe benefits are **excludable from wages,** assuming all relevant requirements are met.[97]

- Educational assistance programs (2% shareholder's tax-free benefit is limited to 5% of the total benefit provided to employees)
- Dependent care assistance (2% shareholder's tax-free benefit is limited to 25% of the total benefit provided to employees)
- No-additional-cost benefits
- Employee discounts
- Working-condition fringe benefits
- De minimis fringe benefits
- On-premises athletic facilities

IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits,* states that employer-provided adoption assistance and **employer contributions** to an HSA must be treated as distributions to 2% shareholders. (Such shareholders are not eligible for pre-tax contributions to an HSA.) Fringe benefits that are treated as distributions to 2% shareholders are not included when determining if disproportionate distributions create additional classes of stock. This is because the shareholders are treated as partners instead of employees for this purpose. The partnership rules allow disproportionate distributions among partners. Consequently, for fringe benefits treated as partner distributions, the disproportionate distribution rules do not apply.

> **Note.** IRS Pub. 15-B states that employee achievement awards are taxable to 2% shareholders. However, Dr. Jamison argues that these benefits are excludable by partners and therefore should also be excludable by 2% shareholders.[98]

90. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*, uses the following phrase to indicate that a fringe benefit should be included in wages: "Treat a 2% shareholder as you would a partner in a partnership for fringe benefit purposes, but don't treat the benefit as a reduction in distributions to the 2% shareholder."

91. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*. See also IRC §79.

92. Under IRC §105.

93. Under IRC §106.

94. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*.

95. Under IRC §119.

96. Under IRC §132(f)(5)(E).

97. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*.

98. Robert W. Jamison, *S Corporation Taxation*, ¶805.01 (2016 ed., CCH Inc. 2015).

Employer-Provided Cell Phones.[99] The value of an employer-provided cell phone may be excludable from an employee's income as a working-condition fringe benefit. Furthermore, the personal use of an employer-provided cell phone may also be excluded as a de minimis fringe benefit.

To qualify, the phone must be provided to the employee primarily for noncompensatory business reasons. Examples of such business reasons include the employer's:

- Need to contact the employee at all times for work-related emergencies,
- Requirement that the employee be available to speak with clients at times when the employee is away from the office, and
- Need to speak with clients located in other time zones at times outside the employee's normal workday.

The value of a cell phone provided to promote goodwill of an employee, to attract a prospective employee, or as a means of providing additional compensation to an employee is not excludable from wages.

Medical Insurance Premiums and Health Plans.[100] The health and accident insurance premiums paid on behalf of a 2% shareholder-employee are deductible by the S corporation as fringe benefits. Such premiums are reportable as wages for income tax withholding purposes on the shareholder-employee's Form W-2, *Wage and Tax Statement*. The premiums are not subject to social security, Medicare, or unemployment taxes. Therefore, this additional compensation is included in box 1 ("wages, tips, other compensation") of the Form W-2 but is not included in boxes 3 or 5 ("social security wages" and "Medicare wages and tips," respectively).

A 2% shareholder-employee may be eligible for a deduction from adjusted gross income on line 29 ("self-employed health insurance deduction") of Form 1040 for amounts paid during the year for medical care premiums. The deduction is limited to the Medicare wages paid by the employer to the 2% shareholder. The medical care coverage must be established by the S corporation. If the medical care plan is in the 2% shareholder's name and not in the S corporation's name, a medical care plan is considered to be established by the S corporation if both of the following conditions are met.

1. The S corporation either paid **or** reimbursed the 2% shareholder for the premiums.
2. The S corporation reported the premium payment or reimbursement as wages on the 2% shareholder's Form W-2.[101]

The Affordable Care Act (ACA) did not change the rules regarding the federal income and employment tax treatment of health and accident premiums paid for a 2% shareholder. However, the ACA imposes an excise tax on the S corporation if the S corporation offers a health plan that fails to comply with certain market reform provisions. The potential excise tax is $100 per day, per employee, per violation.

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99. IRS Notice 2011-72, 2011-38 IRB 407.

100. *Wage Compensation for S Corporation Officers.* Aug. 18, 2012. IRS. [www.irs.gov/uac/wage-compensation-for-s-corporation-officers] Accessed on Jun. 5, 2016; *S Corporation Compensation and Medical Insurance Issues.* Jun. 15, 2016. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues] Accessed on Jun. 27, 2016.

101. IRS Notice 2008-1, 2008-2 IRB 251.

The excise tax for failure to satisfy the ACA market reforms generally is **not** imposed on an S corporation in the following two situations.

1. The S corporation provides medical benefits under a health plan that satisfies the ACA market reform requirements (for example, a group health plan that does not provide for reimbursement of individual policy premiums).
2. Only one active employee participates in the employer payment plan on the first day of the plan year under which the S corporation reimburses the cost of individual policy premiums.[102]

> **Note.** An S corporation with only family employees who are covered by the same plan falls under the second exception to the market reforms.

The Department of Labor and the IRS are contemplating publication of additional guidance on the application of the market reforms to a 2% shareholder-employee healthcare arrangement. Until such guidance is issued, the excise tax will **not** be asserted for any failure to satisfy the market reforms by a 2% shareholder-employee healthcare **arrangement** covering only 2% shareholders.[103]

> **Note.** Unless additional guidance provides otherwise, an S corporation with a 2% shareholder-employee healthcare arrangement is not required to file Form 8928, *Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code*, solely as a result of having a 2% shareholder-employee healthcare arrangement.

LOANS BETWEEN SHAREHOLDERS AND THE CORPORATION

In situations involving closely held corporations, it is common for loans to be made to and from the corporation without adequate documentation. Loans in either direction may have serious consequences if the proper procedures are not observed.

Loans From Shareholders

The IRS may reclassify loans to a corporation as equity contributions if the loans do not meet certain requirements. This can cause the following problems.

1. Interest paid to the shareholder-lender could be disallowed as a corporate deduction.[104]
2. A bad debt deduction by the shareholder-lender could be disallowed if the debt becomes uncollectible.[105]
3. A shareholder-lender may have different rights than the other shareholders, thus creating a second class of stock in violation of the prohibition against S corporations having more than one class of stock.[106]

> **Note.** FSA 001959 (Dec. 5, 1996) provides a comprehensive discussion of the various factors that may be considered when determining if advances from a shareholder constitute debt or equity.

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102. IRC §9831(a)(2).
103. *S Corporation Compensation and Medical Insurance Issues.* Jun. 15, 2016. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues] Accessed on Jul. 15, 2016.
104. See *Georgia Cold Storage Company v. U.S.,* 934 F.2d 1265 (11th Cir. 1991).
105. See *Miles Production Company v. Comm'r,* 457 F.2d 1150 (5th Cir. 1972).
106. IRC §1361(b)(1)(D).

Debt That Is Not Treated as a Second Class of Stock. "Straight debt" as defined by the Code is **not** treated as a second class of stock. Straight debt is any **written unconditional promise to repay** the loan if **all three** of the following conditions are met.[107]

1. The interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors. Fluctuations tied to the prime rate are acceptable.[108]
2. There is no convertibility (directly or indirectly) into stock.
3. The creditor is an individual (other than a nonresident alien), an estate, a QSST, or a person who is actively and regularly engaged in the business of lending money.

Straight debt may be payable on demand or on a certain date. Qualifying as straight debt does not mean that the IRS cannot reclassify excessive interest as compensation, impose the imputed interest rules, or reclassify the debt as equity. It simply means that the IRS cannot terminate the S election based on reclassifying the debt as a second class of stock.

There is a **safe harbor** in the regulations for certain short-term unwritten advances and proportionately held obligations. Even if the advances would be considered equity under general Code principles, **unwritten advances** from a shareholder are not treated as a second class of stock for that tax year when the loans:[109]

- Do not exceed a total of $10,000 at any time during the corporation's tax year,
- Are treated as debt by the parties, and
- Are expected to be repaid within a reasonable time.

Debt obligations that are owned solely by the shareholders and in the same proportion as the outstanding corporation stock are not treated as a second class of stock, even if the debt would be considered equity under general Code principles. Debt obligations owned by the **sole shareholder** of a corporation are always held proportionately to the corporation's outstanding stock. The IRS does not assert that the debt results in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitations regarding eligible S corporation shareholders.[110]

Loans to Shareholders[111]

The IRS can reclassify loans to shareholders as dividends, distributions to the shareholders, or wages subject to employment taxes. To avoid these potential problems, a loan to a corporate shareholder or officer should include the characteristics of a loan made at arm's length. There should be a written contract with a stated interest rate, a specified length of time for repayment, and a consequence for failure to repay the loan. Collateral is also a positive indication of a loan.

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107. IRC §1361(c)(5).

108. Ltr. Rul. 9342019 (Jul. 21, 1993).

109. Treas. Reg. §1.1361-1(l)(4)(ii)(B).

110. Ibid.

111. *Paying Yourself*. Jun. 10, 2016. IRS. [www.irs.gov/businesses/small-businesses-self-employed/paying-yourself] Accessed on Jun. 30, 2016.

Below-Market Loans[112]

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate (AFR). A below-market loan generally is considered an arm's-length transaction in which the borrower is considered as having received both of the following.

1. A loan in exchange for a note that requires the payment of interest at the AFR
2. A deemed payment in an amount equal to the forgone interest

The deemed payment is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the transaction's substance. The deemed payment may be deducted by the borrower if the deemed payment otherwise qualifies as deductible. The deemed payment is taxable income to the lender.

For any period, forgone interest is the interest that would be payable for that period if interest accrued on the loan at the AFR and was payable annually on December 31, minus any interest actually payable for the period accrued at the loan's stated rate.

Example 11. Monique is the 50% shareholder of Interesting Narrative Inc., which is an S corporation. On January 1, 2015, she loaned $100,000 to the corporation at 0% interest via a demand note. The annual AFR on that date for a short-term obligation (demand notes are considered short term) was 0.41%.[113] The corporation used the borrowed funds for operating purposes.

On December 31, 2015, the corporation was deemed to have paid Monique interest of $410 ($100,000 loan × 0.41% AFR). The corporation deducted the interest. Monique reported the entire $410 as income, and 50% of the interest expense passed through to her.

Note. AFRs are published by the IRS each month in a revenue ruling. These revenue rulings can be found at **uofi.tax/16b4x1** [apps.irs.gov/app/picklist/list/federalRates.html].

Generally, the rules for below-market loans do **not** apply when the total amount of the outstanding loans between the borrower and lender is **$10,000 or less**. This exception applies only to compensation-related loans and corporation-shareholder loans if the avoidance of any federal tax is **not** a principal purpose of the interest arrangement.

The below-market loan rules also do not apply if the taxpayers can show that the interest arrangement has no significant effect on the lender or the borrower's federal tax liability.

The determination of whether an interest arrangement has a significant effect on the lender or the borrower's federal tax liability is based on all the facts and circumstances, such as the following.

- Whether items of income and deduction generated by the loan offset each other
- The amount of the items
- The cost of complying with the below-market loan provisions if they were to apply
- Any reasons, other than taxes, for structuring the transaction as a below-market loan

Note. A below-market term loan **other** than a gift or demand loan is treated as an original issue discount (OID) obligation. The OID may be classified as a dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

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112. IRS Pub. 535, *Business Expenses.*

113. Rev. Rul. 2015-01, 2015-1 IRB 331.

REIMBURSEMENTS TO SHAREHOLDERS

The S corporation's board and management are responsible for setting policies concerning which payments on behalf of the corporation are reimbursable. Under any business structure, the reimbursed expenses must meet the IRC §162 tests for ordinary and necessary business expenses. An ordinary expense is one that is common and accepted in the taxpayer's industry. A necessary expense is one that is helpful and appropriate for the taxpayer's trade or business. An expense does not have to be indispensable to be considered necessary.[114]

To avoid payments being treated as wages, the employee must provide substantiation for reimbursed expenses as required under the IRS's accountable plans provisions. In order to qualify as an accountable plan, the reimbursement or allowance arrangement must require that employees meet all three of the following rules.[115]

1. There must be a business connection to the expenditure.
2. There must be adequate accounting by the employee within a reasonable period of time, generally 60 days. Employees must verify the date, time, place, amount, and the business purpose of the expenses. Receipts are required unless the reimbursement is made under a per diem plan.
3. Excess reimbursements or advances must be returned within a reasonable period of time, generally 120 days.

Amounts paid under an accountable plan are not wages and are not subject to income tax withholding and payment of social security, Medicare, and Federal Unemployment (FUTA) taxes.

> **Caution.** One reimbursement policy that is sometimes used by S corporations is to reimburse a shareholder-employee for the expenses of operating an office out of their home. There is no authority that specifically allows this practice even if the home office is exclusively used for business and meets the requirements that would apply to a sole proprietor. Therefore, if the corporation chooses to reimburse the shareholder-employee for home office expenses, it must establish that the reimbursement is based on the actual additional cost the employee incurs by operating out of their home.

DISPROPORTIONATE DISTRIBUTIONS

The one-class-of-stock eligibility requirement for subchapter S requires that all current and liquidating distributions be in proportion to shareholders' stock ownership. The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the **governing provisions).**

A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds, and therefore is not a governing provision unless a principal purpose of the agreement is to circumvent the one-class-of-stock requirement. Although a corporation is not treated as having more than one class of stock as long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.[116]

> **Note.** It is not uncommon for S corporation shareholders to take distributions casually. In addition, tax preparers sometimes reclassify personal expenses as distributions. Unfortunately, the existence of distributions that are disproportionate to stock ownership can be an indication that the shares are not of the same class or that the distributions are more correctly classified as compensation.

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114. IRS Pub. 535, *Business Expenses.*

115. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses.*

116. Treas. Reg. §1.1361-1(l)(2)(i).

Because a binding agreement to distribute profits disproportionately creates a second class of stock, this can result in inadvertent termination of the corporation's S status. As such, S corporations must be careful about agreeing to give shareholders equal **after-tax** distributions. If the shareholders' tax rates are different, the corporation has agreed to treat the stock owned by shareholders as having different distribution rights. This creates multiple classes of stock.

However, the regulations do allow the corporation to make distributions based on the shareholders' varying ownership interests in the S corporation's income in the current or immediately preceding tax year.[117] The distributions must be made within a reasonable time after the close of the tax year in which the varying interests occur. If the distributions occur too late, the IRS may recharacterize the payments as compensation or other types of income. However, the IRS will not assert that there was a second class of stock.

> **Example 12.** William Craft owned 100% of the shares of Thousand Miles Inc. from January 1, 2015, to June 30, 2015. From July 1, 2015, through December 31, 2015, he owned 40% of the shares and John Langston owned the other 60%. Using a per-day weighted average, William owned 69.92% of the shares in 2015. John owned the remaining 30.08%. The taxable S corporation profits for 2015 are allocated to each shareholder on Schedule K-1 based on these percentages.
>
> After the S corporation return is completed in September 2016, Thousand Miles Inc. distributes $30,000. This distribution is based on 30% of the taxable income reported on the corporation's 2015 tax return. The intent of the distribution is to compensate the shareholders for the taxes they must pay on the income they declare.
>
> Although William and John own 40% and 60% of the shares, respectively, it is acceptable for the corporation to make 69.92% of the September distributions to William, which is equal to $20,976 ($30,000 × 69.92%). Thus, William's share of the $30,000 is based on his average ownership share in 2015 instead of his ownership on the distribution date.

If the S corporation files a **composite state return** on behalf of nonresident shareholders, the corporation may pay state taxes for some shareholders (but not all). To avoid the problem of disproportionate distributions, the corporation should make equalizing distributions to the other shareholders.[118]

REPORTING FOR NIIT PURPOSES

The net investment income tax (NIIT) applies to investment income above certain thresholds. S corporation income is subject to this tax if the taxpayer does **not** materially participate in the company's operations. Furthermore, some activities (such as financial trading) are subject to NIIT as a function of law, regardless of the shareholder's level of participation.[119]

If the S corporation has multiple activities, it is necessary to identify its activities on an attachment to the Schedule K-1. If the S corporation elects to group activities together, the combined activities must be an appropriate economic unit.[120]

S corporations must comply with the disclosure instructions for multiple activities as contained in the instructions for Form 1120S. Generally, this is done by separately stating the amounts of income and loss for each activity on attachments to the shareholders' Schedules K-1. A shareholder may not treat activities grouped together by the S corporation as separate activities.[121]

> **Note.** Comprehensive information about grouping activities and the NIIT can be found in the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive]. For additional information about the NIIT, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Individual Taxpayer Issues.

117. Treas. Reg. §1.1361-1(l)(2)(iv).

118. Ltr. Rul. 201240012 (May 9, 2012).

119. Treas. Reg. §1.1411-5.

120. Treas. Reg. §1.469-4(c)(1).

121. Rev. Proc. 2010-13, 2010-4 IRB 329.

CHANGES IN SHAREHOLDER INTERESTS

An S corporation does not dissolve when a shareholder sells or otherwise disposes of their shares in the corporation. However, the S corporation and the shareholders should consider certain elections based on the circumstances of the disposition. The following elections may be appropriate.

1. A **terminating election** under IRC §1377 or under Treas. Reg. §1.1368-1(g) to treat the activity prior to the sale and after the sale as two separate tax years for purposes of determining the Schedule K-1 allocation to the shareholders
2. An IRC §338 election to treat a stock purchase as an asset purchase (available only to corporate purchasers)

THE TERMINATING ELECTION OPTIONS

There are two provisions allowing for termination elections.

- Under IRC §1377, the qualifying disposition must be of the shareholder's **entire interest** in the corporation.
- Under Treas. Reg. §1.1368-1(g), only a **certain portion** of the corporation's shares must change hands. The basic mechanics of the elections are the same.

The default method for allocating each shareholder's pro-rata share of any pass-through item for any tax year is determined on a per-share, per-day basis.[122] The last day of a shareholder's interest in the corporation is included as one of the days allocable to the shareholder.[123] However, in certain circumstances, the corporation's activity may be separated into two periods and then allocated on the per-share, per-day basis during each period.[124]

Example 13. Lucy owned 100% of the shares in Akron Women Inc., an S corporation, from January 1, 2016, through July 19, 2016. On July 19, 2016, she sold her shares to Sally. For the 2016 tax year, the S corporation made a net profit of $366,000.

If the terminating election is not made, Lucy's Schedule K-1 will report her share of the pass-through items as $201,000 ($366,000 × 201/366 days). Sally's reportable share will be $165,000 ($366,000 − $201,000).

Example 14. Use the same facts as **Example 13,** except Lucy and Sally agreed to make the terminating election. For the period from January 1, 2016, through July 19, 2016, the corporation made a net profit of $1,000, which Lucy will report on her 2016 tax return. The rest of the profit, $365,000, is reportable by Sally on her 2016 tax return.

> **Note.** It may be wise for transferors to obtain the transferee shareholders' consent and for the S corporation to make the termination election at the time the terminating transaction is negotiated instead of after the tax year ends.

A terminating election does not change the S corporation's tax year, nor does it change the year in which the shareholders report the income. A terminating election is irrevocable and is effective only for the terminating event for which it is made.

All affected shareholders and the corporation must agree to the termination election. Affected shareholders include the **transferor** shareholder and the **recipient** shareholder. If the shareholder transfers their shares to the corporation, the term "affected shareholders" includes all persons who are shareholders during the tax year.

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122. IRC §1377(a).
123. Treas. Reg. §1.1377-1(a)(2)(ii).
124. IRC §1377(a).

The IRC §1377 Terminating Election

To qualify for this election, the shareholder's entire interest in an S corporation must have terminated during the S corporation's tax year. A shareholder's entire interest is terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, such as the following.

1. A sale or exchange
2. A gift
3. A spousal transfer
4. A redemption by the corporation regardless of the tax treatment of the redemption
5. The shareholder's death

A shareholder's entire S corporation interest is **not** terminated if the shareholder retains ownership of any stock that would result in the shareholder being considered a shareholder as defined for purposes of making an S corporation election under IRC §1362(a)(2). This includes any interest **treated as stock** under Treas. Reg. §1.1361-1(l). However, any interest held by the shareholder because of their status as a creditor, employee, director, or in any other nonshareholder capacity is disregarded for this purpose.

An S corporation makes a terminating election by attaching a statement to its timely filed original or amended return for the tax year during which a shareholder's entire interest is terminated. The election statement must include the following.

1. A declaration by the S corporation that it elects under IRC §1377(a)(2) and Treas. Reg. §1.1377-1(b) to treat the tax year as if it consisted of two separate tax years
2. Information explaining when and how the shareholder's entire interest was terminated (e.g., a sale or gift)
3. A declaration that the corporation and each affected shareholder consent to the terminating election (An executor or administrator of a deceased affected shareholder's estate may consent to the terminating election on behalf of the deceased affected shareholder.)

If there is more than one terminating election for the tax year, a single election statement may be filed with the tax return. However, a shareholder who consented to the election concerning their termination is not required to consent to a subsequent terminating election unless that shareholder is an affected shareholder with respect to the subsequent termination as well.

The Treas. Reg. §1.1368-1(g) Terminating Election

To qualify for this election, there must be a qualifying disposition during the tax year. A qualifying disposition is **one** of the following.

1. A disposition by a shareholder of 20% or more of the corporation's outstanding stock in one or more transactions during any 30-day period during the corporation's tax year
2. A redemption treated as an exchange[125] of 20% or more of the corporation's outstanding stock from a shareholder in one or more transactions during any 30-day period during the corporation's tax year
3. An issuance of an amount of stock equal to or greater than 25% of the previously outstanding stock to one or more **new** shareholders during any 30-day period during the corporation's tax year

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[125] Under IRC §§302(a) or 303(a).

A corporation makes this election by attaching a statement to a timely filed (including extensions) original or amended return. The election statement must include the following.

- That the corporation makes the election for the tax year under Treas. Reg. §1.1368-1(g)(2)(i) to treat the tax year as if it consisted of separate tax years
- The facts relating to the qualifying disposition (e.g., sale, gift, stock issuance, or redemption)
- A declaration that each shareholder holding stock in the corporation during the tax year consents to this election

A single election statement may be filed for all elections made under this provision for the tax year. The statement is verified by signing the return in lieu of signing the statement itself.

Coordination with IRC §1377(a)(2) Election. If the event resulting in a qualifying disposition also results in a termination of a shareholder's **entire** interest, the election under IRC §1377 must be made instead of this one. The effect is the same under either election.

TREATING A STOCK PURCHASE AS AN ASSET PURCHASE[126]

Under the IRC §338 elections, the acquired corporation (also called the **target corporation**) is treated as having sold all its assets for FMV at the close of the acquisition date. This is a taxable event. The IRC §338 elections are **not** mechanisms to create nontaxable exchanges.

This same corporation is subsequently deemed to be a **completely new** corporation. This new corporation then "buys" all of the former corporation's assets. **These deemed events allow the corporation to step up the basis of its assets to the FMV.** It also causes all of the former corporation's tax attributes to disappear, including elections, tax year, AEP, etc.

The IRC §338 elections are available to corporations purchasing other corporations in a variety of ways. Although the provisions allow for multiple acquisitions prior to the date the acquiring corporation has acquired 80% of the target, these provisions do not apply to purchases of S corporations. This is because a corporation is not a permitted shareholder of an S corporation.[127] The target's S status is terminated at the time a nonqualified entity becomes a shareholder.

IRC §338(g) Election

The §338(g) election causes the deemed sale and repurchase transactions to be treated as if they both occurred **immediately after the stock transfer.** Because this places the burden of claiming the gain from the asset sales on the target corporation's buyer, this method is rarely used.[128] The more common election is the one made under §338(h)(10).

IRC §338(h)(10) Election[129]

If the target is an S corporation, this election is only available to unrelated corporations that purchase 80% or more of the stock in one transaction. As explained previously, the target does not retain its S corporation status if a corporation becomes a shareholder.

The §338(h)(10) election causes the deemed sale of assets to be treated as if it occurred immediately **before the stock transfer**. The deemed **purchase of assets** is treated as occurring immediately **after the stock transfer.** This election requires the consent of both the seller and purchaser of the stock. The election is irrevocable.

> **Note.** The IRC §338(h)(10) election is also available to parent corporations selling subsidiary corporations to other unrelated corporations. These types of transactions are beyond the scope of this chapter.

126. IRC §338.

127. IRC §1361(b).

128. Robert W. Jamison, *S Corporation Taxation,* ¶1505.08, p. 1348 (CCH, 2016).

129. Treas. Reg. §1.338(h)(10)-1.

Example 15. Dress Reforms Inc. is an S corporation whose stock was 100% owned by Amelia Bloomer on January 1, 2015. Seneca Falling Inc., a C corporation, wished to acquire Dress Reforms as one of its subsidiaries. After some negotiations, Amelia agreed to sell 80% of her shares to Seneca. After further negotiations and additional concessions by Seneca, Amelia agreed to an IRC §338(h)(10) election. The sale took place on August 8, 2015.

On its 2015 return, Dress Reforms reported the deemed sale of all of its assets on August 8, 2015, for $600,000. As of August 8, 2015, Dress Reforms had an ineligible shareholder (the C corporation), and its S election was terminated.

As of August 9, 2015, a new tax year started for the corporation. It elected a fiscal year ending June 30. Its first Form 1120 covered the period August 9, 2015, through June 30, 2016. The corporation treated all of the assets as purchased by the C corporation on August 9, 2015.

The total net gains from the deemed sale of the assets by Dress Reforms was $100,000. Amelia reported 100% of these pass-through gains on her 2015 personal return. Her basis in all of her shares increased by the $100,000 of gains she reported.

After the deemed asset sale but before the S corporation shareholders sell their shares of stock to the acquiring corporation, the S corporation is deemed to have transferred the asset sale proceeds to its shareholders and ceased to exist. The S election continues in effect through the close of the acquisition date, including the time of the deemed asset sale and the deemed liquidation. The phantom transfer is treated for income tax purposes in the same manner as if the proceeds had actually been distributed.

Example 16. Use the same facts as **Example 15.** On her 2015 return, Amelia reported the deemed transactions as if she received 100% of the proceeds from the asset sale in a complete company liquidation. She then reported the sale of 80% of her shares and used 80% of her adjusted basis in the S corporation as her basis for the sale of the shares.

When the target corporation is an S corporation, the income tax liability for the deemed sale naturally flows through to the shareholders. If the S corporation owes any BIG tax as a result of the deemed sale, the new corporation is liable for the tax.[130]

Making the IRC §338(h)(10) Election. An IRC §338(h)(10) election is made on Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases.* The shareholders who sell their stock, the corporation, and the S corporation shareholders who do **not** sell their stock must all consent to the election. The election must be made no later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. However, if the election is not filed by the due date, the taxpayer may qualify for relief under the provisions contained in Rev. Proc. 2003-33.[131]

Form 8883, *Asset Allocation Statement,* must be filed with the final Form 1120S and with the new corporation's first return. Failure to file Form 8883 without reasonable cause may subject the taxpayer to penalties under IRC §§6721 through 6724.[132]

Note. IRC §338 and the related regulations contain many nuances. Compliance with all of the associated laws is critical to achieving the desired tax effects. This material is presented as an introduction to the availability of the elections in this Code section and is **not** intended to be a comprehensive guide with respect to the elections and the tax reporting of the deemed transactions.

130. Treas. Reg. §1.338-4(d)(1).

131. Rev. Proc. 2003-33, 2003-1 CB 805.

132. Instructions for Form 8883.