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Please note. Corrections were made to this workbook through January of 2020. 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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ELIGIBILITY FOR S CORPORATION STATUS

Only a **small business corporation** may elect and maintain S corporation status under the Code.[1] Generally, for purposes of this rule, a small business corporation is a corporation that meets the following requirements.[2]

- Is a domestic corporation
- Has no more than 100 shareholders
- Has only eligible shareholders
- Does not have any nonresident aliens as shareholders
- Does not have more than one class of stock

However, there are special rules and certain exceptions applicable to some of these requirements.

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Not only must these requirements be met by the business entity when it first elects S corporation status, but these requirements must also be **continuously maintained** by the S corporation in order to preserve its S status. S corporation status is automatically **terminated** if any event occurs that would preclude the corporation from qualifying as a small business corporation.[3]

> **Note.** For additional information on the termination of an S corporation election, including revocation by shareholders, the effective date of the termination, and the tax treatment of the year in which the termination occurs, see IRC §1362 and underlying regulations.

DOMESTIC CORPORATION[4]

In order for a domestic entity to be considered a corporation, it must be classified as a corporation for federal tax purposes under the federal tax classification rules. Under the federal tax classification rules, the following business entities are automatically considered a corporation for federal tax purposes.

- A business entity organized under a federal or state statute that refers to the entity as a "corporation" or that refers to the entity as "incorporated"
- A business entity organized under a state statute that refers to the entity as a "joint-stock company" or "joint-stock association"

Under the classification rules, an entity that is not automatically considered a corporation is eligible to elect its own tax classification.[5] A noncorporate entity with two or more owners is given a default classification as a partnership but may be taxed as a corporation if the appropriate election is made. The election treats the eligible entity as an association that is taxed as a corporation.[6]

A noncorporate entity with a single owner is treated as a disregarded entity for federal tax purposes[7] but may make an appropriate election to be treated as a corporation.[8]

1. IRC §1361(a)(1).
2. IRC §1361(b)(1).
3. IRC §1362(d)(2); Treas. Reg. §1.1362-2(b).
4. IRC §1361(a)(1); Treas. Regs. §§301.7701-2, 301.7701-3, 301.7701-5(a).
5. Treas. Reg. §301.7701-3(a).
6. Treas. Regs. §§301.7701-3(a) and 301.7701-2(b)(2).
7. Treas. Reg. §301.7701-2(c)(2)(i).
8. Treas. Reg. §301.7701-3(a).

A domestic entity is generally any entity that is established under federal law or the law of any state.[9] This includes a corporation organized under both the laws of the United States or any U.S. state and of a foreign jurisdiction.[10] A foreign corporation may file domestication forms with a state in order to become a domestic entity.

Observation. The Illinois Business Organizations Entity Omnibus Act, 805 ILCS 415, Article 3, provides for the domestication of foreign entities. Upon filing Form EOA 305 with the Illinois Secretary of State and obtaining approval, a foreign entity may be treated as an Illinois corporation. For additional details, see 805 ILCS 415 and Form EOA 305 at **uofi.tax/19b5x1** [www.ilga.gov/legislation/ilcs/ilcs5.asp?ActID=3831&ChapterID=65] and **uofi.tax/19b5x2** [www.cyberdriveillinois.com/publications/pdf_publications/eoa305.pdf], respectively.

A limited liability company (LLC) is an example of a domestic entity that is not a traditional state law corporation but is nevertheless eligible for S status.[11]

Example 1. Carla establishes a new business entity, Carla's Cake Creations, LLC (CCC) in Illinois. Because she is the sole owner, the LLC is treated as a disregarded entity under the default federal tax classification rules unless Carla makes an election, using Form 8832, *Entity Classification Election,* to have the LLC treated as a corporation. If Carla wishes to operate CCC as an S corporation, she must make this election on Form 2553, *Election by a Small Business Corporation,* and ensure that the entity meets all of the other S corporation requirements.

Example 2. Ben and Bridgette are the two owners of a new Pennsylvania LLC, B&B Metal Fabricating, LLC (BB). They wish to operate the business as an S corporation. Under the default classification rules, BB is treated as a partnership unless Ben and Bridgette elect to have BB treated as a corporation. This election would allow BB to be treated as an S corporation as long as it meets all other S corporation requirements.

NO MORE THAN 100 SHAREHOLDERS

To qualify as an S corporation, a small business corporation may not have more than 100 shareholders.[12] The determination of who is an S corporation shareholder is a matter of federal rather than state law. Generally, the person obligated to include in their income any dividends distributed with respect to the stock is considered a shareholder.[13] Beneficial ownership in the S corporation may be sufficient to be counted as a shareholder, even if the shareholder is not reflected as such in corporate records or is not entitled to state shareholder rights.[14]

Family members, including their spouses and estates, are considered as one shareholder.[15] Family members include lineal descendants of a common ancestor, as well as spouses, former spouses, and estates of the lineal descendants or common ancestor. [16] However, this rule is subject to the limitation that the common ancestor may not be removed by more than six generations from the youngest generation of shareholders on the **latest** of:[17]

- The date of the S corporation election (explained later),
- The earliest date at which any family member becomes a shareholder, or
- October 22, 2004.

9. Ltr. Rul. 9512001 (Sep. 30, 1994).
10. Treas. Reg. §301.7701-5(a).
11. *Limited Liability Company (LLC)*. May 8, 2019. IRS. [www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc] Accessed on May 28, 2019.
12. IRC §1361(b)(1)(A).
13. Treas. Reg. §1.1361-1(e)(1).
14. *Kean v. Comm'r*, 469 F.2d 1183 (9th Cir. 1972), *aff'g in part* 51 TC 337 (1968).
15. IRC §1361(c)(1)(A)(ii).
16. IRC §1361(c)(1)(B).
17. Ibid.

In addition, a spouse (or former spouse) is considered in the same generation as the person to whom they are (or were) married. Each person owning the S corporation stock jointly or by tenancy in common is counted as a shareholder. However, special rules apply to married couples.[18] **Married couples are considered one shareholder** until dissolution of the marriage for any reason other than death.[19] Therefore, after a divorce, each spouse is considered a separate shareholder.

Example 3. Sigma Corporation (SC) must ensure it has no more than 100 shareholders in order to qualify for S corporation status. SC has 99 shareholders and issues additional stock to Fred and Frieda. Fred and Frieda are unrelated and will own the stock jointly. SC no longer qualifies for S corporation status because it has more than 100 shareholders.

Example 4. Use the same facts as **Example 3,** except Fred and Frieda are married. SC qualifies for S corporation status after the stock is issued to Fred and Frieda because it has no more than 100 shareholders.

Note. For additional details regarding how S corporation shareholders are counted, including shareholders that are entities, see Treas. Reg. §1.1361-1(e).

Practitioner Planning Tip

The late filing penalty for an S corporation return is generally $205 per month, **per shareholder,** up to a maximum of 12 months per shareholder for returns required to be filed in 2020.[20]

For each failure to furnish Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.,* to a shareholder when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a $270 penalty may be imposed with respect to each Schedule K-1 for which a failure occurs. If the requirement to report correct information is intentionally disregarded, each $270 penalty is increased to $540, or 10% of the aggregate amount of items required to be reported correctly, whichever is greater.[21] See IRC §§6722 and 6724 for more information.

The penalty will not be imposed if the corporation can show that not furnishing information timely was due to reasonable cause.

Therefore, practitioners are advised to review the calculation of any penalties assessed to ensure the penalties accurately reflect the number of shareholders and that there is only one penalty for shareholders who are a married couple.

18. Treas. Reg. §§1.1361-1(e)(2), (3).
19. IRC §1361(c)(1); Treas. Reg. §1.1361-1(e)(2).
20. IRC §6699(b)(1); Rev. Proc. 2018-57, 2018-49 IRB 827.
21. See IRC §6721(e) and Rev. Proc. 2018-57, 2018-49 IRB 827.

For each failure to furnish Schedule K-1 to a shareholder when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a $270 penalty may be imposed with respect to each Schedule K-1 for which a failure occurs. If the requirement to report correct information is intentionally disregarded, each $270 penalty is increased to $540, or 10% of the aggregate amount of items required to be reported correctly, whichever is greater.[22] See IRC §§6722 and 6724 for more information.

The penalty will not be imposed if the corporation can show that not furnishing information timely was due to reasonable cause.

Exceeding the maximum number of shareholders disqualifies a business entity from obtaining (or maintaining) S corporation status.

Shareholder agreements that restrict the transfer of shares may be used to prevent unintended increases in the number of S corporation shareholders. Moreover, strategies involving the use of related entities may be used to ensure the 100-shareholder limitation is adhered to.

> **Example 5.** TJC Sports Enterprises (TJC) is operated by 300 unrelated individuals. These individuals are divided into three equal groups of 100 individuals, and each group formed a separate corporation (T, J, and C). The three corporations then formed a partnership for the joint operation of TJC. Each of the constituent corporations (T, J, and C) qualifies for S corporation status. This is true even if the partnership structure was developed for the purpose of circumventing the 100-shareholder limitation.[23]

ELIGIBLE SHAREHOLDERS

In order to obtain and maintain S corporation status, shares must be held by eligible shareholders. Such eligible shareholders generally include the following.

- Individuals other than nonresident aliens[24] (discussed further in the next section)
- Estates[25]
- Bankruptcy estates[26]
- A qualified subchapter S trust (QSST) or other trust that is considered owned by a U.S. citizen or resident under federal tax rules[27]
- An electing small business trust (ESBT)[28]

> **Note.** For further details on eligible shareholders, see IRC §1361(c)(2)(A).

22. See IRC §6721(e)(1) and Rev. Proc. 2018-57, 2018-49 IRB 827.
23. Rev. Rul. 94-43, 1994-27 IRB 8.
24. IRC §§1361(b)(1)(B) and (C).
25. IRC §1361(b)(1)(B).
26. IRC §1361(c)(3).
27. IRC §§1361(c)(2)(A)(i) and 1361(d).
28. IRC §1361(c)(2)(A)(v).

While an estate generally qualifies as an eligible S corporation shareholder, the IRS may disregard an unreasonably prolonged estate. In this case, the IRS deems the estate's beneficiaries to be the S corporation shareholders. This may result in the termination of an existing S corporation election if the beneficiaries do not qualify as eligible shareholders.[29] However, when S corporation stock is transferred to a trust under the terms of a will, the resulting testamentary trust is considered a shareholder of the respective S corporation but only for the 2-year period beginning on the day on which such stock is transferred to it.[30]

In addition, while a bankruptcy estate qualifies as an eligible shareholder, the bankruptcy court may distribute the stock to an ineligible shareholder and trigger a termination of the S election. It may therefore be desirable to use strategies in a bankruptcy situation to ensure the bankruptcy estate's continued ownership of any S corporation stock.

> **Example 6.** When Boris, a U.S. citizen, filed for bankruptcy, he owned two S corporations, Extravaganza Endeavors, Inc. (EE) and Greenacres Landscaping Corporation (GLC). At the time of the bankruptcy, Boris also owned two residential apartment buildings and other property.
>
> The S corporation shares of EE and GLC, as well as the apartment buildings and other property owned by Boris, are transferred to the bankruptcy estate as a result of the bankruptcy proceedings. Although the apartment buildings and other property are transferred from the bankruptcy estate to a liquidating trust for the benefit of creditors under order of the bankruptcy court, the S corporation shares are not transferred. The bankruptcy court does not order the S corporation shares to be transferred because the liquidating trust is not an eligible S corporation shareholder. Transferring the shares would result in a termination of the S election for both EE and GLC. Instead, the bankruptcy estate retains title to the shares without any ownership rights, with all ownership rights and economic benefits accruing to the trustee of the liquidating trust. This strategy prevents the transfer of shares to an ineligible shareholder and preserves the S election of both corporations.[31]

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QSST Shareholders[32]

A small business corporation can have a grantor trust as a shareholder.[33] A QSST, similar to a grantor trust, is also eligible to hold the stock of an S corporation. A number of requirements must be met for a trust to qualify as a QSST. The trust documents must provide that all of the income of a QSST be distributed (or required to be distributed) to a single income beneficiary and the income beneficiary must be a U.S. citizen or resident. This requirement ensures that the income is taxed on an individual income tax return and not on the trust income tax return.

Finally, if the terms of the trust are such that it qualifies to be treated as a QSST, the beneficiary must make the required election (see the section titled "Electing S Corporation Status").[34] A separate election is required for the stock of each S corporation held by the trust.

ESBT Shareholders[35]

An ESBT is eligible to be an S corporation shareholder as long as the requirements of IRC §1361(e) are satisfied. An ESBT is treated as two trusts for income tax purposes. The ESBT must treat their S corporation items as a separate trust and is taxed on those items at the trust level at the highest applicable tax rate for trusts. The remaining assets are treated as if held in a second trust and taxation follows general trust rules. Additionally, the grantor or another person may be treated as the owner of all or a portion of these deemed trusts. Before the enactment of the Tax Cuts and Jobs Act (TCJA), nonresident aliens could not be potential current beneficiaries of ESBTs.

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29. *Old Virginia Brick Company, Inc. v. Comm'r*, 367 F.2d 276 (4th Cir. 1966).

30. IRC §1361(c)(2)(A)(iii).

31. The facts of this example illustrate the strategy used in *Benton v. Comm'r,* 122 TC 20 (2004).

32. Treas. Reg. §1.1361-1(j); *Using qualified Subchapter S trusts (QSSTs)*. Ellentuck, Albert B. Dec. 1, 2017. The Tax Adviser. [www.thetaxadviser.com/issues/2017/dec/using-qssts.html] Accessed on May 29, 2019.

33. IRC §1361(c)(2)(A)(i).

34. IRC §1361(d)(2).

35. Treas. Reg. §1.641(c)-1.

Qualified Business Income Deduction.[36] An ESBT is entitled to the IRC §199A qualified business income deduction (QBID). However, special rules apply to an ESBT. The S portion of the ESBT takes into account qualified business income (QBI) items from any S corporation owned by the ESBT, while the other deemed trust takes into account QBI items, if any, from remaining assets.

However, the ESBT is considered a **single** trust when determining if the ESBT's taxable income exceeds the IRC §199A(e)(2)(A) threshold amount.

NO NONRESIDENT ALIEN SHAREHOLDERS

Under IRC §1361, a domestic corporation cannot obtain S corporation status if it has any nonresident alien (NRA) shareholders.[37] If a qualifying shareholder has an NRA spouse, this disqualifies the domestic corporation from S status from the moment state community property law or the law of a foreign jurisdiction confers stock ownership to the NRA spouse.

However, an NRA spouse, when married to a U.S. citizen or resident, may elect to be treated as a U.S. resident for federal income tax purposes. If such an election is made, the electing spouse is considered a U.S. resident for S corporation purposes and that spouse is considered a qualified S corporation shareholder.

> **Note.** For additional details on the elections available to NRA spouses to be treated as U.S. residents for tax purposes, including the criteria that must be met, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Special Taxpayers. These elections are made under IRC §§6013(g) and 6013(h).

Special rules were adopted for dual status residents (DSRs).[38] A DSR is an individual who is considered both a U.S. resident (under U.S. law) and a resident of another country (under that country's laws) with which the U.S. has a tax treaty. A DSR is considered a U.S. resident, and therefore a qualified S corporation shareholder, if the DSR does not claim a reduced U.S. tax rate under the applicable treaty.[39] If the DSR does claim such a treaty benefit, they are generally considered a disqualified S corporation shareholder on the first day of the tax year in which that treaty claim is effective. However, a DSR claiming a treaty benefit may still be considered a U.S. resident if the following conditions are met.[40]

- The DSR treats all S corporation income and loss items as pass-through items from a U.S. trade or business.
- The DSR treats any gain or loss from the sale of S corporation stock as a disposition of a partnership interest.
- The S corporation and the DSR agree that the S corporation will withhold tax from any S corporation income allocable to the DSR and from any gain on an S corporation stock sale.
- The DSR files a statement with their U.S. tax return indicating the DSR understands claiming a treaty benefit as a nonresident terminates the S corporation's status unless a withholding agreement is in place.

The IRS has been rigid on the prohibition against ineligible shareholders with respect to the preservation of S status for a corporation, even in cases where the benefits of ownership accrued only to eligible shareholders.[41]

36. Treas. Reg. §1.199A-6(d)(3)(vi).
37. IRC §1361(b)(1)(C).
38. Treas. Reg. §301.7701(b)-7(a).
39. Treas. Reg. §301.7701(b)-7(a)(4).
40. Treas. Reg. §§301.7701(b)-7(b), (c).
41. *W&W Fertilizer Corporation v. U.S.,* 527 F.2d 621 (Ct. Cl. 1975) and *American Nurseryman Publishing Company v. Comm'r,* 75 TC 271 (Nov. 17, 1980).

ONLY ONE CLASS OF STOCK

A small business corporation may only have one class of stock.[42] As a general rule, an S corporation is considered to have only a single class of stock if all outstanding shares provide shareholders with identical distribution and liquidation rights and no other instruments, obligations, or arrangements that may be treated as a second class of stock have been entered into by the corporation.[43]

Governing corporate documents (such as articles, bylaws, and any binding agreements) as well as state law are generally determinative of whether outstanding corporate stock provides equal distribution and liquidation rights to all shareholders. Circumstances involving actual, constructive, or deemed distributions that differ among shareholders in timing or in amounts that reflect terms other than equal rights among all shareholders in accordance with their respective ownership interests may be construed as creating a prohibited second class of stock.[44] However, the Tax Court has held that an unequal distribution alone does not result in a second class of stock as long as the outstanding shares are actually entitled to equal distributions.[45]

Practitioner Planning Tip

State laws that require corporations to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders are **disregarded** in determining whether all outstanding shares of a corporation's stock confer identical rights to distribution and liquidation proceeds.[46] Therefore, for example, the Illinois requirement for S corporations, partnerships, and trusts to withhold Illinois income tax on behalf of nonresident shareholders, partners, and beneficiaries does not place an S corporation election at risk.[47]

Some contracts entered into by the corporation, such as leases, employment agreements, or loan agreements, are not considered governing documents of the corporation for purposes of establishing the number of the corporation's stock classes. Accordingly, an S corporation that pays excessive compensation to one shareholder relative to other shareholders is not considered to have more than one class of stock unless the principal purpose of the payment was to circumvent the single-class-of-stock requirement.[48] Below-market loans to shareholders that are characterized as deemed distributions are also generally not considered to create unequal distribution rights that establish more than one class of stock.

42. IRC §1361(b)(1)(D).
43. Treas. Reg. §1.1361-1(l)(1).
44. Treas. Reg. §1.1361-1(l)(2)(i).
45. *Linda K. Minton v. Comm'r,* 562 F.3d 730 (5th Cir. 2009), *aff'g* TC Memo 2007-32 (Dec. 26, 2007), and *Craig P. Mowry and Cricket U. Mowry v. Comm'r,* TC Memo 2018-105 (Jul. 5, 2018).
46. Treas. Reg. §1.1361-1(l)(2)(ii).
47. *Subchapter S, Pass-through Withholding Payments*. Illinois Department of Revenue. [www2.illinois.gov/rev/research/taxinformation/income/Pages/subchapters.aspx] Accessed on May 29, 2019.
48. Treas. Reg. §1.1361-1(l)(2)(vi), Example (3).

In addition, differences in voting rights among shares of outstanding stock are disregarded for purposes of determining whether more than one class of stock exists.[49] Generally, as long as all shares have equal distribution and liquidation rights, the fact that some shares are voting and others are nonvoting is not construed as establishing more than one stock class. Similarly, shares with rights to vote on differing issues, irrevocable proxy agreements, or shares that have differing rights to elect board of director members is not considered more than one class of stock.

A redemption agreement is an agreement between the S corporation and its shareholders in which the S corporation agrees to redeem or purchase stock if a specified event occurs, such as the death, divorce, disability, or employment termination of a shareholder. Such agreements, as well as buy-sell agreements and restricted transfer agreements that result in differing rights among outstanding shares, are generally disregarded under the one-class-of-stock requirement. However, such agreements may be considered to have established more than one stock class if:[50]

- Circumvention of the one-class-of-stock requirement was a principal purpose of the agreement, and
- The agreement establishes a purchase price that is significantly different from the fair market value (FMV) of the stock at the time the agreement is entered into by its parties.

Note. For additional details on how other corporate agreements such as deferred compensation plans, call options, or varying interest distributions may impact the one-class-of-stock requirement, see Treas. Reg. §1.1361-1(l). This regulation provides guidance on the impact of several types of corporate agreements under this requirement.

ELECTING S CORPORATION STATUS

If all requirements (mentioned earlier) are met, any domestic corporation or other entity eligible to be taxed as a corporation may make an S election. This election is made by filing Form 2553.

Note. A copy of Form 2553 is included in the appendix to this chapter.

MAKING THE ELECTION

To make the S election, Form 2553 must be filed:[51]

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

Example 7. Gretchen and Hilda establish a new LLC in Illinois. The LLC is established on September 16, 2019. Under the default federal tax classification rules, the new LLC receives partnership tax treatment unless Gretchen and Hilda make an election to have the LLC taxed as an S corporation.

Gretchen and Hilda want the LLC to be taxed as an S corporation effective with the LLC's September 16, 2019 inception date. Therefore, they must file Form 2553 no more than two months and 15 days after this date (which is the beginning of the LLC's first tax year). The two month and 15 day period ends on November 30, 2019. Accordingly, Form 2553 must be filed during the period that begins on September 16, 2019, and ends on November 30, 2019, to obtain S corporation tax treatment effective from the beginning of the LLC's first tax year on September 16, 2019.

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49. Treas. Reg. §1.1361-1(l)(1).

50. Treas. Reg. §1.1361-1(l)(2)(iii).

51. Instructions for Form 2553.

LLC Conversion to S Corporation

An LLC taxed as a partnership that converts to an S corporation is deemed to have:[52]

1. Contributed all of its assets and liabilities to the corporation in exchange for its stock, and
2. Liquidated by distribution of the corporate stock to its partners.

When converting to an S corporation, the LLC should ensure that its operating agreement and associated documents are modified to comply with corporation eligibility requirements and inform the relevant state agency of its new entity classification.[53]

Caution. Tax practitioners are advised to determine if clients considering a conversion may be contributing liabilities in excess of the tax basis of assets to the entity, which may create a taxable event.

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Practitioner Planning Tip

To simplify accounting and tax reporting, it is recommended that a partnership electing S corporation classification does so effective at the beginning of the year. This ensures that the deemed contribution and liquidation are treated as if they occurred immediately before the close of the previous tax year and there is no intervening short tax year.[54]

EIN Requirements. A single-member or a multi-member LLC taxed as a partnership is **not** required to obtain a **new** employer identification number (EIN) when electing to be taxed as an S corporation.

Completion and Filing of Form 2553

Form 2553 requires that the corporation indicate the tax year for which the election will become effective. It is essential that this date be indicated appropriately to avoid confusion or undesired results.

Example 8. Use the same facts as **Example 7,** except while the LLC's Form 2553 indicates September 16, 2019, as the effective date of the election, the election is filed on March 13, 2020. Therefore, there is no valid election. The LLC is taxed as a partnership until a valid S election is made.

For an election to be valid for the tax year beginning January 1, 2020, it must be made before March 15, 2020, and Form 2553 must indicate January 1, 2020, as the effective date of the election. If it is too late to file an election for the 2020 tax year, the LLC may file an election at any time during 2020 for a valid election to become effective on January 1, 2021. In such a case, Form 2553 must indicate that January 1, 2021, will be the effective date of the election.

The original election form must be sent to one of three IRS service centers. The appropriate IRS service center to which Form 2553 should be sent is determined by the state in which the corporation's principal business or office is located. The instructions to Form 2553 provide the relevant IRS service center addresses and fax numbers.

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52. Treas. Reg. §301.7701-3(g)(1)(i).

53. *Electing S Corporation Status for a Limited Liability Company*. Ellentuck, Albert B. Nov. 30, 2019. The Tax Adviser. [www.thetaxadviser.com/issues/2013/dec/casestudy-dec2013.html] Accessed on May 29, 2019.

54. Ibid; Rev. Rul. 2009-15, 2009-21 IRB 1035.

Generally, within 60 days after filing Form 2553, the corporation is notified about whether the election was approved or denied.

Note. For additional guidance regarding the completion of Form 2553, see the IRS instructions for the form.

Practitioner Planning Tip

Form 2553 must be signed by both an officer (page 1) and the shareholders of the electing entity (page 2).

Besides making an S election, trust income beneficiaries can use part III of Form 2553 to make a QSST election (discussed earlier). In addition, part I, item F, and part II of Form 2553 can be used by a corporation to select a fiscal tax year.

LATE ELECTION RELIEF[55]

The Code provides the IRS with the authority to treat a late election as timely when the taxpayer had reasonable cause for missing the deadline.[56] Rev. Proc. 2013-30 provides the exclusive methods for taxpayers to request relief for a late S election. This guidance also contains provisions to make late elections for classification as an ESBT, QSST, qualified subchapter S subsidiary (QSub), or corporation.

To obtain relief, all the following requirements must be met.[57]

1. The requesting entity intends 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 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 was 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.

Note. Practitioners must ensure all affected shareholders actually reported the entity activity appropriately on their respective personal returns. If any shareholder did not, late relief is not available.

55. Rev. Proc. 2013-30, 2013-36 IRB 173.

56. IRC §1362(b)(5).

57. Rev. Proc. 2013-30, 2013-36 IRB 173 (§§4.02, 5.02).

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 Form 2553.

A corporation that meets criteria 1, 3, and 4 (as noted previously) but does not meet the deadline noted in criteria 2 may still request late election relief if all of the following are true.

- The corporation and all shareholders reported income consistent with S corporation tax treatment for the year in which the election should have been made and all subsequent tax years.
- At least six months has passed since the date on which the corporation filed its return for the first year in which the corporation desired S corporation tax treatment.
- Neither the corporation nor any shareholder received IRS notification of any problem with the S corporation tax status within six months of the date on which the S corporation filed its timely return.

Additional attestations are required for an entity that also makes a late corporate classification election (see Form 2553, part IV).[58]

A corporation not meeting any of the above requirements for late election relief generally must use the private letter ruling request process. For 2019, this process is described in Rev. Proc. 2019-4.

C CORPORATIONS ELECTING SUBCHAPTER S STATUS

Under the federal tax classification rules, the default method of taxation for a corporation is found under subchapter C. Many of these C corporation tax rules are irrelevant to S corporations that have elected subchapter S treatment effective as of the date of incorporation. However, if the corporation operated as a C corporation for a period of time before the effective date of an S election, the built-in gains (BIG) tax is among the important factors to consider prior to making the S election.

The BIG tax was established to eliminate taxpayer incentive to cause a C corporation with substantially appreciated assets to elect S tax treatment immediately prior to selling or distributing those assets in order to subvert the double tax aspects of C corporation tax treatment.

Under the BIG provisions, the S corporation may be liable for tax at the maximum corporate tax rate. In addition, the BIG tax's recognition period is the 5-year period beginning on the effective date of the S election.[59] Gains from assets sold after the recognition period ends are not subject to the BIG tax.

Observation. Prior to the TCJA, corporate tax rates were graduated, with a 35% maximum corporate tax rate. For 2018 and subsequent tax years, the TCJA's flat 21% tax rate is the maximum rate. In addition to a relatively short 5-year recognition period, the low corporate tax rate currently in effect may provide significant planning opportunities for existing C corporations with appreciated assets.

The 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: C Corporations, contains comparative tables regarding the relative cost of the BIG tax on S corporation shareholders. These tables distinguish between ordinary and capital gains and compare costs at different individual tax rates.

58. Rev. Proc. 2013-30, 2013-36 IRB 173 (§5.03).

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

PERMITTED TAX YEARS

An S corporation must use a permitted tax year.[60] A permitted tax year is one of the following.[61]

1. The calendar year
2. A 52-53 week year that ends with reference to the required year
3. A year elected under IRC §444
4. Any other year, if the S corporation demonstrates to the IRS that there is a business purpose for using a fiscal year

A newly electing S corporation does not require IRS approval for using a permitted year, and either of the first three options may be adopted.[62] An electing S corporation that wants to adopt any other tax year (option 4) must obtain IRS approval under IRC §442.

RENT PAID FOR SHAREHOLDER'S HOME OFFICE

Sole proprietors may claim a home office deduction, which is reported on Schedule C, *Profit or Loss From Business*. Upon establishing an S corporation, the now-incorporated proprietor may still benefit from a home office deduction.[63] However, within an S corporation setting, the home office deduction is a corporate-level deduction based on the S corporation renting office space from the shareholder. In addition to the rental agreement, the S corporation can reimburse the shareholder through an accountable plan arrangement. These two approaches are discussed next.

RENTAL OF OFFICE FROM SHAREHOLDER

Generally, when an S corporation rents home office space from the shareholder, the following reporting is required.

- Rent payments from the S corporation to the shareholder are a deduction by the S corporation on line 11 of Form 1120S, *U.S. Income Tax Return for an S Corporation*.
- The shareholder reports the rent payments as rental income on Schedule E, *Supplemental Income and Loss.*

Rental income is generally passive.[64] However, under the self-rental rule,[65] the rental income to the shareholder is recharacterized as nonpassive. Any losses remain passive in nature.

Moreover, the deduction for the business use of a home is limited[66] if part of the home is rented to the taxpayer's employer and the taxpayer uses the rented part in performing services for the employer. The taxpayer/employee can deduct mortgage interest and real estate taxes for the rented portion of the home, subject to any limitations. These items are reported on Schedule E. However, the taxpayer cannot deduct otherwise allowable trade or business expenses, business casualty losses, or depreciation related to the use of the home in performing services for the employer.[67]

Observation. As a sole proprietor, the home office deduction allows the deduction of expenses without application of the limitation regarding rentals to employers. Expenses such as the amount of homeowner's insurance, repairs and maintenance, and utilities properly allocable to the home office may be deducted (or the simplified home office deduction may be claimed). However, while the rental income is fully taxable as nonpassive income to the shareholder, it is not subject to self-employment (SE) tax because it is rental income.

60. IRC §1378.
61. IRC §1378(b); Treas. Reg. §1.1378-1(a).
62. Treas. Reg. §1.1378-1(b).
63. IRC §§280A(a) and (c).
64. IRC §469(c)(2).
65. Treas. Reg. §1.469-2(f)(6).
66. IRC §280A(c)(6).
67. IRC §280A(c)(1).

For the rental of office space to comply with IRC §280A, it must be exclusively used by the shareholder in their trade or business on a regular basis as their principal place of business **or** as a place normally used to meet patients, clients, or customers of the business.[68]

When taking this approach, there should be a bona fide rental agreement between the shareholder and the S corporation, with a fair rental value. Rental payments from the S corporation to the shareholder should actually be paid, documented, and identified.

Practitioner Planning Tip

A bona fide agreement regarding the rental of office space by an S corporation from a shareholder may permit the shareholder to justify receiving less compensation from the S corporation than would otherwise be the case. It may also help establish the residence as the tax home of the taxpayer for purposes of accountable plan business expenses such as mileage.

ACCOUNTABLE PLAN ARRANGEMENT

An accountable plan (AP) arrangement is established under Treas. Reg. §1.62-2(c)(2) to permit the S corporation to reimburse the shareholder for employee expenses. The AP must meet three conditions.

1. The expenses covered by the plan must have a nexus to the business.
2. The plan must require substantiation of the covered expenses.
3. The plan must require the shareholder to return any amounts received in excess of the substantiated expenses.

Under this method, the S corporation may deduct the amounts paid to the shareholder in reimbursement for the substantiated expenses, and such payments are not taxable to the shareholder. These reimbursed expenses may include expenses attributable to home office use, **including those expenses not deductible under the limiting rules associated with the self-rental approach.**

Practitioner Planning Tip

An AP arrangement is now a particularly important tax planning tool due to the suspension of miscellaneous itemized deductions subject to the 2%-of-AGI floor (including unreimbursed employee business expenses) during the TCJA period, which is January 1, 2018 through December 31, 2025.[69]

Note. For additional details regarding accountable plans, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues, and IRS Pub. 463, *Travel, Gift, and Car Expenses.*

68. Ibid.

69. PL 115-97, §11045.

REASONABLE COMPENSATION

Observation. QBI must be reduced by reasonable compensation.

The reasonable compensation requirement is unique to corporations. S corporation distributions are not subject to employment taxes, while shareholder wages are subject to such taxes. This creates an incentive to maximize distributions in lieu of wages. To prevent this abuse, the IRS requires S corporation owners to pay themselves a reasonable salary each year.[70] The IRS first addressed this issue in 1974,[71] and since that time, the IRS has successfully litigated this issue and substantial legal precedent has been established.[72] Courts have upheld the IRS's ability to recharacterize distribution amounts as wage compensation in order to ensure the business owner reports a reasonable amount as wage compensation for the tax year.

Note. IRS Fact Sheet 2008-25, "Wage Compensation for S Corporation Officers," provides some guidance on how to determine the amount of wage compensation that is reasonable. This publication is found at **uofi.tax/19b5x3** [www.irs.gov/pub/irs-news/fs-08-25.pdf]. The IRS provides additional guidance, including a discussion of litigation on the subject of reasonable compensation at **uofi.tax/19b5x4** [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-employees-shareholders-and-corporate-officers] and at **uofi.tax/19b5x5** [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues].

For a detailed discussion of reasonable compensation, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Entity Comparison.

A court's determination of whether reasonable compensation was paid involves a facts-and-circumstances analysis.[73] Some of the specific factors considered by the courts include the following.

- The training and experience of the taxpayer
- The taxpayer's duties and responsibilities
- The time and effort the taxpayer devotes to the business endeavor
- The dividend history
- The payments made to nonshareholder employees
- The timing and manner of paying bonuses to key people in the business
- The amount of comparable pay for similar services that the taxpayer provides
- The existence of any compensation agreements
- Whether there is any formula that determines compensation

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

71. Ibid.

72. *David E. Watson, PC v. U.S.,* 668 F.3d 1008 (8th Cir. 2012); *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 (Dec. 2002), *aff'd* 93 Fed.Appx. 473; *Nu-Look Design, Inc. v. Comm'r*, 85 TCM 927, *aff'd* 356 F.3d 290 (Jan. 2004).

73. *David E. Watson, PC v. U.S.,* 668 F.3d 1008 (8th Cir. 2012).

The IRS indicates that the key to establishing the amount of reasonable compensation is to consider the activity engaged in by the shareholder-employee with respect to the S corporation.[74] Looking at the source of gross receipts is relevant. For purposes of this inquiry, there are three major sources of gross receipts.

1. Services provided by the shareholder-employee
2. Services provided by the nonshareholder employees
3. Capital and equipment

If the source of funds come from either items 2 or 3, then such payments may not be considered services attributable to the shareholder-employee's personal services and it is reasonable that distributions would be received along with any compensation. However, if most of the gross receipts arise from item 1, most of the profit distribution may need to be in the form of compensation in order to withstand IRS scrutiny.

Note. It is important to document the sources of information used to justify the wage compensation amount paid to an S corporation business owner. Sources of information include the U.S. Department of Labor, employment agencies, placement offices, union administrations, and professional associations.

QBID CONSIDERATIONS

Note. For a detailed explanation of the QBID calculation, including information about qualified property and specified service businesses, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: QBID Update.

The introduction of the QBID by the TCJA potentially complicates the application of reasonable compensation standards.[75] This is because compensation is classified as wages from Form W-2, *Wage and Tax Statement,* which do not constitute QBI.[76] Furthermore, because compensation reduces the corporation's ordinary income and consequently its QBI, there can be a further incentive to minimize compensation, particularly for S corporation shareholders whose taxable income is below the applicable income threshold.[77] However, S corporation shareholders with taxable income exceeding the threshold may receive a higher QBID by maximizing W-2 wages. These contrasting situations are illustrated in the following examples.

Example 9. Bradley, the sole owner of Feldon Enterprises (an S corporation), is married to Mary, and they file jointly. In 2019, Feldon Enterprises has ordinary business income of $280,000. Bradley also receives $20,000 of W-2 wages from the corporation.

Feldon Enterprises is a qualified business for purposes of the QBID but is not a specified service business and has no qualified property (QP). The Feldons have no other income and claim the standard deduction. Bradley is the only employee of Feldon Enterprises.

For 2019, the Feldons have a $44,324 tax liability (including Bradley's FICA tax), determined as follows.

Caution. Facts and circumstances should be discussed with the taxpayer as to what is reasonable compensation, which is not defined. Failure to adequately explain the risks of not taking reasonable compensation could result in taxpayer penalties as well as practitioner penalties.

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74. *S Corporation Compensation and Medical Insurance Issues.* Mar. 2, 2019. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues] Accessed on Apr. 18, 2019.

75. PL 115-97, §11011; IRC §199A.

76. IRC §199A(d)(1)(B).

77. IRC §199A(b)(3).

Feldon Enterprises ordinary business income (which constitutes QBI)	$280,000
Bradley's W-2 wages from Feldon Enterprises	20,000
Total income	$300,000
Less: standard deduction	(24,400)
Taxable income before QBID	$275,600
Final QBID, which is the **lesser of:**	
• $56,000 ($280,000 QBI × 20%), **or**	
• $55,120 ($275,600 tentative taxable income × 20%)	(55,120)
Taxable income	$220,480
Federal income tax from the 2019 MFJ tax rate schedule: ((\$220,480 taxable income − \$168,400) × 24%) + \$28,765	$ 41,264
FICA tax on wages: $20,000 × 15.3%	3,060
Total federal income and FICA tax	$ 44,324

Because the Feldons' taxable income is below the applicable QBID income threshold, the W-2 wages/QP limit does not apply. Bradley cannot increase his QBID by minimizing his S corporation wages because of the application of the overall taxable income (OTI) limitation (i.e., taxable income before the QBID × 20%). However, if the Feldons had other income, then the OTI would be higher and Bradley could potentially increase his QBID by minimizing his S corporation wages.

Example 10. Use the same facts as **Example 9,** except Mary has $200,000 of compensation from her employment with a U.S. bank.

For 2019, the Feldons have a $116,407 tax liability (including Bradley's FICA tax but **excluding** Mary's FICA) determined as follows.

Feldon Enterprises ordinary business income (which constitutes QBI)	$280,000
Bradley's W-2 wages from Feldon Enterprises	20,000
Mary's W-2 wages from employment with a U.S. bank	200,000
Total income	$500,000
Less: standard deduction	(24,400)
Taxable income before QBID	$475,600
Less: Final QBID, which is the **lesser of:**	
• $95,120 OTI ($475,600 tentative taxable income × 20%), **or**	
• $10,000, which is the **lesser of:**	
♦ $56,000 ($280,000 net QBI × 20%), **or**	
♦ $10,000 W-2 wages/QP limit ($20,000 × 50%)	(10,000)
Taxable income	$465,600
Federal income tax from the 2019 MFJ tax rate schedule: ((\$465,600 taxable income − \$408,200) × 35%) + \$93,257	$113,347
FICA tax on Bradley's wages: $20,000 × 15.3%	3,060
Total federal income and FICA tax	$116,407

Because the Feldons' taxable income is now above the QBID upper income threshold, the W-2 wages/QP limit applies and consequently the resulting QBID is limited to 50% of Bradley's $20,000 S corporation W-2 wages.

The next example looks at what happens if Bradley decides to restructure his corporation's ordinary income/compensation allocation to maximize the QBID.

Example 11. Use the same facts as **Example 10,** except Feldon Enterprises has ordinary business income of $209,259 and Bradley received $85,714 of W-2 wages from the corporation.

For 2019, the Feldons have a $113,874 tax liability (including Bradley's FICA tax and the excess Medicare tax but **excluding** Mary's FICA tax), determined as follows.

Feldon Enterprises ordinary business income (which constitutes QBI)	$209,259
Bradley's W-2 wages from Feldon Enterprises	85,714
Mary's W-2 wages from employment with a U.S. bank	200,000
Total income	$494,973
Less: standard deduction	(24,400)
Taxable income before QBID	$470,573
Less: Final QBID, which is the **lesser of:**	
• $94,115 ($470,573 tentative taxable income × 20%), **or**	
• $41,852, which is the **lesser of:**	
♦ $41,852 ($209,259 net QBI × 20%), **or**	
♦ $42,857 W-2 wages/QP limit ($85,714 × 50%)	(41,852)
Taxable income	$428,721
Federal income tax from the 2019 MFJ tax rate schedule: ((\$428,721 taxable income − \$408,200) × 35%) + \$93,257	$100,439
FICA tax on Bradley's wages: $85,714 × 15.3%	13,114
Excess Medicare tax (Bradley's $85,714 wages + Mary's $200,000 wages − $250,000 threshold amount) × 0.9%	321
Total federal income and FICA tax	$113,874

Due to Bradley's compensation restructuring, the Feldons save $2,533 in taxes ($116,407 – $113,874). Perhaps more importantly, the additional $10,054 in FICA taxes incurred ($13,114 – $3,060) will increase Bradley's eventual social security benefit entitlement.

Practitioner Planning Tip

The QBI provisions sunset on December 31, 2025.[78] Tax practitioners with clients who increase their W-2 compensation and benefit from a higher QBID may have difficulty justifying a reduction in their compensation after 2025.

Note. The 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Entity Comparison, explores reasonable compensation in more detail. Moreover, this chapter contains several examples contrasting shareholder tax liabilities for different business entity structures (i.e., sole proprietorship, S corporation, and C corporation).

[78] PL 115-97, §11011; IRC §199A.

STOCK SALES TREATED AS ASSET SALES

In a taxable corporate stock acquisition transaction, the selling shareholders typically transfer all of their stock in their corporation (the "target corporation," or "target") to the purchasing corporation ("purchasing") in exchange for cash, notes, or other consideration. "Purchasing," with its controlling interest, becomes the parent of the newly purchased "target." The selling shareholders report any gain or loss on their respective stock sales to "purchasing" under IRC §§61(a)(3) and 1001. "Purchasing" receives a basis in its purchased "target" stock that is reflective of its purchase price for that stock,[79] and assets within "target" retain the same basis throughout the stock transaction.[80]

Example 12. Springfield Spring & Sprocket, Inc. (SSS) is an S corporation. SSS manufactures parts for historic vehicles. It owns and maintains old tooling and equipment that is highly valuable because of the market for the parts this equipment produces. SSS also has exclusive, nontransferable contracts with several parts suppliers who have a long-term business relationship with SSS.

SSS is owned by three shareholders, Xavier, Yvette, and Zachary, with each shareholder owning a one-third interest. The shareholders have owned SSS for approximately 20 years. Each shareholder has a $100,000 basis in their SSS stock. SSS has the following assets with an FMV of $1 million, in which the corporation has a $250,000 basis.

Assets	Tax Basis	FMV
Cash	$ 50,000	$ 50,000
Inventory	100,000	200,000
Accounts receivable	150,000	150,000
Equipment	0	200,000
Goodwill	0	450,000
Accounts payable	(50,000)	(50,000)
Net	$250,000	$1,000,000

AutoParts Conglomerate, Inc. (APC), a C corporation, is a major market supplier of modern automobile parts that is very interested in developing the ability to sell parts for historic vehicles. APC believes this would be a new growth market for its operations. APC discusses its purchase of SSS with Xavier, Yvette, and Zachary, and eventually, the three shareholders agree to sell their stock to APC for $1 million in a stock sale. The three shareholders transfer their shares to APC in exchange for $1 million on September 30, 2019. One-third of the $1 million proceeds from the sale of stock, or $333,333, is allocable to each of the three shareholders.

After the transaction, each shareholder reports gain of $233,333 ($333,333 proceeds – $100,000 basis). This is long-term capital gain for each shareholder. APC is the new owner of SSS, and SSS continues to have a $250,000 basis in assets that have an FMV of $1 million.

While APC now owns SSS's appreciated assets, it owns those assets with the same $250,000 basis that SSS had prior to the stock purchase. It can continue to claim any depreciation available on this asset basis amount. If APC had purchased SSS's assets for $1 million, it could have obtained a stepped-up basis in those assets under IRC §1012. Investing the purchase price in assets rather than stock provides the purchaser with an opportunity to depreciate the assets using the much higher basis, providing greater depreciation deductions against future income.

Note. In a sale of assets, the purchase price is allocated among the assets in accordance with IRC §1060.

79. IRC §1012.

80. IRC §334(b).

> **Note.** There may be non-tax reasons for purchasing stock rather than assets. In the preceding example, SSS had exclusive contracts with suppliers that may not have been transferable to APC. These contracts may have required APC to make the acquisition of SSS in a manner that retained SSS's independent corporate identity.

HISTORICAL BACKGROUND

In *Kimbell-Diamond Mining Co. v. Comm'r*,[81] Kimbell-Diamond (KD) owned a mill that was destroyed by fire. It began a search for a replacement mill and found a target company, Whaley, that owned a suitable replacement mill. KD bought all of Whaley's stock and subsequently liquidated Whaley. KD then became the direct owner of the mill when the mill was distributed from the liquidated Whaley corporate structure to KD in a liquidating distribution.

> **Observation.** This 2-step stock-purchase-and-liquidation transaction had the same end result that the outright purchase of the mill by KD from Whaley would have had if Whaley had liquidated after the mill sale.

The facts of this case are unusual in that Whaley's basis in the mill was larger than KD's purchase price for its stock. Typically, in such an acquisition, the purchaser's cost basis is higher than the target's asset basis.

The issue in the court case was KD's basis in the mill for depreciation purposes. KD argued that it had the ability to claim the same basis in the mill that Whaley had, which was higher than KD's purchase price. The IRS argued that KD **intended** to make an asset purchase because it was seeking a replacement mill; therefore, the 2-step stock-purchase-and-liquidation transaction should be viewed as an asset purchase under the step transaction doctrine. This would provide KD with a basis in the mill that reflected the purchase price that was lower than KD's purchase price for the stock.

The court agreed with the IRS, holding that KD really made an asset acquisition because it intended to acquire the asset, and therefore KD's basis in the mill was its purchase price for the asset it sought instead of the higher carryover basis from Whaley.

While the IRS view prevailed in this case, it led to an intent-based rule: taxpayers knew they could be certain to obtain a cost basis in the assets of a target simply by manifesting an intention to acquire those assets. This intent-based rule involved uncertainty, leading Congress to pass a Code provision in 1954[82] to codify *Kimbell-Diamond* while eliminating the unpredictability of an intent-based test for acquisition transactions. This 1954 provision was not elective and required liquidation of the target in order for the purchasing company to obtain the stepped-up basis in assets.

In 1982, Congress eliminated the 1954 provision and replaced it with IRC §338, which has been amended and reformed into the current-day Code provision. The current provision is available to corporations making a qualified stock purchase and is elective.

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81. *Kimbell-Diamond Mining Co. v. Comm'r*, 14 TC 74 (Jan. 27, 1950), *aff'd per curiam* 187 F.2d. 718 (5th Cir. 1951), *cert. denied* 342 U.S. 827 (1951).

82. This provision was a previous version of IRC §334(b)(2).

IRC §338

The provisions of §338 are **elective for the parties to an acquisition transaction** as long as all requirements are met. This Code section generally treats a newly acquired "target" corporation as if it sold all assets at FMV on the date of acquisition. After this deemed disposition, the "target" then liquidates, and a fictitious "new target" is established that repurchases the assets that the "old" liquidated "target" sold in the deemed disposition. **This repurchase price provides the purchaser with the stepped-up basis in the assets despite the fact that the legal structure was a stock purchase.**

In order to make an election under §338, "purchasing" must make a qualified stock purchase (QSP) in its acquisition of "target." A QSP is defined as a transaction (or a series of transactions) in which a "purchasing" corporation acquires stock in a "target" corporation that represents:[83]

- At least 80% of the total voting power of the "target" corporation, and
- Has a value of at least 80% of the total value of "target" stock.

The stock meeting this dual 80% test must be acquired during a 12-month period beginning with the date of the first acquisition by a purchase of stock that is included in a QSP.[84]

One provision of §338 is of significant importance in S corporation acquisitions. **A joint election by both "purchasing" and "target" under §338(h)(10) allows the "target" S corporation to recognize gain or loss on the deemed asset sale while the selling shareholders do not recognize any gain or loss with respect to the actual stock sale.**

> **Note.** There are two elective provisions under §338. A §338(g) election is also available, which applies to acquisitions of C corporations.

In order to make an election under §338(h)(10), the purchaser must be a corporation.[85] This includes both C and S corporations. Individuals, partnerships, or other noncorporate entities do not qualify. Moreover, a qualified target must be a corporation that falls into one of the following categories:[86]

- A corporation that is a subsidiary within a consolidated group (which meets the 80% ownership test for consolidated returns required by IRC §1504)
- A corporation within a subsidiary group that is eligible to, but does not, file a consolidated return
- An S corporation

TAX CONSEQUENCES TO THE PURCHASER

With the §338(h)(10) election, the purchaser is considered **to have acquired all of the assets** on the opening of the business day following the acquisition date. The asset purchase price is the adjusted grossed-up basis (AGUB). **Therefore, the purchaser receives a stepped-up tax basis in the assets.**

> **Note.** The methodology for allocating AGUB includes allocating the AGUB amount across various ordered classes of assets in a manner similar to a purchase and sale of assets under §1060. Goodwill and going concern value receive any final AGUB allocation after allocations to other classes.

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83. IRC §338(d)(3).

84. IRC §338(h)(1).

85. Treas. Reg. §1.338(h)(10)-1.

86. Ibid.

TAX CONSEQUENCES TO THE SELLER

The S corporation is deemed to have sold assets on the acquisition date. **The S corporation realizes gains or losses upon this hypothetical disposition.** Such gains or losses pass through to the shareholders, who report their pro-rata share of such gains or losses. Because the amount used as the sales price is the aggregate deemed sale price (ADSP), this is generally the amount the shareholders receive in the hypothetical liquidating distribution.

The installment method may be used by the "old target" (in connection with the deemed asset disposition) and is also available for the "old target" and shareholders in the deemed liquidation. However, the "old target" may not obtain any tax benefit from a §338(h)(10) election that it would not receive if it sold assets and liquidated instead of making the election.[87]

When selling an S corporation via a §338(h)(10) election, the shareholders often incur higher taxes from selling the corporation's assets rather than its stock, as the next example illustrates.

Example 13. Use the same facts as **Example 12,** except Xavier, Yvette, and Zachary and APC agree that they will jointly elect to treat the stock sale from the three shareholders to APC as an asset sale.

Xavier, Yvette, and Zachary are all single, have no other income, and claim the standard deduction. Under §338(h)(10), the transaction involves the following steps.

Xavier, Yvette, and Zachary transfer their shares to APC in exchange for APC's consideration of $1 million. APC acquires the shares from the shareholders on September 30, 2019.

Upon making the §338(h)(10) election, SSS is treated as selling its assets to an unrelated party on September 30, 2019, the day APC acquires SSS stock, with SSS obtaining $1 million in proceeds. The assets are sold at a price reflective of FMV. The allocation of the sales proceeds between SSS's assets is shown on the following Form 8883, *Asset Allocation Statement Under Section 338*.

87. Treas. Reg. §§1.338(h)(10)-1(d)(8) and (9).

For Example 13

Form **8883** (Rev. October 2017) Department of the Treasury Internal Revenue Service

Asset Allocation Statement Under Section 338

▶ Attach to your income tax return.
▶ Go to *www.irs.gov/Form8883* for instructions and the latest information.

OMB No. 1545-0123

Part I Filer's Identifying Information

1a Name as shown on return **Springfield Spring & Sprocket, Inc.**	**1b** Identifying number as shown on return **22-3658945**
1c Check applicable box (see instructions): ☐ Old target ☒ New target	**1d** Was a valid and timely Form 8023 filed? . . . . ☒ Yes ☐ No If "Yes," enter the date filed ▶ **10/01/19**

Part II Other Party's Identifying Information

2a Name of other party to the transaction **AutoParts Conglomerate, Inc.**	**2b** Other party's identifying number
Address (number, street, and room or suite no.)	
City or town, state, and ZIP code	

Part III Target Corporation's Identifying Information

3a Name and address of target corporation **Springfield Spring & Sprocket, Inc.**	**3b** Employer identification number
	3c State or country of incorporation

Part IV General Information

4a Acquisition date **09/30/19**	**4b** What percentage of target corporation stock was purchased: *(i)* During the 12-month acquisition period? ______ % *(ii)* On the acquisition date? . . . . . . **100.00** %

5a Stock price	**5b** Acquisition costs/Selling costs	**5c** Target liabilities	**5d** AGUB/ADSP
$ **1,000,000**	$	$ **50,000**	$ **1,050,000**

			Yes	No
6		Was the filer listed in Part I, above, a member of an affiliated group of corporations before the acquisition date? .		×
7		Was the target corporation a member of an affiliated group before the acquisition date?		×
8		Is the target corporation or any target affiliate:		
	a	A controlled foreign corporation? If "No," check here if it was a CFC at any time during the preceding 5 years ▶ ☐		×
	b	A foreign corporation with income, gain, or loss effectively connected with the conduct of a trade or business within the United States (including U.S. real property interests)?		×
	c	A qualifying foreign target under Regulations section 1.338-2(e)(1)(iii)?		×
	d	A corporation electing under section 1504(d) or section 953(d)?		×
	e	A domestic international sales corporation (DISC)?		×
	f	A passive foreign investment company (PFIC)?		×
	g	If the answer to item 8f is "Yes," is the PFIC a pedigreed qualified electing fund?		

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For Example 13

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Part V Original Statement of Assets Transferred

9 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of AGUB or ADSP
Class I	$ **50,000**	$ **50,000**
Class II	$	$
Class III	$	$
Class IV	$ **200,000**	$ **200,000**
Class V	$ **350,000**	$ **350,000**
Class VI and VII	$ **450,000**	$ **450,000**
Total	$ **1,050,000**	$ **1,050,000**

Part VI Supplemental Statement of Assets Transferred—Complete if amending an original statement or previously filed supplemental statement because of an increase or decrease in AGUB or ADSP.

10 Enter the tax year and tax return form number with which the original Form 8023 or Form 8883 and any supplemental statements were filed. ▶

11 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of AGUB or ADSP
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

12 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

Form **8883** (Rev. 10-2017)

The shareholders are deemed to accept a liquidating distribution of the $1 million proceeds that are deemed to be received by SSS. This leads to a hypothetical end to the life of the "old" SSS, which is considered terminated. This includes the termination of all tax attributes of the "old" SSS, including prior tax elections, the accumulated adjustments account, and other tax history.

Xavier, Yvette, and Zachary must report the corporation's gains and losses on this deemed asset sale on their respective returns[88] as reflected on the final Schedule K-1. (see the following table).

88. Treas. Reg. §1.338(h)(10)-1(e)(2)(ii).

Asset	Sales Proceeds	Tax Basis	Gain (Sales Proceeds − Basis)	Gain Character
Cash	$ 50,000	$ 50,000	$ 0	
Net accounts receivable[a]	100,000	100,000	0	
Inventory	200,000	100,000	100,000	Ordinary
Equipment	200,000	0	200,000	Ordinary
Goodwill	450,000	0	450,000	Capital
Total	$1,000,000	$250,000	$750,000	

[a] $150,000 accounts receivable less $50,000 accounts payable.

Consequently, the three shareholders of SSS each have a 2019 federal income tax liability of $37,747 calculated as follows.

SSS ordinary gains (which constitute QBI): $300,000 ÷ 3	$100,000
SSS long-term capital gains: $450,000 ÷ 3	150,000
Total income	$250,000
Less: standard deduction	(12,200)
Taxable income before QBID	$237,800
Less: Final QBID, which is the **lesser of:**	
• $20,000 OTI ($100,000 taxable income × 20%), **or**	
• $0, which is the **lesser of:**	
♦ $20,000 ($100,000 net QBI × 20%), **or**	
♦ $0 W-2 wages/QP limit	(0)
Taxable income	$237,800
Federal income tax from the 2019 MFJ tax rate schedule: (($237,800 taxable income − $150,000 capital gain − $84,200) × 24%) + $14,383	$ 15,247
Federal income tax on capital gains: $150,000 × 15%	22,500
Total federal income tax	$ 37,747

Contrast this result with the $30,064 tax from the 2019 capital gains tax rate schedule (($237,800 taxable income − $37,375) × 15%) that would have resulted if the shareholders had each sold their stock in SSS to APC (i.e., resulting in a long-term capital gain).

Therefore, Xavier, Yvette, and Zachary each incur additional federal income tax of $7,683 ($37,747 – $30,064) from making the §338(h)(10) election.

Observation. The preceding example appropriately did not calculate the 3.8% net investment income tax (NIIT),[89] as this was a sale of business assets. Tax practitioners are encouraged to review software calculations on Form 8960, *Net Investment Income Tax for Individuals, Estates, and Trusts,* to ensure proper calculations have been made.

89. IRC §1411(c)(4).

Hypothetical "new" SSS is established on October 1, 2019, the day after APC's stock acquisition date. It is deemed to acquire the previously disposed of assets from the deemed disposition. The assets are acquired at a price that is reflective of APC's stock purchase price of $1 million.

SSS is now a controlled subsidiary of APC and APC has a stepped-up basis in SSS assets that reflects the consideration paid for the SSS shares. "New" SSS remains intact as a separate corporate entity.

Note. The deemed sale price of assets is determined by computing the ADSP for the assets. For more information on the methodology for computing ADSP, see Treas. Regs. §§1.338-4 and 1.338-6.

Note. The price at which "new" SSS acquires the assets is the AGUB. Generally, AGUB is based on the price paid by APC for the shares with adjustments for any liabilities that remain in SSS or result from the transaction.[90] For additional details on the AGUB computation, see Treas. Reg. §1.338-5.

Observation. Once SSS is acquired by APC, it loses its status as an S corporation because APC, as a C corporation, is not a qualified S corporation shareholder.

Practitioner Planning Tip

In most case, sellers prefer not to make a §338(h)(10) election because it increases their tax burden as compared to a straight stock sale. However, the benefit to the buyer is generally high enough that the seller can "gross up" the selling price. Typically, in sales negotiations, when a buyer requests a §338(h)(10) transaction, the seller may negotiate the splitting of the tax savings with the buyer to the benefit of both parties.

A §338(h)(10) election may nevertheless be attractive for a seller with tax attributes (e.g. a net operating loss (NOL) carryforward) because they can net the losses with gain resulting from the deemed asset sale.

90. Treas. Reg. §1.338(h)(10)-1(f)(2).

MAKING THE ELECTION

The §338(h)(10) election is made jointly by "purchasing" and "target" on Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases.* Any S corporation shareholders who do not sell their stock must also consent to the election.[91] Both the purchaser and seller corporations must file the form.

Form 8023 is generally due by the 15th day of the ninth month after the acquisition date.

> **Example 14.** Use the same facts as **Example 12.** Because the acquisition date is September 30, 2019, the deadline for Form 8023 is June 15, 2020.

> **Note.** The IRS established relief procedures for the late filing of Form 8023. Generally, under Rev. Proc. 2003-33, there is an extension period of 12 months from the date it is discovered that a §338(h)(10) election was not timely made by filing Form 8023. This revenue procedure provides the exclusive remedy for a late filing of this form.

In addition, the "target" corporation must file two versions of Form 8883. One version reflects the allocation of ADSP across the assets in the deemed disposition of the target, while a second version reflects the deemed purchase of assets and allocates the AGUB.

> **Observation.** Form 8883 generally serves the same purpose as Form 8594, *Asset Acquisition Statement Under Section 1060,* which is generally used for asset sales and acquisitions outside the parameters of §338.

The first version of Form 8883 that reflects the asset sale is filed with the seller's return. The second version is filed with the "new target's" first return.

Tax Return Due Dates and Tax Years

Generally, the final return of the "old target" is due on the 15th day of the third month following the month in which the acquisition date occurs.[92] The acquisition date represents the liquidation and termination date of the "old target" and serves as the final date of its final tax year.

The "new target" is generally treated as a new corporation unrelated to the "old target." As a new corporation, the "new target" may adopt any allowable tax year and accounting method. The "new target" adopts a tax year by filing its first return for the desired tax year on or before the final day for making the §338(h)(10) election.[93]

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91. Instructions for Form 8023.
92. Treas. Reg. §1.338-10(a)(6)(ii).
93. Treas. Reg. §1.338-1(b)(1).

QUALIFIED SUBCHAPTER S SUBSIDIARY ELECTION

If the purchaser in the §338(h)(10) transaction is an S corporation, then the purchaser may want to make a QSub election. Prior to the Small Business Job Protection Act of 1996,[94] an S corporation could not own other corporations, and this had an impact on corporate acquisition planning. The changes that resulted from this legislation that are currently in effect include the following.

- An S corporation may own up to 100% of a subsidiary that is a C corporation.[95]
- An S corporation parent is not permitted to file a consolidated return along with its C corporation subsidiaries.[96]
- A C corporation may not own an S corporation subsidiary[97] (because a C corporation is not a qualified S corporation shareholder).
- A subsidiary of an S corporation may also be an S corporation (i.e., a QSub) if all requirements are met.[98]

A QSub is any domestic corporation that qualifies as an S corporation and is 100% owned by an S corporation parent that elects to treat it as a QSub.[99] A QSub must be an eligible subsidiary[100] and satisfy the following criteria.

- Be a domestic corporation
- Be 100% owned by an S corporation
- Not be considered an ineligible corporation

Note. The above three qualifying factors must exist both at the time of a QSub election and continuously thereafter in order to maintain the effectiveness of the election. If the subsidiary no longer meets all of the above criteria, it fails to qualify as an eligible subsidiary and the QSub election is terminated.

THE QSUB ELECTION

Generally, when an S corporation parent makes a valid QSub election in connection with a subsidiary, there is a deemed liquidation of that subsidiary, with the parent receiving the liquidating distribution. The tax consequences of the deemed liquidation are determined under all applicable Code provisions and principles.[101] The liquidation provisions (described next) are of particular importance when an S corporation purchases an existing C corporation and then makes a QSub election for that C corporation.

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94. PL 104-188.
95. PL 104-188, §1308.
96. IRC §1504(b)(8).
97. IRC §1361(b)(1)(B).
98. IRC §1361(b)(3).
99. IRC §1361(b)(3)(B).
100. Ibid.
101. Treas. Reg. §1.1361-4(a)(2).

Liquidation Provisions

IRC §332 provides that no gain or loss is recognized by a corporation receiving a liquidating distribution of an 80%-or-more-owned corporation in complete liquidation. However, certain requirements must be met in order to qualify for this nonrecognition treatment. The following requirements must be considered in QSub elections.[102]

- The liquidation must be a complete liquidation.
- The parent must receive all of the liquidating distribution(s) within the tax year or, if a series of distributions is made that occur beyond the tax year, they must be completed within three years pursuant to a liquidation plan.
- The parent must own 80% of both the total voting power and value of the liquidating subsidiary (80% control test).
- The liquidating subsidiary must not be insolvent.

The 80% test must be met at the time a formal liquidation plan is adopted (if such a plan is required) and continuously until all liquidating distributions are complete. In addition, nonrecognition treatment under this provision is not available if the subsidiary is insolvent,[103] or if the FMV of assets distributed to the parent is less than the amount of subsidiary liabilities taken by the parent.[104]

Moreover, when §332 requires the adoption of a plan of liquidation, a QSub election is treated as the necessary liquidation plan unless a formal liquidation plan was adopted earlier.[105]

Rather than recognize gain or loss upon the complete liquidation of the subsidiary, §332 defers such recognition by providing for a carryover basis in assets distributed in liquidation from the subsidiary to the parent.[106] The parent also inherits the subsidiary's tax attributes upon its liquidation.[107] Moreover, the liquidating subsidiary generally recognizes no gain or loss upon making the liquidating distribution.[108]

Making the Election

QSub elections are subject to timing issues that must be considered before making an election. The deemed liquidation of the subsidiary into the parent is deemed to have occurred at the close of the day before the QSub election is effective.[109]

Example 15. Parent Lumber Corp. (PLC) is a C corporation that owns 100% of Subterranean Wood Milling, Inc. (SWM), another C corporation. PLC has owned SWM for 12 years. On December 31, 2019, PLC files Form 2553 in order to become an S corporation effective January 1, 2020. On the same day, PLC also makes a QSub election for SWM. The deemed liquidation of SWM will occur at the close of December 31, 2019, on the final day PLC is a C corporation.

If the S corporation parent does not own 100% of the subsidiary's stock on the day before the effective date of the QSub election, the deemed liquidation takes place immediately after the parent first attains 100% ownership.[110]

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102. IRC §332.
103. Treas. Reg. §1.332-2(b).
104. Rev. Rul. 68-359, 1968-2 CB 161.
105. Treas. Reg. §1.1361-4(a)(2)(iii).
106. IRC §334(b)(1).
107. IRC §381(a).
108. IRC §§337(a), 336(a), and 336(d)(3).
109. Treas. Reg. §1.1361-4(b)(1).
110. Treas. Reg. §1.1361-4(b)(3)(i).

A QSub election may be made any time during the tax year, but the requested effective date cannot be more than either:[111]

- 12 months after the date the election form is filed, or
- Two months and 15 days before the election form is filed.

If an election is filed more than 12 months before the requested effective date, an effective date that is 12 months after the filing date is used. Moreover, an election filed more than two months and 15 days after the requested effective date is considered late. This results in an effective date that is two months and 15 days before the filing date.

Note. Relief for a late-filed election is available under Rev. Proc. 2013-30. An election filed more than two months and 15 days after the requested effective date is treated as timely if reasonable cause for failure to file timely is demonstrated. Otherwise, a private letter ruling requesting late election relief is necessary.

The election is made by the parent S corporation using Form 8869, *Qualified Subchapter S Subsidiary Election.* Once completed and signed by an authorized officer of the parent corporation, the form is filed with the IRS service center to which the subsidiary filed its most recent tax return.

Note. If the parent forms a new subsidiary and makes an election for the new subsidiary upon its formation, Form 8869 is filed with the IRS service center to which the parent filed its most recent return.

The IRS generally notifies the parent within 60 days of filing of either the acceptance of the election (with confirmation of the effective date) or its rejection.

Note. Even though the election triggers a deemed liquidation, Form 966, *Corporate Dissolution or Liquidation,* is not required to be filed. However, for subsidiaries that existed as separate corporations before the election, a final return is generally required.[112]

Termination of the QSub Election[113]

A QSub election may terminate by revocation or by an event that disqualifies the subsidiary from being an eligible subsidiary (including the loss of the parent corporation's S election).

Termination by Revocation. A QSub election may be revoked by filing a revocation statement with the IRS service center where the parent's S corporation return was filed. The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent and QSub. The revocation is generally effective on the revocation statement's filing date, but the statement may specify an effective date no more than two months and 15 days after it is filed.

Termination Through Loss of Eligible Subsidiary Status. If the QSub fails to maintain its status as an eligible subsidiary by continually meeting the qualifying factors (domestically owned corporation, 100% owned by an S corporation, and not an ineligible corporation), the election terminates. The termination occurs at the close of the day on which the disqualifying event occurred. If the QSub election terminates due to the parent's loss of its own S corporation election, the QSub election is considered terminated at the close of the final day of the parent's tax year.

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111. Instructions for Form 8869.

112. Ibid.

113. Treas. Reg. §1.1361-5.

Example 16. Pietrangelo Homes, Inc. (PHI), an S corporation, owns 100% of Quality Roofing & Siding Corp. (QRS), a QSub. On June 6, 2019, PHI sells one share of its QRS stock to Morgantown Development LP. Because PHI no longer owns 100% of QRS, the QSub election in effect for QRS terminates at the close of June 6, 2019.

In a tiered QSub situation, stock transfers from the QSub to the parent do not terminate a QSub election.

Example 17. Use the same facts as **Example 16,** except in addition to PHI owning 100% of QRS, QRS owns 100% of Alpha Bathrooms Corporation (ABC). QSub elections are in effect for both QRS and ABC. QRS transfers all of its ABC stock to PHI. The stock transfer does not terminate ABC's QSub election because PHI is treated as owning the stock of ABC both before and after the transfer.

Note. For further details regarding the termination of a QSub election, including termination due to the QSub joining a consolidated group, see Treas. Reg. §1.1361-5.

Consequences of a Terminated Election

Upon the termination of a QSub election, the former QSub corporation is treated as a new corporation. It is deemed to have acquired all of its assets and assumed all of its liabilities from the parent in exchange for stock in the new corporation immediately before the termination. The applicable regulation indicates that the tax treatment of this transaction is determined under the Code and general principles of tax law, including the step-transaction doctrine.[114]

Note. This deemed establishment of a new corporation means that new tax and accounting method elections are required.

IRC §351 and related sections apply to capital contributions to new corporations in exchange for their stock. Several requirements must be met in order for nonrecognition treatment, including an 80%-control test.

Note. A contribution of property to a corporation in exchange for its stock is tax-free if no other property or boot is received in the exchange.[115] When this is not the case, gain is recognized by the transferor to the extent of boot and the FMV of other property received in the transaction.[116]

Note. For purposes of determining whether the formation of the new corporation is tax-free under §351, any instruments, obligations, or other arrangements not treated as QSub stock under the S corporation one-class-of-stock requirement similarly do not count as stock in determining whether the IRC §368(c) 80%-control test requirement is met. For further details on §351, see the 2012 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: S Corporation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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114. Treas. Reg. §1.1361-5(b)(1).

115. IRC §351(a).

116. IRC §351(b).

If the QSub election terminates due to a sale of QSub stock, a special rule applies. The stock sale is treated as the sale of an undivided interest in the QSub's assets and liabilities, based on the percentage of its stock that has been sold. This is immediately followed by a deemed establishment of a new corporation in a transaction that qualifies under §351, disregarding the §368(c) 80%-control test.[117]

> **Observation.** This means that if a parent S corporation sells more than 20% of a QSub's stock, in the deemed establishment of the new subsidiary that follows the termination of the subsidiary's QSub election, the parent generally receives §351 nonrecognition treatment.

If the parent sells 100% of the stock, the deemed establishment of a new subsidiary is disregarded for federal income tax purposes. Instead, the transaction is considered a transfer of the subsidiary's assets to the purchaser of the stock, followed by that purchaser's capital contribution of such assets to the purchased subsidiary in exchange for its stock.[118]

Moreover, if the purchaser of 100% of the stock is an S corporation that makes a QSub election for the subsidiary that is effective on the date the stock is acquired, the capital contribution transaction is entirely disregarded for federal income tax purposes.

Post-Termination Elections

As a general rule, after a QSub's election terminates, it cannot make an S election or a QSub election for a period of five tax years without the IRS's consent.[119] However, under an exception to this rule, the subsidiary with a terminated QSub election may make an S or QSub election again within the 5-year period without IRS consent if:

- That subsidiary qualifies for the S or QSub election immediately following the termination of the previous election, and
- Makes the relevant election immediately after loss of the QSub election.

Example 18. PharmaOne, Inc. (PO), an S corporation, owns 100% of Sigma Drugstore Corp. (SDC). SDC has a QSub election in effect. PO has seven shareholders. It distributes its SDC stock to its seven shareholders on November 30, 2019. This stock distribution terminates the QSub's election because it is no longer owned by an S corporation. However, PO's seven shareholders could elect to treat SDC as an S corporation by filing a valid S corporation election effective on the date of the stock distribution if SDC qualifies for the election. This election may be made without the IRS's consent.

Example 19. Use the same facts as **Example 18,** except PO sells 100% of its stock to IsoData Corporation (ID), an S corporation. ID may elect to treat SDC as a QSub effective on the date it acquired SDC's stock.

> **Note.** For additional details regarding the making of post-termination elections, see Treas. Reg. §1.1361-5.

117. IRC §1361(b)(3)(C)(ii).

118. Treas. Reg. §1.1361-5(b)(3), example 9.

119. Treas. Reg. §1.1361-5(c).

QSUB PLANNING OPPORTUNITIES

Several planning opportunities are available for QSubs, particularly because the QSub, for most purposes, is not treated as a separate entity. In addition, as an S corporation, it has pass-through tax treatment.

Example 20. Naomi, an interior designer, owns two S corporations: Delta Designs, Inc. (DD) and Enterprising Endeavors, Inc. (EE). She has a $100,000 basis in her DD stock and a zero basis in EE stock. DD is profitable annually, but EE has $75,000 in suspended losses and will likely continue to generate losses for the next few tax years until Naomi develops her interior design software, which EE will sell. Naomi would like to use the $75,000 of suspended losses in EE against her income in DD. To accomplish this, Naomi transfers all of her DD stock and EE stock to a new S corporation, Naomi Business Holdings, Inc. (NBH). NBH makes QSub elections for DD and EE. This restructuring may allow Naomi to use the EE suspended losses because DD and EE are no longer treated as separate entities once they are QSubs.[120] This is the case as long as there is a valid business purpose for the corporate restructuring and all of the other requirements for using those suspended losses are met.

Example 21. Use the same facts as **Example 20,** except Naomi transfers her EE stock to DD in a transaction qualifying for nonrecognition treatment under §351. DD, as the new parent of EE, makes a QSub election for EE. Naomi may use the EE suspended losses because DD and EE are no longer treated as separate entities once they are QSubs,[121] as long as all of the other requirements for using those suspended losses are met.

Practitioner Planning Tip

In **Example 21,** the profitable company became the parent corporation and the company generating losses became the subsidiary. The goal of using the suspended losses could still be achieved by making the loss-generating company the parent. However, one important consideration with the loss-generating company may be the ability of creditors to obtain the profitable company's stock through legal process if such stock were owned by it. It may be best to have the company with the least risk serve as the parent. If both companies are considered high risk, use of the holding company strategy as illustrated in **Example 21** may be best. With this type of planning, there are many non-tax considerations that may determine an optimal strategy.

Observation. Despite risks involved in the business operations, the QSubs still exist as separate legal entities that are respected for legal purposes. Maintaining business activities in separate limited-liability entities, such as S corporations, is helpful in reducing liability risk. Owners must, however, adhere to corporate formalities and respect the independence of the corporations from their own personal finances in order to reduce the risk of piercing the corporate veil. For further information on the legal doctrine of piercing the corporate veil, see **uofi.tax/19b5x6** [scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=3501 &context=clr].

Note. Valid business reasons must exist for the restructuring in the preceding examples. These reasons should be documented.

120. Treas. Reg. §1.1361-4(c).

121. Ibid.

Avoiding Excess Net Passive Income Tax

If an S corporation was formerly a C corporation and has accumulated C corporation earnings and profits at the end of the tax year, the S corporation may incur tax liability on its excess net passive income (ENPI).[122]

> **Note.** IRC §1375 established the ENPI tax. Under §1375(a), the rate of tax used is the highest corporate tax rate. The TCJA eliminated the graduated corporate income tax rates that existed prior to the TCJA's adoption of a flat 21% corporate tax rate.

If passive income is more than 25% of gross receipts for three consecutive years, the S election is terminated at the beginning of the fourth tax year.[123] Use of one or more QSubs with nonpassive income may allow an S corporation to avoid the ENPI tax. Nonpassive QSub income may be used to ensure a parent's net passive income (NPI) does not exceed the 25% threshold necessary to trigger the tax. The parent and QSubs' gross receipts and NPI are aggregated. As long as there is sufficient aggregate gross receipts for aggregate NPI to remain below the 25% threshold, the ENPI tax does not apply.

Material Participation Planning[124]

Under the passive income and loss rules, material participation in an activity is generally necessary for income or losses from that activity to be considered nonpassive. The taxpayer must meet one of seven tests in order for the taxpayer's participation to be considered material participation in an activity. Participating in an activity for more than 500 hours during the year is one such test.

> **Note.** For further details regarding the rules and tests associated with material participation, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Selected Real Estate Topics.

DIVISIVE D REORGANIZATIONS

A divisive reorganization generally takes place when an existing corporation transfers part of its assets to another corporation to divide the corporate business. This differs from an acquisitive reorganization in which all of the corporate assets are transferred. A divisive reorganization involves the breaking up of a single corporate investment structure into two or more corporate investment structures.

Reasons for divisive reorganizations vary. Such a transaction may be required for antitrust or regulatory reasons, or to isolate business risks associated with a line of business into a separate corporate entity, thereby mitigating exposure of the parent company's assets. Battling shareholder factions may also result in the division of a business through a divisive reorganization, and access to financing is another reason to divide the corporate business.

Like acquisitive reorganizations, a divisive reorganization may be either taxable or tax-free.

122. IRC §1375.

123. IRC §1362(d)(3).

124. IRC §469; Temp. Treas. Reg. §1.469-5T.

Example 22. Larson and Loretta are the sole shareholders of L&L Amusements, Inc. (LL), which they own equally. LL owns and operates an amusement park. Larson operates and oversees the maintenance of all of the amusement park's rides. Loretta heads the food service in the amusement park, which includes management of all the park's restaurants and concession stands. Each shareholder wishes to eventually use their respective management skills in other new areas of business each can adopt.

The shareholders make a decision to divide the business by distributing the amusement park ride assets to Larson and the food service assets to Loretta in a complete liquidation transaction. Such a liquidation could be taxable unless it qualifies as tax-free. Moreover, if the shareholders wish to continue to operate LL while still accomplishing a division, a nonliquidating distribution to Larson and Loretta could be made. The nonliquidating distribution would be taxable. Still another taxable option would be to affect a share redemption in exchange for business assets with one shareholder, leaving the other shareholder as sole owner with their business assets.

Instead of dividing a business in a taxable transaction, a tax-free method might be considered by structuring the divisive transaction to meet the rules in subchapter C of the Code.

> **Note.** The tax-free organization and reorganization section of subchapter C consists of IRC §§351–368.

REQUIREMENTS FOR NONRECOGNITION

IRC §355 is designed to provide nonrecognition treatment to divisive corporate reorganizations that represent mere changes in the form of business or adjustments to business structure for legitimate business purposes.

To qualify as a tax-free divisive D reorganization, one corporation transfers part of its assets to another corporation, and afterwards either the transferor or one or more of its shareholders or any combination of them is in control of the transferee corporation.[125]

A Type D reorganization is a corporate reorganization that qualifies under IRC §368(a)(1)(D). This Code section defines several types of corporate transactions that may qualify for tax-free treatment. While the term "reorganization" is frequently used to describe many types of transactions, it specifically refers to those transactions defined in IRC §368, including the "Type D" reorganization that is the subject of this section.

In addition, if the Type D reorganization is followed by a distribution of transferee stock, the transaction must also satisfy the requirements of §355 to be tax-free.[126] Such requirements include statutory and judicially developed requirements.

Statutory Requirements[127]

Under IRC §355, the following requirements must be met for nonrecognition treatment to be given to the divisive Type D reorganization.

- **Prior control requirement —** The distributing corporation must distribute only stock or other securities of a corporation it controls immediately prior to the distribution.
- **Distribution requirement —** The distributing corporation must distribute all of the stock and securities in the controlled corporation it holds immediately prior to the distribution.
- **Trade or business requirement —** Immediately after the distribution, both the distributing corporation and the controlled corporation must be in the "active conduct of a trade or business."
- **Non-device requirement —** The transaction must not be used principally as a device to distribute corporate earnings and profits of the distributing and/or controlling corporation.

125. IRC §368(a)(1)(D).

126. Ibid.

127. IRC §355.

Prior Control Requirement. Nonrecognition treatment is limited to distributions of stock and/or securities of a controlled corporation. Under this rule, a parent corporation may distribute stock or securities in an existing or newly created subsidiary corporation.[128]

In addition, nonrecognition treatment is only available if the distributing corporation has not acquired control through a taxable transaction within the past five years.[129]

Distribution Requirement. Under this requirement, the distributing corporation must either:

- Distribute all of the stock or securities of the controlled corporation held immediately prior to the distribution, or
- Distribute enough of the stock that the amount distributed represents a controlling interest.

If less than all the stock is distributed and the distributing corporation chooses to distribute enough to constitute a controlling interest, the distributing corporation must satisfy the IRS that the undistributed stock was not retained principally for tax-avoidance purposes.[130]

Observation. Note that a corporation could abuse nonrecognition treatment by using such treatment for smaller distributions of stock that should be properly characterized as taxable dividend distributions. This is the reason for the need to satisfy the IRS regarding the retention of any stock when less than all the stock is distributed. Moreover, this concern is also reflected in the non-device requirement.

Practitioner Planning Tip

Because Rev. Proc. 2013-32 restricts the scope of private letter rulings on these corporate reorganizations, the taxpayer should retain adequate documentation sustaining the tax-free treatment of the transaction in the event of a challenge by the IRS. A 2017 article in the Tax Adviser provides valuable advice on the appropriate content of such documentation. This article can be found at **uofi.tax/19b5x7** [www.thetaxadviser.com/issues/2017/jan/document-tax-free-d-reorganization-with-split-off.html].

While all, or a controlling interest, must be distributed, it need not be distributed pro-rata among the shareholders.[131] Whether the shareholders receiving the subsidiary stock surrender any distributing corporation stock of the parent in the transaction is irrelevant.[132]

Observation. Even though at least a controlling interest must be distributed, the other requirements allow significant flexibility in structuring the ownership of a subsidiary as well as the continued ownership of the parent.

128. Treas. Reg. §1.355-1(b).

129. IRC §355(b)(2)(D).

130. IRC §355(a)(1)(D).

131. IRC §355(a)(2)(A).

132. Ibid.

Trade or Business Requirement. Under this requirement, both the distributing corporation and the controlled corporation(s) must be engaged immediately after the distribution in the "active conduct of a trade or business."

IRC §355 provides no guidance on the meaning of "active conduct of a trade or business." However, Treas. Reg. §1.355-3(b)(2)(ii) states:

> *A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.*

In addition, Treas. Reg. §1.355-3(b)(2)(iii) indicates that whether a trade or business is actively conducted is a facts-and-circumstances determination. In making this determination, it is recognized that the corporation may perform active and substantial management and operational activities itself, but can also retain outside services, such as those from independent contractors, to assist in the active conduct of business.

Activities that do not constitute the active conduct of a trade or business include the following.[133]

- Holding stock, securities, real estate, or other property for investment purposes
- The ownership and operation of real or personal property (including the leasing out of such property) used in a trade or business unless the owner performs significant services with respect to the property's operation and management

In addition, there is a pre-distribution active trade or business requirement.[134] Generally, the trade or business must be actively conducted throughout the 5-year period ending on the distribution date. However, this rule does recognize the possible need for changes to the business within the prior 5-year period and, accordingly, changes such as business expansions or acquisition of another business in the same industry are disregarded as long as they do not constitute the acquisition of a new or different business. Moreover, the distributing corporation must not have acquired the trade or business in a taxable transaction within five years before the distribution. This includes taxable acquisition of either the trade or business directly or indirectly through acquisition of the corporation engaged in that trade or business.[135]

Vertically Dividing Single Businesses. In the early 1960s, the IRS took the position that the division of a single business was ineligible for IRC §355 nonrecognition treatment because the active trade or business requirement could only be met if, immediately after the distribution, two or more separate and distinct businesses were operating. Dividing a single business vertically into its own components was insufficient.

This was the issue in *Coady v. Comm'r,*[136] and the court did not agree with the IRS. The following example is based on the facts of this case.

> **Example 23.** Cramer Purification Systems, Inc. (CPS) was in the business of constructing sewage disposal plants. It has two major contracts, each to build a large new plant. CPS creates a new subsidiary and transfers half of its assets to it. Subsequently, it transfers all of the stock in the new subsidiary to one of the CPS shareholders in exchange for that shareholder's CPS stock. As a result of the reorganization, one of the two major contracts is retained by CPS, while the other major contract is transferred to the new subsidiary. As long as this reorganization meets all of the other requirements for a tax-free reorganization, it meets the active conduct of a trade or business requirement and is given nonrecognition treatment.[137]

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133. Treas. Reg. §1.355-3(b)(2)(iv).

134. Treas. Reg. §1.355-3(b)(3).

135. IRC §355(b)(2)(C).

136. *Coady v. Comm'r,* 33 TC 771 (1960), *aff'd* 289 F.2d 490 (6th Cir. 1961).

137. The facts of this case are now found in Treas. Reg. §1.355-3(c), example 4. Another similar case in which the IRS lost the same argument is *U.S. v. Marett,* 325 F.2d 28 (5th Cir. 1963), the facts of which are reflected in example 5 of the same regulation.

Non-Device Requirement.[138] IRC §355 presents the opportunity for tax avoidance by providing the ability to subvert the taxable dividend provisions of the Code through the use of tax-free stock distributions under the guise of a reorganization. Accordingly, the IRS applies a facts-and-circumstances analysis to the reorganization transaction to determine whether the transaction was used principally to distribute what otherwise would have been a taxable dividend. In the process of making this facts-and-circumstances analysis, "device factors" (or evidence that the transaction was used as a device to distribute dividends) and "nondevice factors" (or evidence that the transaction was not used as a device) are looked to.

Device factors include the following.[139]

- Controlling corporate distributions that are pro-rata or substantially pro-rata
- A subsequent sale of the distributed stock
- A prearranged or negotiated sale (this is considered **substantial** evidence of device)
- The presence of cash or other liquid assets in the transaction that are not required for reasonable business needs

In addition, if a subsequent sale of the stock takes place, the greater the percentage sold and the shorter the length of time between the distribution and subsequent sale, the stronger the evidence is of the device factor.

For nondevice factors used to establish that the transaction was not principally a device to distribute dividends, the taxpayer may establish a business purpose as supporting evidence. However, the stronger the evidence of device, the stronger the evidence of a business purpose must be to overcome a determination that the transaction was used for tax avoidance.

While these device and nondevice factors are looked to in the facts-and-circumstances analysis, the inquiry is not limited to only these factors.

Nonstatutory Requirements

In addition to the statutory requirements that must be met under §355, the following nonstatutory requirements must be satisfied.

1. Business purpose
2. Continuity of proprietary interest

Business Purpose.[140] Under the business purpose test, the reason for the transaction must be, in whole or substantial part, due to one or more non-tax corporate purposes. A business separation does not meet the business purpose requirement if the business purpose could be accomplished with a nontaxable transaction without any stock distribution of a controlled corporation as long as the alternative is neither impractical nor unduly expensive.

> **Example 24.** Formidable Power Tools, Inc., (FPT) is engaged in the business of making specialized sanders and drills. One market for FPT's new product, a self-guiding power saw, has been growing rapidly over the past year. However, FPT is concerned about the much higher liability risks associated with the power saw industry. The board of directors decides to isolate the liability risks from the power saw business by establishing a separate subsidiary. The power saw business is transferred to the new subsidiary and the new subsidiary's stock is distributed to FPT shareholders. The business purpose of managing risk is addressed by transferring the business to a subsidiary. The subsequent distribution of stock of the subsidiary is not necessary to achieve this business purpose. Therefore, the distribution does not meet the corporate business purpose test.[141]

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138. Treas. Reg. §1.355-2(d).

139. Treas. Reg. §1.355-2(d)(2).

140. Treas. Reg. §1.355-2(b).

141. The facts of this example are based upon Treas. Reg. §1.355-2(b)(5), example 3.

Note. The business purpose requirement originally arose from the landmark Supreme Court case *Gregory v. Helvering,*[142] in which the taxpayer transferred highly appreciated stock in a solely owned corporation to a newly established subsidiary corporation. The new subsidiary existed for three days and never engaged in any business. While the transaction met the requirements of the reorganization statute in effect at the time, tax-free reorganization treatment was denied because of the lack of a business purpose.

Continuity of Proprietary Interest.[143] Under the continuity of proprietary interest requirement, one or more previous owners must own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporation forms in which business is conducted after the separation.

Example 25. Nomad Shoes, Inc. (Nomad) has been in the shoe business for the past 10 years. Nomad owns a subsidiary, RainGear, Inc. (RG) that manufactures and sells boots. Nomad is owned in equal shares by Norman and Roger, who are unrelated. For valid business purposes, Nomad's stock in RG is distributed to Roger in exchange for his Nomad stock. After this transaction, Norman owns 100% of Nomad, and Roger owns 100% of RG. This transaction meets the continuity of interest requirement because one or more persons who were owners of Nomad before the distribution own, in the aggregate, an amount of stock that establishes a continuity of interest in both Nomad and RG after the distribution transaction.

Example 26. Use the same facts as **Example 25,** except Rebecca, a person unrelated to either Norman or Roger, buys half of the stock Norman owns in Nomad. Norman continues to hold the unsold half of his stock. Thereafter, for valid business reasons, Nomad distributes all of its RG stock to Roger in exchange for his Nomad stock. After the distribution, Norman and Rebecca are equal co-owners of Nomad, and Roger is sole owner of RG. The distribution of RG stock by Nomad to Roger satisfies the continuity of interest requirement because Norman and Roger own, in the aggregate, an amount of stock establishing a continuity of interest in both Nomad and RG after the distribution.

Example 27. Use the same facts as **Example 25,** except Rebecca, a person unrelated to either Norman or Roger, purchases all of the Nomad stock owned by Norman. For valid business purposes, Nomad's stock in RG is distributed to Roger in exchange for his Nomad stock. After this distribution, neither Norman nor Roger own any interest in Nomad, and Roger is sole owner of RG. The continuity of interest requirement is not met because the owners of Nomad before the distribution do not, in the aggregate, own an amount of stock establishing a continuity of their interest in Nomad. While they have, in the aggregate, retained 50% of their collective interest in the formerly combined entity (because of Roger's sole ownership of RG), they do not have the sufficient minimum stock interest in Nomad necessary to meet the continuity of interest requirement.

Example 28. Use the same facts as **Example 25,** except Rebecca purchases only 80% of the stock owned by Norman in Nomad. For valid business purposes, Nomad's stock in RG is distributed to Roger in exchange for his Nomad stock. After this distribution, Norman and Rebecca own 20% and 80% of Nomad respectively, while Roger is sole owner of RG. Norman's 20% remaining interest in Nomad is insufficient to meet the continuity of interest requirement.

Note. The facts in the above examples are based on the examples provided in Treas. Reg. §1.355-2(c). While the examples provide some insight on what percentages of stock ownership do **not** meet the continuity requirement, the guidance does not provide any minimum requirement. For additional details, see Treas. Reg. §1.355-2.

142. *Gregory v. Helvering,* 293 U.S. 465 (1935).

143. IRC §368(a)(1)(D); Treas. Reg. §1.355-2(c)(1).

Type D Reorganization Transactions

When the statutory and nonstatutory requirements of §355 are met, a type D divisive reorganization is provided tax-free treatment. Type D divisive reorganizations are categorized as either a spin off, a split-off, or a split-up. All such transactions involve separating a corporate business structure.

Spin-Off Transaction. A spin-off transaction is accomplished through a pro-rata distribution of a subsidiary corporation to its existing shareholders. The shareholders are not required to surrender their stock in the parent company.

If the spin-off does not qualify under §355, the parent company is taxed under IRC §311 on any appreciation in the value of subsidiary stock that is distributed. Moreover, the shareholders are taxed under §301 (the dividend tax rules).[144]

> **Note.** For more information on the taxation of S corporation distributions, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: S Corporation Entity Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Split-Off Transaction. In a split-off transaction, a non-pro-rata distribution is made by a parent corporation of stock it owns in a subsidiary to some of its shareholders. Those shareholders exchange their parent stock for the subsidiary stock. This serves to divide the business, with the parent continuing to be owned by some of its original shareholders, while the subsidiary is owned by other, former shareholders of the parent.

The parent is taxed on the appreciated value of the subsidiary stock distributed under IRC §311 if the transaction does not qualify for nonrecognition treatment. In addition, failure to qualify for nonrecognition treatment triggers tax liability to the shareholders receiving subsidiary stock under IRC §302 (relating to tax on a stock redemption).

Split-Up Transaction. A split-up transaction occurs when the parent establishes two or more subsidiaries and divides its current business up among those subsidiaries. The stock in the subsidiaries is distributed on a non-pro-rata basis to all of the shareholders of the parent. The parent shareholders exchange their parent stock for the subsidiary stock they receive. After the transactions are completed, the former parent shareholders own the subsidiaries, and the parent ceases to exist.

If a split-up transaction does not meet the requirements for a tax-free transaction, the parent corporation is generally taxed on the distribution of the subsidiaries as if the parent sold those subsidiaries at FMV under IRC §336. The shareholders are taxed under IRC §331 (relating to gain or loss recognized on property in complete liquidation).

> **Note.** For additional details regarding IRC §§331 and 336, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Planning for C Corp Termination. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

[144] IRC §356(b).

Additional Tax Consequences to the Shareholders

When the requirements of §355 are met for a tax-free reorganization, the shareholders do not report gain or loss or otherwise report any income based on the stock (or other securities) received from the distributing parent corporation.[145]

However, any property received other than stock or securities is treated as boot and is taxable.[146] The amount by which the principal amount of securities in the subsidiary exceeds the principal amount of securities that are surrendered by the shareholder is considered boot.[147] For purposes of these rules, nonqualified preferred stock is considered to be neither stock nor securities.[148] Securities do include, however, rights issued by the distributing corporation or the subsidiary to acquire more stock in the issuing corporation.[149]

> **Note.** In a spin-off type of transaction, shareholders do not exchange or surrender any shares for the shares received in the subsidiary corporation. In such cases, the boot received is taxed as a dividend under IRC §301.

Hot-Stock Rule. A special rule applies if the parent distributes stock in a subsidiary it acquired in a taxable transaction within five years of the distribution. In this situation, that stock is considered boot.[150]

> **Note.** Under the prior control requirement rules of IRC §355, if the necessary control was obtained by the parent over the subsidiary in a taxable transaction within the five years leading up to the distribution, the transaction does not qualify for nonrecognition treatment. Accordingly, it appears that the hot-stock rule applies to the narrow circumstance in which the parent corporation has acquired the requisite control before the 5-year period, but then acquires additional stock in the subsidiary within the five years before the Type D reorganization distribution. It is the additional shares acquired to which the hot stock rule applies.

D REORGANIZATION EXAMPLE

The following example illustrates the application of the previously discussed requirements to a Type D reorganization of a family business.

Example 29. Parent Corporation is a business 100% owned by members of the White family. Parent Corporation owns and operates a retail flower shop. In addition to the flower shop, Parent Corporation also takes orders for printed invitations.

Various family members own shares and also work in the business. Some of the shareholders believe that the business of taking orders for printed invitations is a money-loser because the market is being eroded by a number of online sellers. However, some family members believe that the invitation business could be expanded into an online operation selling printed products other than the invitations.

The shareholders decide to split the two businesses. First, Parent Corporation forms New Corporation and then Parent Corporation contributes all of the assets associated with the invitation line of business to New Corporation in exchange for New Corporation stock. Then Parent Corporation distributes the New Corporation stock to the shareholders using either a spin-off (stock to all shareholders) or a split-off (stock to only the shareholders that want to own the invitation business).

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145. IRC §355(a)(1).

146. IRC §§355(a)(4)(A) and 356.

147. IRC §355(a)(3)(A).

148. IRC §355(a)(3)(D).

149. Treas. Reg. §1.355-1(c).

150. IRC §355(a)(3)(B).

The following requirements establish whether the proposed restructuring is a tax-free Type D reorganization.

Requirement	Facts	Met?
Prior control	Parent Corporation controls stock of New Corporation prior to the stock distribution	X
Stock distribution	Parent Corporation distributes 100% of New Corporation stock	X
Active trade or business	Both Parent Corporation and New Corporation will continue in business: one as a florist and one as an online printer/distributor of printed products	X
Non-device	The business purpose for the reorganization is to resolve a shareholder dispute over business to be transacted by putting the riskier online printer/distributor activity into a separate business	X

Therefore, the preceding requirements are met and, as long as both companies continue to operate, the reorganization should be tax-free to all parties.

S CORPORATIONS AND RETIREMENT PLAN CONTRIBUTIONS

There are various retirement plan alternatives available to S corporations and their shareholders. The following are some of the factors to consider when choosing a retirement plan.

- The preferred amount of retirement plan contributions
- The contributor's age
- The contributor's income level
- Whether the contributor already participates in a qualified retirement plan
- Whether the S corporation has employees and, if so, how many

Generally, common-law employees can participate in a retirement plan offered by an S corporation. This includes shareholders who are also employees.[151] However, distributions received by a shareholder of an S corporation are **not** earned income for retirement plan contribution purposes.[152]

> **Note.** For a discussion about the qualification requirements for establishing and contributing to various retirement plans ranging from traditional IRAs to SEP and SIMPLE IRAs and IRC §401(k) plans, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Retirement Plans for Small Businesses. Some of the plans allow for both employer and employee contributions. The effect of these contributions on an S corporation shareholder's QBID is discussed next.

151. *Retirement Plan FAQs Regarding Contributions — S Corporation*. Feb. 26, 2019. IRS. [www.irs.gov/retirement-plans/retirement-plan-faqs-regarding-contributions-s-corporation] Accessed on Jun. 4, 2019.

152. IRC §§401(c)(1) and 1402(a)(2).

RETIREMENT PLAN CONTRIBUTION EFFECT ON THE QBID

Employer Contributions to Retirement Plans

An S corporation can claim a tax deduction for the contributions it makes to its employees' retirement plan accounts.[153] Contributions made by an S corporation for its employees to the following retirement plans/deferred compensation arrangements are reportable on Form 1120S, line 17.[154]

- Qualified retirement plan (e.g., a 401(k) plan)
- Simplified employee pension (SEP)
- Savings incentive match plan for employees (SIMPLE) IRA
- Profit-sharing plan
- Annuity
- Deferred compensation plan

S corporations contributing to employees' IRAs include the contribution in salaries and wages on Form 1120S, line 8, or Form 1125-A, *Cost of Goods Sold*, line 3.[155]

Consequently, the ordinary business income of an S corporation (reported on Form 1120S, line 21) is net of retirement plan contributions made by an S corporation for its employees. Because an S corporation shareholder's QBI is based on their allocable share of the corporation's ordinary income, that QBI share is also effectively net of these contributions.[156]

Employee Contributions to Retirement Plans

Employee contributions to qualified retirement plans (also known as deferrals) are reported on Form W-2, box 12, and reduce wages reported on Form W-2, line 1.[157] Although employee wages do not constitute QBI,[158] they are nevertheless part of the W-2 wages/QP limit,[159] which can affect the determination of the QBID. There are three alternative methods[160] that the preparer of the S corporation tax return can utilize when reporting W-2 wages for QBI purposes.

1. Unmodified box method
2. Modified box 1 method
3. Tracking wages method

Unmodified Box Method. Using this method, W-2 wages are the **lesser** of:

1. The sum of Form W-2, box 1 amounts; or
2. The sum of Form W-2, box 5 (Medicare wages and tips) amounts.

> **Note.** Generally, S corporations offering qualified retirement plans to their employees find that the sum of Form W-2, box 1 amounts are less than the sum of Form W-2, box 5 amounts because Medicare wages and tips are not reduced for employee retirement plan deferrals.

153. IRC §404.
154. Form 1120S instructions.
155. Ibid.
156. Ibid.
157. Form W-2 instructions; *Topic Number 424 - 401(k) Plans*. Feb. 22, 2019. IRS. [www.irs.gov/taxtopics/tc424] Accessed on Jun. 5, 2019.
158. IRC §199A(d)(1)(B).
159. IRC §199A(b)(2)(B).
160. Rev. Proc. 2019-11, 2019-09 IRB 742.

Modified Box 1 Method. When using this method, W-2 wages are calculated as follows.

1. The sum of Form W-2, box 1 amounts; **less**
2. The sum of amounts that are not wages for federal income tax withholding purposes (e.g., supplemental unemployment compensation benefits within the meaning of Rev. Rul. 90-72); **plus**
3. The sum of Form W-2, box 12 elective deferral amounts coded D, E, F, G, and S.

Tracking Wages Method. When using this method, W-2 wages are calculated as follows.

1. The sum of Form W-2, box 1 amounts, **plus**
2. The sum of Form W-2, box 12 elective deferral amounts coded D, E, F, G, and S.

S corporation shareholders can be negatively affected regarding the calculation of QBI by the W-2 wages method chosen by the preparer of the S corporation tax return as illustrated in the following examples.

Illustrative Examples

Example 30. Jim Bolton, a single taxpayer, is the sole shareholder of Bolton Retail (an S corporation), which is a qualified business for purposes of the QBID but is not a specified service business and has no qualified property. In 2019, Bolton Retail has ordinary business income of $300,000. This is reported on line 1 and as QBI on line 17, code V, of Jim's Schedule K-1. In addition, $100,000 is entered as W-2 wages for purposes of the QBID on Jim's Schedule K-1 in line 17, with code W. The preparer of the S corporation's tax return chose the **unmodified box 1** method for reporting W-2 wages.

Jim also receives a 2019 Form W-2 from Bolton Retail. This shows box 1 wages of $100,000, box 5 wages of $119,000, and a box 12 entry coded D for Jim's $19,000 elective deferral to a Solo 401(k) plan. Jim has no other income and claims the standard deduction.

Because Jim's taxable income exceeds the 2019 upper taxable income threshold of $210,700,[161] Jim's **initial QBID** is the **lesser** of:

1. 20% of the QBI with respect to each qualified business, **or**
2. The W-2 wages/QP limit.

This results in an **initial QBID** of $50,000, calculated as the **lesser of:**

- $60,000 ($300,000 QBI × 20%), **or**
- $50,000 W-2 wages/QP limit, which is the **greater of:**
  - $50,000 ($100,000 W-2 wages ×50%), **or**
  - $25,000 ($100,000 W-2 wages × 25% + 2.5% × $0 UBIA)

Jim has taxable income of $387,800 ($300,000 ordinary income + $100,000 wages − $12,200 standard deduction[162]) and a **final QBID** of $50,000 because his $50,000 **initial QBID** is less than his overall taxable income limitation of $77,560 ($387,800 taxable income × 20%).

> **Note.** See the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: QBID Update, for a detailed explanation of the QBID calculation.

161. Rev. Proc. 2018-57, 2018-49 IRB 827; IRC §199A(b)(3)(B)(i)(I).

162. Rev. Proc. 2018-57, 2018-49 IRB 827.

Example 31. Use the same facts as **Example 30,** except the S corporation tax return preparer uses the **modified box 1** method. Now, $119,000 ($100,000 box 1 wages + $19,000 box 12, code D) is entered as W-2 wages for purposes of the QBID on Jim's Schedule K-1 in line 17, with code W.

Jim's **initial QBID** is now $59,500, which is the **lesser of:**

- $60,000 ($300,000 QBI × 20%), **or**
- $59,500 W-2 wages/QP limit, which is the **greater of:**
  - $59,500 ($119,000 W-2 wages ×50%), **or**
  - $29,750 ($119,000 W-2 wages × 25% + 2.5% × $0 UBIA)

Jim's initial QBID is also his **final QBID** because his $59,500 **initial QBID** is less than his overall taxable income limitation of $77,560 ($387,800 taxable income × 20%).

Practitioner Planning Tip

These examples illustrate that an S corporation shareholder's QBID can be negatively affected if the preparer of the S corporation's tax return chooses the unmodified box 1 method for reporting W-2 wages. Therefore, the preparer should also consider the impact on the shareholder when choosing which of the wage reporting methods to use for the QBID computation.

Note. When evaluating the merits of retirement plan contributions for their clients, tax practitioners should consider the **"deduction-reduction problem."**[163] This is addressed in the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: QBID Update.

163. The term "deduction-reduction problem" is from an article by Jeffrey Levine. See *How The New QBI Deduction-Reduction Ruins The Value Of Pre-Tax Retirement Plans For Small Business Owners*. Levine, Jeffrey. Feb. 6, 2019. Nerd's Eye View. [www.kitces.com/blog/199a-qbi-deduction-reduction-small-business-owner-retirement-plan-contributions-roth/] Accessed on Feb. 11, 2019.

APPENDIX — FORM 2553

Form **2553**
(Rev. December 2017)
Department of the Treasury
Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)
(Including a late election filed pursuant to Rev. Proc. 2013-30)

▶ You can fax this form to the IRS. See separate instructions.
▶ Go to *www.irs.gov/Form2553* for instructions and the latest information.

OMB No. 1545-0123

Note: This election to be an S corporation can be accepted only if all the tests are met under *Who May Elect* in the instructions, all shareholders have signed the consent statement, an officer has signed below, and the exact name and address of the corporation (entity) and other required form information have been provided.

Part I **Election Information**

Type or Print	Name (see instructions)	**A** Employer identification number
	Number, street, and room or suite no. If a P.O. box, see instructions.	**B** Date incorporated
	City or town, state or province, country, and ZIP or foreign postal code	**C** State of incorporation

D Check the applicable box(es) if the corporation (entity), after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) . . . . ▶ ______

Caution: A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:
(1) ☐ Calendar year
(2) ☐ Fiscal year ending (month and day) ▶ ______
(3) ☐ 52-53-week year ending with reference to the month of December
(4) ☐ 52-53-week year ending with reference to the month of ▶ ______
If box (2) or (4) is checked, complete Part II.

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under *Who May Elect* in the instructions) ▶ ☐

H Name and title of officer or legal representative whom the IRS may call for more information	Telephone number of officer or legal representative

I If this S corporation election is being filed late, I declare I had reasonable cause for not filing Form 2553 timely. If this late election is being made by an entity eligible to elect to be treated as a corporation, I declare I also had reasonable cause for not filing an entity classification election timely and the representations listed in Part IV are true. See below for my explanation of the reasons the election or elections were not made on time and a description of my diligent actions to correct the mistake upon its discovery. See instructions.

Sign Here

Under penalties of perjury, I declare that I have examined this election, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.

▶ **Signature of officer** ______ **Title** ______ **Date** ______

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 18629R Form **2553** (Rev. 12-2017)

Name	Employer identification number

Part I **Election Information** *(continued)* **Note:** If you need more rows, use additional copies of page 2.

J Name and address of each shareholder or former shareholder required to consent to the election. (see instructions)	K **Shareholder's Consent Statement** Under penalties of perjury, I declare that I consent to the election of the above-named corporation (entity) to be an S corporation under section 1362(a) and that I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I understand my consent is binding and may not be withdrawn after the corporation (entity) has made a valid election. If seeking relief for a late filed election, I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the S corporation election for the year for which the election should have been filed (see beginning date entered on line E) and for all subsequent years.		L Stock owned or percentage of ownership (see instructions)		M Social security number or employer identification number (see instructions)	N Shareholder's tax year ends (month and day)
	Signature	Date	Number of shares or percentage of ownership	Date(s) acquired		

Name	Employer identification number

Part II **Selection of Fiscal Tax Year** (see instructions)

Note: All corporations using this part must complete item O and item P, Q, or R.

O Check the applicable box to indicate whether the corporation is:

1. ☐ A new corporation **adopting** the tax year entered in item F, Part I.

2. ☐ An existing corporation **retaining** the tax year entered in item F, Part I.

3. ☐ An existing corporation **changing** to the tax year entered in item F, Part I.

P Complete item P if the corporation is using the automatic approval provisions of Rev. Proc. 2006-46, 2006-45 I.R.B. 859, to request (1) a natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) or (2) a year that satisfies the ownership tax year test (as defined in section 5.08 of Rev. Proc. 2006-46). Check the applicable box below to indicate the representation statement the corporation is making.

1. Natural Business Year ▶ ☐ I represent that the corporation is adopting, retaining, or changing to a tax year that qualifies as its natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) and has attached a statement showing separately for each month the gross receipts for the most recent 47 months. See instructions. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

2. Ownership Tax Year ▶ ☐ I represent that shareholders (as described in section 5.08 of Rev. Proc. 2006-46) holding more than half of the shares of the stock (as of the first day of the tax year to which the request relates) of the corporation have the same tax year or are concurrently changing to the tax year that the corporation adopts, retains, or changes to per item F, Part I, and that such tax year satisfies the requirement of section 4.01(3) of Rev. Proc. 2006-46. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

Note: If you do not use item P and the corporation wants a fiscal tax year, complete either item Q or R below. Item Q is used to request a fiscal tax year based on a business purpose and to make a back-up section 444 election. Item R is used to make a regular section 444 election.

Q Business Purpose—To request a fiscal tax year based on a business purpose, check box Q1. See instructions for details including payment of a user fee. You may also check box Q2 and/or box Q3.

1. Check here ▶ ☐ if the fiscal year entered in item F, Part I, is requested under the prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046. Attach to Form 2553 a statement describing the relevant facts and circumstances and, if applicable, the gross receipts from sales and services necessary to establish a business purpose. See the instructions for details regarding the gross receipts from sales and services. If the IRS proposes to disapprove the requested fiscal year, do you want a conference with the IRS National Office?

☐ Yes ☐ No

2. Check here ▶ ☐ to show that the corporation intends to make a back-up section 444 election in the event the corporation's business purpose request is not approved by the IRS. See instructions for more information.

3. Check here ▶ ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event (1) the corporation's business purpose request is not approved and the corporation makes a back-up section 444 election, but is ultimately not qualified to make a section 444 election, or (2) the corporation's business purpose request is not approved and the corporation did not make a back-up section 444 election.

R Section 444 Election—To make a section 444 election, check box R1. You may also check box R2.

1. Check here ▶ ☐ to show that the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item F, Part I. To make the election, you must complete **Form 8716,** Election To Have a Tax Year Other Than a Required Tax Year, and either attach it to Form 2553 or file it separately.

2. Check here ▶ ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event the corporation is ultimately not qualified to make a section 444 election.

Name	Employer identification number

Part III **Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)* Note:** If you are making more than one QSST election, use additional copies of page 4.

Income beneficiary's name and address	Social security number
Trust's name and address	Employer identification number

Date on which stock of the corporation was transferred to the trust (month, day, year) . . . . ▶

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under section 1361(d)(2). Under penalties of perjury, I certify that the trust meets the definitional requirements of section 1361(d)(3) and that all other information provided in Part III is true, correct, and complete.

Signature of income beneficiary or signature and title of legal representative or other qualified person making the election   Date

*Use Part III to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. The QSST election must be made and filed separately if stock of the corporation is transferred to the trust **after** the date on which the corporation makes the S election.

Part IV **Late Corporate Classification Election Representations** (see instructions)

If a late entity classification election was intended to be effective on the same date that the S corporation election was intended to be effective, relief for a late S corporation election must also include the following representations.

1 The requesting entity is an eligible entity as defined in Regulations section 301.7701-3(a);

2 The requesting entity intended to be classified as a corporation as of the effective date of the S corporation status;

3 The requesting entity fails to qualify as a corporation solely because Form 8832, Entity Classification Election, was not timely filed under Regulations section 301.7701-3(c)(1)(i), or Form 8832 was not deemed to have been filed under Regulations section 301.7701-3(c)(1)(v)(C);

4 The requesting entity fails to qualify as an S corporation on the effective date of the S corporation status solely because the S corporation election was not timely filed pursuant to section 1362(b); **and**

5a The requesting entity timely filed all required federal tax returns and information returns consistent with its requested classification as an S corporation for all of the years the entity intended to be an S corporation and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years, **or**

b The requesting entity has not filed a federal tax or information return for the first year in which the election was intended to be effective because the due date has not passed for that year's federal tax or information return.

Form **2553** (Rev. 12-2017)