

Chapter 15

Taxation of S Corporations

"Tax Option" corporations/Subchapter S.

Fundamental inquiry: Should the corporation (as an entity) be subject to any federal income tax?

Alternatively, should the corporate/ shareholder tax regime be fully integrated?

Note other structuring options: the "check-the-box" regs. and transparent entities, e.g., LLCs, limited partnerships, general partnerships & the disregarded entity (or "tax nothing").

Comparisons - S Corp. vs. C Corp. vs. Partnership

1) Shareholders of an S corporation must report a prorata share of each corporate item (as determined at the corporate level); Partnerships - special allocations of income and deductions are permitted.

2) Partnership vs. S Corporation - debt.

Debts incurred by the S corporation have no effect on the tax basis for the shareholder's stock.

3) Note: Impact of Subchapter C to S corporations (a) after S election (made when a C corp), & (b) for §351, liquidation & reorganization.

S Corporation Status Eligibility

p.673

§1361(b) - must be a domestic corporation (but must not be an "ineligible corporation").

1) 100 total shareholder maximum limit.

2) Only shareholders who are individuals, estates, certain types of trusts, and exempt organizations.

H&W count as one shareholder.

Note: Members of a family are treated as one shareholder (6 generations up from shareholder to determine the "family" relationship). *continued*

S Corporation Status Eligibility, continued

3) Nonresident alien shareholders are not permitted as shareholders. Why?

4) Not more than one class of stock permitted (but outstanding voting stock and nonvoting stock of the same class is acceptable).

No limitation is applicable based on the size/net worth of the corporation. Some S corporations have a significant net worth.

S Corporation Limitations on Corporate Type p.674

- 1) Banks & insurance companies - not eligible to be S corporations, except when? See §1361(b)(2)(A).
- 2) Are S corporation subsidiaries permitted?
 - a) C corporation status for a sub? yes.
 - b) S corporation status? - QSSS election & the 100% owned subsidiary is then disregarded as a taxable entity. §1361(b)(3). When the QSSS election is terminated - deemed incorporation treatment applies (i.e., §351).

Some Trusts Are Eligible as S Corp. Shareholders p.675

- 1) Voting trust - each beneficial owner is treated as a separate shareholder.
- 2) Grantor trust – e.g., a revocable “living trust.”
- 3) Former grantor trust continuing for 2 years after grantor’s death as a testamentary trust.
- 4) Testamentary trust receiving S corporation stock under the terms of last will (for 2 years after death).
- 5) Qualified Sub S Trust (QSST). QTIP Trust?
- 6) Electing Small Business Trust (ESBT). E.g., a “spray & sprinkle” trust.

One Class of Stock Requirement-§1361(b)(1)(D)

Objective of the one class requirement: to prevent “special allocations” which enable income shifting among the owners; cf., e.g., partnerships.

Shares are to provide identical rights as to (1) profits distributions and (2) liquidation proceeds.

Ordinarily, no second class of stock arises from:(1) contractual arrangements, or (2) redemption or stock purchase (i.e., buy-sell) agreements.

The Code provides a straight debt “safe harbor” (to avoid second class of stock) – but other situations?

Straight Debt Safe Harbor

§1361(c)(5)

p.678

Requirements for the debt “safe harbor:”

- 1) Interest rate and payment dates are not contingent on the corporate profits or the borrower’s discretion.
 - 2) Non-convertibility of debt into stock.
 - 3) The creditor is an individual (not NRA), estate, trust or a bank lender.
- Subordination of this debt is not disqualifying here.

Problem (a) p.679

Z Corporation - 120 shares

Issue: S corporation 100 shareholder limit.

Z has (i) 99 individual shareholders, and (ii) two shareholders, A & B (not spouses) holding 21 shares JTWRORS. Does a violation of the 100 shareholder limit occur? §1361(b)(1)(A).

Are A & B to be treated as a single shareholder?
Yes (since family members). Corp. has only 100 shareholders. §1361(c)(1)(B).

Problem (b)

p.680

§1361(c)(1)(A)(i) Spousal Rule

Z has 99 shareholders and two additional married shareholders holding both (1) community and (2) separate property.

§1361(c)(1) treats a husband and wife as one shareholder and the corporation will have only 100 shareholders. What is “marriage”? Cf., DOMA.

The format of the husband/wife ownership is not relevant (e.g., JTWRROS is not essential).

Both A&B must file S corp. shareholder consents.

Problem (c)

p.680

Transfer from Probate Estate

A dies and bequeaths (her community & separate) interests in Z stock to friend, F.

The §1361(c)(1) rule concerning shareholder count applies to spouses and their estates.

Estates are also permissible shareholders.

Upon distribution to F the election will terminate (under §1362(d)(2)(A)), since Z will then have 101 shareholders (with B & F not treated as “family”).

S termination upon the share distribution date.

Problem (d) Voting Trust

p.680

Remaining 21 shares are held by a voting trust which has three beneficial owners.

A voting trust is a permissible S corporation shareholder under §§1361(b)(1)(B) & 1361(c)(2)(A)(iv). But, see §§1361(b)(2)(B)(iv): Each beneficiary of the trust is treated as a separate shareholder; therefore, Z will have 102 shareholders. Z will not qualify as an S corp.

Problem (e) Revocable Trust

p.680
Subpart E

The remaining 21 shares are owned by a revocable living trust created by an individual (with income owned by the grantor under §671).

A trust treated as owned by an individual is a permissible shareholder under §§1361(b)(1)(B) & 1361(c)(2)(A)(i).

Z will qualify since only 100 shareholders (the deemed owner/trust grantor is treated as a shareholder). Reg. § 1.1361-1(h)(1)(v).

Problem (f)

p.680

QTIP Trust - §2056(b)(7)

The remaining 21 shares in Z Corp. are owned by a QTIP trust. What is a “QTIP trust”?

Is this trust a "qualified subchapter S trust" (QSST) under §1361(d)? See §1361(d)(3).

The trust will be treated as a trust described in §1361(c)(2)(A)(i) if the beneficiary makes an election under §1361(d)(2).

Beneficiary is treated (for income tax) as the owner of trust assets (under §678). Reg. §1.1361-1(j)(7).

Problem (g)

p.680

Partnership of S Corporations

Z, Inc. has a partnership with two other S corporations, each of which have 100 individual shareholders, for the purposes of jointly operating a business.

Rev. Rul. 94-43 (no casebook reference): The three S corporations (each having the maximum shareholders) do not lose separate S status when organizing a partnership for joint operation of a business even when avoiding the shareholder number limits.

Problem (h)

p.680

Two Classes of Stock?

Z Corporation has outstanding two classes of common stock, differing only as to voting rights.

Does Z violate the one-class-of stock limitation in §1361(b)(1)(D)?

1) Under §1361(c)(4) the difference in voting rights between the two classes is not deemed to create two classes of stock for S corp. rules.

2) Authorized but unissued preferred stock is not relevant (until issued). See Reg. §1.1361-1(l)(1).

Problem (i)

p.680

Differing Distributions

A shareholder agreement mandates larger payments to those shareholders with greater state income tax burdens.

Z will be treated as having more than one class of stock because the rights of all shareholders are *not* identical.

Cf., Reg. §1.1361-1(l)(2)(ii) recognizing that some states may require direct payments to the state taxing authority; ok, assuming identical distributions (without regard to timing).

Problem (j)

p.681

Debt as Equity? Safe Harbor?

Individuals own shares of stock and 15 year bonds.
25:1 debt/equity ratio (& interest 3% + prime).

Substantial possibility exists that the Z bonds will be classified as equity under general debt/equity tax principles. Bonds (i) are held proportionately and (ii) are subordinated to the rights of general creditors.

If “straight debt” exists - then not considered as a second class of stock under §1361(c)(5)(A) & (B).

Electing, Revoking and Terminating S Corp Status

Election. §1362. (1) S corporation election is available if (2) all the shareholders consent.

Election is effective as of beginning of the tax year if made by 15th day/3rd month of the taxable year.

All shareholders (including during the pre-election period) during the tax year must (1) consent and (2) be eligible. Otherwise, the election is effective as of beginning of the following taxable year (assuming eligible shareholders). §1362(b)(2).

S Corp Revocation and Termination of Status

Revocation: Revocation occurs if more than 1/2 of the outstanding shares consent to the revocation.

Revocation may specify a prospective effective date. Code §1362(d)(1)(D); otherwise, a 2 ½ month test.

Termination: If a terminating event (e.g.):

- 1) exceeding the 100 shareholder limitation;
- 2) issuance of a second class of stock; or,
- 3) transfer of stock to an ineligible shareholder.

Passive Investment Income Limit - §1362(d)(3) P.682

S Corp. election terminates if for three years:

- 1) “passive investment income” exceeds 25 percent of S corporation’s gross receipts, and
- 2) Corp has Subchapter C E&P.

Ordinarily applies where (1) Corp was a C Corp, but, (2) can be where an acquisition of a C Corp. (with E&P) has occurred. Special bank treatment – interest is not passive income (§1362(d)(3)(C)(iii)).

Inadvertent Termination

p.683

Usual rule: No new S corp. election after S. corp. termination – subject to a 5 year waiting period, unless IRS consent. See §1362(g).

However, §1362(f) provides relief (& S corp. status is treated as continuing) when an “inadvertent termination” occurs. Corporation has the burden to so demonstrate & to agree with IRS concerning any remedial measures to be implemented.

Taxable Year of S Corp

p.683

S corporation must use a “permitted year”:

1) a calendar year; or, 2) an accounting period for which a “business purpose” is established, e.g., a “natural business year” (25% of income is derived in last 2 months). Choice can not be based on tax deferral. See §1378. Why this requirement?

Option to have a fiscal year if paying a deferral charge. Code §444 (authorization) and §7519 (payment).

Problem (a)

Shareholder Consent

p.685

(1) Who must consent to the S corporation election?
§1362(a)(2) requires all shareholders to consent to the election. This includes shareholders with nonvoting stock. Why?

(2) B sold stock to brother (G) prior to the election: Both B & G are required to consent for the election to be effective for the first year.

(3) Is the (seller) partnership a prior permitted shareholder? No. Therefore, no S corp qualification for the 1st year (but for next year).

Problem (b)

Timing for Election

p.685

When to make the Sub S election?

§1362(b)(1)(B) requires an election on or before the 15th day of the third month of the taxable year (for retroactive effect to the beginning of the year).

When does the taxable year begin? Reg. §1.1362-6(a)(2)(ii)(C) specifies the year begins when the corporation begins to do business (or acquires assets). Oct. 3 in this problem? Therefore, date is plus 2 months & 15 days from Oct. 3 (i.e., Dec. 17).

Problem (c)

Taxable Year

p.685

What taxable year is available?

Under §1378(a) Snowshoe must have a "permitted year" as its taxable year.

Under §1378(b) a "permitted year" is (1) a calendar year or (2) any other accounting period for which the corporation establishes a "business purpose" to the satisfaction of the IRS.

Deferral of income is not a "business purpose."

Here a "seasonal business" & fiscal year permitted?

Problem (d)

p.685

S Corp Election Revocation

Is the revocation of the S election permitted by A without the consent of B, C or D?

A needs the consent of one other shareholder.

See Code §1362(d)(1)(B).

Revocation is only made with the consent of shareholders who, at the time of revocation, hold more than one-half of the issued and outstanding stock, including any nonvoting stock.

Problem (e)

p.686

S Corp Election Termination

Sale to a nonresident alien (ineligible shareholder).

This sale will terminate the S election (under §1362(d)(2)) since Snowshoe will have a nonresident alien as a shareholder and will cease to be a small business corporation.

This termination is effective on the date of cessation of S corporation status.

This termination will divide the corporation's tax year into (1) an S short year and (2) a C short year.

Problem (f)

p.686

Inadvertent Termination

Mistake made concerning stock sale to the NRA?

Possible applicability of the special Code §1362(f) rule for inadvertent elections or terminations.

Applicability of this provision can enable retention of the S corporation status.

See Reg. §1.1362-4(b) for determining that the termination was inadvertent.

Planning: Have a shareholders' agreement limiting share disposition!

Problem (g)

p.686

Passive Income Limitation

Diversified business income, including investment income - Does the S corporation status terminate?
No. Code §1362(d)(3) terminates the S election only if:

(1) corporation has Subchapter C earnings and profits at the end of three consecutive years; and,
(2) more than 25 percent of its gross receipts is passive investment income.

How have this income? Prior C status?

Treatment of the S Corporation

p.686

- 1) S corporation is exempt from tax. §1363(a).
- 2) Determination is made at the corporate level of:
 - (i) gross income;
 - (ii) deductions;
 - (iii) other items.

No dividends received deduction to the S Corp.

Tax elections are made at the corporate level.

Treated as an entity for tax filing purposes.

Pass-through Treatment to Shareholders

p.687

A pro rata share of the corp's income is deemed distributed to the shareholders - §1366(a) & (c).

Tax characterization is retained on a flow-through basis to the shareholders for certain items.

This necessitates:

- 1) separately stated items - §1366(a)(1)(A), &
- 2) non-separately stated items - §1366(a)(1)(B).

Allocation occurs on a pro rata per share daily basis.

Assignment of Income Considerations

p.688

Code §1366(e) enables IRS to make a reallocation of S Corporation income to a shareholder who is inadequately compensated for:

- 1) advancements of capital, or**
- 2) providing of services to the S corporation.**

Objective: Avoid inappropriate deflection of income to others (family members).

Tax Basis Adjustments for the Shareholder **p.688**

§1367 requires (i) an increase of shareholder's tax basis for income items, and (ii) a reduction of tax basis by (a) losses, deductions, and non-deductible expenses not constituting capital expenses, and (b) tax-free distributions.

The ordering of these tax basis adjustments:

- 1) increased by current income (& tax-exempt);
- 2) decreased by any distributions; and
- 3) decreased by any losses.

Loss Limitations Applicable to the S Corp Shareholder p.689

Code §1366(d) limits losses allocated to a shareholder to that shareholder's:

1) adjusted tax basis in the S corporation stock;
plus,

2) adjusted tax basis in any indebtedness of the S corporation to the shareholder.

Query: How to assure sufficient income tax basis to exist for shareholder to enable full current tax loss utilization?

Loss Limitations Applicable to the S Corp Shareholder p.689

Possible loss carryforward to be treated as a loss in a subsequent year (if/when tax basis then exists). Code §1366(d)(2). Including carryover permitted to spouse who receives S corporation stock in a §1041 (tax-free/transferred basis) transfer.

Possible other limitations on S corporation loss:

- 1) Code §465 (at risk rule), and
- 2) Code §469 (passive loss limit, material participation requirement).

Harris case - Guaranteed Debt as a Shareholder Loan? p.690

Issue: Does the shareholder's guarantee of a bank loan constitute either (i) an equity investment by the shareholder, or (ii) an indirect shareholder loan to the corporation?

Holding: Not the equivalent of a loan by the shareholder and, therefore, no increase in the S corp. tax basis to the shareholder from the guaranteed bank loan.

Advice (A): (1) shareholder borrowed from a bank, and (2) then shareholder loans the borrowed funds directly to the corporation.

Advice(B): Tax returns & books should reflect deal.

S Corp Losses & §362(e)(2)

p.697

Transferor in §351 transaction transfers assets into corporation having an aggregate built-in loss. Is loss shifting available?

§362(e)(2) requires a corporation to reduce its tax basis in the property to FMV.

Alternatively, shareholder of the corporation can elect to reduce shareholder's basis for the stock.

See p. 686 examples re various income tax effects.

Advice: Do not contribute loss property to corp.!

Sale of S Corporation Stock Capital Gains? P.699

§1(h) provides for several capital gains rates: e.g., (1) 20% (normal maximum CG rate), (2) lower LTCG rate if less than 37% bracket, & (3) 28% (collectibles gain). Regulations provide for a partial capital gains “look-through” rule for sales and exchanges of a share interest in an S corporation.

Applicable to 28% taxed collectibles gain.

However: Look-through is not applicable to ordinary income property, e.g., inventory or §1250 depreciation recapture (cf., Sub K).

Problem 1(a) Income Allocations

See §1366
p.700

<u>Separately stated items:</u>	<u>A</u>	<u>B</u>
Tax-exempt income	667	333
Interest expense	(4,000)	(2,000)
§1231 gain	8,000	4,000
STCG (AT&T)	5,000	2,500
<u>Net LTCG</u> (15 – 9 = 6)	4,000	2,000
Recovery of bad debt	<u>3,000</u>	<u>1,500</u>
Gross income	20,667	10,333

(i.e., not including the interest expense)

Problem 1(a), cont. p.700

Non-separately computed income or loss:

Business income	92,000	
plus §1245 gain	<u>7,000</u>	<u>99,000</u>
<u>Less deductions:</u>		
Salary expense	44,000	
Depreciation	8,000	
Property taxes	7,000	
Supplies	<u>4,000</u>	<u>(63,000)</u>
<u>Net: (allocated 24,000 & 12,000)</u>		<u>36,000</u>

Problem 1(b)

A's Stock Basis

p.701

A's basis in stock (as adjusted):

<u>Initial basis</u>	<u>\$12,000</u>
1) §1367(a)(1)(A) increase:	20,667
2) §1367(a)(1)(B) increase:	24,000
(99k less 63x = 36x times 2/3rds)	
3) §1367(a)(2)(D) decrease (bribe):	(4,000)
4) §1367(a)(2)(B) decrease (interest):	<u>(4,000)</u>
<u>A's basis after adjustments</u>	<u>\$48,667</u>

(Note adjustments for §103 interest and bribe).

Problem 1(c)

Accounting Method

p.701

Accounting method issues:

S corporation will select its own accounting method, subject to the restrictions in the Code. See §1363(c)(1).

The corporation's accounting method controls the timing of its recognition of its income and deductions.

Problem 1(d)

§1033 Election

p.701

Who makes the §1033 involuntary conversion gain non-recognition election - the corporation or the shareholder? Answer: The corporation.

Code §1363(c)(1) specifies that any election affecting the computation of items derived from an S corporation shall be made by the corporation.

But, see the exceptions in Code §1363(c)(2).

Problem 1(e)

p.701

Inventory Classification?

Assume property is described in Code §1221(a)(1) (i.e., inventory) if held by A.

What is the relevance in the S corp. context?

§1366(b) - entity level characterization.

However, a possible “dealer” problem can exist at the shareholder level when property is held by the shareholder for sale in the ordinary course of business.

Problem 2(a)

p.701

Mid-year Partial Stock Sale

Problem of allocation and adjustment rules -
shareholder sells 1/2 of stock at mid-year:

Basis for shares to be sold \$5,000

(1/2 of 10x at beginning of the year)

Plus: business income share 10,000

Less: allocable §1231 loss (5,000)

Basis for shares sold: 10,000

Sale for 25,000 less 10,000 basis = 15,000 gain

Problem 2(a), cont. p.701

D's Tax Basis at Year-end

D's tax basis as of the end of the year for D's stock held at end of the year:

§1012 cost basis (1/2 of 10x)	\$5,000	
Plus: §1367(a)(1)(B)	20,000	income
Less: §1367(a)(2)(B)	<u>(10,000)</u>	loss
Equals:	15,000	

(allocations to this 1/2 of stock based on 1/6 of total amounts)

Problem 2(a), cont.

p.701

Purchaser's Tax Basis

G's tax basis as of the end of the year in the stock purchased mid-year:

§1012 cost basis	\$25,000	
Plus: §1367(a)(1)(B)	10,000	income
Less: §1367(a)(2)(B)	<u>(5,000)</u>	loss
Equals:	30,000	

(allocations based on
1/12 of total amounts,
i.e, 1/6 share interest x 1/2 year equals 1/12th)

Problem 2(b)

p.701

Total Stock Sale (1/3rd of total)

D sold all D's stock to G for \$50,000.

§1377(a)(2) allows D and G to treat the year as consisting of two taxable years - the first of which ends on the date of D's sale.

Closing of the books would occur for purposes of making allocations to D and G (including an allocation of the entire §1231 loss attributable to D's shares to D). *cont.*

Problem 2(b), cont. p.701

Loss Increase; CG Increase

D's basis for shares sold:	\$10,000
(at beginning of the year)	
Plus: business income share	20,000
($1/6^{th}$ allocation of 120,000)	
Less: allocable §1231 loss	<u>(20,000)</u>
(<u>$1/3^{rd}$</u> of 60,000; not $1/6^{th}$)	
Basis for shares sold:	<u>10,000</u>
Sale for 50,000 less 10,000 basis =	40,000 gain
<i>(Cf., if no election: 10x loss, 20x basis & 30x gain)</i>	

Problem 3(a)

p.701

Loss Utilization

50% shares

Loss limitation rules - §1366(d).

Total \$8,000 loss is incurred by corporation.

Dick and Harry each own 1/2 of the S corp. stock and each has \$2,000 stock basis; Dick has also loaned \$4,000 to Ace.

Dick's basis is \$6,000 for both the stock & note.

Dick can take a \$4,000 loss (1/2 of the \$8,000 loss).

Basis (\$2,000) in Dick's stock is reduced to -0-.

Note basis is reduced to \$2,000. §1367(b)(2)(A).

continued

Problem 3(a), cont. p.701

Suspended loss utilization

Harry can take only a \$2,000 loss.

Basis in Harry's stock is reduced to -0-.

For Harry the additional \$2,000 loss is suspended and can be used only when Harry subsequently has tax basis in his shares (or loans his funds to the corporation and has a tax basis in the loan).

Note: Bank borrowing does not provide additional tax basis (e.g., Harris case).

Problem 3(b)

p.701

Loss first & Income Next Year

Ace has \$6,000 of net income from operations in next year: \$3,000 is allocated to Dick and \$3,000 is allocated to Harry.

Dick's basis in the note will be restored by \$2,000 and Dick's stock basis is increased by \$1,000.

Code §1367(a)(1)(B) & (b)(2)(B).

Harry's stock basis is also (1) increased by \$3,000 under §1367(a)(1)(B) & then (2) the \$2,000 loss is used & (3) his stock basis is then reduced to \$1,000.

Problem 3(c)

p.701

Proportionate Loss Allocation

Allocation of different types of losses.

Dick is not affected, since he is allocated \$1,000 of the operating loss and \$3,000 of the long term capital loss which then reduces the basis of his stock to zero and his note to \$2,000.

Harry is allocated \$1,000 of operating loss and \$3,000 of long term capital loss.

Harry's loss is limited to \$2,000 under §1366(d)(1).
His loss availability is proportionately allocated.

Problem 3(d)

p.701

Protection of Suspended Loss

Ace's S corporation status was terminated at the end of the year. Harry has \$2,000 of suspended loss.

§1366(d)(3) allows Harry to deduct the suspended loss if he has stock basis on the last day of any post-termination period.

Harry will have at least one year to increase his tax basis in the stock.

Problem 4(a)

p.701

Loss Disallowance?

Allied (S corp) sells depreciated real estate to Portland (S corp) for \$20,000 less than Allied's tax basis for the real estate.

Tax issue concerns the applicability of the Code §267 loss disallowance rules to related S corps.

Loss is disallowed since Betty & Chuck together own over 50% of the value of each S corporation. Code §267(b)(11).

Problem 4(b) C Corporation Variant

p.701

Allied (an S corp) sells real estate at a loss to Portland, a C corporation.

The same persons own more than 50% of each corporation.

This ownership relationship causes the Code §267 limitation to apply - see Code §267(b)(12).

Allied is not allowed to deduct the loss.

Problem 4(c)

p.702

Accounting Year Gap

Allied (an accrual method taxpayer) owes a salary of \$1,500 to Betty (on the cash method) on Dec. 31.

Allied pays the salary on the next January 15.

A gap exists between accounting periods/methods.

See Code §267(e)(1)(B)(ii) concerning the relationship test when a pass-through entity.

Code §267(a)(2) - Allied is not allowed the deduction until the following year since the salary is not includible in Betty's income until paid (next year).

Distributions to Shareholders

p.702

Alternative situations concerning S corporations:

- 1) Distribution of cash when:
 - a) Corporation has no E&P.
 - b) Corporation does have E&P (prior C corp. or E&P is received from another corp. in a tax-free acquisitive reorganization).
- 2) Distribution of other (appreciated) property, rather than cash? Appreciation recognized?

Distributions to Shareholders

p.702

Assume: The S corporation without accumulated earnings and profits (E&P) makes distributions to its shareholders. See Code §1368(b)(1) & (2).

These distributions are:

- 1) First, sourced from the shareholder's tax basis for the stock. See §1367 re tax basis adjustments.
- 2) Recovery of tax basis.
- 3) Capital gain (excess over the tax basis recovery).

continued

Distributions to Shareholders, cont. p.702

Assume the S corporation with earnings and profits makes distributions. See Code §1368(c).

The allocation of distributions is (in this order):

- 1) from the accumulated adjustments account (AAA) (undistributed S corporation income);
- 2) dividend income to the extent of E&P;
- 3) tax basis recovery for the stock; &
- 4) capital gain (as if from the sale of property).

Distributions - Appreciated Property

p.703

The S corporation can distribute appreciated property to its shareholders.

Gain recognition occurs at the corporate (distributor) level upon the distribution. §311(b).

This gain is passed through to S corp. shareholder.

The shareholder will take a fair market value tax basis for the property received from the corp.

This concept applies to all S corp. distributions.

Problem 1(a)

p.704

Distribution Effects

Dewey's Dewey owns 1/3rd of Ajax
basis: 3,000
plus: 3,000 (of 9,000) from operations
plus: 1,000 (of 3,000) LTCG (stock sale)
equals: 7,000 basis
less: 5,000 tax-free distribution
equals: 2,000 remaining basis
(Milt: 5 + 6 (profit) + 2 (LTCG) = 13 basis - 10)

Problem 1(b)

p.704

Larger Distribution Amounts

Distribution of 8,000 to Dewey

- exceeds his 7,000 basis (see problem 1(a))
- produces 1,000 capital gain

Distribution of 16,000 to Milt

- exceeds his 13,000 basis (see problem 1(a))
- produces 3,000 capital gain - §1368(b)(2).

Stock basis is reduced to zero. §1367(a)(2)(A).

Character of this gain for each shareholder?

Problem 1(c)

Stock Redemption

p.704

Ajax redeems all of Dewey's stock on the last day of the year for \$20,000.

Dewey's basis for the stock redeemed will be \$7,000 (see problem 1(a)).

The redemption is treated as a complete termination under Code §302(b)(3).

Result: Dewey has \$13,000 capital gain.

Problem 1(d)

p.704

Pro Rata Stock Redemption

Partial redemption not qualifying for exchange treatment under §302(b) - since it is pro rata.

The redemption (Dewey - \$5000) is classified as a §301 distribution - see §302(d).

Therefore, characterized under §1368(b).

Dewey's basis is 7,000; Milt's basis is 13,000.

Results will be as in (a) above.

No income is recognized; tax basis is reduced (e.g., Dewey from \$7000 to \$2000).

Problem 1(e)

Gain or Loss Property

p.704

Depreciated property to Dewey – no tax loss available when loss property is distributed. §311(a).

Appreciated property to Milt:

§311(b) gain of \$3,000 to Ajax (Corp)

Milt has additional \$2,000 gain as income.

Dewey has \$1,000 of the \$3,000 gain as income.

Stock basis is increased (§1367) and this increase affects the distribution to be excluded under §1368(b).

Problem 1(f)

p.704

Corp's Notes Distributed

Distribution of the corporation's own notes.

No corporate recognition of gain is required on the note distribution - §311(b)(1)(A).

Dewey's basis remains \$7,000 - distribution of the \$8,000 note produces \$1,000 gain to Dewey.

Milt's basis remains \$13,000 - distribution of the \$16,000 note produces a \$3,000 gain to Milt.

FMV basis for each note to the shareholders.

Problem 2(a) E&P p.704

§1368(c) Distribution Rules

Nancy's

basis: 1,000

plus: 2,000 (of 4,000) LTCG - 1367(a)(1)(A)

plus: 3,000 (of 6,000) income- 1367(a)(1)(B)

equals: 6,000 stock basis

less: 5,000 distribution - characterized as basis recovery since not exceeding the AAA (which is 10,000). See §1368(c)(1). Nancy's basis is reduced to \$1,000. AAA reduced by the 10,000 distribution.

Problem 2(b) p.704

§1368(c) Distribution Rules

Nancy's basis equals: 6,000 & P's AAA is \$10,000.

less: 10,000 distribution to her

For Nancy allocated as follows:

\$5,000 §1368(c)(1), (b)(1) (her 1/2 of 10,000 AAA)

\$3,000 §1368(c)(2) (1/2 of E&P)

\$1,000 §1368(c)(3), (b)(1) (her basis)

\$1,000 §1368(c)(1), (b)(2) (cap gain to her)

Basis in stock is reduced to zero. AAA is zero.

Problem 2(c) p.704

§1368(c) Distribution Rules

Nancy's basis equals \$6,000 (at beginning).

Additional corp. receipt of \$4,000 interest and \$2,000 of interest also distributed to each shareholder (total \$7,000 distribution; not \$5,000).

Her stock basis increases to \$8,000. §1367(a)(1)(A).

P's AAA is still \$10,000 (see 2(a)) – No upward AAA adjustment for tax-exempt interest - §1368(e)(1)(A).

\$7,000 distribution - \$5,000 is from AAA, and \$2,000 dividend from E&P. Basis reduced to \$3,000.

E&P is reduced by 4,000 (2,000 + 2,000) to 2,000.

Problem 2(d)

Transferee & AAA

p.705

Nancy sells to Rose for \$6,000.

Distribution to Rose of \$6,000 in Year 2.

\$5,000 of the distribution (1/2 of 10,000 AAA) is characterized as basis recovery since not exceeding the AAA. See §1368(c)(1).

Dividend (from E&P) in the amount of \$1,000.

Stock basis for Rose is reduced to \$1,000 (6,000 less 5,000 AAA distribution).

Problem 2(e)

p.705

S Election Revoked

Current year - no distributions. \$5,000 of E&P realized next year (when not an S corp).

Distribution of \$7,000 to each shareholder.

Cash distribution during the post-termination transition period (§1377(b)):

First, \$5,000 of basis recovery (§1371(e)(1), takes precedence).

Next, \$2,000 as dividend under §301(c)(1).

Taxation of the S Corporation

p.693

1) Tax on built-in gains - §1374; the BIG tax.

- no avoidance of the accrued double tax burden while a C corp. is permitted.

- net built-in gains to be taxed for ten years after the S corp. election. Note: Seven year rule for 2009-2010 ; 5 year rule for 2011, 2012-2013 .

§1374(d)(7)(B). Year 2014 – back to ten years.

Necessitates an appraisal of assets at time of conversion to S corp. status.

Taxation of the S Corporation

Continued p.705

2) If excessive passive investment income:

- a) possible loss of S corporation status, and
- b) §1375 tax (35% of “excess net passive income”).

Occurs when S corp. election made after being a C corp. and passive income exceeds 25% of gross receipts for 3 years.

Possible relief under §1375(d).

Problem1(a)

p.711

Corp. formed in year 2011 as C corp.; S. Corp election as of 1-1-2016 when no Sub. C E&P.

Sale of building in 2017 for \$75,000 (basis \$10,000); would have \$75,000 taxable income of \$75,000 if S. Corp.

\$40,000 gain of which \$25,000 is recognized built-in gain under §1374(d)(3) (disregarding §168).

Tax of 35% on 25,000 gain.

Problem 1(b)

p.711

**Same as (a) (i.e., \$25,000 recognized built-in gain),
but taxable income for 2017 is only \$20,000.**

**See §1374(d)(2) – net recognized built-in gain cannot
exceed the corporation's taxable income.**

**But, the excess \$5,000 is carried over, to be treated
as recognized built-in gain in the succeeding year.**

§1374(d)(2)(B).

Problem1(c)

p. 711

Same as (a), but B Corp sells machinery in 2018 when it would have substantial taxable income, if not then an S corp.

B Corp has \$25,000 gain (40,000 less 15,000 basis, & disregarding depreciation) and \$15,000 gain at time of S Corp. election.

But, see §1374(c)(2) limit on gain recognition.

Problem 1(d)

p. 711

**§1031 exchange & §1374(d)(3)(B) & 1374(d)(6) re
reference back to tax basis (& status of prior
property).**

Then similar to Problem 1(a).

Problem1(e)

p. 711

Sale of building for significant gain in 2022.

Sale in a taxable year after the ten year recognition period and not subject to §1374.

Problem 2

p.711



[to come]

Problem 3

p.711



[to come]

Issue is treatment of rents as passive income.

Coordination with Subchapter C

p.712

Provisions of Subchapter C are also applicable
(unless inconsistent) to S corp. - §1371(a):

- Formation - §351 applicable (e.g., 80% control)
- No DRD (p. 686).
- Distributions and (complete) liquidations.
- Taxable disposition – stock or asset purchase
 - pass-through of gain/loss on an asset sale)
 - gain on stock sale (historic inside asset basis)
- Tax-free reorganizations – loss of S corp. status?

Problem 1

p.719

If continuing as a C Corp. – subject to tax on a taxable asset acquisition.

If electing S corporation status – tax under §1374 for any recognized built-in gain during the 10 year recognition period. But, only applicable to pre-S election gain.

Problem 2(a)

p.719

If P purchases T's stock for cash and notes is the S election destroyed?

An S corporation can have a controlled C subsidiary.

Problem 2(b)

p.719

Is the S election preserved after T's assets are acquired in a Type C reorganization?

Compensation Issues

p.719

Dividend or compensation (latter situation: recipient is subject to payroll taxes)?

Avoid Federal Social Security & Medicare taxes by only paying S Corp dividends (and not paying deductible compensation)?

See Radtke case (*next slide*); how moderate this result through tax planning?

This is the “John Edwards loophole.”

See, also §1372: Possible limit on fringe benefit special treatment to a more than 2% shareholder.

Radtke case

p.721

Legal services corporation & one employee (the attorney).

Zero salary and all earnings received as “dividends.”

No federal employment taxes paid.

Do the dividends constitute wages?

Held: The dividends are to be re-categorized as wages (and, therefore, are subject to FICA and FUTA).

And, now also, the 3.8% Medicare tax.

Comparing Subchapters K & S

p.725

Note the multiplicity of similar types of entities, but differences exist between partnership & S corp:

- income (special partnership allocation)
- effect of debt on tax basis
- sale of interest (stock vs. partnership interest)

Note that a state law partnership can: (1) elect corporate tax classification, and, then (2) make an S corporation election.

See Rev. Rul. 2009-15 re conversion of a partnership to a corporation and an immediate S election.

Comparing Subchapters K & S continued p.725

Should the S corporation be eliminated?

But, currently more S corporations are organized every year than any other entity.

Corporate form is often preferred in the public equity markets. E.g., start-ups in Silicone Valley.