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Companion to PPC's

1120S Deskbook

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Interactive Self-study CPE

Companion to PPC's 1120S Deskbook

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INTRODUCTION

Companion to PPC's 1120S Deskbook consists of two interactive self-study CPE courses. These are companion courses to *PPC's 1120S Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2018**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of the preparation of Form 1120S. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions at the end of the course**. You may record your answer choices by printing the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

Qualifying Credit Hours—NASBA Registry (QAS Self-Study)

Checkpoint Learning is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: **www.nasbaregistry.org**.

Checkpoint Learning is also approved for "QAS Self Study" designation.

The requirements for NASBA Registry membership include conformance with the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. Each course is designed to comply with the *Standards*. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the **Overview** page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the **Examination for CPE Credit**. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by emailing, mailing, or faxing your completed **Examination for CPE Credit Answer Sheet** to Thomson Reuters (Tax & Accounting) Inc. for grading. Answer sheets are located at the end of the course PDFs. They may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet

for each course. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Payment for emailed or faxed answer sheets is $89. There is an additional $10 charge for manual print grading, so please include a total of $99 with answer sheets sent by regular mail. Please take a few minutes to complete the **Self-study Course Evaluation** so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the Overview and Exam Instructions pages.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted ($89 when sent by email or fax; $99 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

Obtaining EA and NCRP Credit

To receive IRS Enrolled Agent (EA) or Non-Credentialed Return Preparer (NCRP) credit, you must provide your PTIN to Thomson Reuters in one of two ways. Log on to **cl.thomsonreuters.com**, select the "Settings" tab, and then "Edit My Membership Information." Select "IRS PTIN" from the drop-down menu, and input your PTIN. (Your PTIN should start with a capital "P" and be followed by eight numbers.) Alternatively, if you are submitting your exam for print grading, write your PTIN in the space provided on your answer sheet.

Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion.* You should retain it and a copy of these materials for at least five years.

COMPANION TO PPC'S 1120S DESKBOOK

COURSE 1

TOPICS RELATED TO DEDUCTIONS AND PASS-THROUGH TO SHAREHOLDERS (T2STG171)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study CPE course tackles several topics that S corporation shareholders may face when recording deductions and pass-through items on their Form 1120S. Lesson 1 discusses issues related to compensation. Lesson 2 covers items the effects of fringe benefits and retirement plans. Lesson 3 discusses other deductions that may apply for S corporation shareholders. Lesson 4 takes a look at pass-through on Schedules K and K-1 of Form 1120S. Finally, Lesson 5 discusses the alternative minimum tax.

PUBLICATION/REVISION DATE: November 2017

RECOMMENDED FOR: Users of *PPC's 1120S Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Experience with the preparation of Form 1120S

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP): This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.

CTEC CREDIT: 8 CTEC Federal Tax Law Hours

IRS EA CREDIT: 8 Federal Tax Law/Tax Related Matters Hours

IRS NCRP CREDIT: 8 Federal Tax Law Hours

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2018**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Compensation

Completion of this lesson will enable you to:

- Identify considerations for the deduction for reasonable officer and employee compensation and how to reclassify compensation disguised as distributions or other payments.
- Recognize the proper treatment for accrued shareholder compensation under the matching principle, compensation paid in the form of stock and other employee incentive plans, treating shareholder-officers as employees or independent contractors, additional Medicare tax for highly paid employees, and the net investment income tax.

Lesson 2—Fringe Benefits and Retirement Plans

Completion of this lesson will enable you to:

- Identify deductions for taxable and nontaxable fringe benefits.
- Identify deductions for self-employed medical insurance for S shareholders, contributions to retirement plans, contributions to simplified employee pensions and simple retirement plans, and payments to nonqualified deferred compensation plans and assess issues related to employee stock ownership plans, treating deferred compensation as a loss for built-in gains tax purposes, determining whether small employer health insurance is eligible for a tax credit, and dealing with cafeteria plans.

Lesson 3—Other Deductions

Completion of this lesson will enable you to:

- Recognize how to claim the domestic production activities deduction (DPAD).
- Recognize the effect of passing charitable contributions through to shareholders; lease and rental expenses; reporting directors' fees and expenses; deducting advertising, professional fees, and other selected business items; penalties, bribes, and political expenses; and the tax benefit rule for recovering previous deductions.

Lesson 4—Schedules K and K-1—Pass-through

Completion of this lesson will enable you to:

- Identify how nonseparately stated income or loss, separately stated items, reporting the results of operations, and allocating pass-through to shareholders affects Schedules K and K-1.
- Recognize how to deal with allocating income and losses in an S termination year, passing through corporate-level tax to shareholders, reporting self-charged interest, disclosing inconsistent treatment on the shareholder's return, deducting corporate expenses paid by the shareholder, limitations on loss and deductions, considering a beneficial owner to be an S corporation shareholder, and the effects of the 3.8% net investment income tax and the 0.9% additional Medicare tax on S shareholders.

Lesson 5—Alternative Minimum Tax

Completion of this lesson will enable you to:

- Identify the following about the alternative minimum tax (AMT): how it applies at the shareholder level, when S corporations are not subject to AMT, how to apply AMT rules to depreciation adjustments and preferences, how to make corporate and shareholder elections that will minimize AMT, how adjustments and preferences from passive activities are reported, how to calculate the shareholder's basis, how to apply noncorporate AMT rates for qualified dividend income and long-term capital gains, and how AMT affects business credits.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs.** Online grading allows you to get instant CPE credit for your exam.

Alternatively, you can submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
- Mail to:

Thomson Reuters
Tax & Accounting—Checkpoint Learning
T2STG171 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for additional instructions and payment information.

ADMINISTRATIVE POLICIES:

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Lesson 1: Compensation

Introduction

Compensation from an S corporation can take many forms, including cash, stock, property, and contributions to both qualified and nonqualified deferred compensation plans. Compensation of officers generally is included on line 7 of Form 1120S; salaries and wages paid to other employees are reported on line 8. Retirement plan contributions and fringe benefits generally are reported on lines 17 and 18, respectively. Under the UNICAP rules, a portion of compensation may be included in cost of goods sold.

Salary, by far the most common form of compensation, is reported no differently for S corporations than for any other employer; salary payments are deducted by the employer and taxed to the employee. Furthermore, social security and unemployment taxes are imposed, up to certain statutory levels. The additional impact of salary (and other forms of deductible compensation) on S corporations is a decrease in the nonseparately stated income that passes through to shareholders because the salary expense reduces the corporation's net income.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify considerations for the deduction for reasonable officer and employee compensation and how to reclassify compensation disguised as distributions or other payments.
- Recognize the proper treatment for accrued shareholder compensation under the matching principle, compensation paid in the form of stock and other employee incentive plans, treating shareholder-officers as employees or independent contractors, additional Medicare tax for highly paid employees, and the net investment income tax.

How to Deduct "Reasonable" Officer and Employee Compensation

Compensation Must Be Reasonable

For compensation to be deductible, it must be reasonable for the personal services actually rendered. In addition, a member of an S corporation shareholder's family must receive reasonable compensation for services rendered or capital furnished to the corporation. This provision applies to family members, as defined in IRC Sec. 704(e)(3), whether or not they own shares in the corporation.

Although these rules seem straightforward, tax problems can surface if the compensation is too high (e.g., to minimize the built-in gains tax), too low (e.g., to reduce payroll taxes), or not in fact payment purely for services, particularly when the employees are also shareholders. The IRS is specifically empowered to reallocate an S corporation's income in family income-splitting situations. Under this rule, the IRS can adjust income to reflect reasonable compensation for services rendered or capital furnished to the corporation. The allocation takes place among family members and can include those who are not shareholders if they are rendering services or furnishing capital to the corporation. Inadequate salary, rent, or interest can result in reallocations by the IRS.

Section 162(m) Deduction Cap Does Not Apply to S Corporations. Although IRC Sec. 162(m) generally limits a publicly traded corporation's compensation deduction for its five highest paid employees to a maximum of $1 million each, this deduction cap does not apply to S corporations because their stock is not publicly traded.

Compensation for Shareholder-employee's Services Is Wages

Pass-through income and distributions from an S corporation are not subject to self-employment tax. Furthermore, compensation for services (other than minor services) rendered for the corporation by an officer-shareholder is wages, not self-employment income.

Factors for Determining Reasonable Salaries

As mentioned previously, compensation must be reasonable for the personal services actually rendered by a shareholder-employee. This reasonable compensation standard can be applied to adjust compensation that is either too high or too low.

There is no rigid set of rules for measuring the reasonableness of compensation. No definition of "reasonable" is contained in the Code; the regulations provide only that reasonable compensation is an amount paid for like service by like enterprise under like circumstances. Court cases have shown, however, that each situation must be resolved based on its unique facts and circumstances. Some Tax Court decisions have focused on the following factors:

1. the character and financial condition of the corporation;
2. the role the shareholder plays in the corporation, including the employee's position, hours worked, and duties performed;
3. the corporation's compensation policy for all employees and the shareholder's individual salary history including the corporation's internal consistency in establishing the shareholder's salary;
4. how the compensation compares with similarly situated employees of similar companies;
5. conflicts of interest in setting compensation levels; and
6. whether a hypothetical independent investor would conclude that there is an adequate return on investment after considering the shareholder's compensation.

The courts have also considered additional factors in deciding whether the amount of compensation is reasonable, including:

1. the employee's qualifications;
2. the size and complexity of the business;
3. a comparison of salaries paid to sales and net income;
4. general economic conditions;
5. comparison of salaries to shareholder distributions and retained earnings;
6. the corporation's dividend history;
7. whether the employee and employer dealt at arms' length;
8. corporate intent; and
9. whether the employee guaranteed the employer's debt.

The court decisions confirm that no single factor controls, but rather a combination of the factors must be considered. Furthermore, these factors are not all-inclusive (and may not be given equal weight). Fewer or additional factors may be appropriate, depending on the surrounding facts and circumstances.

Increasing or Reducing Salaries for Tax-savings Purposes

Substantial tax advantages can be gained by S corporations using compensation to achieve certain objectives. For example, increasing compensation reduces the corporation's income, which can limit the built-in gains tax in that year. Furthermore, salaries may be reduced in order to split income with other family members who own shares in the S corporation. As a result, a significant portion of IRS activity in the S corporation area is directly or indirectly related to the reasonableness issue.

Paying a Year-end Bonus

In *Menard, Inc.*, a retail home improvement chain operating as a C corporation paid its founder and president a bonus of 5% of the company's net income before income taxes. This resulted in a $17,467,800 bonus for the tax year at issue, which the Tax Court found to be excessive and to look more like a dividend than a bonus. In upholding the bonus, the 7th Circuit noted that dividends typically are specified as so many dollars per share rather than a percentage of earnings. Although tying compensation to the market value of the company's stock has been criticized because of factors besides managerial effort and ability that influence the price of a publicly traded stock, stock in Menards (like stock in S corporations) is not publicly traded. Furthermore, the fact that the bonus was paid at the end of the year was of no consequence because net income for the year was not determinable until the close of the last day of the year on which the chain's stores were open. As a practical matter, bonuses are usually paid in a lump sum once a year, often at Christmas, although that would not be feasible unless Menards closed its stores the following week.

The Tax Court also found the requirement that the president reimburse the corporation should the deduction of the bonus from the corporation's taxable income be disallowed by the IRS and/or state tax authority (i.e., a pay-back agreement) to be another indication that the bonus looked more like a dividend than salary. The Circuit Court responded that: "Given the fondness of the IRS and the Tax Court for a *totality of the circumstances* approach to determining excessive compensation, it was prudent (and incidentally not in Menard's personal financial interest) for the company to require him to reimburse it should the IRS successfully challenge the deduction."

Making up for Prior Year Undercompensation

Often, small companies pay lower salaries in the early years in order to invest the money back into the business and facilitate growth. Also, in years in which a company has a loss, it may reduce salaries of top executives (i.e., owner/officers). It is important to document in the corporate minutes in the years of undercompensation that the salary paid for the year is less than adequate for the services provided, and that future bonuses will take this into consideration. Additionally, in the year that a bonus is paid to make up for prior year undercompensation, the corporate records should document that the bonus is for prior year compensation and detail how the amount is calculated and to which years of undercompensation it relates.

In a case appealable to the 9th Circuit, the Tax Court allowed a deduction for bonuses of $2 million and $1 million to a corporation's sole shareholder/officer. During the two years at issue, the corporation realized sales of approximately $12.5 million and $5.7 million, resulting in a return on equity of 93% and 25%, respectively. The owner was the driving force behind the corporation's success and served in all of the corporation's executive and managerial roles. His pay for one of the years reasonably included compensation for significant underpayment in earlier years. The court also considered the time value of money and applied an interest factor based on the applicable federal rate compounded semiannually to the prior year's underpayment, which increased the amount of the bonus deduction allowed. The averages of the methods used by the court to determine reasonable compensation resulted in compensation of approximately $1.4 million and $1 million for the two years at issue, and the future value of six years of underpayments was $547,350. Considering these combined amounts, the court determined that the bonuses for the two years were deductible.

Compensating Professionals in a Professional Services Firm

In the case of a professional services firm, any amount paid as compensation to a shareholder/employee is generally reasonable, as long as it does not exceed the net profit derived from billing out the professional services of that employee. However, the reasonable compensation issue becomes more complex when the professional services firm generates additional taxable income from activities beyond the pure delivery of professional services by shareholder/employees. Many professional services corporations that previously delivered services have now diversified into product sales, including drugs and pharmaceuticals for medical services firms and technology products for accountants and others.

Taxpayers must include all amounts paid to the shareholder/employee, either directly or indirectly, when determining whether compensation is reasonable. In *Mulcahy*, the taxpayers were founders of an accounting and consulting firm who owned 80% of the firm's stock, served as officers and directors of the firm, and were the only members of the compensation committee. In addition to the firm paying each founder annual compensation of $100,000, it also

paid consulting fees to three entities owned by the founders even though the entities did not perform any services for the firm. The 7th Circuit agreed with the Tax Court's finding that payments to the related entities should be classified as dividends. The fees failed the reasonable compensation independent investor test since they reduced the firm's income to zero or below, and there was no evidence (e.g., payroll tax withholding, Forms W-2 or 1099-MISC reporting) the fees were actually compensation for services provided by the founders.

The Tax Court imposed dividend treatment on shareholder/employees of a medical corporation when the court concluded that two nonshareholder doctors generated net profits in the years in question, which were then entirely paid out to the shareholder/employees. The court upheld the IRS's argument that part of the money paid to the shareholder/employees, which essentially cleared out all taxable income of the corporation, represented dividends derived from net profits generated by the two nonshareholder doctors.

IRS Enforcement of Adequate Shareholder Compensation

According to the Government Accountability Office (GAO) report, "Actions Needed to Address Noncompliance with S Corporation Tax Rules" (GAO-10-195), 13% of S corporations paid inadequate wage compensation in tax years 2003 and 2004. S corporations with the fewest shareholders made up the largest portion of the shareholder compensation net underpayments. In fact, those with one to three shareholders accounted for almost all of the net underpayments. The median adjustment for underpaid shareholder compensation in all categories was $20,127.

Due to the difficulties in determining reasonable compensation, examiners told the GAO they pursue the issue when the shareholders are paid little to no wages and receive large distributions. Examination data for fiscal years 2006 through 2008 showed that the IRS examined less than 1% of the S corporations that filed Form 1120S. Of the Forms 1120S that were examined, adequate compensation was reviewed in 14.3% of the cases in 2006, 21.6% in 2007, and 15.6% in 2008.

When examining this issue, the examiners generally did not document their analysis. In a random sample, GAO found evidence of some kind of analysis in 24 of 114 cases where the examiner identified shareholder compensation as an issue to review. These analyses included comparisons with online job site information (e.g., monster.com) and Bureau of Labor Statistics wage data. In the other 90 cases, examiners did not document an analysis, and in some cases merely reconciled the officer's Form W-2 to the return.

Setting and Supporting Reasonable Compensation

Taxpayers generally will not prevail when compensation paid by an S corporation is extremely low (or nonexistent) in exchange for substantial services. It is impossible to make a general statement as to what amount of compensation is reasonable because reasonableness must be determined based on the surrounding facts and circumstances. However, in many situations, compensation can be set at the low end of an otherwise wide salary range that is both reasonable and supportable. The better the documentation (e.g., in the corporate minutes) and the greater the business purpose for transactions between the S corporation and its shareholders, the more likely the transactions will withstand IRS attack. In any case, the compensation to the shareholder-employee must be reasonable for the services rendered.

While the IRS has succeeded in court with the right fact patterns, the courts have also acted as a deterrent, as in the *Grigoraci* case. Here, the taxpayer was a CPA who had formed an S corporation in which he was the sole shareholder, and the S corporation then joined an accounting general partnership organized under the laws of West Virginia. The two original partners in the general partnership held their interests through S corporations. The taxpayer's income from the partnership was reported on Form 1120S, and that income was in turn reported on the taxpayer's Form 1040. However, the taxpayer did not report self-employment tax on the income. The IRS contended that the corporation was a sham and the income was personal service income subject to self-employment tax. However, the court held that the IRS's position was belied by the facts that the corporation was properly organized under West Virginia law and that the taxpayer used it as a valid liability-limiting vehicle.

Noncash Compensation

Although the IRS usually places more emphasis on cash payments, fringe benefits and retirement plan contributions can also receive IRS scrutiny when determining reasonable compensation, especially when the noncash

compensation represents a substantial benefit to the employee. In a C corporation, the cost of a fringe benefit generally is deductible at the corporate level, and the employee who receives the benefit excludes the value from income. In an S corporation, however, fringe benefits paid on behalf of a "2% shareholder" are subject to special rules. Fringe benefits and retirement plans are discussed in Lesson 2.

Deducting Employee and Officer Compensation

Cash method employers deduct compensation in the year paid. Although the constructive receipt rule requires a cash basis employee to report compensation when constructively received, there is no constructive payment rule allowing cash method employers to deduct compensation before actual payment. Cash method employers deduct taxes withheld from an employee's compensation in the tax year the taxes are withheld (even though the withheld taxes may not be deposited with the government until the following tax year). However, unemployment (FUTA) taxes and the employer's share of FICA taxes are not deductible until paid.

Compensation is deductible by accrual method employers when (1) all events have occurred that determine the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy [requirements (1) and (2) are collectively referred to as the "all events test"], and (3) economic performance has occurred. Accrual method employers deduct FUTA taxes and the employer's share of FICA taxes accrued on year-end compensation, but not deposited until the following year, if the requirements of the recurring item exception are met. The same rule applies to deferred compensation (i.e., vacation pay) even though the deferred compensation is not deductible until the following year under IRC Sec. 404.

A deduction for accrued compensation (such as vacation and severance pay) is allowed in the year of accrual only if it is actually received (not merely constructively received) by the employee within 2½ months of year-end. However, an accrual method employer cannot deduct, in the year of accrual, bonuses paid within the 2½-month period if the bonus plan requires recipients to still be employed when the bonuses are paid and forfeited amounts revert to the employer.

An accrual method S corporation cannot deduct salaries and bonuses paid to any cash basis shareholder (or someone related to a shareholder) until the payment is included in the payee's income. In effect, the S corporation is placed on the cash basis with respect to any year-end accrual of shareholder salary, bonus, or other compensation that would otherwise be currently deductible (assuming the shareholder is on the cash basis).

Reporting Compensation on Form 1120S

Compensation paid to officers is reported on line 7 of the S corporation's income tax return, Form 1120S. The corporation determines who its officers are, in accordance with the laws of the state in which it is incorporated. Salaries and wages paid to employees other than officers are reported on line 8.

The portion of compensation attributable to cost of goods sold is reported on Form 1125-A (*Cost of Goods Sold*) and included in the total cost of goods sold carried to page 1 of Form 1120S.

Certain fringe benefits paid to a shareholder who owns, directly or indirectly, more than 2% of the corporation's stock are included in the shareholder's wages. Fringe benefits are discussed in Lesson 2.

Form 1125-E. S corporations must complete and attach Form 1125-E (*Compensation of Officers*) with their Form 1120S if their total gross receipts are $500,000 or more. Stock ownership, percentage of time devoted to the business, and each officer's SSN are reported on Form 1125-E.

Gross income for purposes of the $500,000 test is defined in the instructions to Form 1125-E, and generally includes (1) Form 1120S, page one, lines 1a (Gross receipts or sales), 4 [Net gain or loss from Form 4797 (*Sales of Business Property*)], and 5 (Other income); (2) income reported on Schedule K, lines 3a (Other gross rental income), 4 (interest income), 5a (ordinary dividends), and 6 (royalties); (3) income or net gain reported on Schedule K, lines 7 and 8a (Net short-term and long-term capital gain or loss), 9 (Net Section 1231 gain or loss), and 10 (Other income or loss); and (4) income or net gain reported on certain lines of Form 8825 (*Rental Real Estate Income and Expenses of a Partnership or an S Corporation*).

Return Preparer Penalty Considerations

Tax return preparers can avoid the Section 6694(a) tax understatement penalty if the position has a reasonable basis and is adequately disclosed. According to Reg. 1.6694-2(d)(3)(i), adequate disclosure occurs if Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement) is properly filed, or disclosure is made in accordance with the annual revenue procedure authorized by Reg. 1.6662-4(f)(2). Each year's revenue procedure identifies the circumstances when disclosure of an item or position on an income tax return will be adequate to avoid the Section 6694(a) return preparer penalty. One such circumstance is reporting officer's compensation on Form 1125-E (Compensation of Officers) according to the applicable instructions.

However, disclosure of a dollar amount is not adequate when a tax understatement arises from a "transaction between related parties," which is not defined. This is problematic since the reasonableness of compensation is rarely an issue when the corporation and the employee are unrelated since such compensation is normally set by arm's-length negotiations. The revenue procedure adds that an entry presenting "a legal issue or controversy because of a related-party transaction . . . must be disclosed on a Form 8275 or Form 8275-R."

Since the reasonableness of compensation is a common issue in audits of closely-held corporations, it is worth looking at the Circular 230 ramifications. According to Circular 230, Sec. 10.34(a), practitioners cannot sign a tax return or advise a client to take a position that lacks a reasonable basis or is an unreasonable position under IRC Sec. 6694(a)(2). Furthermore, under Circular 230, Sec. 10.22(a), practitioners must exercise due diligence in preparing or assisting in the preparation of tax returns and other documents to be filed with or submitted to the IRS.

How to Reclassify Compensation Disguised as Distributions or Other Payments

Shareholder-officers of an S Corporation Are Employees

Social Security, Medicare, federal unemployment taxes, as well as tax withholding requirements, are imposed on employers for wages paid to their employees. An officer of a corporation is included in the definition of "employee" if the officer performs services (other than minor services) for the corporation and receives remuneration in any form for those services. The form of payment is immaterial. Thus, the IRS can recharacterize payments to shareholders as wages if the payments are actually disguised compensation. Furthermore, as previously discussed, the IRS can reallocate an S corporation's income to reflect reasonable compensation for services rendered or capital furnished to the corporation.

Employment Contract Does Not Avoid Reasonable Salary Requirement

The corporation cannot avoid paying the shareholder a reasonable salary by entering into a formal employment contract specifying that no salary is to be paid to the shareholder during the year. In *Joseph Radtke*, an attorney tried to use the formalities of an employment contract to avoid employment taxes. His scheme failed in the District Court and on appeal to the 7th Circuit Court of Appeals. A similar arrangement failed in *Dunn and Clark, P.A.*

Compensation Disguised as Distributions

The IRS and the courts have made it increasingly clear that distributions to an actively employed S corporation shareholder can be recharacterized as wages subject to payroll taxes if it is determined the distributions are actually disguised compensation. Since distributions are not subject to payroll taxes or self-employment tax, shareholders and the corporation can reduce or eliminate social security and unemployment taxes if the shareholder receives distributions instead of salary. However, if the payment to the shareholder actually represents compensation for services rendered to the corporation, the payments are not Section 1368 distributions but instead are wages subject to payroll taxes and withholding. Maintaining corporate records that substantiate the reasonableness of compensation is extremely important, as discussed previously under "Setting and Supporting Reasonable Compensation."

Distributions to Corporate Officers May Be Wages

Shareholder-officers of a corporation who are performing services that fall within the scope of duties of corporate officers are employees of the corporation. Therefore, even though a payment for such services is called a distribution or a draw, the payment may be compensation for services, and subject to payroll taxes and withholding.

Example 1B-1 Distributions to corporate officers.

Dale is a practicing attorney who also serves as secretary-treasurer of Essco, Inc., an S corporation in which she is a minority shareholder. Dale is employed full-time by a law firm. In her role as secretary-treasurer of Essco, Dale attends to legal and financial matters but is not involved in the day-to-day affairs. Dale is paid no compensation for her services but did receive a $15,000 distribution.

If the $15,000 payment to Dale was actually compensation for services, it is considered to be wages subject to payroll taxes and withholding.

Distributions Can Be Recharacterized Even If Wages Are Actually Paid. The IRS can recharacterize all or part of distributions to a shareholder as additional compensation subject to employment taxes, even when the S corporation has both paid a salary for services and made distributions to the shareholder. In *Watson*, the S corporation's sole shareholder, a CPA, authorized an annual salary of $24,000 for himself and received distributions of $320,000 over two years. The IRS sought to recharacterize $67,044 of the distributions as compensation, which would increase the taxpayer's salary to $91,044 ($24,000 + $67,044) per year. The taxpayer argued that the corporation's intent should control, and that the IRS cannot compel a corporation to pay a higher salary than it chooses. But in *Watson*, a District Court, citing Rev. Rul. 74-44 and *Joseph Radtke*, held that the IRS has the power to convert distributions to salary. The 8th Circuit upheld the District Court's findings that (1) the taxpayer was a qualified accountant with an advanced degree and 20 years' experience, (2) he worked 35–45 hours per week as a primary earner in a reputable firm with substantial gross earnings, and (3) the $24,000 salary was unreasonably low compared to other similarly situated accountants. The *Watson* case illustrates the methodology that the IRS and courts will employ to determine reasonable compensation.

Consequences of Failing to Withhold and Remit Income and Employment Taxes

Having distributions reclassified as wages can be expensive. The corporation must pay the FICA and federal unemployment taxes (FUTA) on the wages, and may be required to pay income tax withholding on the wages. (The withholding is abated if the shareholder pays the proper income tax.) The corporation will be subject to the failure to file penalty under IRC Sec. 6651(a)(1), the failure to deposit penalty under IRC Sec. 6656(b)(1) (if payroll tax returns were not filed), and conceivably, the negligence penalty under IRC Sec. 6662(c). Also, a social security recipient's benefits may be reduced because of the reclassified wages, if the recipient is under the full benefit retirement age, and the earned income (including the wages) is above a threshold amount. (Full benefit retirement age is gradually increasing from age 65 in 2003 to age 67 in 2027.)

For examples of the consequences of misclassifying an employee, see *Western Management* and *Cave*. In *Western Management*, a corporation had an attorney as its sole shareholder. The attorney worked for the corporation, but he was treated as an independent contractor. Consequently, the corporation paid no payroll taxes. On audit, the IRS argued that the shareholder was an employee. The Tax Court and 9th Circuit agreed with the IRS and the corporation was assessed the payroll taxes together with the penalty for failure to make timely payroll tax deposits and the accuracy-related negligence penalty. In *Cave*, the 5th Circuit affirmed the Tax Court and ruled that an S corporation law firm was responsible for employment taxes on payments to its sole shareholder, three associate attorneys, and a law clerk who were treated as independent contractors. The taxpayer, as an officer of the corporation, was an employee under IRC Sec. 3121(d) while the others were common law employees because of the degree of control, investment in facilities, permanence of the relationship, and profit or loss indicated an employer-employee relationship.

Compensation Disguised as Loans to Shareholders

Frequently, an S corporation will loan funds to shareholders. However, if such payments are not bona fide loans, but instead represent compensation for services rendered to the corporation, the payments may be reclassified as

wages. (As discussed earlier in this lesson, the IRS can adjust income to reflect reasonable compensation for services rendered or capital furnished to the corporation.) The corporation should generate and maintain conclusive evidence that loans are *bona fide* in order to guard against an IRS argument that the payments to shareholders are disguised wages rather than loans. A loan is *bona fide* if the corporation and shareholder have a debtor-creditor relationship based on the shareholder's valid and enforceable obligation to pay a fixed or determinable sum of money to the corporation.

Example 1B-2 Compensation disguised as loans to shareholders.

Fred owns all the stock of Flycorp, an S corporation, and is responsible for managing and operating the business. The corporation does not engage a tax practitioner. During the current year, the corporation makes loan payments to Fred of $80,000. The corporation, however, maintains no loan documents or other records showing the existence or amounts of the loans. No other payments are made to the shareholder.

Flycorp is vulnerable to an IRS argument that the loan payments are actually disguised wages subject to payroll taxes. Under similar facts, the 6th Circuit affirmed the Tax Court that "loan" payments to a majority shareholder, who was the driving force behind the business, were wages.

In *Scott Singer Installations, Inc.,* its sole shareholder made advances to the S corporation over a five-year period to fund business operations. In turn, the corporation paid personal expenses on behalf of the shareholder. The IRS argued that these payments constituted wages and were subject to employment taxes. The taxpayer disagreed, claiming that the payments were repayments of loans. The Tax Court concluded that even though there were no formal promissory notes, the shareholder and the corporation intended to form a debtor-creditor relationship. Therefore, the payments were not wages subject to employment taxes. In AOD 2017-04, the IRS has acquiesced in result only in this court case. The IRS will continue to assert unless taxpayer objectively substantiates both existence of loan and that payments made were in repayment of that loan, that payment of personal expenses by S corporation on behalf of corporate officer/employee constitute wages subject to employment taxes.

Compensation for Services Is Not Self-employment Income

Pass-through income and distributions from an S corporation are not subject to self-employment (SE) tax. While this saves SE tax, the income cannot be treated as net earnings from self-employment for purposes of making retirement plan contributions, and pass-through losses cannot be used to reduce SE income from other sources. Furthermore, compensation for services (other than minor services) rendered for the corporation by an officer-shareholder is wages, not SE income.

IRS Guidance on Reasonableness of Compensation

An IRS fact sheet discusses compensation paid to S corporation officers for services rendered, which should be treated as wages and not as distributions or loans. The amount of compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go to the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate. While there are no concrete guidelines for determining when compensation is reasonable, some of the factors considered by the courts are (1) the officer's training, experience, duties, and responsibilities; (2) the time and effort devoted by the officer to the business; (3) the company's dividend history, payments to nonshareholder employees, and timing and manner of bonus payments; (4) what comparable businesses pay for similar services; (5) the existence and content of compensation agreements; and (6) the use of a formula to determine compensation.

The fact sheet also states that health and accident insurance premiums paid for greater-than-2%-shareholder-employees are deductible by the corporation and are wages for income tax withholding but not for FICA or FUTA purposes.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following occurs when an S corporation pays compensation?

    a. Shareholders must treat wages as self-employment income.

    b. Compensation must meet specific guidelines outlined in the Code.

    c. Acceptable compensation is based on the shareholder's role and the character of the corporation.

    d. Salaries can be increased or reduced to accrue more tax savings.

2. Doing which of the following will allow an S corporation to avoid the Section 6694(a) penalty for tax understatement?

    a. Making adequate disclosure of the position.

    b. Disclosing a dollar amount.

    c. Its practitioner performs due diligence.

    d. Use line 8 of the income tax return to report compensation to its officers.

3. The following individuals are all shareholders in the Everyman S Corporation. They provide services to Everyman and have been designated as officers. Which one would be exempt from the social security, Medicare, federal unemployment taxes, and tax withholding requirements for employees of the S corporation?

    a. Alan has an employment contract that stipulates he will receive no salary.

    b. Betty receives a fair wage for the services provided to the corporation.

    c. Carlos performs only minor services for the corporation.

    d. Delia receives no wages but is paid a large distribution in return for her services.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following occurs when an S corporation pays compensation? **(Page 5)**

   a. Shareholders must treat wages as self-employment income. [This answer is incorrect. Per IRC Sec. 3121(d)(1) and Rev. Rul. 73-361, compensation from an S corporation for services (other than minor services) rendered for the corporation by an officer-shareholder is wages, *not* self-employment income.]

   b. Compensation must meet specific guidelines outlined in the Code. [This answer is incorrect. There is no rigid set of rules for measuring the reasonableness of compensation. No definition is contained in the Code.]

   c. Acceptable compensation is based on the shareholder's role and the character of the corporation. [This answer is incorrect. The character and financial condition of the corporation and the role the shareholder plays in the corporation (including the employee's position, hours worked, and duties performed) are factors some Tax Court decisions have focused on to resolve reasonable compensation cases. However, court decisions confirm that no single factors controls, but rather a combination of the factors must be considered.]

   d. Salaries can be increased or reduced to accrue more tax savings. [This answer is correct. Substantial tax advantages can be gained by S corporations using compensation to achieve certain objectives. For example, increasing compensation reduces the corporation's income, which can limit the built-in gains tax in that year. Furthermore, salaries may be reduced in order to split income with other family members who own shares in the S corporation.]

2. Doing which of the following will allow an S corporation to avoid the Section 6694(a) penalty for tax understatement? **(Page 5)**

   a. Making adequate disclosure of the position. [This answer is correct. Tax return preparers can avoid the Section 6694(a) tax understatement penalty if the position has a reasonable basis and is adequately disclosed. According to Reg. 1.6694-2(d)(3)(i), adequate disclosure occurs if Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement) is properly filed, or disclosure is made in accordance with the annual revenue procedure authorized by Reg. 1.6662-4(f)(2).]

   b. Disclosing a dollar amount. [This answer is incorrect. Disclosure of a dollar amount is not adequate when a tax understatement arises from a "transaction between related parties." Therefore, disclosing a dollar amount will not always be enough for the S corporation to avoid the Section 6694(a) penalty.]

   c. Its practitioner performs due diligence. [This answer is incorrect. According to Circular 230, Sec. 10.34(a), practitioners cannot sign a tax return or advise a client to take a position that lacks a reasonable basis or is an unreasonable position under IRC Sec. 6694(a)(2). Further, under Circular 230, Sec. 10.22(a), practitioners must exercise due diligence in preparing or assisting in the preparation of tax returns and other documents to be filed with or submitted to the IRS. Though having its practitioner perform due diligence is likely a step in the right direction to avoiding the Section 6694(a) penalty for tax understatement, there are other things that the S corporation will have to do to ensure its avoidance.]

   d. Use line 8 of the income tax return to report compensation to its officers. [This answer is incorrect. Compensation paid to officers is reported on line 7 of the S corporation's income tax return, Form 1120S. The corporation determines who its officers are, in accordance with the laws of the state in which it is incorporated. Salaries and wages paid to employees other than officers are reported on line 8. However, even if the S corporation used the correct line to report officer compensation (7, not 8), there are other, specific things it must do to avoid the Section 6694(a) penalty.]

3. The following individuals are all shareholders in the Everyman S Corporation. They provide services to Everyman and have been designated as officers. Which one would be exempt from the social security, Medicare, federal unemployment taxes, and tax withholding requirements for employees of the S corporation? **(Page 10)**

   a. Alan has an employment contract that stipulates he will receive no salary. [This answer is incorrect. The corporation cannot avoid paying the shareholder a reasonable salary by entering into a formal employment contract specifying that no salary is to be paid to the shareholder during the year. This idea failed in court cases such as *Joseph Radtke*; therefore, Alan will still fall under the definition of "employee" and be subject to social security, Medicare, federal unemployment taxes, and tax withholding requirements.]

   b. Betty receives a fair wage for the services provided to the corporation. [This answer is incorrect. Per IRC Sec. 3121(d) and Reg. 21.3121(d)-1(b), if an officer receives remuneration for services performed they fall under the definition of "employee" and the social security, Medicare, federal unemployment taxes, and tax withholding requirements will apply. Betty falls under this aspect of the definition of "employee."]

   c. Carlos performs only minor services for the corporation. [This answer is correct. According to IRC Sec. 3121(d) and Reg. 21.3121(d)-1(b), an officer of a corporation is included in the definition of "employee" if the officer performs services (other than minor services) for the corporation and receives remuneration in any form for those services. Therefore, since Carlos only provides minor, he is exempt from all the withholding related to being a corporation employee.]

   d. Delia receives no wages but is paid a large distribution in return for her services. [This answer is incorrect. The IRS and the courts have made it increasingly clear that distributions to an actively employed S corporation shareholder can be recharacterized as wages subject to payroll taxes if it is determined that the distributions are actually disguised compensation. If the payment to the shareholder actually represents compensation for services rendered to the corporation, as Delia's does, the payments are not Section 1368 distributions but instead are wages subject to payroll taxes and withholding.]

How to Deduct Accrued Shareholder Compensation under the Matching Principle

An accrual-basis S corporation cannot deduct expenses, including salaries and bonuses, paid to any shareholder or certain parties related to a shareholder until the payment is included in the payee's income. In effect, the S corporation is placed on the cash basis with respect to any year-end accrual of shareholder salary, bonus, or other form of compensation that would otherwise be currently deductible by the corporation (assuming the shareholder is on the cash basis).

Example 1C-1 Accrual of year-end bonus to shareholder.

Carco, Inc., is an accrual-basis, calendar-year S corporation. The board of directors maintains a compensation policy whereby certain employees receive a bonus at the end of the year if certain performance goals have been met. In December 20X1, the board authorized a $10,000 bonus payment to Mike Davis, the sales manager, who is also a 10% shareholder in Carco. The corporation accrued the bonus on its books as of December 31, and paid the bonus to Mike on the first Friday of 20X2.

Carco will not be able to deduct the bonus paid to Mike until 20X2. An S corporation cannot deduct an amount paid to *any* shareholder until the shareholder includes the amount in income. Therefore, even though Mike only owned 10% of the stock, the bonus payment will be suspended for tax purposes for Carco. Because the bonus is recorded on the books in the current year, but is not deducted for tax purposes until the following year, it is reported as a timing difference on Form 1120S, Schedule M-1 or M-3. In this case, the $10,000 is entered on line 3 of Schedule M-1, and a description such as "Shareholder bonus suspended under IRC Sec. 267(a)(2)" should be written in the space provided within that line. The Schedule M-1 of the following year will also be completed to reflect the fact that the expense is deducted for tax purposes, but not book purposes, in that year. The $10,000 is entered on line 6 of the schedule, with the same description.

The Section 267(a)(2) deduction limitation pertains to other types of expenses in addition to compensation. Rent and interest expense paid to an S corporation shareholder are examples of other expenses not deductible by the corporation until the shareholder includes the amount in income.

Example 1C-2 Accrual of year-end bonus to a related party.

Bruce Coleman retired several years ago from his position as president and chief executive officer of Coleco, Inc., an accrual-basis, calendar-year S corporation, although he retained ownership of 100% of the company stock. His son, Jerry, is now president and CEO of the company. Coleco's regular payday for salaried employees is the first day of each month. The December 31, 20X1, books of Coleco accrued salaries for services rendered in December. Included in the accrual entry was $7,500 payable to Jerry.

The accrued salary payable to Jerry will be suspended and not deductible by Coleco until 20X2. IRC Sec. 267(e)(1)(D) provides that accrued expenses payable to any person related to a shareholder are not deductible by the S corporation until the amount is includable in the related person's income. Related persons include siblings, spouses, ancestors, and lineal descendants. Therefore, since Jerry is the son of a shareholder, the accrued expense will not be deductible by Coleco until 20X2 when Jerry includes the amount in his taxable income. Coleco reports the suspended deduction as a timing difference on Schedule M-1 or M-3 of its Form 1120S for 20X1 and 20X2, as discussed in Example 1C-1. (Note that same-sex spouses are considered to be spouses for purposes of the related party rules.)

Example 1C-3 Acceleration of shareholder's income by fiscal-year S corporation.

Bruce is the sole shareholder of Willco, Inc., an accrual-basis S corporation using an October 31 fiscal year. As of October 31, 20X1, Willco had accrued a $10,000 salary payment to Bruce that it paid on November 30.

Even though Willco had accrued the salary payment on its books, the payment is not deductible for tax purposes until it is paid, which in this case is in the following fiscal year ending October 31, 20X2. Thus, Bruce will report the salary in 20X1, but will not receive benefit of the S corporation's deduction until 20X2 when

Willco's net income will pass through. Willco will report the accrued but suspended salary payment in Schedule M-1 or M-3 of its Form 1120S, as discussed in Example 1C-1.

If Wilco had paid the bonus on October 31 (rather than November 30), the corporation would deduct the $10,000 on its return for the year ending October 31, 20X1, and Bruce would include that amount in salary income on his Form 1040 for 20X1.

Compensation Paid in the Form of Stock and Other Employee Incentive Plans

Issuing Stock to Compensate Employees

When an S corporation uses shares of its own stock to compensate employees, the existing shareholders benefit because the corporation gets a compensation deduction, thus reducing pass-through income, with no out-of-pocket expenditure. (See the following paragraph.) The employees benefit because they receive an asset that hopefully will appreciate. (As covered in the following discussion, however, the employee may be subject to tax when the stock is received, even though he or she receives no extra cash to pay the tax.) The tax practitioner must closely monitor a number of tax issues that arise when the stock is transferred to employees. For example, if the stock constitutes a second class of stock or if the total number of shareholders exceeds 100, the S election will terminate. If the stock issued to the employees has restrictions, such as deferred vesting, the practitioner must determine who the "owner" is for purposes of allocating pass-through income or loss.

Unrestricted Stock

IRC Sec. 83 governs the tax treatment for the corporation and the employee who receives the stock. If the stock is issued outright with no restrictions, the FMV of the stock is included in the employee's salary in the year received (reduced by any amount paid for the stock) and is subject to payroll taxes. The corporation includes a corresponding deduction for compensation on line 7 or 8 of Form 1120S in the same year. The shareholder's basis in the shares is the amount of compensation plus any amount paid for the stock.

Example 1D-1 Compensation using unrestricted stock.

Fred received 100 shares of common stock from Essco, Inc., an S corporation, as part of his compensation package. No restrictions were attached to the stock. Each share was worth $50 at the date the stock was transferred to Fred. (Assume that Fred's marginal tax bracket is 28%.)

Fred's Form W-2 for the year includes $5,000 of income, representing the FMV of the stock he received as compensation. Essco reports the $5,000 of wages on line 8 of Form 1120S (line 7, if Fred is an officer of the corporation). The $5,000 wage expense is deductible in arriving at the nonseparately stated income or loss that will pass through to shareholders on a per-share, per-day basis (as explained in Lesson 4).

Restricted Stock and the Section 83(b) Election

The correct tax treatment for restricted stock is less straightforward. The corporation may impose restrictions, for example, as an enticement for the employee's continued employment or as a means to prevent the stock from being transferred to an outsider. The latter restriction may be important to S corporations to avoid breaching the 100-shareholder limit or transferring stock to an ineligible shareholder. When restrictions are attached to the shares, the excess of the FMV of the stock when the restrictions lapse over any amount paid by the employee is treated as compensation at that time.

Example 1D-2 Compensation with restricted stock.

Suppose in Example 1D-1 the shares received by Fred contained a restriction that he would not be able to dispose of the stock in any way unless he is still in the employ of Essco on January 1, 2019.

Absent a special election [i.e., the Section 83(b) election discussed later in this lesson], Fred reports no income and Essco receives no compensation deduction until 2019 when the restrictions lapse. During the

intervening years, any distribution Fred receives with respect to the stock will be considered additional compensation. The one-class-of-stock regulations clarify that in this situation, the stock is not treated as outstanding stock, and Fred will not be treated as a shareholder for pass-through purposes. Therefore, until the restrictions lapse on January 1, 2019, the restricted shares will be ignored for purposes of allocating income and loss to shareholders.

Substantially Nonvested Stock. Substantially nonvested stock is nontransferable stock subject to a substantial risk of forfeiture, such as when the stock ownership is contingent on future employment. Some S corporations have treated substantially nonvested stock for which no Section 83(b) election has been made as outstanding stock for pass-through purposes. The fact that the stock is substantially nonvested and no Section 83(b) election has been made with respect to it will not cause the stock to be treated as a second class of stock. A history of issuing a Schedule K-1 with respect to the stock is evidence that the corporation has treated the nonvested stock as outstanding.

When Property Becomes Substantially Vested

Until property transferred in connection with the performance of services becomes substantially vested in the employee, the corporation cannot claim a compensation deduction and the employee does not recognize compensation income. Property is substantially vested when:

1. the property is not subject to a substantial risk of forfeiture, and
2. the property is transferable.

Substantial Risk of Forfeiture

The determination of whether property is subject to a substantial risk of forfeiture depends on facts and circumstances.

Two Conditions Cause Property to be Subject to Substantial Risk of Forfeiture. Property is subject to a substantial risk of forfeiture if the rights to its full enjoyment are conditioned (directly or indirectly) upon:

1. the future performance (or refraining from performance) of substantial services by the employee, or
2. the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial.

The regularity of the performance of services and the time spent performing them indicate whether the required services are substantial. The property will be included in the income of the employee in the year the restriction causing the substantial risk of forfeiture lapses. The amount included in income is the excess of the FMV of the property at the time the restriction lapses over the amount paid for the property by the employee.

Example 1D-3 Substantial risk of forfeiture caused by future performance requirement.

ABC Inc., an S corporation, transfers 100 shares of its stock to employee Monica Smith on December 1 in connection with the performance of services. Monica is subject to a binding commitment to return the stock if she leaves the employment of ABC for any reason within two years from the date of the transfer.

Since Monica must surrender the stock if she fails to meet the commitment (if she leaves her job) within two years of receipt of the stock, her rights in the stock are subject to a substantial risk of forfeiture.

Example 1D-4 Substantial risk of forfeiture caused by condition related to purpose of the transfer.

JKL, Inc., an S corporation, has annual sales that have remained fairly constant for the last five years. JKL transfers 100 shares of its stock to employee Jack Thompson on December 1. Jack has exceptional marketing skills, and as a condition of the transfer, is subject to a binding commitment to return the stock unless the total earnings of the company increase 7.5% within two years from the date of the transfer.

Since Jack must surrender the stock if the earnings of the company do not increase by 7.5% within two years of receipt of the stock, the possibility of forfeiture is substantial. Thus, his rights in the stock are subject to a substantial risk of forfeiture.

Variation: Another S corporation, LMN Inc., is a long-standing seller of lighting fixtures. There is no indication that demand for the fixtures will fall or that the employer will be unable to sell them in the future. LMN transfers stock to employee Sam Jones subject to a binding agreement that the stock must be forfeited if the employer's gross receipts fall by 90% over the next three years.

Sam's rights in the stock are not subject to a substantial risk of forfeiture. The forfeiture condition, although related to the transfer's purpose, is very unlikely to be fulfilled. As a result, the employee's taxation on the stock transfer should not be deferred. The preamble states that, in determining whether a substantial risk of forfeiture exists based on a condition related to the transfer's purpose, both the likelihood that the forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered.

Proposed Regulations. Under proposed regulations, a substantial risk of forfeiture would exist only in the case of a condition relating to (1) performance, or (2) a purpose of the transfer (i.e., the two conditions shown in the preceding list). The preamble to the proposed regulations states that this provision is necessary because some confusion has arisen as to whether other conditions may also give rise to a substantial risk of forfeiture. The preamble cites *Prentice I. Robinson*, in which the First Circuit held that a substantial risk of forfeiture may exist in cases other than performance or purpose of the transfer, depending on the facts and circumstances. The regulations are proposed to apply to property transferred on or after January 1, 2013, but taxpayers may rely on them for property transferred after May 30, 2012.

Transferability

Property is transferable, and therefore substantially vested, if the employee can transfer any interest in the property to any person other than the employer, and the transferee's rights in the property are not subject to a substantial risk of forfeiture. That is, the property is substantially vested if the employee can sell, assign, or pledge his or her interest in it to any person other than the employer, and such other person is not required to give up the property or its value if the event causing the substantial risk of forfeiture occurs.

Ownership before Property Becomes Substantially Vested. Until property transferred in connection with the performance of services becomes substantially vested in the employee, the employer is considered to be the owner of the property. (See Example 1D-6.)

Nonlapse Restrictions

Restrictions that will never lapse place a permanent limitation on the transferability of property (i.e., are nonlapse restrictions). Such restrictions are not considered to subject transferred property to a substantial risk of forfeiture. However, nonlapse restrictions are considered when determining the FMV of the property on the date of transfer. Nonlapse restrictions tend to cause the value of the property to be lower than it would be without the restrictions. A nonlapse restriction includes a limitation requiring the employee to surrender stock received in connection with the performance of services whenever the employee leaves the corporation as well as a limitation subjecting the property to a permanent right of first refusal at a price determined under a formula. An obligation to sell at FMV is not a nonlapse restriction.

Example 1D-5 Nonlapse restrictions-permanent right of first refusal.

GHI, Inc., an S corporation, transfers 200 shares of its stock with a FMV of $1,000 (which is also the stock's book value formula price) to employee Ray on September 15 in connection with the performance of services. As a condition of the transfer, Ray must offer the stock to the corporation at its book value formula price if he ever decides to sell it. In addition, he must offer the stock to GHI at his retirement at its then existing book value formula price, and his estate must offer it to GHI in the event of Ray's death prior to retirement.

Under this scenario, the restrictions imposed on the GHI stock are nonlapse restrictions. Consequently, Ray must recognize the FMV of the stock ($1,000) as income at the date he receives it (September 15). The book value formula price will ordinarily be determinative of the stock's FMV based on these facts and circumstances. The amount recognized as income becomes the employee's basis in the stock. Thus, assuming that in the following year Ray is required to sell the stock back to the employer at a book value formula price of $1,500, he will have a capital gain of $500, the difference between his $1,000 basis in the stock and the $1,500 sales price.

Making the Section 83(b) Election

An employee who receives property subject to a substantial risk of forfeiture in connection with the performance of services may make an election under IRC Sec. 83(b) to recognize compensation income equal to the fair market value (FMV) of the property on the date the employee receives it less any amount the employee paid for it. The election is allowed even though the employee pays full FMV for the property transferred.

If the Section 83(b) election is made, any subsequent appreciation in the property's value is not treated as compensation income and is not recognized until the property is disposed of. As a result, the employee can defer recognition of appreciation on the property. In addition, the employee could receive capital gain treatment on its sale (if it qualifies as capital gain property). Consequently, the Section 83(b) election should be considered whenever property subject to a substantial risk of forfeiture is received.

The holding period for the transferred property begins just after the date of transfer if a Section 83(b) election is in effect. If the election is not made, the holding period begins when the restrictions on the property lapse.

The employer is allowed a compensation deduction for the income the employee recognizes as a result of the Section 83(b) election. The deduction is allowed during the employer's tax year including the end of the employee's tax year in which the income is recognized. If the Section 83(b) election is not made, the corporation has to wait until the restrictions on the transferred property lapse to claim the deduction.

Example 1D-6 Section 83(b) election to currently recognize income upon receipt of restricted stock.

Fred received 100 shares of common stock from Essco, Inc., an S corporation, as part of his compensation package. Each share is worth $50 at the date the stock was transferred to Fred. The shares contain a restriction that he cannot dispose of the stock in any way unless he is still employed by Essco on January 1, 2019. (These are the same facts as in Example 1D-2.) Assume that Fred's current marginal tax rate is 28% and he expects the stock to be worth $250 per share when it becomes vested in 2019. He would rather pay tax on $5,000 (the current FMV) in 2017 using a 28% tax rate than on $25,000 (100 shares at $250) in 2019 at whatever tax rate is in effect at that time. He can elect under IRC Sec. 83(b) to include the current value of the restricted stock ($5,000) in income when received in 2017. If Fred makes the election, Essco can deduct the same amount as compensation.

If Fred makes a Section 83(b) election, the stock will be treated as outstanding stock. Fred, as the shareholder, will be allocated his proportionate share of pass-through income and loss.

Filing the Section 83(b) Election. The Section 83(b) election is made by filing a written statement no later than 30 days after the date of the transfer of the property. The employee must file the statement with the IRS Service Center where the employee expects to file his or her return. The employee is also required to give a copy of the election to his or her employer so it will know when to claim the related compensation deduction.

Once made, the Section 83(b) election cannot be revoked without IRS permission. IRS will grant permission to revoke the election under limited circumstances.

Second Class of Stock Danger. A serious danger arises when a shareholder makes a Section 83(b) election if the stock is substantially nonvested. Such stock will be treated as a second class of stock (thus terminating S status) unless the stock confers distribution and liquidation rights identical to those associated with other outstanding shares. Only differences in voting rights can be ignored. Furthermore, the company's S election will terminate if the person making the Section 83(b) election is an ineligible shareholder or the S corporation has more than 100 shareholders.

Example 1D-7 Section 83(b) election can create a second class of stock.

Joe is the sales manager for Autobahn, Inc., an S corporation foreign car dealership. Joe received 100 shares of Autobahn stock as compensation for the company's outstanding sales performance. However, the stock does not entitle Joe to vote or receive distributions for three years. The fair market value of the stock when Joe received the shares was $100 per share. Since Autobahn was a new company, Joe felt the value would increase significantly within the next few years. Therefore, Joe made a timely Section 83(b).

Since Joe made the Section 83(b) election, the stock is considered outstanding and, furthermore, will be considered a second class of stock because it contains no distribution rights. Therefore, Autobahn, Inc. will lose its S status. The lack of voting rights does not create a second class of stock.

Employer's Compensation Deduction. The Federal Circuit Appeals Court held that the Court of Federal Claims improperly determined that the amount of an employer's deduction under IRC Sec. 83(h) was limited to the value of the transferred restricted stock that an employee actually included in his gross income. The appeals court stated that "included" under IRC Sec. 83(h) meant the amount the employee was legally required to report. This decision is in direct conflict with the 6th Circuit's findings in *Venture Funding, Ltd.*

Incentives Not Involving Issuance of Stock

Instead of issuing stock, some S corporations issue stock options. However, a call option, warrant, etc., may be treated as a second class of stock under certain conditions.

Another type of employee incentive not involving the issuance of stock is the deferred compensation plan. These plans are covered in Lesson 2.

Treating a Shareholder-officer as an Employee or Independent Contractor

Pass-through income and distributions from an S corporation are not subject to self-employment tax. Thus, the income cannot be treated as net earnings from self-employment for purposes of making retirement plan contributions, and pass-through losses cannot be used to reduce self-employment income from other sources. Furthermore, compensation for services (other than minor services) rendered for the corporation by an officer-shareholder is wages, not self-employment income. Thus, a shareholder-officer who receives remuneration for services performed for the corporation cannot be treated as an independent contractor.

Example 1E-1 Shareholder-officer is not treated as an independent contractor.

John owns 50% of the shares of JKL Corp., an S corporation. John and JKL enter into an agreement whereby John will perform services for the corporation as an independent contractor. At the end of the year, JKL issues a 1099-MISC to John showing $120,000 of "management fees" paid to John. Is this a correct procedure?

No. The payments to John are compensation for services by a shareholder-officer and are wages, not self-employment income.

The consequences of incorrectly treating a shareholder-employee as an independent contractor can be substantial. Numerous civil penalties exist for failure to withhold and remit income and employment taxes, and the penalties can be overwhelming.

Distinguishing between Compensation and Director Fees

Fees paid for serving as a director and for attending board of director meetings represent self-employment earnings and are reported to the IRS and the director on Form 1099-MISC (Miscellaneous Income) in the year paid. When a company officer also serves as a director, questions may arise concerning whether he or she is acting in an officer or director capacity. While this is primarily a question of fact to be resolved by analyzing the pertinent facts and circumstances, members of the board who meet at various times during the year to consider policy matters (conduct, management, and overall administration of the business) are performing services of a directorial nature. Conversely, whenever an officer performs services for the corporation other than those required by attendance at and participation in meetings of the board of directors, he or she may be acting in an officer capacity.

S Corporation Officer Ruled to Be Independent Contractor

As stated earlier, a shareholder-officer who receives remuneration for services performed for the corporation cannot be treated as an independent contractor. However, in a summary opinion, the Tax Court ruled that an S corporation's shareholder-officer who received a W-2 from the corporation was an independent contractor. This classification entitled him to deduct his business expenses on his Form 1040, Schedule C.

In the year at issue, Dean Cibotti became a 33.3% owner in Liberty Mortgage where he had been a mortgage loan officer. He did not perform any services as an officer of Liberty Mortgage, but was named president because he

owned the most shares. He received no compensation for acting as president. Liberty Mortgage did not provide him with an office in which to conduct his business. He was compensated by the company solely on the basis of commissions, and received no base pay or employee benefits. He reported the wages from the Form W-2 but also claimed business expense deductions relating to his work on a Schedule C.

The IRS determined that Cibotti was a common law employee of Liberty Mortgage and that any unreimbursed employee expenses he incurred during the year should have been claimed on Schedule A as itemized deductions. The Tax Court ruled, however, that the taxpayer was not an employee simply because he was president. He performed no services in that capacity and received no payments for serving as a corporate officer. Furthermore, (1) the company did not control his hours nor how he worked, (2) he provided for his own office at home, (3) he was paid as a percentage of what he sold with no guaranty, and (4) no employee benefits were provided. Thus, Cibotti was an independent contractor of Liberty Mortgage. As such, he was entitled to deduct his business expenses related to the company on Schedule C.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Which of the following is an advantage of paying S corporation employees with its stock instead of wages?

    a. Existing shareholders will have more pass-through income.

    b. Employees receive an asset that can appreciate.

    c. The corporation will pay any resulting tax on the employees' behalf.

    d. The corporation is in less danger of termination because it has more shareholders.

5. Nonlapse restrictions may do which of the following?

    a. Require an Section 83(b) election.

    b. Extends the employer's ownership of the property.

    c. Make property subject to permanent risk of forfeiture.

    d. Affect the property's fair market value (FMV).

6. Which of the following scenarios has correctly addressed a compensation issue related to an S corporation?

    a. The Ableworth Corporation treats an officer-shareholder as an independent contractor.

    b. The Beckington Corporation reports director fees paid as employee wages rather than self-employment earnings.

    c. Caroline treats her S corporation pass-through income as self-employment net earnings when making retirement plan contributions.

    d. Douglas, who is a compensated bank president receiving benefits, claims his unreimbursed expenses on Schedule A.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. Which of the following is an advantage of paying S corporation employees with its stock instead of wages? **(Page 17)**

   a. Existing shareholders will have more pass-through income. [This answer is incorrect. When an S corporation uses shares of its own stock to compensate employees, the existing shareholders benefit because the corporation gets a compensation deduction, thus *reducing* (not increasing) pass-through income, with no out-of-pocket expenditure.]

   b. Employees receive an asset that can appreciate. [This answer is correct. This is an advantage of paying S corporation employees with the S corporation's stock. Because the employee is receiving an asset that hopefully will appreciate, the employees are more satisfied, which benefits the S corporation. The corporation's existing shareholders will also receive advantages, which makes them more satisfied. Therefore, this can be an advantageous strategy, as long as all tax consequences are appropriately dealt with.]

   c. The corporation will pay any resulting tax on the employees' behalf. [This answer is incorrect. The employee may be subject to tax when the stock is received, even though he or she receives no extra cash to pay the tax. This is a disadvantage of this method of compensation.]

   d. The corporation is in less danger of termination because it has more shareholders. [This answer is incorrect. If the stock constitutes a second class of stock or if the total number of shareholders now exceeds 100, the S election will terminate. If not managed properly, this is a disadvantage of using this type of compensation.]

5. Nonlapse restrictions may do which of the following? **(Page 17)**

   a. Require an Section 83(b) election. [This answer is incorrect. An employee who receives property subject to a substantial risk of forfeiture in connection with the performance of services may make an election under IRC Sec. 83(b) to recognize compensation income equal to the FMV of the property on the date the employee receives it less any amount the employee paid for it. However, this election is not universally required when the property has associated nonlapse restrictions.]

   b. Extends the employer's ownership of the property. [This answer is incorrect. According to Reg. 1.83-1(a), until property is transferred in connection with the performance of services and becomes substantially vested in the employee, the employer is considered to be the owner of the property. However, this is not the case when the property is subject to nonlapse restrictions. However, such restrictions do have other disadvantages.]

   c. Make property subject to permanent risk of forfeiture. [This answer is incorrect. According to Reg. 1.83-3(c), nonlapse restrictions—as defined in Reg. 1.83.3(h)—are *not* considered to subject transferred property to a substantial risk of forfeiture. However, nonlapse restrictions do have other disadvantages.]

   d. Affect the property's fair market value (FMV). [This answer is correct. Restrictions that will never lapse place a permanent limitation on the transferability of property (i.e., are nonlapse restrictions). They are considered when determining the FMV of the property on the date of transfer. Nonlapse restrictions tend to cause the value of the property to be lower than it would be without the restrictions.]

6. Which of the following scenarios has correctly addressed a compensation issue related to an S corporation? **(Page 21)**

   a. The Ableworth Corporation treats an officer-shareholder as an independent contractor. [This answer is incorrect. According to IRC Sec. 3121(d)(1), among others, compensation for services (other than minor services) rendered for the corporation by an officer-shareholder is wages, not self-employment income. Thus, a shareholder-officer who receives remuneration for services performed for the corporation cannot be treated as an independent contractor. Therefore, amounts paid to Ableworth's shareholder-officer will need to be treated as wages and not as self-employment income.]

   b. The Beckington Corporation reports director fees paid as employee wages rather than self-employment earnings. [This answer is incorrect. Fees paid for serving as a director and for attending board of directors meetings are considered self-employment earnings and are reported to the IRS on Form 1099-MISC (Miscellaneous Income). Therefore Beckington Corporation would need to report director fees as self-employment earnings, not employee wages.]

   c. Caroline treats her S corporation pass-through income as self-employment net earnings when making retirement plan contributions. [This answer is incorrect. Pass-through income and distributions from an S corporation are not subject to self-employment tax. Therefore, the income cannot be treated as net earnings from self-employment for the purpose of making retirement plan contributions. Caroline has handled the income improperly.]

   d. Douglas, who is a compensated bank president receiving benefits, claims his unreimbursed expenses on Schedule A. [This answer is correct. Since Douglas is compensated as a bank employee and receiving benefits, he is considered a share-holder officer and not as an independent contractor. Therefore he is correct in reporting his expenses on Schedule A as itemized deductions.]

Lesson 2: Fringe Benefits and Retirement Plans

Introduction

S corporations can offer employees the same fringe benefits as other business entities. However, more-than-2% S corporation shareholder-employees (referred to as "2% shareholders") are treated like partners for fringe benefit purposes. Because partners generally are considered to be self-employed rather than employees, tax-favored treatment (i.e., corporate deductibility and employee exclusion from income) for fringe benefits paid on behalf of 2% shareholders appears to be unavailable unless a specific statute treats a partner as an employee.

S corporations generally are eligible to establish the same types of qualified retirement plans that C corporations can establish. As with C corporations, contributions to a qualified retirement plan are deductible by the corporation and tax-deferred to the employees. Fortunately, the 2% shareholder fringe benefit rules do not limit deductions for qualified plan contributions.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify deductions for taxable and nontaxable fringe benefits.
- Identify deductions for self-employed medical insurance for S shareholders, contributions to retirement plans, contributions to simplified employee pensions and simple retirement plans, and payments to nonqualified deferred compensation plans and assess issues related to employee stock ownership plans, treating deferred compensation as a loss for built-in gains tax purposes, determining whether small employer health insurance is eligible for a tax credit, and dealing with cafeteria plans.

Deducting Both Taxable and Nontaxable Fringe Benefits

A fringe benefit is any compensation or other benefit received by an employee that is not in the form of cash. A business can generally deduct the cost of providing fringe benefits, whether they are taxable or tax-free to the recipient.

Contributions to employee benefit programs and fringe benefits that are not an incidental part of a qualified retirement plan are deducted on line 18 (Employee benefit programs) of Form 1120S and so are included in the corporation's nonseparately stated income or loss. The deduction on this line applies to fringe benefits provided to employees who own no stock or who own 2% or less of the corporation's stock. Fringe benefits furnished to more-than-2% shareholder-employees are reported on line 7 (Compensation of officers) or line 8 (Salaries and wages) of Form 1120S, whichever applies.

Compensation Must Be Reasonable

An employee's compensation must be reasonable in relation to the services rendered. Compensation includes not only salary, but also fringe benefits and retirement plan contributions.

2% Shareholder Rule

The Code sections dealing with fringe benefits generally permit employees to exclude the fringe benefit from gross income and employers to deduct the fringe benefit.

The Subchapter S Revision Act of 1982 introduced IRC Sec. 1372, which provides that for employee fringe benefit purposes:

1. S corporations are to be treated as partnerships; and

2. any S corporation shareholder owning, directly or indirectly, more than 2% of the stock on any day during the tax year (2% shareholder) is treated like a partner in a partnership.

Family Attribution Rules. The members of an S shareholder's family are treated as owning the S shareholder's stock for purposes of the fringe benefit rules. In general, the terms *spouse, husband,* and *wife* mean an individual lawfully married to another individual, regardless of sex. These terms should be considered when applying the family attribution rules to the fringe benefit provisions.

Example 2A-1 Family attribution rules affect fringe benefit treatment.

William owns 100% of the stock of Essco, Inc., an S corporation. William retired a few years ago and promoted his son Bill to president and CEO of Essco. The corporation covers all its employees, including Bill, with group medical insurance. The cost of premiums for Bill for the year was $3,000.

Since Bill's father owns 100% of the stock of Essco, Bill is deemed to own all of the stock for applying the 2% shareholder test. According to Rev. Rul. 91-26, which is discussed later in this lesson, the corporation treats the insurance provided to Bill as compensation. So, Bill's taxable income is increased by $3,000, while the corporate deduction passes through to William, who owns 100% of the stock. However, Bill may be able to claim an above-the-line deduction for the medical insurance premiums.

Nontaxable Fringe Benefits

Because 2% shareholders are treated as partners for fringe benefit purposes, and because partners generally are considered self-employed persons rather than employees, tax-favored treatment (i.e., corporate deductibility and employee exclusion from income) for employee fringe benefits paid on behalf of 2% shareholders appears to be unavailable unless a specific statute treats a partner as an employee.

Qualified Retirement Plans. IRC Sec. 401(c)(1) treats self-employed persons, *including partners*, as employees for purposes of qualified retirement plans. Therefore, contributions to qualified retirement plans on behalf of 2% shareholders (even 100% shareholders) are deductible by the corporation and excludable from the income of the shareholder.

Other Nontaxable Fringe Benefits. Several other employee fringe benefit programs define "employees" with reference to the Section 401(c)(1) definition that includes self-employed individuals (i.e., partners). Because partners are considered self-employed and therefore eligible to receive the following benefits on a tax-favored basis, 2% S shareholders (even 100% shareholders) are eligible to receive those benefits as well:

1. Educational assistance programs.

2. Dependent-care assistance programs.

3. Qualified employee discounts, no-additional-cost services, working condition fringes, on premises athletic facilities, *de minimis* fringes, and retirement planning services.

Tax Treatment of Nontaxable Fringe Benefits

Educational Assistance Programs. An S corporation can deduct the cost of an educational assistance program, and employees can exclude from taxable income up to $5,250 of such benefits per year. The corporation's method of accounting (cash or accrual) determines the timing of the deduction. If the cash method is used, the payment is deductible when paid. If the accrual method is used, it is deductible when all events necessary to determine the liability amount have occurred.

If the program fails the requirements of IRC Sec. 127, payments for highly compensated and regular employees are taxable compensation. The S corporation still deducts the payments, but as taxable compensation to the employee. The only exceptions are if the payments qualify as a working condition fringe benefit because the education is job-related or as a qualified tuition reduction or qualified scholarship.

Dependent Care Assistance Programs. An S corporation can deduct amounts paid or incurred for dependent care assistance for its employees, and employees can exclude up to $5,000 ($2,500 for married employees filing separately) of such benefits provided by the employer during the year. Benefits for highly compensated employees

(HCEs) are excludable from their income if provided under a qualified dependent care assistance program (DCAP). Benefits in excess of the exclusion limit or provided under a nonqualified DCAP to HCEs are includable in the recipient's income and are deducted by the corporation as compensation.

Dependent care assistance can be provided through a cafeteria plan financed with employer and/or employee pretax contributions. A 2% shareholder cannot participate in a cafeteria plan maintained by the S corporation, nor can a spouse, child, grandchild, or parent of a 2% shareholder. If a 2% shareholder participates in the plan, it is not a cafeteria plan for any participating employee. In that case, employees cannot make pretax contributions to obtain any of the benefits offered under the plan.

Section 132 (Statutory) Fringe Benefits

Section 132 fringe benefits (also known as work-related or statutory fringe benefits) include qualified employee discounts, no-additional-cost services, working condition fringe benefits, *de minimis* fringe benefits, on-premises athletic facilities, qualified transportation fringe benefits, qualified moving expense reimbursements, and qualified retirement planning services. Section 132 fringe benefits, are available on a tax-favored basis to 2% shareholders, except for qualified transportation fringe benefits and qualified moving expense reimbursements:

- The exclusion for qualified transportation fringe benefits applies to employees, which under Reg. 1.132-1(b)(2) includes common law employees and other statutory employees. Since 2% shareholders are not employees for this purpose, these benefits generally are fully taxable to them. However, they may be able to exclude certain transportation benefits from income pursuant to the working condition fringe rules or the *de minimis* fringe rules.

- The IRS has not comprehensively defined "employee" for purposes of the moving expense reimbursement exclusion. However, IRS Pub. 15-B, "Employer's Guide to Fringe Benefits," provides that 2% shareholders are not employees for the moving expense reimbursement exclusion.

Qualified Employee Discount Program. Employee discounts that do not exceed the qualified product's gross profit percentage price or 20% of the qualified service's price are excluded from the employee's income. The benefit can be provided to the employee, the employee's spouse and dependent children, former employees who are retired or disabled, and the widowed spouse of an individual who died while employed or who separated from service due to retirement or disability. As noted, 2% shareholders are eligible for the benefit. However, this benefit may not be provided to parents or friends of the employee, directors, or independent contractors.

The excludable portion of the discount on qualified products is the excess of the selling price to a customer less the selling price to the employee, but not in excess of the product's gross profit. The remaining portion of the discount is a taxable fringe benefit.

No-additional-cost Service. A *no-additional-cost service* is one that (1) is normally offered to customers in the ordinary course of the line of business in which the employees perform services, and (2) does not require the S corporation to incur substantial additional cost in providing the service to employees (including forgone revenues but excluding employee payments for the service). The entire FMV of a no-additional-cost service is an excludable fringe benefit, as opposed to a qualified employee discount where only part of the property or service may be an excludable fringe benefit.

Only excess capacity services such as hotels; airlines, buses, or trains; or telephone services are eligible for this exclusion. Nonexcess capacity services, such as free employee stock trades by brokerage firms or free legal services by a law firm, do not qualify, although they may be eligible for the qualified employee discount exclusion for services provided.

This benefit can be provided to the employee, the employee's spouse and dependent children, former employees who are retired or disabled, and the widowed spouse of an individual that died while employed or who separated from service due to retirement or disability. Use of air transportation by an employee's parents also may be eligible for the exclusion. As noted, 2% shareholders are eligible for the benefit. However, the benefits must not be provided in a way that discriminates in favor of highly compensated employees.

Providing Identity Protection Services Businesses have increasingly become targets for identity theft, whether through computer hacking or phishing emails to payroll or human resources departments. As such, many employers are making significant efforts to safeguard the personal information of their employees. This includes providing credit reporting and monitoring services, identity theft insurance policies, identity restoration services, and other identity protection services to employees following a data breach.

An employer that provides identity protection services to employees whose personal information may have been compromised in a data breach does not have to include the value of such services in the employees' gross income and wages (IRS Ann. 2015-22). However, cash received in lieu of identity protection services is included in employee taxable wages.

Some businesses provide identity protection services to employees before a data breach occurs. The IRS has stated that the exemption for identity protection services outlined in IRS Ann. 2015-22 should be extended to services provided to employees before a data breach occurs (IRS Ann. 2016-2). The exemption, however, does not apply to cash received in lieu of identity protection services or to proceeds received under an identity theft insurance policy.

Working Condition Fringe Benefit. A *working condition fringe benefit* is property or services provided to an employee that could be deducted by the employee as a work-related expense. It is available to current employees, certain leased employees, and 2% shareholders. With exceptions related to product testing and parking, directors and independent contractors providing services are also eligible for the exemption. To qualify for exclusion from income, (1) the benefit must be deductible by the employee as a trade or business expense or as a depreciable asset if he or she had paid for it, (2) the employee's use of the property or service must be substantiated by adequate records or other evidence, and (3) the employee's use of the property or service must be related to his or her work for the employer.

Examples of working condition fringe benefits include business-related subscriptions; professional dues; job-related education; outplacement services; business travel and entertainment; and business use of a company-provided car, computer, or cell phone. Nondeductible club dues and spousal travel may also qualify as working condition fringe benefits under certain circumstances.

Substantiation requirements (e.g., under IRC Sec. 274) apply when determining whether the property or service is excludable. This means that expenses for travel, entertainment, and listed property (including autos and laptop computers) must satisfy the substantiation requirements of IRC Sec. 274(d). Under IRC Sec. 274(d), no deduction is allowed unless the amount, time and place (or date and use), business purpose, and business relationship are properly substantiated and documented. Expenses not governed by IRC Sec. 274(d) (e.g., office supplies, dues, or subscriptions) are subject to somewhat less stringent substantiation requirements under Reg. 1.162-17.

Cell Phones as Working Condition Fringe Benefit. If there are substantial noncompensatory business reasons for an employer to provide an employee with a cell phone (or similar telecommunications device), the employee's business use of the phone is a tax-free working condition fringe benefit. No substantiation of the phone's use is required and any personal use by the employee is treated as a tax-free *de minimis* fringe benefit. Examples of noncompensatory business reasons include an employer's need to contact the employee at all times for work-related emergencies, the employer's requirement that the employee be available to speak with clients when the employee is away from the office, and the employee's need to speak with clients located in other time zones at times outside the employee's normal work day. If the employer provides a cell phone for compensatory reasons (e.g., to promote employee morale or goodwill), only the business use qualifies as a tax-free working condition fringe benefit.

Rules similar to those in IRS Notice 2011-722011-38 IRB 407 apply to employer reimbursements to employees for the business use of the employee's personal cell phone. Employers that require employees, primarily for noncompensatory business reasons, to use their personal cell phones for business purposes may treat reimbursements of the employee's expenses for reasonable cell phone coverage as nontaxable. This treatment does not apply to reimbursements of unusual or excessive expenses or reimbursements that replace a portion of the employee's regular wages.

Cash Payments as Working Condition Fringe Benefit. A cash payment to an employee qualifies as a working condition fringe only if the employee is required to (1) use the payment for expenses in connection with a specific or prearranged activity or undertaking for which a deduction is allowable as a trade or business expense or as depreciation, (2) verify to the employer that the payment is actually used for such expenses, and (3) return to the employer any part of the payment not so used.

De Minimis Fringe Benefits. A *de minimis fringe benefit* is one that normally would be a taxable fringe benefit, but because the goods or services have a nominal value, accounting for the item is unreasonable or administratively impractical. If a fringe benefit does not qualify as *de minimis*, the entire amount of the benefit is taxable; thus, it is not possible to reduce the value of the benefit for an amount considered to be *de minimis*.

Examples of *de minimis* benefits include occasional typing of personal letters by a company secretary; occasional personal use of an employer's copying machine; occasional parties or group meals for employees and their guests; traditional birthday or holiday gifts of noncash property with a low value; occasional theater or sporting event tickets, coffee, doughnuts, soft drinks, and local telephone calls; and flowers or similar property provided to employees under special circumstances including illness, outstanding performance, or family crisis.

Examples of benefits not excludable as *de minimis* include season tickets to sporting or theatrical events; commuting use of an employer-provided automobile or other vehicle more than one day a month; membership in a private country club or athletic facility; use of employer-owned or leased facilities such as an apartment, hunting lodge, or boat; and benefits provided to an employee through the use of a gift certificate or charge or credit card.

Nondiscrimination Requirements. No-additional-cost services, qualified employee discounts, employer-operated eating facilities, and qualified retirement planning services must be available to all employees in a manner that does not discriminate in favor of highly compensated employees. If the plan is discriminatory, highly compensated employees must include the benefits' value in income.

A highly compensated employee (HCE) is one who (1) was a more-than-5% owner (or a family member of that owner) at any time during the current or preceding year or (2) earned greater than $120,000 (for 2017) during the preceding year and, if the employer so elects, was in the top 20% of employees based on compensation for the preceding year.

Reporting Nontaxable Fringe Benefits

The S corporation's deduction for contributions to retirement plans is reported on page 1, line 17, of Form 1120S ("Pension, profit-sharing, etc., plans"). The deduction for other nontaxable fringe benefits paid on behalf of its employees (including 2% shareholders) is reported on page 1, line 18, of Form 1120S ("Employee benefit programs"). No additional reporting to shareholders is required on their Schedules K-1.

Example 2A-2 S corporation providing a dependent-care assistance program for a shareholder-employee.

Essco, Inc., an S corporation, maintains a Section 129 dependent-care assistance program for its employees. During the year, the plan furnished $1,200 of benefits to Joe Poole, the controller and 10% shareholder.

Since IRC Sec. 129(e)(3) defines "employee" by reference to IRC Sec. 401(c)(1), which treats self-employed individuals, including partners, as employees, Joe is considered an employee for purposes of Essco's dependent-care assistance program. Essco can deduct the $1,200 as an employee benefit expense on line 18 of Form 1120S. It is not reported on Joe's Schedule K-1 or Form W-2.

Taxable Fringe Benefits

The Committee Reports to the Subchapter S Revision Act of 1982 specifically mention several types of fringe benefits that Congress had in mind when it created IRC Sec. 1372 to treat S shareholders like partners. For these benefit programs, the Committee Reports say that the corporation should receive no fringe benefit deduction for its

cost to cover 2% shareholders, but the 2% shareholders can deduct the amounts on their own returns, to the extent allowable, as if they had incurred the expenses themselves. These expenses include the following:

1. The cost of up to $50,000 of group-term life insurance.

2. Amounts paid for or to an accident and health plan. This type of fringe benefit typically includes plans providing for the payment of premiums on accident and health insurance, short- and long-term disability insurance, and qualified long-term care insurance.

3. Meals and lodging furnished for the convenience of the employer.

The following fringe benefits are also taxable fringe benefits:

1. Employee achievement awards.

2. Cafeteria plans.

3. Qualified transportation fringe benefits.

4. Qualified moving expense reimbursements.

5. Adoption assistance programs.

Group-term Life Insurance Coverage. It seems likely that an S corporation can deduct group-term life insurance premiums paid on behalf of a 2% shareholder, who must include the *entire amount* of such premiums in income. A 2% shareholder is not eligible to exclude from income the cost of the first $50,000 of qualified group-term life insurance coverage under IRC Sec. 79(a). The exclusion is available to employees only, and a 2% shareholder is treated as a self-employed partner with respect to this fringe benefit.

S corporation shareholder-employees who own 2% or less of the corporation are treated as employees. Thus, they can receive up to $50,000 of tax-free group-term life insurance coverage that is deductible by the corporation, the same as any other employee.

Group Medical Plans. Employees exclude payments received under the plan from income if they are reimbursed medical expenses, regardless of whether payments are made by an insurance company or the S corporation. However, highly compensated employees (one of the five highest paid officers, a more than 10% shareholder, or one of the highest paid 25% of all employees) may have to recognize income if the plan is self-insured and discriminates in favor of highly compensated employees. If a self-insured plan fails the nondiscrimination test, the nonhighly compensated employees are unaffected.

Although no direct authority exists, best practices indicate that medical benefit payments to 2% shareholders under a self-insured plan are deductible by the S corporation and includable in the shareholders' income under Rev. Rul. 91-261991-1 CB 184. Since the plan is not insured, the benefits cannot be excluded from income under IRC Sec. 104(a)(3).

For plan years beginning after 2013, the Affordable Care Act (ACA) institutes market reform provisions that apply to all employer group health plans, including self-insured medical plans and plans provided by small employers. The provisions place significant restrictions on the use of medical reimbursement plans and other employer payment arrangements for employee medical expenses. See, "Affordable Care Act (ACA) and Health Insurance Benefits" later in this lesson for more information.

Disability Plans. Based on the tax treatment of medical insurance premiums, it seems likely that an S corporation can claim a compensation deduction for disability insurance premiums paid on behalf of a 2% shareholder, who includes the premiums in income. Shareholder-employees who own 2% or less of the corporation are treated as employees. Thus, they can receive tax-free disability insurance coverage that is deductible by the corporation, the same as any other employee.

Health Savings Accounts. An individual is eligible to contribute to an HSA if he or she is (1) covered by a qualifying high-deductible health plan (HDHP) and (2) not covered under any other health plan that is not an HDHP. After December 31, 2015, an individual shall not fail to be an eligible individual because he or she receives hospital care or medical services administered by the Department of Veterans Affairs for a service-connected disability.

An employer can also contribute to an eligible employee's HSA. For employees who are not 2% shareholders, the employer contributions are excluded from the employee's gross income for both federal income and employment tax purposes and can be deducted by the employer (i.e., tax-free fringe benefit treatment applies). Subsequent HSA withdrawals by the employee to cover qualifying medical expenses are also tax-free. (See IRC Sec. 223.) If an S corporation has employees who are eligible to make HSA contributions, the S corporation can make contributions to HSAs of those eligible employees and deduct the contributions as an employee benefit expense on line 18 on page 1 of Form 1120S.

Employer contributions to an employee's HSA, assuming they are within the prescribed limits, are treated as employer-provided coverage for medical expenses under an accident or health plan. However, an S corporation's contributions to a 2% shareholder's HSA are considered a taxable fringe benefit because IRC Sec. 106(b)(1) does not treat a 2% shareholder as an employee. Thus, the contributions are added to the 2% shareholder's wages. The IRS has ruled that the additional wages attributable to an S corporation making HSA contributions on behalf of a 2% shareholder are subject to withholding taxes, but not subject to FICA and FUTA if the payments are made pursuant to a plan providing accident and health coverage.

HSAs are not considered a group health plan for purposes of the ACA provisions. However, a high-deductible health plan established with the HSA is subject to ACA provisions.

For tax years beginning in 2017, the maximum HSA contribution amounts are $3,400 for an individual with self-only coverage or $6,750 for an individual with family coverage. The same limits apply whether the contributions are made by the individual or the employer (or a combination of both). However, if an individual is age 55 or older as of the end of the tax year for which the HSA contribution is made, the contribution limit that would otherwise apply is increased by $1,000.

Meals and Lodging. The FMV of qualifying meals or lodging furnished to an employee, or the employee's spouse or dependents, is excluded from the employee's gross income. To qualify for exclusion, the meals or lodging must be furnished (1) on the S corporation's business premises; (2) for the S corporation's convenience; and (3) in the case of lodging (but not meals), the employee must be required to accept the lodging.

The Section 119 exclusion does not apply to 2% shareholders since they are not employees for this purpose. Presumably, shareholder-employees who own 2% or less of the corporation are treated as employees and can receive tax-free meals or lodging.

The exclusion applies only to meals or lodging furnished in kind (i.e., the S corporation actually provides the meals or lodging). Cash allowances or reimbursements received by an employee are not excludable under IRC Sec. 119 (although the reimbursement may qualify as a *de minimis* fringe benefit). If the employee can receive cash instead of meals or lodging, the exclusion does not apply.

Employee Achievement Awards. Under IRC Sec. 74(c), an employee's gross income does not include the FMV of an employee achievement award [as defined in IRC Sec. 274(j)] if the cost of the award does not exceed the amount of the employer's deduction. In other words, the exclusion is tied to the employer's deduction for the cost of the award. However, 2% shareholders are not considered to be employees for award purposes.

The amount of deductible (and thus, excludable) nonqualified plan awards made to an employee during the year cannot be more than $400. The total amount of deductible (and thus, excludable) employee achievement awards made to an employee during the year, including nonqualified and qualified plan awards, cannot be more than $1,600. If the employer's cost exceeds the allowable deduction, the employee has taxable compensation (and so the S corporation has a compensation deduction) equal to the greater of (1) the excess of the employer's cost over the employer's deduction (but not more than the award's FMV), or (2) the excess of the award's FMV over the employer's deduction.

Tax Treatment of Accident and Health Insurance Premiums

Premiums Paid on Behalf of 2% Shareholders. Accident and health insurance premiums paid on behalf of 2% shareholder/employees are reported as additional compensation to the shareholders. The rationale for this treatment is IRC Sec. 707(c), which deals with guaranteed payments to partners. Such guaranteed payments are deductible by the partnership and taxed to the recipient partner. This satisfies the requirement that S corporations be treated like partnerships and the shareholders like partners for purposes of fringe benefits. The expense is deducted on Form 1120S as compensation under IRC Sec. 162(a), assuming that total compensation to each shareholder is "reasonable."

Self-employed Health Insurance Deduction. A discussion of the self-employed medical insurance deduction for S shareholders appears later in this lesson.

A 2% shareholder-employee who provides services to an S corporation must be treated as an employee. Such a shareholder (also referred to as a more-than-2% shareholder-employee) is eligible for an above-the-line deduction under IRC Sec. 162(l) for the cost of accident and health insurance premiums paid by the corporation.

The deduction is equal to 100% of the amount paid for medical insurance for the shareholder, his spouse, and dependents and is reported as an adjustment to income on the shareholder's Form 1040.

This deduction has two limitations imposed by IRC Sec. 162(l)(2):

1. The deduction is not available for calendar months in which the 2% shareholder or spouse is eligible to participate in another employer-subsidized health insurance plan.

2. The deduction cannot exceed the taxpayer's earned income derived from the trade or business that provides the health insurance plan. S corporation shareholders treat their *social security wages from the S corporation* as earned income for purposes of this limitation.

The portion of the deduction that exceeds the earned income limitation is deductible as an itemized deduction subject to the AGI floor for such itemized medical deductions.

Example 2A-3: Spouse participating in employer health plan.

Jerry is president and sole shareholder of Jerrico, Inc., an S corporation. Jerry's W-2 from Jerrico reflects taxable wages of $64,000, which includes $4,000 of medical insurance premiums paid by the company on behalf of Jerry and his family. His Schedule K-1 from Jerrico reflects a $75,000 net loss passed through for the current year. His W-2 from Jerrico reports gross wages of $64,000 and social security wages of $60,000. In addition, Jerry's wife, Doris, is covered by a group medical policy by her employer.

Although Jerry's social security wages of $60,000 are considered his earned income regardless of the loss on his Schedule K-1, Jerry and Doris cannot claim the self-employed medical insurance deduction because Doris is covered by her employer. However, the entire $4,000 can be reported on Schedule A as an itemized deduction, subject to the applicable AGI limitation for medical expenses.

Example 2A-4: Self-employed health insurance deduction based on shareholder's salary.

Assume the same facts as in Example 2A-3, except that Doris is not covered by her employer. In that case, Jerry and Doris can claim the entire $4,000 of medical insurance premiums above-the-line as an adjustment to income. Jerry's social security wages on his W-2 from Jerrico are considered earned income, while the pass-through loss is not included in the determination.

Example 2A-5: Deduction does not increase income tax of sole owner.

Jim is the sole shareholder of Esscorp, and the S corporation paid him a salary of $45,000 during the year. Esscorp also paid $5,000 in medical insurance premiums on Jim's behalf during the year and included that amount on his W-2 in accordance with Rev. Rul. 91-261991-1 CB 184. Jim's marginal income tax bracket is 25%, and his adjusted gross income (AGI) is $65,000.

Jim is entitled to deduct 100% of the premium above-the-line under IRC Sec. 162(l). Since he is the sole shareholder of the corporation, the $5,000 of additional wage income will not result in additional income tax liability because the entire amount also is passed through to him as a reduction to the company's nonseparately stated income. The tax savings from the deduction on Form 1040 is $1,250 ($5,000 × 25%).

If Jim owns less than 100% of the company, the pass-through of the additional salary expense will not be a wash (because the company will pass through to him less than the $5,000 in additional salary expense). This will increase the income tax cost to him of the company paying the premium on his behalf.

As previously discussed, an S corporation shareholder's social security wages from the S corporation are treated as earned income for purposes of the earned income limitation. Since health insurance premiums are not included in social security wages, this definition of earned income effectively requires a 2% shareholder to have cash wages that equal or exceed the premiums if the full 100% deduction is going to be allowable. S shareholders who are active full-time employees, of course, will typically not face this barrier. However, retired employees or family members of S shareholders who receive corporate-provided health insurance but little or no cash wages will face the earned income limitation.

According to Notice 2008-12008-2 IRB 251, a 2% shareholder who meets the requirements of IRC Sec. 162(l) is eligible for the self-employed health insurance deduction if the plan providing the medical care coverage is established by the S corporation, which means that—

1. the S corporation pays the premiums for the accident and health insurance policy covering the 2% shareholder (and his or her spouse and dependents, if applicable) in the current tax year; or

2. the 2% shareholder pays the premiums and furnishes proof of payment to the S corporation, after which the S corporation reimburses the 2% shareholder for the premium payments in the current tax year.

Premiums for all types of Medicare qualify for the self-employed health insurance deduction. In addition, the S corporation must report the accident and health insurance premiums that are paid or reimbursed as wages on the 2% shareholder's Form W-2 in that same year, and the 2% shareholder must report the premium payments or reimbursements as gross income on his or her Form 1040.

The premium arrangements described in IRS Notice 2008-1IRS Notice 2008-12008-2 IRB 251 are exempt from FICA because they are considered *plans* for FICA tax purposes. Nevertheless, these arrangements may subject the S corporation to significant penalties under the Affordable Care Act. However, until further guidance is issued, the IRS will *not* assess the Section 4980D penalty with regard to a health care arrangement of a 2% shareholder, and taxpayers can continue to rely on guidance in IRS Notice 2008-12008-2IRB 251.

Affordable Care Act (ACA) and Health Insurance Benefits

Legislation has been introduced to repeal the Affordable Care Act. Practitioners should monitor this area for future developments.

Generally, medical reimbursement plans are funded entirely by the employer and typically reimburse out-of-pocket health care costs of employees. The plan may define the categories of health care costs it will reimburse, but generally the terms will allow reimbursement of any deductible medical expense, such as out-of-pocket copays, health insurance premiums, dental and vision costs, and similar medical outlays. Most medical reimbursement plans have a limit on the amount that can be reimbursed for any particular calendar year. For income tax purposes, these employer reimbursements of medical expenses are a tax-free fringe benefit to employees other than 2% shareholders. Under IRC Sec. 105(h), these plans have a nondiscrimination requirement, although there is an exclusion for part-time and seasonal employees.

IRS Notice 2013-542013-40 IRB 287 and DOL FAQs Part XXII. The agencies responsible for implementing the ACA [the IRS, Department of Labor (DOL), and Department of Health and Human Services (HHS)] have issued guidance regarding the market reform provisions of the ACA. In IRS Notice 2013-542013-40 IRB 287 and DOL FAQs Part XXII, the agencies provided guidance that placed significant restrictions on the use of medical reimbursement plans and other employer payment arrangements for medical expenses.

Generally, the guidance eliminated an employer's ability to use medical reimbursement plans or offer employer pretax reimbursement of individual insurance premiums. Plans or other arrangements that reimburse an employee for individual health insurance premiums (or directly pay those premiums) fail to meet certain ACA market reform requirements. Section 125 cafeteria plans set up to allow employees to electively reduce compensation to fund individual policy premiums on a pretax basis also fail to meet these requirements. The penalty for violating these rules is $100 per participant, per day, or $36,500 per participant, per year.

In Notice 2013-542013-40 IRB 287, the IRS indicated that a plan was not deemed established as long as the reimbursements were taxable for both federal income tax (FIT) and FICA tax purposes. However, in later guidance (DOL FAQs Part XXII), the agencies stated that regardless of whether the reimbursement is provided as an after-tax or pretax benefit, a plan (for ACA purposes) is established that will not meet the ACA market reform requirements. Therefore, the employer is subject to the Section 4980D penalties.

Exceptions to ACA Market Reforms. IRS Notice 2013-54 and IRC Sec. 9831(d) (under the 21st Century Cures Act enacted December 13, 2016) identify several limited exceptions under which Section 105 medical reimbursement plans and health reimbursement accounts (HRAs) may continue to reimburse employee medical expenses without violating the market reforms. Section 105 plans are still permitted for ancillary benefits such as dental and vision coverage, long-term care, and disability coverage because these are not part of the essential health benefits to which the ACA market reform provisions apply. Retiree-only medical reimbursement plans are also accepted from the ACA market reform rules. Additionally, the market reforms do not apply to group health plans with fewer than two current employees. Therefore, an arrangement that covers only a single employee (whether or not the employee is a more-than-2% shareholder-employee) generally is not subject to the Section 4980D penalty. However, if an S corporation maintains more than one health care arrangement for different employees, all such arrangements are treated as a single arrangement covering multiple employees.

For years beginning after 2016, qualified small employers are allowed to offer HRAs to employees without also offering other health insurance coverage. The HRA must meet certain requirements, and the amount the employer can contribute to the HRA is limited. Additionally, reimbursements to the employee for medical expenses are tax-free only if the employee is enrolled in other health coverage (e.g., individual coverage) that is minimum essential coverage. The HRAs also can affect an employee's eligibility for a premium tax credit, or the amount of premium tax credit that is available. Small employers that have reimbursed individual health insurance premiums from a stand-alone HRA before January 1, 2017, will not be subject to the Section 4980D penalty. An employer that makes a contribution to a qualified small employer HRA must provide written notice to each eligible employee no later than 90 days before the beginning of such year. However, initial notices are not required any earlier than 90 days following the issuance of further guidance from the IRS (IRS Notice 2017-20).

Under the ACA, applicable large employers (ALEs) must offer employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan. ALEs that do not offer minimum essential coverage, or offer minimum essential coverage that is not affordable or does not provide minimum value, may be subject to a penalty under IRC Sec. 4980H(a) or (b). The penalty, also known as the employer shared responsibility payment, can be substantial and is a nondeductible business expense for income tax purposes.

An ALE is a business that employed an average of at least 50 full-time employees on business days during the preceding calendar year. All businesses treated as a single employer under IRC Sec. 414 (e.g., controlled groups or affiliated service groups) are treated as one employer when making this determination. A business not in existence throughout the preceding calendar year determines whether it is an ALE based on the average number of employees it reasonably expects to employ in the current calendar year. The term *employer* includes predecessor and successor employers, but the regulations reserve, and therefore do not address, the rules for identifying a predecessor employer.

Tax Treatment of Other Taxable Fringe Benefits

Although Rev. Rul. 91-261991-1 CB 184 deals only with accident and health insurance premiums, the logic of the ruling appears to apply to other taxable fringe benefits paid on behalf of 2% shareholders when the shareholders are not considered employees (because of their treatment as partners).

FICA and FUTA Taxes and Federal Income Tax Withholding

Taxable fringe benefits treated as compensation generally are subject to employment taxes (FICA and FUTA). Payments of health and accident insurance premiums made pursuant to a plan (see the following paragraph) are *not* subject to FICA and FUTA but are subject to federal income tax withholding.

To be exempt from FICA and FUTA taxes, the payments must be made under a plan or system for employees and their dependents generally or for a class (or classes) of employees and their dependents. There is no definition of a class of employees and dependents, and there is no requirement that the class not be discriminatory. It appears, then, that any employees grouped using reasonable criteria should meet the class of employees test. A plan or system normally exists if one of the following applies:

1. The plan is in writing or is otherwise made known to employees.
2. There is reference to the plan in the employment contract.
3. Employees contribute to the plan.
4. There is a separate fund for payments apart from the employer's salary account.
5. The employer is required to make the payments.

See "Affordable Care Act (ACA) and Health Insurance Benefits" earlier in this lesson for more on the impact of ACA on premium payments in employer-provided health plans.

Reporting Taxable Fringe Benefits

An S corporation treats taxable fringe benefits paid on behalf of its 2% shareholders as additional compensation to them. The corporation includes the additional compensation on Form 1125-E (Compensation of Officers) if that form must be filed, and deducts the additional compensation on page 1, line 7 ("Compensation of officers") or line 8 ("Salaries and wages") of its Form 1120S. The corporation reports the additional compensation to the shareholder-employees on Forms W-2. The additional compensation is subject to federal tax withholding and is generally subject to employment taxes (FICA and FUTA). However, as discussed in the preceding paragraphs, payments made pursuant to a plan providing accident and health coverage are not subject to employment taxes.

Summary of Partner versus Employee Treatment

As previously discussed, partners and 2% shareholders can reap the tax advantages of a fringe benefit if they are treated as employees for that benefit. When a 2% shareholder is treated as a partner, the S corporation's costs to provide the benefit to the 2% shareholder are deducted as compensation by the S corporation and reported as taxable compensation to the 2% shareholder. When a 2% shareholder is treated as an employee, the S corporation can deduct the cost of providing the benefits (on the "Employee benefit programs" line) and the benefits are tax-free to the recipient, assuming that the basic tax qualification rules for the benefit are met. The following table summarizes the fringe benefits for which 2% shareholders are treated as a partner or an employee.

2% Shareholder Treated as Partner (Taxable Compensation to Shareholder)	2% Shareholder Treated as Employee (Tax-free Fringe Benefit)
Premiums for accident and health insurance coverage for the partner (or shareholder), spouse, and dependents.	Qualified educational assistance program.
Group term life insurance coverage.	Qualified dependent care assistance program.
Disability insurance coverage.	No-additional-cost services.
Medical reimbursement plans.	Qualified employee discounts.
Meals or lodging furnished for the convenience of the company.	Working condition fringe benefits.

Cafeteria plan.
Qualified transportation fringes.
Qualified employee achievement award.
Qualified adoption assistance program.
Health savings accounts.
Qualified moving expense reimbursements.
De minimis fringe benefits.
On-premises athletic facilities.
Qualified retirement planning services.

Valuing and Deducting Taxable Noncash Fringe Benefits

Amount Included in Employee's Income. An employee must include in gross income the amount by which the Fair Market Value (FMV) of the fringe benefit exceeds the amount the employee pays for the benefit plus the amount excluded from gross income under IRC Sec. 132 or other Code section. Therefore, no amount is included in income if the employee reimburses the S corporation for the FMV of the fringe benefit.

Using the General Valuation Rule. Unless the S corporation elects a special valuation rule, FMV is determined based on the facts and circumstances. This means that the FMV of the fringe benefit is the amount an individual would pay for it in an independent arm's length transaction. In establishing FMV, any special relationship between the S corporation and the employee must be disregarded. Also, the employee's perception as to the value of the noncash benefit is irrelevant.

Using a Special Valuation Rule. Subject to the requirements in Reg. 1.61-21, an S corporation can elect to value certain fringe benefits using special valuation rules. (Otherwise, the general valuation rule applies.) A summary of the special valuation rules follows:

- *Company Cars.* The IRS has established the following optional special valuation rules for valuing personal use of a company car: (a) automobile lease valuation rule, (b) vehicle cents-per-mile rule, and (c) vehicle commuting valuation rule.

- *Company Planes.* The IRS has developed the noncommercial flight valuation rule to value personal use of a company plane.

- *Free or Discounted Meals.* If an S corporation operates an on-premises cafeteria that meets the requirements of Reg. 1.132-7, an optional special valuation rule is available to value meals provided at the employer-operated eating facility.

- *Employer-provided Commuting for Unsafe Conditions.* If the S corporation is in an unsafe area and hires transportation (e.g., a taxi or limo) to ensure the safety of an employee to and from work, an optional rule may be used to establish the value of the commuting use of this transportation.

Once elected, a special valuation rule must be used for income tax, employment tax, and reporting purposes. When a special valuation rule is properly applied to a fringe benefit, the IRS accepts the calculated value as the FMV of that fringe benefit. [When a special valuation rule is not properly applied, the fringe benefit must be determined under the general valuation rule, per Reg. 1.61-21(c)(5).] The S corporation and employee may also use a special valuation rule to determine the amount of reimbursement due to the S corporation by the employee. This means no amount is included in an employee's income if he or she reimburses the S corporation for the FMV established by the special valuation rule.

The special valuation rules generally ignore the business-use portion of the fringe benefit. For example, the vehicle cents-per-mile valuation rule uses only personal miles to establish the FMV of the fringe benefit. The remaining special valuation rules, other than the automobile lease valuation rule, also adopt this approach of valuing only the personal use of the fringe benefit.

Employer Deduction for Noncash Benefit. An S corporation that includes the value of a taxable noncash fringe benefit in an employee's gross income cannot deduct this amount, only the costs incurred to provide the benefit to the employee. Deductible costs include depreciation under IRC Sec. 168 (subject to the limitations in IRC Sec.

280F), a Section 179 expense deduction or, if the noncash fringe benefit is property leased by the employer, a deduction for the cost of leasing the property. Where the S corporation incurs little or no cost to provide a benefit (such as no-additional-cost services and employee discounts), the deduction is limited to the small amount of the cost (if any) incurred to provide the benefit.

Example 2A-6 S corporation deducts actual costs of providing noncash fringe benefits.

Anderson Inc. provides Mike with use of a company car for business and personal use. The total FMV of Mike's use of the car during the year is $5,000. Anderson incurs $1,000 in out-of-pocket costs for the company car and has a depreciation deduction of $1,775. During the year, Mike uses the car 80% for company use and 20% for personal use; therefore, Anderson reports $1,000 ($5,000 × 20%) as fringe benefit compensation. While Anderson is entitled to deduct 100% of the costs incurred to provide the company car [$2,775 ($1,000 out of pocket + $1,775 depreciation)] as auto and depreciation expenses, it is not entitled to deduct the $1,000 imputed fringe benefit income.

Special Accounting Rule for Taxable Noncash Fringe Benefits

Fringe benefits must be treated as paid no later than December 31 of the calendar year in which they are provided. This requirement can be problematic for S corporations that must calculate the FMV of fringe benefits provided during the last quarter of the year. Therefore, IRS Ann. 85-113 allows employers to use any 12-month period that begins between November 1 and December 31, inclusive, rather than the calendar year, to compute personal use income for the calendar year. The special accounting rule is optional, so an S corporation can use the rule for determining the value of some fringe benefits but not others, and the special accounting period need not be the same for each fringe benefit. However, an S corporation using the rule for a particular fringe benefit must use the rule with respect to all employees who receive that fringe benefit.

The S corporation need not notify the IRS of the election, but must notify affected employees that the special accounting rule has been used and the period for which it has been used. Employers must provide the notice at or near the time the employer provides the employee with the Form W-2; however, notification cannot occur earlier than with the employee's last paycheck of the calendar year.

Failing the Nondiscrimination Requirements

No-additional-cost services, qualified employee discounts, employer-operated eating facilities, and qualified retirement planning services are subject to nondiscrimination requirements. If these benefits do not satisfy the requirements, recipients who are highly compensated cannot exclude any portion of the benefit from gross income. However, this has no direct bearing on the S corporation's deduction since it can deduct only the costs incurred in providing the benefit. Where the S corporation incurs little or no cost (such as with no-additional-cost services and employee discounts), the S corporation's deduction is limited to the small amount of the cost (if any) that the employer incurs to provide the benefit.

Other Issues

Allocation Issues. When taxable fringe benefits are included in wage income, all shareholders will share in the corporation's additional compensation deduction, in accordance with the per-share, per-day allocation rules. Therefore, if a single shareholder owns 100% of the stock, his or her compensation income is increased, but pass-through income from the S corporation is decreased by the same amount.

Example 2A-7 Fringe benefits paid for employee-shareholder treated as compensation.

Al, Bill, and Carol each own 33$^1/_3$% of the stock of Sloco, Inc., an S corporation. Carol is employed full-time by the company, and Al and Bill are passive investors who are not employed by the company. Under its benefit plan, Sloco paid $3,000 of medical insurance premiums on Carol's behalf during the year.

Carol's medical insurance premiums are treated as additional compensation, subject to federal income tax withholding but not FICA or FUTA taxes. Therefore, her taxable wages are increased by $3,000 on her W-2. The officers' compensation deduction on Form 1120S is increased by $3,000 and passes through equally to

each shareholder, based on relative stock ownership. Therefore, each shareholder's nonseparately stated income is decreased by $1,000.

Subject to rules discussed in this lesson, Carol may be able to claim 100% of the $3,000 medical insurance premiums on her personal return as an adjustment to income.

Fringe Benefits Paid for Nonemployee-shareholders. The S corporation treats both taxable and nontaxable fringe benefits paid on behalf of nonemployee-shareholders as distributions to them. The distributions are not deductible by the S corporation, and may or may not be taxable to the distributee.

Example 2A-8 Fringe benefits paid for nonemployee-shareholder.

Assume the same facts as in Example 2A-6, except that Sloco paid $3,000 of medical insurance premiums for each shareholder. The premiums paid on Carol's behalf would be treated as compensation, as described in Example 2A-6, but the medical insurance premiums paid for Al and Bill presumably would be considered distributions of $3,000 to each since the premiums are not paid for services rendered to the corporation.

Fringe Benefits Will Generally Not Be Considered a Second Class of Stock. Payments of health insurance premiums for shareholders will *not* be considered distributions for purposes of the one-class-of-stock rule. Furthermore, fringe benefit programs are not considered "governing provisions" for purposes of determining whether S corporations have more than one class of stock. Therefore, fringe benefits will not be considered a second class of stock unless they are part of a plan to circumvent the second class of stock rules.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Which of the following statements most accurately describes the tax treatment of fringe benefits?

    a. They can usually be deducted by the business regardless of whether they are taxable to the employee.

    b. Amounts paid to an employee in cash can be considered fringe benefits.

    c. Fringe benefits are excluded from the determination of whether an employee's compensation is reasonable.

    d. Contributions to fringe benefits that are not an incidental part of a qualified retirement plan are deducted on page 1, line 7 of Form 1125-E.

8. Median Transit, an S corporation, offers its employees free rides anywhere its trains run. This is an example of which of the following types of fringe benefits?

    a. A working condition fringe benefit.

    b. A no-additional-cost service.

    c. A *de minimis* fringe benefit.

    d. A qualified employee discount.

9. Assuming all other qualifications are met, health insurance premiums paid by an S corporation would be exempt from FICA and FUTA taxes under which of the following circumstances?

    a. Contributions made for employees are limited to those made by the corporation.

    b. Employees are required to make the payments.

    c. The plan is specifically made known to corporation employees.

    d. The corporation's salary account is used to make the payments.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Which of the following statements most accurately describes the tax treatment of fringe benefits? **(Page 27)**

   a. They can usually be deducted by the business regardless of whether they are taxable to the employee. [This answer is correct. A business can generally deduct the cost of providing fringe benefits, whether they are taxable or tax-free to the recipient.]

   b. Amounts paid to an employee in cash can be considered fringe benefits. [This answer is incorrect. A fringe benefit is any compensation or other benefit received by an employee that is *not* in the form of cash.]

   c. Fringe benefits are excluded from the determination of whether an employee's compensation is reasonable. [This answer is incorrect. According to Rev. Rul. 92-93, an employee's compensation must be reasonable in relation to services rendered. Compensation includes not only salary, but also fringe benefits and retirement plan contributions.]

   d. Contributions to fringe benefits that are not an incidental part of a qualified retirement plan are deducted on page 1, line 7 of Form 1125-E. [This answer is incorrect. Contributions to employee benefit programs and fringe benefits that are not an incidental part of a qualified retirement plan are deducted on line 18 (Employee benefit programs) of Form 1120S and so are included in the corporation's nonseparately stated income or loss.]

8. Median Transit, an S corporation, offers its employees free rides anywhere its trains run. This is an example of which of the following types of fringe benefits? **(Page 27)**

   a. A working condition fringe benefit. [This answer is incorrect. According to IRC Sec. 132(d), a *working condition fringe benefit* is property or services provided to an employee that could be deducted by the employee as a work-related expense. An example of this would be a company-provided car. The type of travel provided by Median Transit in this scenario is different because it would not normally be deductible in that way.]

   b. A no-additional-cost service. [This answer is correct. A *no-additional-cost service* is one that (1) is normally offered to customers in the ordinary course of the line of business in which the employees perform services and (2) does not require the S corporation to incur substantial additional cost in providing the service to employees (including foregone revenues but excluding employee payments for the service). Only excess capacity services such as hotels; airlines, buses, or trains; or telephone services are eligible for this exclusion. Therefore, since Median Transit is an excess capacity service, it can provide this fringe benefit.]

   c. A *de minimis* fringe benefit. [This answer is incorrect. According to IRC Sec. 132(e) and Reg. 1.132-6, a *de minimis fringe benefit* is one that normally would be a taxable fringe benefit, but because the goods or services have a nominal value, accounting for the item is unreasonably or administratively impractical. An example of this type of fringe benefit is occasional personal use of an employer's copy machine. The travel provided to employees by Median Transit is of a much higher market value than a *de minimis* fringe benefit can be.]

   d. A qualified employee discount. [This answer is incorrect. According to IRC Sec. 132(c), employee discounts that do not exceed the qualified product's gross profit percentage price or 20% of the qualified service's price are excluded from the employee's income and can be considered this type of discount. However, according to IRC Sec. 132(b) and Reg. 1.132-2, in a qualified employee discount, only part of the property or service may be an excludable fringe benefit. Therefore, since Median Transit is providing the service to employees free of charge (instead of just at a reduced price), this benefit would not be considered a qualified employee discount.]

9. Assuming all other qualifications are met, health insurance premiums paid by an S corporation would be exempt from FICA and FUTA taxes under which of the following circumstances? **(Page 27)**

   a. Contributions made for employees are limited to those made by the corporation. [This answer is incorrect. According to Rev. Rul. 80-303, employees must make contributions for it to be considered a plan and be eligible for the FICA and FUTA exemption.]

   b. Employees are required to make the payments. [This answer is incorrect. Per Rev. Rul. 80-303, the employer is required to make payments for it to be considered a plan and qualify for the FICA and FUTA exemption.]

   c. The plan is specifically made known to corporation employees. [This answer is correct. According to IRC Secs. 3121(a)(2) and 3306(b)(2), to be exempt from FICA and FUTA taxes, the payments must be made under a plan or system for employees and their dependents generally or for a class (or classes) of employees and their dependents. According to Rev. Rul. 80-303, a plan or system normally exists if certain circumstances are met. One of those circumstances is that the plan is in writing or is otherwise made known to employees.]

   d. The corporation's salary account is used to make the payments. [This answer is incorrect. Based on the guidance in Rev. Rul. 80-303, one of the indications that a plan exists is that there is a separate fund for payments apart from the employer's salary account. Therefore, it is less likely that a plan with this type of account for payments would qualify for the FICA and FUTA exemption.]

Deducting Contributions Made to Retirement Plans

S Corporations Can Establish Qualified Retirement Plans

S corporations generally are eligible to establish the same types of qualified retirement plans that C corporations can establish. As with C corporations, the corporation's contributions to a qualified retirement plan are deductible by the corporation and tax-deferred to the employees. The fringe benefit rules for 2% shareholders (defined earlier in this lesson) do not limit deductions for qualified plan contributions. This means a 2% shareholder who works for the S corporation and receives a Form W-2 can participate in the S corporation's qualified retirement plans. The shareholder's W-2 wages are qualifying compensation. However, for 2017, the maximum qualifying compensation is limited to $270,000 per employee.

Retirement Plans Common to S Corporations

The following paragraphs list the most common types of retirement plans available to S corporations. *PPC's Tax Planning Guide—S Corporations*, and *PPC's 1120S Deskbook* include more in-depth information on this topic.

Defined Benefit Plan. A defined benefit plan provides a definitely determinable benefit at retirement. Therefore, the annual contribution for each employee must be actuarially determined.

Defined Contribution Plan. There are various types of defined contribution plans. The two most common are the profit-sharing plan and the money-purchase pension plan. A profit-sharing plan allows the employer discretion in determining the level of annual contributions to the plan, subject to maximum contribution limitations. Under a money-purchase pension plan the employer is obligated to pay a fixed percentage of an employee's annual compensation or a set dollar amount for each qualified employee.

Example 2B-1 Contributing to a defined benefit plan.

Essco, Inc., an S corporation, implements a defined benefit pension plan. The corporation's actuary determines that a contribution of $70,000 must be made to the plan. Since it is a defined benefit plan, this $70,000 must be contributed despite any operating losses, cash flow problems, or other financial difficulties.

Example 2B-2 Contributing to a money-purchase pension plan.

Essco, Inc., an S corporation, has a 25% money-purchase pension plan. During the current year, Essco pays its non-shareholder employees $40,000 and pays its sole shareholder-employee $60,000. Total qualifying compensation is $100,000. Thus, the corporation must contribute $25,000 to the retirement plan.

Example 2B-3 Contributing to a profit-sharing plan.

Essco, Inc., an S corporation, has a profit-sharing plan that provides for a contribution of up to 25% of qualified compensation. During the current year, Essco had very poor earnings. It can contribute a maximum of $25,000 (on qualified compensation of $100,000) but wants to make only a $5,000 contribution to the plan. Since the profit-sharing plan permits a contribution of any amount up to 25% of compensation, the corporation can make the $5,000 contribution.

Cash or Deferred Arrangements [401(k) Plans]. This type of profit-sharing plan provides an employee the option of having the employer pay an amount to a qualified plan, or make payments directly to the employee in cash. Usually, the payments to the plan are made by way of salary reductions. The employer can make matching contributions to the plan. Elective contributions are subject to social security and Medicare taxes as well as federal unemployment taxes. Also, the deferred amounts may be included as part of taxable income in some states.

Simplified Employee Pensions (SEPs) and Simplified Retirement Plans (SIMPLEs). These types of plans are discussed later in this lesson.

Employee Stock Ownership Plans (ESOPs). These types of plans are discussed later in this lesson.

Deducting Contributions

Several rules impact an employer's annual deduction for qualified retirement plan contributions. The employer deduction limit under IRC Sec. 404 determines the amount an employer can deduct for contributions made to a qualified plan. For purposes of the employer deduction limit, forfeitures are not included as employer contributions. The annual addition limit under IRC Sec. 415 is the amount of contributions that can be added to each participant's plan account. This limit includes the employer and employee contribution, as well as forfeitures allocated to the account of the participant. Two other limits that can apply are the employee deferral limit under IRC Sec. 402(g), and catch-up contributions under IRC Sec. 414 by individuals age 50 and older by the end of the year.

As illustrated in Example 2B-5, the Section 415 limit is separate from, but integrated with, the Section 404 limit imposed on the amount the employer can deduct on its tax return.

The basic rule is that contributions otherwise deductible as business expenses under any other Code section must be deductible under IRC Sec. 404. This means that if a deduction would be allowed under another section of the Code, IRC Sec. 404 works to potentially limit that deduction. One example of the interaction of IRC Sec. 404 with other Code requirements is the requirement that expenses be ordinary and necessary under IRC Sec. 162.

The Section 162 requirement with the broadest application in this area is the one that requires compensation to be reasonable in amount. A deduction for a contribution to a plan for the benefit of an employee is not allowed under IRC Sec. 404(a) unless that contribution, together with the employee's other compensation, constitutes reasonable compensation for services actually rendered. Thus, to be deductible at all, contributions to plans must first be ordinary and necessary under IRC Sec. 162. They are then subject to limitations under IRC Sec. 404.

A restorative payment allocated to a participant's account is not subject to the Section 415 limits and is treated as a business expense under IRC Sec. 162. Generally speaking, these payments restore some or all of a plan's losses due to an action or failure to act that creates a reasonable risk of liability for a breach of fiduciary duty. Restorative payments are deductible under IRC Sec. 162 if made to resolve potential claims against the employer for breach of fiduciary duty incurred in the ordinary course of its trade or business. If a fiduciary other than the employer is responsible for the breach, the deduction is still allowed if the plan requires the employer to indemnify the fiduciary.

An employer can deduct, without limit, recurring administrative or overhead expenses, such as trustee's fees and actuary's fees, that are not paid from plan contributions to the extent that such expenses are ordinary and necessary business expenses. The deductibility is not affected by whether the employer pays the expenses directly or reimburses the plan for its payment of expenses (although the plan and/or trust document must provide for such payment). Doing so will allow the employer to increase its tax deduction associated with the plan, as these amounts are not limited by the Section 404 deduction limit.

Deadline for Establishing Plan. A qualified plan and trust must be written and adopted before the employer's year-end for which a deduction is being claimed. A SIMPLE IRA plan generally must be established by October 1 of the current year. Unlike the other plans, a SEP can be established (and a contribution deducted) as late as the extended due date of the employer's tax return.

The employer can deduct contributions that are actually made during the current tax year, as well as contributions made on or before the extended due date of the current year return. (For defined benefit or money purchase pension plans, the contribution may have to be made before the extended due date to satisfy the minimum funding standard in IRC Sec. 412.) Contributions that exceed the deductible limitations may be carried over to later years, subject to the applicable limitations. Nondeductible contributions are subject to a 10% excise tax that is payable each year the excess exists. The excise tax is payable on Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans), not Form 1120S.

Employer Contributions. IRC Sec. 415 limits the amount of annual additions that can be made to a participant's account and benefits that can be accrued to a participant in a qualified retirement plan. The Section 415 (annual addition) limit is separate from, but integrated with, the Section 404 limit on the employer's tax deduction for contributions to a qualified plan (see Example 2B-5).

Annual Addition Limit. IRC Sec. 415 imposes limitations on the benefits a defined benefit plan can provide to a participant, or the amount of employer contributions, forfeitures, and employee contributions that can be annually

allocated to a participant's account in a defined contribution plan. Under IRC Sec. 415(b), a defined benefit plan cannot provide an annual benefit that exceeds the lesser of $215,000 for 2017, or 100% of the participant's average compensation for the three consecutive years of highest compensation. For defined contribution plans, the annual addition limit for 2017 under IRC Sec. 415(c) is the lesser of $54,000, or 100% of the participant's compensation.

Employer Deduction Limit. The deduction limit for single employer defined benefit plans is the greater of (1) the sum of the unfunded Section 404(o) amount, or (2) the minimum funding requirement under IRC Sec. 430. These two amounts use the same actuarial assumptions and funding method; however, the minimum funding requirement typically will be less than the maximum deductible contribution.

The deduction for contributions to a profit-sharing, money purchase, or stock bonus plan cannot be more than 25% of total compensation paid to participants during the year, limited in 2017 to $270,000 per participant. Employee pretax contributions to 401(k) plans are not subject to this limit, nor do they reduce participant compensation used in determining the limit. Catch-up contributions for participants age 50 or older by year-end, if allowed by the plan, are not included in this limit.

Example 2B-4 Computing the annual compensation limit.

Advance Services, Inc. (ASI) maintains a profit-sharing plan with a 401(k) arrangement. Jim, a 45-year-old participant in the plan, has compensation of $300,000 and pretax contributions of $18,000 for 2017. Thus, Jim's taxable income is $282,000. ASI also makes an employer contribution of $10,000 to the plan on Jim's behalf. In applying the IRC Sec. 404 deduction limit, Jim's 2017 qualified compensation is $270,000 (unreduced by the pretax contributions of $18,000). If Jim were ASI's only employee, ASI's deduction limit for the year would be $67,500 (25% of $270,000). However, the maximum amount ASI can deduct is $54,000, which is Jim's Section 415 annual addition limitation for 2017.

The employer deductible contribution to a SEP generally is the same as for profit-sharing, money purchase, and stock bonus plans. However, any contributions to those plans reduce the amount that can be contributed to a SEP. Contributions to a SIMPLE IRA plan can be made using a matching contribution formula (generally on a dollar-for-dollar basis, up to 3% of compensation) or a nonelective contribution formula (2% of compensation, limited to $270,000 for 2017).

For 2017, an employer's contribution to a payroll deduction IRA is limited to the lesser of $5,500 or the employee's compensation. However, for employees who are at least 50 at the end of 2017, the limit including catch-up contributions is $6,500.

The deduction limit of IRC Sec. 404 and the annual addition limit under IRC Sec. 415 are separate limits. The deduction limit is related to the employer, and the annual addition limit is an individual limit. Although each is a separate limit, the limit reached first is the one that becomes effective. An employer contribution is still allocable to plan participants, regardless of whether it is currently deductible under IRC Sec. 404, as long as the plan document does not preclude allocation of that nondeductible contribution.

Example 2B-5 Handling the interaction between the Section 404 and 415 limits.

Pluscorp's profit-sharing plan calls for an annual contribution of 11% of profits. In 2017, its profits were $750,000, so its contribution would be $82,500. However, its employees received qualified compensation of $300,000; 25% of that compensation was $75,000. Thus, the contribution deduction is limited to $75,000.

Differences in Tax Year. Determining the deduction limit is fairly simple where the pension plan year and the employer's tax year coincide. If they are different, the calculations are more complex. A full discussion of this topic is beyond the scope of this course, but *PPC's Guide to Small Employer Retirement Plans* contains more information.

Contributions after Year-end. A contribution to a qualified retirement plan is treated as having been made on the last day of the tax year if it is identified as being made on account of that year and is made by the due date of the corporation's tax return, including extensions, for that tax year. The rule applies equally to both accrual-basis and cash-basis taxpayers.

Example 2B-6 Tax year in which contribution is deductible.

Pellco, Inc. is a calendar-year S corporation with a profit-sharing plan. Pellco wants to contribute $15,000 to the plan for 2017. On February 20, 2018, the corporation pays $15,000 to the retirement plan trust and identifies the contribution as being for 2017. Since the contribution was made before the due date of Pellco's 2017 tax return and is identified as a contribution for that year, it is deductible on the 2017 tax return.

Reporting the Deduction

An S corporation's contribution to a qualified retirement plan is reported on page 1 of Form 1120S ("Pension, profit-sharing, etc., plans"), which means that the shareholders' pass-through income will be reduced by the contribution. No additional reporting is required on Schedule K-1.

The employer can deduct contributions to a defined benefit plan, defined contribution plan, SEP or SIMPLE plan that are actually made during the employer's current tax year, as well as contributions made on or before the extended due date of the employer's current year return. If the plan is a defined benefit or money purchase pension plan, the contribution may have to be made earlier than the extended due date of the employer's tax return to satisfy the minimum funding standard of IRC Sec. 412.

Entities under Common Control

When an S corporation is a member of a group of businesses under common control, all businesses must be treated as one employer when applying the participation and discrimination rules.

Deducting Contributions to a Simplified Employee Pension (SEP) or a Simple Retirement Plan (SIMPLE)

Simplified Employee Pensions

One alternative to a qualified retirement plan is a simplified employee pension (SEP) plan. A SEP is a retirement program under which the employer makes contributions to the IRAs of employees. The requirements for establishing a SEP are fairly straightforward:

1. The SEP must be either an individual retirement account or an individual retirement annuity.
2. The employer must make SEP contributions for each employee who is 21 years of age who earned at least $600 in 2017 and who has performed services for the employer in at least three of the five years immediately preceding the current year.
3. The contributions must not discriminate in favor of participants who are highly compensated.
4. Employee withdrawal of employer contributions must be permitted without penalty.
5. The contributions must be made pursuant to a definite written allocation formula.

Contributions are optional, rather than mandatory, each year. No annual reporting to the IRS is required (e.g., a Form 5500 need not be filed). The corporation's contribution to the SEP is reported on page 1 of Form 1120S, on line 17, "Pension, profit-sharing, etc. plans."

One advantage of a SEP over a qualified retirement plan is that a qualified retirement plan must be established by the end of the corporation's tax year in order to make a deductible contribution for that year. In contrast, a SEP can be established up to the time for deducting employer contributions (the due date of Form 1120S, including extensions), making the SEP a great post-year-end planning tool.

Example 2C-1 Retroactive tax planning with a SEP.

Good, Inc., a calendar-year S corporation, discovers after year-end that it had a better year than expected in 2017. Although it is too late to set up a profit-sharing plan and make a deductible contribution for that year,

Good can establish a SEP and make a 2017 contribution as late as March 16, 2018. If this is done, the corporation can deduct the contribution on its 2017 federal income tax return. If Good validly extends its 2017 return, it has until September 15, 2018, to establish the SEP and make a deductible contribution for 2017.

Two limitations apply to SEP contributions at the participant level—the SEP contribution limit for 2017 is the lesser of 25% of the employee's compensation or $54,000. In addition, for Section 415 defined contribution plan limit purposes, SEP plans are treated as defined contribution plans. Under the Section 415 limit for 2017, annual additions to a participant's account cannot exceed the lesser of 100% of compensation or $54,000. Thus, the amount contributed to a SEP must be considered in determining if the Section 415 limit has been exceeded. In addition, there is a limit on how much the employer can deduct. For 2017, employer contributions under a SEP are generally deductible to the extent they do not exceed 25% of the total compensation paid to eligible employees during the calendar year ending with or within the employer's tax year.

SIMPLE Retirement Plans

The savings incentive match plan for employees (SIMPLE) is a simplified retirement plan targeted for small businesses. The main requirements for a SIMPLE are that—

1. the employer must have 100 or fewer employees,

2. employees who earn at least $5,000 or more each, in compensation for the current year and any two preceding years must be allowed to participate,

3. the employer may not maintain another employer-sponsored retirement plan, and

4. all contributions must be fully vested at the time they are made.

SIMPLE IRA. A SIMPLE IRA plan is a written salary reduction arrangement under which eligible employees can elect to have the employer make contributions to a SIMPLE IRA rather than receiving that amount in cash. Employees can elect to defer up to $12,500 ($15,500 if age 50 or older by year-end) of their compensation for 2017.

Under IRC Sec. 408(p)(6)(A)(i), "compensation" for purposes of the SIMPLE IRA plan rules generally means:

1. the total amount of wages for income tax withholding purposes, and

2. the total amount of the employee's elective deferrals, including those under SIMPLE IRA plans.

It appears that the health insurance reported on a 2% shareholder-employee's Form W-2 is considered to be compensation for purposes of the SIMPLE IRA plan rules because such health insurance is included in the shareholder's wages for income tax withholding purposes (item 1 in the preceding list).

Employer contributions are required and can be made using one of two formulas. Under the matching contribution formula, the employer generally must match an employee's elective contributions, dollar-for-dollar, up to 3% of the employee's compensation. However, in two out of every five years the employer has the option of electing a matching percentage as low as 1% of each eligible employee's compensation.

Alternatively, an employer may elect to make a 2%-of-compensation nonelective contribution for each eligible employee who has at least $5,000 of compensation for the year (whether or not the employees put any of their own money in the plan). Compensation for purposes of the employer's nonelective contribution is subject to the Section 401(a)(17) limitation (which in 2017 is $270,000, thus limiting the contribution to $5,400).

SIMPLE 401(k). The rules for maintaining a SIMPLE plan as a 401(k) plan are the same as those discussed for SIMPLE IRA plans, except the option of reducing the employer's match to as little as 1% in two out of every five years is not available for SIMPLE 401(k) plans. Also, the rules generally applicable to qualified plans [other than the special nondiscrimination provisions that normally apply to 401(k) plans] continue to apply to SIMPLE 401(k) plans even though they do not apply to SIMPLE plans set up as IRAs.

Employee Stock Ownership Plans (ESOPs)

Employee stock ownership plans (ESOPs) can own S corporation stock. An ESOP is a special type of defined contribution plan that invests primarily in employer securities. An ESOP may be a stock bonus plan or a combination of a stock bonus plan and a money purchase plan, which has been modified to include the various tax and regulatory requirements of an ESOP.

In an ESOP, the employer makes annual contributions of its stock or cash. If cash is contributed, it is used to purchase the employer's stock or retire debt incurred to acquire the employer's stock. ESOPs may borrow money from the employer, its shareholders, or third parties to purchase stock. Such loans are exempt from the prohibited transaction rules. If the employer securities are not readily tradable, they must be appraised annually by an independent appraiser.

The stock acquired by the ESOP is allocated to employees' accounts, typically on the basis of compensation. As a qualified plan, amounts allocated to employees' accounts are not taxable to employees when contributed. Instead, they accumulate on a tax-deferred basis until the employee retires, becomes disabled, dies, or otherwise terminates employment. The ESOP is required to adjust its basis in the S corporation stock for the ESOP's allocable share of the corporation's pass-through income. The employee or beneficiary recognizes income to the extent the stock's FMV exceeds its adjusted basis at the time the stock is distributed, or when the stock is sold and the proceeds are distributed to the employee.

Technically, an ESOP is a defined contribution plan that is either a stock bonus plan or a combination of a stock bonus and money purchase pension plan qualified under IRC Sec. 401(a) and designed to invest primarily in qualifying employer securities. As already noted, ESOPs can borrow money from the corporation, its shareholders, or third parties to purchase stock. When a shareholder wants out but the ESOP lacks sufficient cash, the ESOP can borrow the money to purchase the shares, and then use the corporation's annual cash contributions to service the debt. An ESOP that borrows funds to acquire employer securities is known as a *leveraged ESOP*.

While the contribution limit on deductions to leveraged ESOPs of C corporations under IRC Sec. 404(a)(9)(A) is 25% of participants' compensation, there is no limit on the deduction for contributions used to pay interest expense (provided not more than one-third of ESOP benefits go to highly compensated employees). Unfortunately, the deduction for contributions used to pay interest for a leveraged ESOP is not available to S corporations. Without the unlimited interest deduction of IRC Sec. 404(a)(9)(B), the 25% of compensation limitation must cover both principal and interest.

The other limitations applicable to profit-sharing/stock bonus plans apply to contributions to an ESOP.

How to Deduct Payments to Nonqualified Deferred Compensation Plans

Nonqualified plans typically are provided to shareholder-employees and key nonfamily executives. Nonqualified plans defer the executive's income and the employer's deduction until the receipt of cash by the executive. They are not subject to the numerous Internal Revenue Code restrictions covering qualified plans.

In a nonqualified deferred compensation plan, the executive defers the receipt of cash compensation to a future year. The amount deferred can be a specified amount or a percentage of an item such as salary or corporate profits. The employer often credits earnings to the executive's deferred compensation account throughout the deferral period (e.g., the employer credits the executive's deferred compensation account for 7% of earnings at the end of each year). The plan must specify the period over which payment is to be made, as well as who will receive the payments if the executive dies before receiving the total amount.

The following are common types of deferred compensation plans:

1. Traditional salary deferral plans allow the executive to defer receipt of a specified amount or a percentage of salary or bonus to a future year. Often the plan credits the deferred amount with earnings each year the compensation is deferred. Because the earnings are expressed as a percentage of the balance in the executive's account, the earnings grow tax-deferred.

2. Deferred compensation plans can be designed as stock-based compensation programs, including stock appreciation rights and phantom stock plans. The executive receives deferred compensation tied to equity appreciation during the plan's duration. The compensation can be paid in cash or in employer stock.

3. Companies often grant stock options to executives. Unless the options are traded, the executive is not taxed at the date of grant. Instead, taxable income is triggered when the option is exercised or sold. If the option is an incentive stock option (ISO) and certain conditions are satisfied, long-term capital gain is recognized when the stock is sold. Exercising stock options that are not ISOs (and ISOs if the conditions are not met) usually results in ordinary income.

Whether using the cash or the accrual method, the employer generally deducts deferred compensation in the tax year that includes the end of the tax year in which the executive recognizes income. This rule for the timing of the employer's deduction covers any payment made *more* than 2 1/2 months after the end of the employer's tax year in which the compensation is earned. If the payment is made *within* 2 1/2 months after the end of the employer's year in which it is earned, it is not treated as deferred compensation and is deductible under the employer's regular tax accounting method.

An amount is not treated as received by an executive (or paid by an employer) until it is actually received by the executive for determining whether compensation is deferred compensation and when it is paid. This means that accrued vacation funded with an irrevocable letter of credit is not considered as received by the executive, and therefore is not deductible by the employer until paid.

Compensation deferred under a nonqualified deferred compensation plan for the tax year (and any earnings on such amounts) is includible in the employee's gross income under IRC Sec. 409A if not subject to a substantial risk of forfeiture and not previously included in gross income, if at any time during the tax year the plan either (1) fails to meet the (a) distribution, (b) acceleration of benefit, or (c) election requirements; or (2) is not operated in accordance with these requirements. Deferred amounts required to be included in income under IRC Sec. 409A are subject to interest at the underpayment rate plus 1%. Furthermore, the executive owes an additional 20% income tax on the amount included in income.

If a plan fails a Section 409A requirement, meaning an executive includes deferred compensation in income before it is paid, this inclusion presumably accelerates the income tax deduction for the amount included in income.

The Treatment of Deferred Compensation as a Loss for Built-in Gains Tax Purposes

Built-in losses reduce net unrealized built-in gain for Section 1374 purposes. Amounts properly deducted in the recognition period under the Section 404(a)(5) rules relating to payments of deferred compensation are recognized built-in losses to the extent that (1) all events have occurred that establish the fact of the liability to pay the amounts, and the amount of the liability can be determined, as of the beginning of the recognition period, and (2) the amounts are not paid to a related party.

Example 2F-1 Treating deferred compensation as a built-in loss for Section 1374 purposes.

ZaZa Inc. is a C corporation that elects S corporation status on January 1, 2018. As of December 31, 2017, Albert, a 60-year-old employee who is a vested participant in ZaZa's unfunded nonqualified plan, is entitled to receive $1,000 a month from retirement until death. Albert retires on December 31, 2019, and receives $1,000 a month from ZaZa. Albert has never directly or indirectly owned shares in the corporation. The $1,000 a month is a built-in loss since all events had occurred to establish the fact and the amount of the liability before the recognition period.

However, any increase Albert receives because of services performed after the beginning of the recognition period or because of a cost of living adjustment after the beginning of the recognition period is not treated as a built-in loss.

Dealing with Cafeteria Plans

Cafeteria plans are written plans that allow employees to choose from among two or more benefits consisting of cash (including cash equivalent benefits) and qualified taxable or nontaxable benefits. *Cafeteria plans*, so called because the employee is able to choose from a menu of cash and qualified benefits, are also commonly referred to as "Section 125 plans" because they must conform to the requirements imposed by IRC Sec. 125. Employees can make contributions for certain qualified benefits through payroll withholding on a pretax basis, which means such contributions generally are not subject to federal income tax or social security and Medicare (FICA) taxes. This results in greater take-home pay for employees and payroll tax savings for the employer.

The deductibility of employer contributions to a cafeteria plan depends on the type of benefit provided. The deductibility of contributions and the amount of the deduction are determined by the Code section for each benefit provided. The expenses of maintaining and administering the plan are normally deductible as ordinary and necessary expenses by the plan sponsor.

Nondiscrimination Rules

The nondiscrimination rules for cafeteria plans are complex. If the plan fails the nondiscrimination tests, some or all of the plan benefits are taxable to the highly compensated and key employee plan participants. However, other participants are not adversely affected.

Treatment of 2% Shareholders

For cafeteria plan purposes, 2% shareholders are not considered to be employees and so cannot participate in a cafeteria plan. Furthermore, the attribution rules of IRC Sec. 318 apply in determining who is a 2% shareholder. Therefore, a spouse, child, grandchild, or parent of a 2% S shareholder is treated as self-employed and cannot participate in the cafeteria plan. If a 2% shareholder participates, the plan is not a cafeteria plan for any participating employee. Other employees cannot make pretax contributions to obtain any of the benefits offered under the plan.

Simple Cafeteria Plans

Simple cafeteria plans can be established and maintained by small employers. A simple cafeteria plan is one that (1) is established and maintained by an eligible employer and (2) meets the contribution, eligibility, and participation requirements of IRC Sec. 125(j).

Eligible Employer. An employer with an average of 100 or fewer employees during either of the two preceding years or a new employer who reasonably expects to employ fewer than 100 employees in the current year is an eligible employer. Once an eligible employer establishes a plan, it may be maintained as long as the employer does not employ an average of 200 or more employees in a subsequent year.

Minimum Eligibility and Participation Requirement. In general, all employees who had at least 1,000 hours of service in the preceding plan year must be eligible to participate. Also, each employee eligible to participate in the plan may elect any benefit available under the plan, subject to the terms and conditions applicable to all participants. Certain employees may be excluded if the employer elects to do so, including those who:

1. have not attained age 21 before the close of the plan year;
2. have less than one year of service with the employer as of any day during the plan year;
3. are covered under a collective bargaining agreement; or
4. are nonresident aliens working outside the United States.

Contributions. The employer must make a contribution to provide qualified benefits on behalf of each qualified employee in an amount equal to:

1. a uniform percentage of at least 2% of the employee's compensation for the plan year, or

2. an amount that is the lesser of 6% of the employee's compensation for the plan year or twice the amount of the salary reduction contributions of each qualified employee.

If option 2 is selected, the rate of contribution for any salary reduction contribution of a highly compensated or key employee cannot be greater than the rate of contribution for any other employee.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Which of the followings statements is true regarding how to deduct qualified retirement plan contributions?

    a. The employer deduction limit under Sec. 415 determines the amount an employer can deduct for contributions made to a qualified plan.

    b. Forfeitures are included as employer contributions for purposes of the employer deduction limit.

    c. Plan contributions must be ordinary and necessary to be deductible under IRC 162.

    d. Most restorative payments that are allocated to a participant's account are treated as a business expense and subject to the Section 415 limits under IRC Sec. 162.

11. Which of the following qualifications must be met for a simplified employee pension (SEP) plan to be established?

    a. For the employer to make contributions, an employee must earn at least $10,000 over the course of the year.

    b. Contributions by the employer must be limited to employees who are considered highly compensated.

    c. Mandatory contributions must be made of the same amount every year the plan is in operation.

    d. The SEP must be an individual retirement annuity or an individual retirement account.

12. Cafeteria plans are written plans that allow employees to choose from among two or more benefits consisting of cash and qualified taxable or nontaxable benefits. Employers may exclude certain employees from participating in the plan, including all of the following **except:**

    a. Employees who have not reached age 21 prior to the close of the plan year.

    b. Employees who have been employed less than one year as of any day during the plan year.

    c. Employees who are not protected under a collective bargaining agreement.

    d. An employee who is a nonresident alien working outside the United States.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Which of the followings statements is true regarding how to deduct qualified retirement plan contributions? **(Page 44)**

    a. The employer deduction limit under Sec. 415 determines the amount an employer can deduct for contributions made to a qualified plan. [This answer is incorrect. The employer deduction limit under IRC Sec. 404, not Sec. 415, determines the amount an employer can deduct for contributions made to a qualified plan.]

    b. Forfeitures are included as employer contributions for purposes of the employer deduction limit. [This answer is incorrect. For purposes of the employer deduction limit, forfeitures are not included as employer contributions.]

    c. Plan contributions must be ordinary and necessary to be deductible under IRC 162. [This answer is correct. The Section 162 requirement with the broadest application in this area is the one that requires compensation to be reasonable in amount. A deduction for a contribution to a plan for the benefit of an employee is not allowed under IRC Sec. 404(a) unless that contribution, together with the employee's other compensation, constitutes reasonable compensation for services actually rendered. Thus, to be deductible at all, contributions to plans must first be ordinary and necessary under IRC Sec. 162.]

    d. Most restorative payments that are allocated to a participant's account are treated as a business expense and subject to the Section 415 limits under IRC Sec. 162. [This answer is incorrect. A restorative payment allocated to a participant's account is not subject to the Section 415 limits and is treated as a business expense under IRC Sec. 162.]

11. Which of the following qualifications must be met for a simplified employee pension (SEP) plan to be established? **(Page 47)**

    a. For the employer to make contributions, an employee must earn at least $10,000 over the course of the year. [This answer is incorrect. According to IRC Sec. 408(k), the employer must make SEP contributions for each employee who is 21 years of age who earned at least $600 in 2017 and who has performed in at least three of the five years immediately preceding the current year.]

    b. Contributions by the employer must be limited to employees who are considered highly compensated. [This answer is incorrect. Based on the guidance provided in IRC Sec. 408(k), the contributions to a SEP plan must *not* discriminate in favor of participants who are highly compensated. Therefore, other types of employees must be involved, as well.]

    c. Mandatory contributions must be made of the same amount every year the plan is in operation. [This answer is incorrect. Per IRC Sec. 408(k), the contributions must be made pursuant to a definite written allocation formula (not the same amount annually). Also, contributions to a SEP plan are optional, rather than mandatory, each year.]

    d. The SEP must be an individual retirement annuity or an individual retirement account. [This answer is correct. A SEP is a retirement program under which the employer makes contributions to the IRAs of employees. The requirements for establishing a SEP are fairly straightforward, and they are outlined in IRC Sec. 408(k). One of these requirements is that the SEP must be either an individual retirement account or an individual retirement annuity.]

12. Cafeteria plans are written plans that allow employees to choose from among two or more benefits consisting of cash and qualified taxable or nontaxable benefits. Employers may exclude certain employees from participating in the plan, including all of the following **except: (Page 51)**

    a. Employees who have not reached age 21 prior to the close of the plan year. [This answer is incorrect. According to the IRC Sec. 125(j) eligibility requirements, certain employees may be excluded if the employer elects to do so, including an employee who has not attained age 21 before the close of the plan year.]

    b. Employees who have been employed less than one year as of any day during the plan year. [This answer is incorrect. Certain employees may be excluded if the employer elects to do so, including an employee who have less than one year of service with the employer as of any day during the plan year per the IRC Sec. 125(j) eligibility requirements.]

    c. Employees who are not protected under a collective bargaining agreement. [This answer is correct. According to the IRC Sec. 125(j) eligibility requirements, certain employees may be excluded if the employer elects to do so, including employees who are covered under a collective bargaining agreement. So, employees who are covered under a collective bargaining agreement are not excluded from the plan.]

    d. An employee who is a nonresident alien working outside the United States. [This answer is incorrect. According to the IRC Sec. 125(j) eligibility requirements, certain employees may be excluded if the employer elects to do so, including any employees who are nonresident aliens working outside the United States.]

Lesson 3: Other Deductions

Introduction

Some of the expenses paid by S corporations involve peculiar or unusual rules concerning either the deductibility or the reporting of the item. In certain cases these rules affect the amount of the corporate deduction (rent paid in advance) or eliminate the corporate deduction entirely (charitable contributions). Furthermore, these specialized rules can affect not only the S corporation, but also the shareholders (domestic production activities deduction), or the recipients of the corporate payment (fees paid to members of the board of directors).

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize how to claim the domestic production activities deduction (DPAD).
- Recognize the effect of passing charitable contributions through to shareholders; lease and rental expenses; reporting directors' fees and expenses; deducting advertising, professional fees, and other selected business items; penalties, bribes, and political expenses; and the tax benefit rule for recovering previous deductions.

The Domestic Production Activities Deduction

Deduction for Domestic Production Activities

The domestic production activities deduction (DPAD) under IRC Sec. 199 is available to any qualified taxpayer, including corporations, partnerships, and limited liability companies. (For pass-through entities, the deduction is claimed at the owner level.) The deduction equals 9% of the lesser of the taxpayer's:

- qualified production activities income (QPAI) for the tax year, which equals domestic production gross receipts (DPGR) less costs of goods sold and other expenses properly allocable to DPGR; or

- taxable income for the tax year, determined without regard to the deduction.

DPGR are gross receipts from the manufacture, production, growth, or extraction of qualifying production property (QPP). However, the allowable deduction cannot exceed 50% of the taxpayer's Form W-2 wages for the year. W-2 wages only include amounts that are properly allocable to DPGR.

The deduction should be claimed, if available, because it is a permanent tax benefit (not a timing difference) and does not reduce any other deduction or credit item (e.g., like employment tax credits based on a percentage of employees' wages, which reduce the wage deduction).

The deduction is reduced for taxpayers with oil-related QPAI (e.g., attributable to the production, transportation, or distribution of oil and gas) by 3% of the lesser of the taxpayer's (1) oil-related QPAI for the year, (2) QPAI for the year, or (3) taxable income (determined without regard to the Section 199 deduction) for the year.

Identifying Qualified Production Property

Qualified production property (QPP) is tangible personal property, computer software, and sound recordings. Tangible personal property is any tangible property other than land, buildings, or structural components of a building, qualified film produced by the taxpayer, electricity, natural gas or potable water produced by the client, computer software, and sound recordings. However, the tangible medium on which a film, software or sound recording is contained, i.e., a videocassette or computer disk, is tangible personal property. QPP does not include intangible property, other than computer software and sound recordings.

In determining whether property is tangible personal property, the fact that property is personal property or tangible property under local law is not controlling. Conversely, property may be tangible personal property for purposes of this deduction even though under local law the property is considered a fixture and therefore real property.

Machinery, printing presses, transportation equipment, office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and signs that are contained in or attached to a building are tangible property for purposes of the deduction. Furthermore, property that is in the nature of machinery, other than structural components of a building, is tangible personal property. For example, a gasoline pump, hydraulic car lift, or automatic vending machine, although attached to the ground, is tangible personal property.

Identifying Activities Eligible for the Deduction

The DPAD is based on qualified production activities, and the definition of those activities is extremely broad. The following activities are qualified production activities:

- The manufacture, production, growth, or extraction (MPGE) in whole or significant part in the U.S. of tangible personal property (e.g., clothing, goods, and food), computer software, or sound recordings.
- Film production (with exclusions provided in the statute), provided at least 50% of the total compensation relating to the production of the film is compensation for specified production services performed in the U.S. A taxpayer with a 20% or greater direct or indirect ownership interest is treated as engaging directly in any film produced by a partnership or S corporation. Similarly, an S corporation or partnership is treated as having engaged directly in any film produced by a shareholder or partner with at least a 20% ownership interest, either directly or indirectly, in the S corporation or partnership.
- The production of electricity, natural gas, or potable water in the U.S.
- The construction or substantial renovation of real property in the U.S. by a taxpayer engaged in the construction business, including residential and commercial buildings and infrastructure such as roads, power lines, and water systems.
- Engineering and architectural services performed in the U.S. by a taxpayer engaged in the business of performing engineering or architectural services, and relating to the construction of real property.

Activities That Include Only Sales or Services Generally Do Not Qualify

An activity does not qualify for the deduction if the activity is (1) exclusively sales of property, or (2) exclusively the rendering of services unless the services are in the fields of construction, engineering, or architecture.

Identifying Manufactured, Produced, Grown, or Extracted (MPGE) Activities

Qualifying Activities. MPGE qualifying activities include manufacturing, producing, growing, extracting, installing, building, developing, improving, and creating QPP. MPGE activities also include creating QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, refining, or changing the form of an item, or by combining or assembling two or more items. Qualifying activities include cultivating soil, raising livestock, fishing, and mining minerals.

MPGE activities also include storage, handling, or other processing activities, but not transportation activities, in the U.S. However, the storage, handling, and processing activities must be related to the sale or other disposition of agricultural products. In addition, the agricultural products must be used in connection with or become part of other QPP, whether or not the taxpayer is involved in the process.

Example 3A-1 Engaging in storage activities.

Farmers, Inc., an S corporation, raises soybeans in the U.S. that it stores in Silos R Us (an unrelated entity) for a fee. Farmers sells its soybeans to Tofu Tonight, LLC (an unrelated entity) that uses the soybeans in its Turkey Tofu. Farmers and Tofu Tonight meet the MPGE criteria. Consequently, their gross receipts qualify as DPGR. Further, since Silos R Us stores an agricultural product that is ultimately part of a qualifying MPGE activity, Silos R Us has gross receipts from a qualifying activity that are DPGR.

Installation Activities. Installation activities qualify as an MPGE activity only if the taxpayer installs QPP that it manufactured, produced, grew, or extracted. In addition, the taxpayer must have the benefits and burdens of

ownership of the QPP while the installation activity is taking place. For example, when the taxpayer manufactures a part that it later installs for its customer, the taxpayer retains ownership of that part while it conducts the MPGE activity. If the taxpayer installs an item of QPP, but engages in no other MPGE activity for the item of QPP, the installation activity does not qualify as MPGE because it is considered a service activity.

Computer Software

Income from the lease, rental, license, sale, exchange, or other disposition of computer software manufactured, produced, grown, or extracted (MPGE) in the U.S. qualifies for the domestic production activities deduction (DPAD), regardless of whether the customer purchases the software off the shelf or takes delivery of the software by downloading it from the Internet.

The term *computer software* means any program, routine, or sequence of machine-readable coding that a taxpayer designs to make a computer perform a desired function. Computer software is not limited to software for computers. It also includes video game software and the rights to use the software. Computer software does not include diskettes or other tangible property on which the taxpayer places the program or machine-readable coding, because these items are tangible personal property for Section 199 purposes. However, the taxpayer may treat the tangible medium (e.g., a diskette) as software if it produces the software and adds the software to the tangible medium, and it does not consider any of its Section 174 costs when determining whether its production activity attributable to the tangible medium is substantial in nature.

Example 3A-2 Computer software and tangible property.

Whiz Kids, Inc. developed a software program at its U.S. location for a video game that it reproduces and sells on a compact disc. Therefore, the sale of the compact disc involves both computer software (the program) and tangible personal property (the compact disc). Whiz Kids may treat the income from the sale of the computer software and the compact disc as DPGR because both were developed and produced in the U.S.

Big Ideas develops the video game software outside the U.S. and licenses the rights to manufacture and distribute the software to Whiz Kids. Whiz Kids manufactures the compact discs (encoded with the software) at its U.S. location and sells the video games to retailers. Whiz Kids derives its gross receipts in part from the sale of the computer software and in part from the sale of the compact disc. Whiz Kids will have to allocate its gross receipts between these two items because only the gross receipts from the sale of the compact disc qualify as DPGR. The portion of Whiz Kids' receipts from the sale of the software does not qualify as DPGR because Big Ideas developed the software outside the U.S.

Gross receipts from customer and technical support, telephone and other telecommunication services, online services (such as internet access services; online banking services; or providing access to online electronic books, newspapers, and journals), and similar services do not constitute DPGR. However, the following exceptions under Reg. 1.199-3(i)(6)(iii) treat gross receipts from providing computer software for customers' direct use while connected to the internet as DPGR (if the other requirements of IRC Sec. 199 are met):

1. The taxpayer derives, on a regular basis, gross receipts from the lease, rental, license, sale, etc., to unrelated persons of computer software that has only minor or immaterial differences from the online software, and has been provided to customers on a tangible medium (e.g., a disk or DVD) or by electronic download from the internet. This is known as the *self-comparable exception*.

2. An unrelated person derives, on a regular basis, gross receipts from the lease, rental, license, sale, etc., of software that is substantially identical to the taxpayer's online software, and delivers that software on a tangible medium or by electronic download from the internet. This is known as the *third party comparable exception*.

Example 3A-3 Online-software-related gross receipts as domestic production gross receipts.

Quantum Payroll (Q) produces payroll management software in Texas. For a fee, Q provides customers access to the payroll management computer software for use while connected to the internet. A competitor, Rogers Payroll Services (R), sells substantially identical payroll management software that can be affixed to

a compact disc or downloaded from the internet. Q's gross receipts from providing access to its payroll management online software qualify as DPGR under Reg. 1.199-3(i)(6)(iii)(B), assuming that all other requirements are met.

Assume the same facts except that R produces inventory control software. R's software is not substantially identical to Q's software from the customers' perspective because "it does not have the same functional result as Q's . . . software and does not have significant overlap of features or purpose with Q's . . . software." Assuming that no other person provides substantially identical software to customers affixed to a compact disc or by download, Q's gross receipts from providing access to its payroll management online software do not qualify as DPGR.

When determining whether software is substantially identical, all computer software games are deemed to be substantially identical software. So, for example, computer software sports games and card games are treated as substantially identical.

For the *substantial in nature* and *safe harbor tests* discussed later, taxpayers generally must disregard research and experimental expenditures leading to the creation of tangible personal property because these activities create an intangible asset. However, in the case of computer software and sound recordings, the taxpayer does not disregard these activities in applying these two tests.

Farming Activities

Qualifying production for DPAD purposes includes producing and growing activities. The regulations expand the *growing* definition to indicate that qualifying activities include cultivating soil, raising livestock, fishing, and mining. Eligible activities also include "storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural products." However, the taxpayer must have the benefits and burdens of ownership of the property while the producing or growing activity takes place for the gross receipts to qualify for the DPAD.

Example 3A-4 Claiming the Section 199 deduction for farming activities.

Eldon owns and operates an incorporated farm that generates $500,000 from the sale of raised grain. The corporation's return also reports $50,000 of USDA farm subsidies, some of which include payments for not producing crops, $40,000 of insurance for hail damage to crops, and $10,000 of revenue for custom combining services that Eldon performed for other farmers.

Proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts for DPAD purposes to the extent they are substitutes for gross receipts that would otherwise qualify.

Therefore, the $500,000 of grain sales, the USDA payments of $50,000, and the hail insurance of $40,000 all represent qualifying DPGR for the DPAD. The $10,000 for custom combining is not DPGR because Eldon and his corporation did not own the agricultural products involved in the activity. However, the $10,000 is less than 5% of the gross receipts of $600,000. Accordingly, the corporation can treat all of the gross receipts as qualifying DPGR because the *de minimis* provision in Reg. 1.199-1(d)(3) applies. This provision states that all of a taxpayer's gross receipts may be treated as non DPGR if less than 5% of its total gross receipts are DPGR. See Reg. 1.199-3 for certain exceptions to this rule.

Nonqualifying Activities. Qualified manufacturing activities do not include packaging, repackaging, labeling, or minor assembly of QPP if those are the taxpayer's only activities. However, this provision is not as restrictive as it appears. A 2012 IRS chief counsel advice involved a provider of drugs to seniors in nursing homes and similar facilities. The taxpayer purchased drugs in bottles, emptied the bottles, and used an assembly line to heat plastic, form indentations in the plastic by using a drug-specific mold, place the pills into the blisters, seal the blister back, and add a scannable bar code identifying the medication, dosage, and expiration date. Because much more than repackaging was involved, the blister packs were QPP even though no changes were made to the pills themselves

The IRS has issued a directive that lists several activities performed at the retail level that are generally not considered activities related to manufacturing, production, growing, or extraction and so do not yield gross receipts that qualify for the DPAD. The listed activities are—

1. cutting blank keys to a customer's specification;
2. mixing base paint and a paint coloring agent;
3. applying garnishments to cake that is not baked where sold;
4. applying gas to agricultural products to slow or expedite fruit ripening;
5. storing agricultural products in a controlled environment to extend shelf life; and
6. maintaining plants and seedlings.

The IRS directive to its employees may be a reaction to extremely taxpayer-favorable holdings in the following court cases. In *Dean,* the court ruled that the activity of designing, assembling, and selling gift baskets and gift "towers" (stacked decorative boxes of food) was MPGE. Also, in *Precision Dose*, the taxpayer purchased medication in bulk after conducting market research that supported selling them in single doses. It then designed proprietary cups and syringes suitable to use for unit doses and developed mixing and testing procedures. The court again ruled that the taxpayer engaged in a complex production process that resulted in a distinct final product.

Who Claims the Deduction. The general rule is that the business entitled to claim the deduction is the one bearing the benefits and burdens of ownership of the property while the qualifying production activity occurs. The taxpayer having the benefits and burdens of ownership is determined from all of the facts and circumstances of the transaction.

A 2012 IRS memo provided a three-step process for determining whether taxpayers have the benefits and burdens of ownership in contract manufacturing arrangements. A subsequent IRS memo helps LB&I examiners determine which unrelated party in a contract manufacturing arrangement can claim a Section 199 deduction because it satisfies the benefits and burdens test. To make this determination, the LB&I examiner should ask the taxpayer to provide a (1) statement that explains the basis for the taxpayer's determination that it had the benefits and burdens of ownership in the year(s) under examination, (2) certification statement (found in Appendix 1 of the directive) signed by the taxpayer, and (3) certification statement (found in Appendix 2 of the directive) signed by the other party. The three statements must be provided for each contract and cannot be changed during the life of the contract. Certification statement requirements were subsequently modified in October 2013.

Example 3A-5 Party bearing the benefits and burdens of ownership can claim the deduction.

Crash Cars, an S corporation, contracts with Sam to build a racecar to sell to Wreckless Racing, Inc. While Sam is building the car, Crash bears the benefits and burdens of ownership, i.e., Crash owns the car and is responsible for any damage, etc. arising during the period the car is being built. Crash is treated as the party qualifying for the deduction. Sam is providing a service to Crash. Since services do not qualify for the deduction, Sam gets no deduction for his work, even though he actually built the car.

An advertising company that distributes direct mail ads in the U.S. was not entitled to the Section 199 domestic production deduction because it did not bear the benefits and burdens of ownership while the advertising material was printed. Ad materials were either supplied by the taxpayer's clients or produced by third-party commercial printers where the taxpayer provided the printer with designs for the ads as rough art, client-supplied art, or reprints with changes. Third-party printers purchased the paper supply from a broker, and it was shipped directly to the printer. The Tax Court's decision came down to the question of who could claim the deduction, either the taxpayer or the printer. In this case, the court found the printer to be the manufacturer eligible for the deduction.

Government Contracts. A special rule applies to U.S. government contracts. Gross receipts from the manufacture, production, growth, or extraction of QPP will be treated as the taxpayer's activity if the contract is with the U.S. government and the Federal Acquisition Regulations require the title to be transferred to the government before the

property's completion. This same rule applies to any subcontractor involved in a U.S. government contract under which title must be transferred before the property is completed.

Photo Processing and Printing. In a Legal Advice Issued to Field Attorneys (LAFA), the IRS has determined that a taxpayer's photo processing and printing activities represent the MPGE of qualifying property for Section 199 deduction purposes. The IRS agreed with the taxpayer that under Reg. 1.199-3(e)(1), the processing and printing activities that the taxpayer uses to produce photo products qualify for the deduction. However, transferring images provided by a customer onto a CD or DVD that was not manufactured by the taxpayer is a service, not a production activity, so the gross receipts from that activity cannot be included when figuring the deduction.

Meeting the *In Significant Part* Requirement

Taxpayers must manufacture, produce, grow, or extract QPP in whole or in significant part within the U.S. A taxpayer manufactures QPP *in significant part* if it meets one of the following two tests:

- *Substantial in Nature Test.* Based on all of the taxpayer's facts and circumstances, the MPGE activity performed by the taxpayer in the U.S. is substantial in nature. Under this test, all of the related factors (i.e., the value added by the production in the U.S. compared to the total value of the property, the relative cost of the property manufactured in the U.S. versus elsewhere, the nature of the QPP and the nature of the MPGE activity itself) must be taken into account. However, manufacturing a key component of the property does not, by itself, automatically meet the *in significant part* test. Research and development activities and the creation of intangible assets are not considered when determining whether this test is met, except that research and development expenses incurred in computer software development and sound recordings are part of the MPGE activities.

- *Safe Harbor Test.* The taxpayer's direct labor and overhead for the manufacture, production, growth, and extraction of the QPP within the U.S. account for 20% or more of the taxpayer's cost of goods sold, or in a transaction without cost of goods sold (such as a lease, rental, or license) account for 20% or more of the taxpayer's unadjusted depreciable basis of the QPP. For taxpayers subject to the UNICAP rules, overhead includes all costs required to be capitalized under IRC Sec. 263A, except for direct materials and direct labor. Software development and sound recording MPGE activity can include research and development expenses as well as the costs of creating intangible assets.

A taxpayer engaging in only packaging, repackaging, labeling, and minor assembly operations must disregard the substantial in nature and safe harbor tests because these are not MPGE activities.

Example 3A-6 Property has been manufactured by the taxpayer *in significant part*.

Fast Car, Inc., an S corporation, operates a classic kit car assembly plant in the U.S. It purchases engines, transmissions, and certain other components from Auto Supply, Inc., an unrelated party, and assembles the component parts into autos. On a per-unit basis, Fast Car's selling price and costs are as follows:

Selling price		$ 2,500
Cost of goods sold		
Material—Acquired from Auto Supply	1,475	
Direct labor and overhead	325	
Total cost of goods sold		(1,800)
Gross profit		700
Administrative and selling expenses		(300)
Taxable income		$ 400

Although Fast Car's direct labor and overhead are less than 20% of each auto's per-unit cost of sales ($325 ÷ $1,800, or 18%), the final regulations say that its activities are substantial in nature, taking into account the nature and the relative value of its activity. Therefore, the autos will be treated as manufactured or produced in significant part by Fast Car within the U.S., even though the safe harbor test is not met.

Variation: Assume that Fast Car's direct labor and overhead total $525 per unit. Under these facts, Fast Car's direct labor and overhead are more than 20% of each auto's per-unit cost of sales ($525 ÷ $2,000, or 26%), so its activities are substantial in nature under the safe harbor rule.

Meeting the *In the United States* Requirement

Under IRC Sec. 7701(a)(9), the U.S. includes the 50 states, the District of Columbia, U.S. territorial waters, and the seabeds and subsoils of any waters adjacent to U.S. territorial waters that the U.S. has exclusive exploration and exploitation rights over. However, the term *United States* does not include U.S. possessions or territories or the airspace or space over the U.S. or that of any of its territories or possessions. For taxpayers with foreign activities, an allocation of the gross receipts will be necessary.

In some cases, a taxpayer imports a partially manufactured item and then finishes the process in the U.S. To the extent that the taxpayer's actions, given all of the facts and circumstances, are substantial, the gross receipts from the activity will qualify as DPGR. Conversely, if the taxpayer manufactures a product in the U.S. and then exports it, all of the gross receipts will be DPGR, regardless of whether the taxpayer imports the property back into the U.S. for final disposition.

Construction Activities

DPGR from the construction of real property performed in the U.S. includes proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer, including buildings, inherently permanent structures and land improvements, oil and gas wells, and infrastructure. Services such as grading, demolition, clearing, and excavating land are considered construction only if the taxpayer performs these services in connection with other activities that constitute the erection or substantial renovation of real property. A substantial renovation must increase the value of the property, prolong the property's useful life, or adapt the property to a new or different use. Construction does not include services such as hauling trash and delivering materials even if these services are essential for the construction, unless the taxpayer performing the construction provides these services. Administrative support services performed in connection with construction can be construction activities.

The regulations clarify that in order for a taxpayer to be considered in a construction NAICS code (generally, NAICS code 23), it must be engaged in a construction trade or business (but not necessarily its primary, or only, trade or business) on a regular and ongoing basis. The determination of whether an entity is in an NAICS code is generally tested on an entity-by-entity basis. Other construction activities also qualify if they are for the construction of real property (e.g., NAICS code 213111—drilling oil and gas wells). DPGR also includes compensation for construction services performed in the U.S.

Identifying Engineering or Architectural Services

DPGR includes gross receipts from engineering or architectural services if the services (1) relate to real property, (2) are performed in the U.S., and (3) are for construction projects in the U.S.

The taxpayer must be in the trade or business of performing engineering or architectural services on a regular and ongoing basis. The services must fall under an NAICS code for engineering (e.g., 541330) or architectural (e.g., 541310) services.

Engineering services include professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to professional services such as the evaluation, planning, design, or supervision of construction to ensure compliance with plans, specifications, and design.

Architectural services include the offering or furnishing of professional services such as consultation, planning, aesthetic, and structural design, drawings and specifications, or supervision of construction (to ensure compliance with plans, specifications, and design) in connection with any construction project.

Food or Beverage Sales

Food and beverages prepared at a retail establishment do not qualify for the deduction. A retail establishment is real property and personal property (e.g., a food cart) used in the trade or business of selling food or beverages to

the public if retail sales occur at the facility. A restaurant at which food and beverages are prepared, sold, and served to customers or a facility at which a taxpayer prepares food or beverage for take out or delivery would both be a retail establishment.

Food or beverages prepared at the facility and sold at wholesale are not treated as prepared at a retail establishment. Therefore, gross receipts related to wholesale transactions are eligible for the deduction. A taxpayer does not have to treat a facility at which food or beverages are prepared as a retail establishment if less than 5% of the gross receipts are from the sale of food or beverages.

Example 3A-7 Identifying a food or beverage activity that qualifies for the deduction.

StarCents is an S corporation that buys, roasts, and sells coffee beans. It also sells prepared coffee and other food that customers can eat in or take out. StarCents is engaging in two activities for Section 199 purposes. Buying, roasting, and selling the coffee beans qualifies as a production activity eligible for the Section 199 deduction because StarCents manufactured (roasted) the coffee beans. Sales of prepared coffee (e.g., cafe latte) and food do not qualify because the sale of food and beverages prepared at a retail establishment does not qualify for the deduction.

Determining Domestic Production Gross Receipts

Domestic production gross receipts (DPGR) is the taxpayer's gross receipts from the lease, rental, license, sale, exchange, or other disposition of qualified production property (QPP) that was manufactured, produced, grown, or extracted in whole or in significant part within the U.S. DPGR also consists of income from additional activities, including (1) qualified film produced by the taxpayer; (2) electricity, natural gas, or potable water produced in the U.S.; (3) construction performed in the U.S.; and (4) engineering or architectural services performed in the U.S. for U.S. construction projects. The IRS has concluded that, under the facts provided in the ruling, proceeds from the sale of leasehold rights were not DPGR since they were not derived from the construction of real property, but were acquired by entering into a lease with the landowner.

Gross receipts from a related party rental, lease, or license are excluded. For these purposes, a related party includes a commonly controlled business, whether incorporated or unincorporated, affiliated service group, or employee leasing agreement and similar arrangements.

Computing Gross Receipts

Gross receipts are computed using the taxpayer's normal method of accounting. Therefore, an S corporation could potentially recognize gross receipts (e.g., advance payments) in a different tax year than when the costs are recognized. Gross receipts include total sales net of returns and allowances, service income, investment income, and any other income from incidental or outside sources. Gross receipts also include interest, gains from the sale of property, dividends, annuities, and tax-exempt income (although these items will reduce the amount of the deduction because such income is not DPGR). Gross receipts exclude sales tax if the tax is imposed on the buyer and the S corporation merely collects the tax and pays it over to the taxing authority.

Cost of sales is not deducted, nor is the basis of property sold deducted if the property is not a capital asset under IRC Sec. 1221. Therefore, there is no basis reduction for property that is inventory, or that is held for sale to customers in the ordinary course of business.

Allocating Gross Receipts

S corporations that have both DPGR and non-DPGR must use a reasonable method to identify gross receipts that constitute DPGR. Whether the IRS will ultimately conclude a method is reasonable depends on such factors as whether the taxpayer has used the most accurate information available, the relationship between the gross receipts and the method used, the accuracy of the method selected compared with other alternatives, whether the method is used by the taxpayer for some other purpose (i.e. management), whether the method is used for other federal or state tax purposes, the burden of using alternative methods, and whether the method is consistently applied.

The IRS requires taxpayers to use a specific identification method if they use specific identification for other purposes (such as for financial statements or internal management documents). However, if specific identification

causes the taxpayer undue burden or expense, the IRS will consider other reasonable methods depending upon several factors, such as the consistency and accuracy of the method chosen.

S corporations that manufacture and sell an item that includes an embedded service (such as a maintenance agreement, warranty, delivery or installation service, or training) must allocate gross receipts between DPGR and non-DPGR because gross receipts from the performance of services do not qualify as DPGR (except for certain construction, engineering, and architectural services). However, taxpayers can include qualified warranty, delivery, operating manual, installation, and computer software maintenance agreement income in DPGR if the charge for the embedded service is included in the price charged for the item in the normal course of business, and the S corporation does not sell the embedded service without the product. In each case, the service must be included in the price of the product and not separately stated, or be available separately.

Example 3A-8 Determining treatment of gross receipts for embedded services.

Prime Performance, Inc., is an S corporation that manufactures air conditioning units, which it sells to retailers. Prime charges a delivery fee for delivering the units to the retailers. Prime separately states the delivery fee on the invoice. The retailers cannot purchase the units without paying the delivery fee. The delivery fee does not qualify as DPGR. Therefore, Prime must allocate its gross receipts between DPGR and non-DPGR.

However, if Prime includes the delivery fee as part of the purchase price of the air conditioning units (i.e., not separately stated), an allocation between DPGR and non-DPGR is not required.

There are a few exceptions to the requirement to allocate gross receipts between DPGR and non-DPGR. If less than 5% of total gross receipts are non-DPGR (such as interest income, gains from the sale of property, and dividends), then the S corporation can classify 100% of its gross receipts as DPGR. Likewise, S corporations with a *de minimis* amount of gross receipts (less than 5%) from embedded services may include the embedded service income as DPGR.

Allocating Costs to Gross Receipts

To determine the QPAI, taxpayers must subtract from DPGR the cost of goods sold allocable to DPGR, as well as other expenses, losses, or deductions (other than the DPAD itself) that are properly allocable to such receipts. The three methods for allocating and apportioning deductions are the Section 861 method, the simplified deduction method, and the small business simplified overall method.

Reg. 1.199-4(b) provides rules for determining cost of goods sold allocable to DPGR (including several LIFO options), while Reg. 1.199-4(c) provides rules for determining deductions properly allocable to DPGR. Reg. 1.199-4(e) enables certain taxpayers to apportion deductions (other than cost of goods sold) to DPGR using the simplified deduction method, while Reg. 1.199-4(f) authorizes use of the small business simplified overall method to apportion costs of goods sold and other deductions to DPGR.

Allocating Cost of Goods Sold

First, the cost of goods sold (COGS) allocable to the DPGR must be determined. COGS include any costs allocated to inventory under IRC Sec. 263A, or under the general inventory valuation rules, including appropriate LIFO adjustments. Thus, write downs to lower-of-cost-or-market or for subnormal goods must also be taken into account in computing COGS for the domestic production activities deduction. COGS also include the basis of any noninventory property if the sales proceeds are included in DPGR.

Taxpayers without any non-DPGR will simply subtract 100% of COGS (no identification is needed). Taxpayers with both DPGR and non-DPGR that cannot specifically identify costs without undue burden can use any reasonable method to allocate costs. Reasonable methods of allocation may include methods based on gross receipts, number of units sold, number of units produced, or total production costs. Consistency is key. If a particular method is used to allocate gross receipts between DPGR and non-DPGR, then using a different method to allocate COGS will not be reasonable, unless the method is demonstrably more accurate for COGS.

Taxpayers can use the small business simplified overall method (small business method) to allocate COGS (and other deductions) between DPGR and non-DPGR. To qualify for this method, the taxpayer must have average

annual gross receipts of $5 million or less or be a farmer not required to use the accrual method under IRC Sec. 447. Taxpayers with average annual gross receipts of $10 million or less, and who are allowed to use the cash method under Rev. Proc. 2016-29, also qualify for the small business method. Under this method, cost of goods sold allocable to DPGR equals: COGS × (DPGR ÷ total gross receipts).

Example 3A-9 Using the small business simplified overall method.

Custom Pianos builds custom pianos and provides piano tuning and repair services. Custom Pianos must allocate its income and deductions between its DPGR (piano manufacturing) and non-DPGR (piano service). Custom's gross receipts for the year are less than $5 million, so it qualifies to use the small business method. Custom Pianos' books and records show the following information for the year:

	Manufacturing	Services	Total
Gross receipts	$ 3,500,000	$ 380,000	$ 3,880,000
Cost of goods sold	2,100,000	190,000	2,290,000

Using the small business method, Custom Pianos would allocate $2,065,722 of its cost of goods sold to its qualifying manufacturing activity [($3,500,000 ÷ $3,880,000) × $2,290,000]. Custom Pianos' QPAI would be $1,434,278 ($3,500,000 − $2,065,722).

Had Custom used the specific identification method, its QPAI would have been $1,400,000 ($3,500,000 − $2,100,000). By using the simplified method, Custom has more QPAI, and thus a larger deduction.

Allocating Other Deductions and Costs

Other deductions and costs must be allocated under the (1) Section 861 method, (2) small business simplified overall method, or (3) simplified deduction method.

Under the Section 861 method, costs that are not directly allocable to DPGR or non-DPGR must be apportioned between them. Clearly, this can be a costly and burdensome calculation. While the resulting QPAI is more accurate than under the other two methods, the offsetting costs and complexity of computing QPAI and the record keeping requirements for using this method may exceed any benefit derived from using this method.

Taxpayers can use the small business simplified overall method previously described to allocate COGS and other deductions between DPGR and non-DPGR. Under this method, the other deductions allocable to DPGR equals: Other Deductions × (DPGR ÷ total gross receipts).

Taxpayers with average annual gross receipts of $100 million or less, or total assets of $10 million or less at the end of the tax year, can use the simplified deduction method. Even though the simplified deduction method works mechanically the same as the small business method, the taxpayer cannot use the simplified deduction method for cost of goods sold. Therefore, all the simplified deduction method does is extend the availability of the small business simplified overall method to allocate other deductions to taxpayers with average annual gross receipts between $5 million and $100 million. For S shareholders, the ability to use the simplified deduction method is determined at the shareholder level, not the S corporation level.

Taxpayers using the simplified deduction method or the small business simplified overall method must use that method for all deductions. Taxpayers eligible to use the small business simplified overall method may choose at any time to use that method, the simplified deduction method, or the Section 861 method for a tax year. Taxpayers eligible to use the simplified deduction method may choose at any time to use that method or the Section 861 method for a tax year.

Using Statistical Sampling to Make Allocations

The calculation of allocable expenses and QPAI can be burdensome, particularly where large amounts of data are involved. To provide some relief, the use of statistical sampling is permitted to, in part: (1) allocate gross receipts between DPGR and non-DPGR sources, (2) allocate COGS between DPGR and non-DPGR, and (3) allocate various deductions between DPGR and non-DPGR.

Whether statistical sampling is appropriate is based on the facts and circumstances, including the time required to analyze large volumes of data, the cost of that analysis, the existence of verifiable information about the taxpayer's Section 199 calculation, and the availability of more accurate information. Statistical sampling will generally be allowed when the taxpayer can show a "compelling reason" to use it.

Determining W-2 Wages

The DPAD is driven by the DPGR, but is limited to 50% of the W-2 wages paid by the S corporation during the year that are properly allocable to DPGR.

W-2 wages for Section 199 purposes include wages subject to income tax withholding, wages that are employee elective deferrals, and employee designated Roth contributions. To count the wages the taxpayer must actually report them on Form W-2 and file the W-2s with the Social Security Administration no later than 60 days after the extended due date for filing the forms. If corrected W-2s are filed after the 60th day after the extended due date, any increase in W-2 wages is disregarded while any decrease in W-2 wages will reduce the 50% of wages limitation for computing the deduction.

S corporations have three options for computing the W-2 wages allocable to DPGR:

1. *Unmodified Box Method.* W-2 wages are the wages computed by taking the lesser of W-2 Box 1 (Wages, tips, other compensation) or Box 5 (Medicare wages).

2. *Modified Box 1 Method.* This method starts with the total of W-2 Box 1 wages, then subtracts any amounts in Box 1 that are not wages for income tax withholding purposes and amounts included in W-2 Box 1 that are treated as wages under IRC Sec. 3402(o), such as supplemental unemployment compensation benefits. Then add to this amounts reported in W-2 Box 12 that are coded D, E, F, G, or S.

3. *Tracking Wages Method.* This is the most complex method, since it requires the S corporation to track total wages subject to federal income tax withholding and then make appropriate modifications. The modifications include adjustments for supplemental unemployment compensation and amounts reported in W-2 Box 12 that are coded D, E, F, G, or S.

AMT Implications

The DPAD is applicable for both regular and alternative minimum tax (AMT) purposes. Thus, alternative minimum taxable income (AMTI) is reduced by the DPAD.

Determining Qualified Production Activities Income

QPAI equals the taxpayer's DPGR less cost of goods sold and other deductions, expenses, and losses allocable to DPGR.

Computing the Deduction

To compute the DPAD:

Step 1 Compare QPAI to taxable income and select the lower amount.

Step 2 Compute the tentative deduction by multiplying the result from Step 1 by 9%.

Step 3 Compute the 50% of wages limitation using the rules provided in the preceding paragraphs.

Step 4 Compare the results from Step 2 and Step 3 and deduct the lesser amount.

Applying the Special Section 199 Pass-through Rules

Deduction Claimed at the Shareholder Level. The domestic production activity deduction is claimed by the shareholder(s), and each shareholder calculates his or her deduction separately. Each shareholder aggregates his

or her share of S corporation pass-through items with the items incurred outside the corporation when allocating and apportioning deductions to DPGR and computing its QPAI.

S corporation deductions are taken into account in computing a shareholder's DPAD only to the extent the stockholder's prorata share of those deductions is not disallowed under the at-risk rules, the passive activity loss rules, the basis rules, or any other provision of the Code. If part of the stockholder's share of the losses or deductions is allowed for the year, a proportionate share of those allowable losses or deductions that are allocated to the S corporation's qualified production activities is taken into account in computing the DPAD for the year. If any of the disallowed amounts are allowed in a later year, the stockholder takes into account a proportionate share of those losses or deductions in computing QPAI for that later year.

Each shareholder must aggregate the W-2 wages allocated from the S corporation with its W-2 wages from other sources to compute the Section 199(b)(1) limitation for the year. (See Example 3A-10.)

Passing Through Domestic Production Activity Deduction Information. There are two methods of passing through the deduction information to shareholders:

1. An eligible S corporation can pass through QPAI and W-2 information only, if it so chooses.

2. Other S corporations pass through the information relating to the separate components of the deduction to provide shareholders with all of the information necessary to calculate the deduction.

Pass-through of QPAI and W-2 Wage Information Only. An eligible S corporation can choose to calculate an owner's share of QPAI and W-2 wages at the entity level. If QPAI is calculated at the S corporation level, each shareholder is allocated his or her share of QPAI and W-2 wages from the entity, which is then combined at the shareholder level with any QPAI and W-2 wages from other sources. Rev. Proc. 2007-34 explains the conditions when an "eligible entity" can choose to calculate QPAI and W-2 wages at the entity level and the rules for making the calculation. An S corporation is an eligible entity if it is one of the following:

- Eligible small pass-though entity, which is an entity that meets the requirements of Reg. 1.199-4(f)(2), and has total costs of $5 million or less. The entity must use the small business simplified overall method of Reg. 1.199-4(f) to calculate QPAI at the entity level. W-2 wages may be calculated using the small business simplified overall method or some other reasonable method.

- Eligible widely-held pass-through entity, which is an entity that is an eligible taxpayer under Reg. 1.199-4(e)(2), and so has average annual gross receipts of $100 million or less or total assets of $10 million or less. Additionally, the entity must have COGS and deductions of $100 million or less, and must be comprised on every day of its current tax year of owners that are individuals, estates, or trusts described in IRC Sec. 1361(c)(2). The entity must use the simplified deduction method of Reg. 1.199-4(e) to calculate QPAI at the entity level. W-2 wages can be calculated using the wage expense safe harbor of Reg. 1.199-2(e)(2)(ii) or some other reasonable method.

An S corporation that qualifies as both an eligible widely held pass-through entity and an eligible small pass-through entity for the year can choose to use either the simplified deduction method of Reg. 1.199-4(e) or the small business simplified overall method of Reg. 1.199-4(f) for calculating QPAI. If the entity uses the simplified deduction method, it can calculate W-2 wages using either the wage expense safe harbor or another reasonable method. If the entity uses the small business simplified overall method, it can calculate W-2 wages using either the small business simplified overall method safe harbor or another reasonable method.

Shareholders receiving an allocation of QPAI and W-2 wages cannot recalculate their share of QPAI or W-2 wages from the entity using another cost allocation method (although they must adjust QPAI from the entity to account for certain disallowed losses or deductions, and for the allowance of suspended losses or deductions).

An eligible entity that calculates QPAI at the entity level must allocate its QPAI for that tax year among the shareholders in the same proportion as gross income is allocated to the shareholders for the year. But if the entity has no gross income for the year, it must allocate QPAI among the shareholders in proportion to the shareholders' ownership interests. The eligible entity then allocates its W-2 wages among the shareholders in the same manner as it allocates wage expense for that tax year.

An S corporation that is an eligible widely held pass-through entity or eligible small pass-though entity and that chooses to calculate QPAI and W-2 wages at the entity level reports the allocable shares of QPAI and W-2 wages directly to the shareholders.

Example 3A-10 Calculating QPAI and W-2 wages under the small business simplified overall method.

Allison Jackson and Jack Sanders are equal shareholders in Jackson Sanders Plastics (JSP), a calendar year S corporation that generates DPGR and non-DPGR. While Jack has other manufacturing activities that generate DPGR and W-2 wages, Allison does not.

JSP qualifies as an eligible small pass-through entity. It chooses to calculate QPAI and W-2 wages allocable to DPGR at the entity level, and under Rev. Proc. 2007-34 uses the small business simplified overall method to allocate costs. For the current year, JSP has total gross receipts of $2 million ($1 million of which is DPGR), COGS of $900,000 (including $400,000 of wage expenses), and deductions of $700,000. JSP uses the safe harbor under Reg. 1.199-2(e)(2)(iii) to calculate W-2 wages. Accordingly, JSP's W-2 wages equal $200,000 [$400,000 of wages described in Reg. 1.199-2(e)(1) × ($1 million DPGR ÷ $2 million total gross receipts)].

Under the small business simplified overall method, JSP's COGS and deductions apportioned to DPGR equal $800,000 [($900,000 COGS + $700,000 of other deductions) × ($1 million DPGR ÷ $2 million total gross receipts)]. So, JSP's QPAI is $200,000 ($1 million DPGR − $800,000 COGS and other deductions).

JSP's QPAI is allocated $100,000 to Allison and $100,000 to Jack. JSP's W-2 wages are similarly allocated $100,000 to Allison and $100,000 to Jack.

Because Allison engages in no other activities generating DPGR, her tentative deduction is $9,000 ($100,000 share of QPAI from JSP × 9%), subject to the Section 199(b)(1) wage limitation (50% of her $100,000 share of W-2 wages from JSP).

Because Jack engages in other production activities generating DPGR, he must combine his $100,000 share of QPAI and his $100,000 share of W-2 wages from JSP with the QPAI and W-2 wages from the other sources. He cannot recompute his share of QPAI from JSP using another cost allocation method.

Pass-through of Domestic Production Activity Deduction Components. S corporations that are not eligible, and eligible S corporations that choose not to pass through only QPAI and W-2 information, pass through all the information necessary for the shareholder to determine the deduction. The S corporation enters code P with an asterisk (P*) on line 12 of Schedule K-1 and, to indicate that there is a statement attached, enters "STMT" in the space that would normally include an amount. The information that should be included in the statement is listed in the instructions to Form 1120S.

Effect of Section 199 Deduction on Basis

The DPAD has no effect on a shareholder's basis in the S corporation.

Reporting the Deduction

The DPAD is computed and claimed at the shareholder level on Form 8903 (Domestic Production Activities Deduction). Each stockholder's share of the S corporation's QPAI and W-2 wages for the year is reported on the shareholder's Schedule K-1, line 12, codes P, Q, and R. From there, it flows to the shareholder's Form 8903.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Which of the following would be considered *qualified production property (QPP)*?

    a. Sound recordings.

    b. Electricity.

    c. A building.

    d. A film.

14. KaraCorp is making allocations so it can claim the domestic production activities deduction. The S corporation has both domestic production gross receipts (DPGR) and non-DPGR, annual gross receipts of $112 million for the year, and $25 million total assets at the end of the year. Which allocation has the corporation made correctly?

    a. It attributes total gross receipts for a manufactured toy and its warranty as DPGR.

    b. It subtracts the total of cost of goods sold (COGS) from its DPGR.

    c. It uses the simplified deduction method to allocate other deductions and costs between DPGR and non-DPGR.

    d. It uses statistical sampling to make allocations between DPGR and non-DPGR.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. Which of the following would be considered *qualified production property (QPP)*? **(Page 57)**

    a. Sound recordings. [This answer is correct. Under the Code, QPP is tangible personal property, computer software, and sound recordings. Per IRC Sec. 199(c)(5), QPP does not include tangible property, other than computer software and sound recordings.]

    b. Electricity. [This answer is incorrect. Electricity produced by the client is excluded from the definition of tangible property under Reg. 1.199-3(j)(2)(i), so it does not qualify as QPP.]

    c. A building. [This answer is incorrect. Among other things, tangible property does not include land, buildings, inherently permanent structures, or land improvements; therefore, a building cannot be considered part of QPP under the Code.]

    d. A film. [This answer is incorrect. While the tangible medium on which a film is contained (i.e., a videocassette or computer disk) is tangible personal property, a qualified film produced by the taxpayer is excluded from the definition of tangible personal property outlined in Reg. 1.99-3(j)(2)(i). Therefore, it cannot be considered QPP.]

14. KaraCorp is making allocations so it can claim the domestic production activities deduction. The S corporation has both domestic production gross receipts (DPGR) and non-DPGR, annual gross receipts of $112 million for the year, and $25 million total assets at the end of the year. Which allocation has the corporation made correctly? **(Page 57)**

    a. It attributes total gross receipts for a manufactured toy and its warranty as DPGR. [This answer is incorrect. S corporations that manufacture and sell an item that includes an embedded service (such as a maintenance agreement, warranty, delivery or installation service, or training) must allocate gross receipts between DPGR and non-DPGR because gross receipts from performance of services do not qualify as DPGR (except for certain construction, engineering, and architectural services), per Reg. 1.199-3(i)(4).]

    b. It subtracts the total of cost of goods sold (COGS) from its DPGR. [This answer is incorrect. Taxpayers *without* any non-DPGR will simply subtract 100% of COGS (no identification is needed). Taxpayers with both DPGR and non-DPGR (like KaraCorp) will need to allocate COGS between the two.]

    c. It uses the simplified deduction method to allocate other deductions and costs between DPGR and non-DPGR. [This answer is incorrect. According to Reg. 1.199-4(c), taxpayers with average annual gross receipts of $100 million or less, or total assets of $10 million or less at the end of the tax year, can use the simplified deduction method. Because KaraCorp's annual gross receipts and total assets for the year are too high to use the simplified deduction method, it will need to use either the Section 861 method or the small business simplified overall method.]

    d. It uses statistical sampling to make allocations between DPGR and non-DPGR. [This answer is correct. The calculation of allowable expenses and qualified production property (QPAI) can be burdensome, particularly where large amounts of data are involved. To provide some relief, the use of statistical sampling is permitted to, in part (1) allocate gross receipts between DPGR and non-DPGR sources, (2) allocate COGS between DPGR and non-DPGR, and (3) allocate various deductions between DPGR and non-DPGR. Therefore, based on the guidance in Rev. Procs. 2007-35 and 2011-42, KaraCorp is allowed to use statistical sampling for these purposes.]

Passing Charitable Contributions through to the Shareholders

S Corporation Charitable Contributions Are Not Deducted at Corporate Level

An S corporation is not entitled to deduct a contribution to a charitable organization. Instead, the total amount of contributions paid by the corporation during the tax year is reported on line 12a (Contributions) of Schedule K, and each shareholder's share of the contributions is reported on line 12, Codes A–G, of the shareholder's Schedule K-1. Each shareholder reports his or her share of the charitable contributions on Schedule A of Form 1040. The limitation on charitable contributions by regular C corporations does not apply to S corporations. However, an individual shareholder's deduction in a tax year is subject to various limitations. A full discussion of those limitations is beyond the scope of this course, but more information is available in *PPC's 1040 Deskbook*.

Passing Through Property Contributions Other Than Cash

In general, the amount passed through to the shareholders due to a contribution of appreciated long-term capital gain property equals the FMV of the property on the date of the contribution. However, the amount passed through due to the contribution of inventory or other ordinary income property is the FMV of the property less the amount that would have been recognized as gain other than long-term capital gain if the property had been sold at its FMV. Thus, the amount of pass-through to shareholders for contributions of ordinary income property is generally limited to the corporation's tax basis in the property.

Alternative Minimum Tax. Charitable contributions are not adjustments for purposes of the AMT. Thus, a contribution deduction allowed for the FMV of property applies in computing both regular tax and AMT.

Adjusting Cost of Goods Sold for Charitable Contributions of Inventory. If inventory is contributed in the same year as its cost was incurred, and that cost would normally be included in cost of goods sold (COGS), the deduction for the item(s) is reported as COGS. If the inventory is contributed after the year its cost was incurred, and the cost is included in beginning inventory, the contribution is not included in COGS but instead is deducted as a charitable contribution under IRC Sec. 170. To avoid deducting the inventory again, the preparer should reduce the beginning inventory reported by the costs of the contributed property and explain the reduction on an attachment.

Contributions of Food Inventory

Taxpayers (other than C corporations) engaged in a trade or business can claim an enhanced charitable deduction for donations of apparently wholesome food inventory. An S corporation reports these contributions on line 12a of Schedule K and line 12 of Schedule K-1, Code C, and attaches an explanatory statement.

Qualified Conservation Easements

The enhanced deduction rules for contributions of qualified conservation easements allows the FMV of any qualified conservation contribution to be deductible to the extent of 50% of the taxpayer's contribution base over the amount of all other allowable charitable contributions. The carryover period for such contributions in excess of the AGI limit is 15 years. For a qualified farmer or rancher, the qualified conservation contribution deduction for donated farm or ranch real property can be 100% of AGI. An S corporation reports these contributions on line 12a of Schedule K and line 12 of Schedule K-1, Code C, and attaches an explanatory statement. Without the enhanced deduction rules for qualified conservation contributions, the deduction for these contributions is limited to 30% of AGI. The carryover period for such contributions in excess of the AGI limit is five years.

Effect on Stock Basis

Each shareholder reduces basis in the corporation by his or her proportionate share of deduction items (including charitable contributions) passed through on Schedule K-1. Deductions passed through from the S corporation in excess of the shareholder's basis in stock and qualifying debt are suspended and carried over by the shareholder to the following year.

Effect on the Accumulated Adjustments Account (AAA)

An S corporation reduces its AAA by charitable contributions that are passed through to shareholders for the year.

Substantiation Requirements

Taxpayers are allowed a deduction for charitable contributions of $250 or more only if the contribution is substantiated by a written acknowledgment from the charity. Multiple contributions can be acknowledged in a single statement covering the entire year. Also, payments of less than $250 do not have to be aggregated when determining if the $250 threshold has been met. The acknowledgment can be made either on paper or electronically, such as via an email addressed to the donor. It must be obtained by the earlier of the date the taxpayer files a return for the tax year in which the contribution was made or the due date (including extensions) for filing that return for the contribution to be deductible (and so must be obtained by the time an early filed return is filed). The S corporation must satisfy the substantiation requirement for its charitable contributions passed through to the shareholders.

An S corporation satisfies the $250 or more substantiation requirement by obtaining from the charity a written acknowledgment that lists the amount of cash and describes (but does not value) any other property received from the corporation. The acknowledgment should state whether the charity provided any goods or services in return for the contribution and, if so, describe them and provide a good faith estimate of their value. (If the charity provides only intangible religious benefits, the acknowledgment should state this, but not value the benefit.)

Contributions by Cash, Check, or Credit Card Require Substantiation. To substantiate a contribution by check, cash, or other monetary gift, the donor must maintain a bank record or written communication from the recipient showing the name of the recipient organization, and the date and amount of the contribution. This rule applies to any such contribution, no matter how small. For contributions made by credit card, the taxpayer must keep the credit card statement showing the name of the charitable organization, as well as the amount and date of the contribution.

Contributions of Vehicles. Form 1098-C (Contributions of Motor Vehicles, Boats, and Airplanes) is used to substantiate the contribution to a charity of a qualified vehicle with a claimed value of more than $500.

Reporting Requirements

If the corporation contributes property and the aggregate amount reported on Schedule K exceeds $500, Form 8283 (Noncash Charitable Contributions) must be completed and attached to Form 1120S. The corporation must furnish a copy of the form to each shareholder if the amount reported for any item of property or group of similar items exceeds $5,000, even if the amount allocated to each shareholder is $5,000 or less. While the corporation need not provide shareholders with a copy of the form if the $5,000 threshold is not exceeded, it must still notify them of their shares of the FMV of the contributed property and provide other information to enable them to complete their own Forms 8283, if necessary. This notification is made on an attachment to the K-1.

Property Contributions of More Than $5,000. For property contributions greater than $5,000 (other than publicly traded securities), the taxpayer must attach a completed Section B (Appraisal Summary) of Form 8283 (Noncash Charitable Contributions) signed by the appraiser to the tax return. Also, the donee organization must complete a portion of Form 8283. There are additional requirements for property contributions valued at more than $500,000.

Exceptions to Reporting Rules. Exceptions to these reporting rules exist. The appraisal requirement in connection with the $5,000 and $500,000 threshold requirements does not apply to contributions of cash, publicly traded securities, vehicles subject to a donee acknowledgment form, and other contributions where the deduction is limited to basis, such as contributions of inventory, patents, and other intellectual property. A deduction will be allowed if the taxpayer can demonstrate that the failure to meet the disclosure or appraisal requirements was due to reasonable cause and not willful neglect. In determining the thresholds, all similar items of property donated to one or more donees are aggregated as a single contribution.

Timing of the Charitable Contribution Deduction

The general rule is that a charitable contribution is deductible in the year paid, regardless of whether the taxpayer uses the cash or accrual method of accounting.

An accrual-basis C corporation can elect to deduct an unpaid contribution that is authorized by the board of directors prior to year-end if it is paid on or before the 15th day of the third month following the end of the tax year.

However, the IRS has ruled that this election cannot be made by an accrual-basis S corporation. Instead, an S corporation passes through a charitable contribution in the year paid, regardless of whether it uses the cash or accrual method of accounting.

Special Rule When Donor Receives the Right to Athletic Event Tickets

A special rule applies to certain charitable contributions made to colleges or universities when the donor receives (directly or indirectly) the right to purchase tickets for athletic events at the institution's stadium. The deduction for such contributions is limited to 80% of the amount contributed.

Charitable Contributions Passed through to an Electing Small Business Trust (ESBT)

Charitable contributions passed through by an S corporation to an ESBT are beyond the scope of this course. However, more information is available in *PPC's 1120S Deskbook.*

Effect of Charitable Contributions on Built-in Gains Tax

Charitable contributions of appreciated property are not subject to the built-in gains tax. More information on this topic is available in *PPC's 1120S Deskbook*.

Expenses for Lease and Rent Payments

Rent and Lease Payments

Generally, if a deposit is held to secure the lessee's performance and must be repaid upon lease termination (assuming lessee compliance with the lease), the deposit is not taxable to the lessor or deductible by the lessee. If a deposit represents prepayment by the tenant of the last month's rent under the lease, it is treated as advance rent and is taxable to the lessor as income upon receipt regardless of the lessor's accounting method. Monthly or other periodic payments are deductible if paid for the use of property not owned by the business. Payments resulting in acquisition of equity are capital expenses and are not deductible. No deduction is allowed for an accrued rent expense payable by an accrual method corporation to a cash basis related party. The corporate payer is deemed to be on the cash method with respect to the related party and may not deduct the amount until paid.

Lease Acquisition Costs. Commissions, bonuses, or fees paid to acquire a lease are amortized over the life of the lease. If an existing lease is acquired from another lessee, any additional costs incurred in securing the lease are also amortized over the life of the lease.

Lease Termination Payments. If a termination payment takes the form of damages to release a lessee from an unprofitable contract, the amount is a deductible business expense. If the lease is terminated so the taxpayer can acquire new property, such as when a company moves its headquarters, the termination payment is an acquisition cost for the new property and must be capitalized.

Leasehold Improvements. A lessee/tenant must use MACRS depreciation for the class of property being leased with the unrecovered basis allowed as a loss when the lease is terminated. If the tenant reimburses the landlord for improvements, the cost is considered advance rent, which is deductible over the remaining lease term. If the remaining lease term is shorter than the MACRS recovery period, it may be advantageous for the tenant to reimburse the landlord for the cost of the improvements.

Reporting Directors' Fees

Compensation paid to the directors of an S corporation is deductible if it is paid for services rendered and is reasonable in amount. There is no line item on Form 1120S for "Directors' fees." They should be included in the "Other deductions" line on the first page of the form (and should be separately listed on the "Other deductions" supporting statement attached to the return). An employee who is also a director should be entitled to receive fees for attending directors' meetings in addition to compensation as an employee. Since the directors determine compensation paid by the corporation, they in effect set the fees they will receive. However, the fees should withstand IRS scrutiny if they are in line with the industry-wide norm.

Directors' Fees Are Reported on Form 1099-MISC

Directors' fees are reported by the corporation to the IRS and the directors on Form 1099-MISC (Miscellaneous Income) in the year paid. The form must be filed for each director who is paid $600 or more during the year. Therefore, it is possible that the corporation will be required to file a Form 1099-MISC to report payments to some but not all directors (e.g., a director who resigns early in the year may be paid less than $600 during the year).

Directors' Fees Are Earnings from Self-employment

Fees paid for attending directors' meetings and for serving as a director represent self-employment earnings. Therefore, a director will be liable for self-employment tax in the year fees are received.

Example 3D-1 Timing of self-employment tax liability on directors' fees.

John serves as a director of Essco, Inc., an S corporation, and has no other source of self-employment income. He attends the annual directors' meeting held on December 15, 2016, and incurs no expense in doing so. On January 15, 2017, Essco pays John a director's fee of $700. Since the corporation must report the fee in the year paid, it will report the $700 fee to John on a Form 1099-MISC for 2017.

Eligibility for Retirement Plan Contributions. Because an individual's directors' fees represent self-employment earnings, the director can base retirement plan contributions on the fees.

Directors' Travel Expenses. Travel expenses incurred by directors attending meetings are deductible on Schedule C, assuming the substantiation requirements of IRC Sec. 274(d) are met. Because directors are considered self-employed, they can claim travel expenses on their personal returns as above-the-line deductions. Alternatively, a director can obtain reimbursement from the corporation, in which case the corporation deducts the reimbursed amount on the first page of Form 1120S in computing its ordinary (i.e., nonseparately stated) income or loss.

Dealing with Advertising, Professional Fees, and Other Selected Business Deductions

Ordinary and Necessary Business Expenses

An S corporation can generally deduct its ordinary and necessary expenses paid or incurred in carrying on its trade or business. Certain expenses, however, are not deductible at the corporate level, but are instead passed through to shareholders to be deducted or otherwise treated on his or her personal return. This lesson discusses common business deductions and explains whether they are deductible at the corporate or shareholder level.

Advertising

Advertising costs that relate to business activities are deductible at the corporate level as current operating expenses. Prepaid advertising costs are deductible in the year to which they apply. Advertising expenses to influence legislation are not deductible. These expenses are separately stated and passed through to the shareholders as nondeductible items that reduce basis.

Professional and License Fees

Legal, accounting, and other professional fees that are ordinary and necessary expenses of operating a business are deductible. Annual license and regulatory fees paid to state or local governments generally are also deductible. However, licenses that are essential to the establishment of a business must be capitalized.

Research and Experimental Costs

An S corporation can deduct reasonable research and experimental costs as a current expense or elect to amortize them over 60 months. These include costs to provide information that would eliminate uncertainty about development or improvement of a product. The term *product* for this purpose includes a formula, invention, patent, pilot

model, process, or similar property. Costs of obtaining and perfecting a patent application are research and experimental costs, but costs to acquire another's patent are not. Research and experimental costs do not include costs for market research, management surveys, or normal product testing. If the S corporation deducts the expenses, an S shareholder reporting the pass-through can generally deduct the expenses currently or elect to amortize them over 10 years under IRC Sec. 59(e).

Utilities

Business expenses for heat, lights, power, telephone service, water, and sewerage are deductible at the corporate level. However, any payments allocable to a shareholder's personal use are not deductible. These personal expenses are passed through as separately stated items and reduce the shareholder's basis in the S corporation.

Insurance Premiums

An S corporation's insurance deduction includes premiums for (1) fire, theft, flood or other casualty insurance; (2) credit insurance to cover losses from unpaid debts; (3) group medical, disability, dental, or life insurance; (4) employer's liability and malpractice insurance; (5) business interruption insurance for lost profits if the corporation is shut down due to fire, natural disaster, etc.; (6) employee performance bonds to insure the faithful performance by employees; and (7) insurance for vehicles used for business purposes. Note that certain insurance payments made on behalf of a shareholder who owns more than 2% of the S corporation's stock may not be deductible unless included in the shareholder's wages.

Moving or Installing Machinery

The cost of moving machinery from one location to another is deductible at the corporate level. However, the cost of installing newly purchased machinery is added to the machinery's basis.

Outplacement Services

The cost of providing outplacement services to employees to help them find new employment is deductible if the services are based on need and a substantial business benefit exists for the employer (positive business image, maintaining employee morale, avoiding wrongful termination suits, etc.). If the employee can choose to receive cash or taxable benefits in place of the services, the value of the services is treated as compensation.

How to Address Penalties, Bribes, and Political Expenses

Penalties and Similar Expenses May Not Be Deductible

Certain penalties may be deductible by S corporations. Other penalties, fines, and similar expenses incurred by an S corporation are not deductible at either the corporate or shareholder levels. Rather, the expenses are passed through to shareholders as separately stated items and reduce the shareholders' bases in their S corporation stock.

Penalties and Fines

Penalties paid for late performance or nonperformance of a contract generally are deductible by S corporations. In contrast, penalties or fines paid to a government agency or instrumentality because of a violation of law are not deductible. These include amounts paid (1) because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding; (2) as a penalty imposed by federal, state, or local law in a civil action, including additions to tax and assessable penalties imposed by the IRS; and (3) to settle actual or possible liability for a fine or penalty, whether civil or criminal.

Bribes or Kickbacks

Payments made directly or indirectly to a government official or employee are not deductible if made in violation of the law. Furthermore, payments are not deductible if made to any person in violation of a federal or state law that

provides a criminal penalty for loss of license or privilege to engage in a trade or business. A kickback includes a payment for referring a client, patient, or customer. For example, assume that a ship repair company returns 10% of its repair bills to the captains of the ships it repairs. Although this practice may be an ordinary and necessary cost of getting business, if it violates the law, it is not deductible for tax purposes.

Political and Lobbying Expenses

Contributions to political parties or candidates, and expenses paid or incurred to take part in any political campaign of a candidate for public office, are not deductible. Dues paid to a tax-exempt organization are not deductible to the extent they are used by the organization for nondeductible lobbying activities. Paying for advertising in convention programs, admission to dinners, or inaugural events is an indirect political contribution and is not deductible if any of the proceeds are for the benefit of a party or candidate. An exception exists for expenses of lobbying a local governing body on local legislation that is of legitimate business interest to the taxpayer.

Payment of Shareholder's Expenses

In *Cavanaugh*, the Tax Court held that legal fees and $2.3 million paid to settle a wrongful death claim against an S corporation and its Chief Executive Officer (CEO) and sole shareholder were not deductible because the claim did not arise out of the company's business activities. The CEO was on vacation with his girlfriend when she died from a drug overdose. The girlfriend's family filed a wrongful death suit claiming the CEO and company employees supplied the drugs to her. Because the events resulting in the fees and settlement payment were not related to the company's profit-seeking activities, no deduction was allowed. While noting that similar decisions involving C corporations have resulted in constructive dividend treatment, the Tax Court stated that the IRS failed to introduce evidence of the S corporation's accumulated earnings and profits (AE&P) or the sole shareholder's basis in his stock, which left the court "with no grounds to decide if the distribution is a constructive dividend."

The Tax Benefit Rule for Recovering Previous Deductions

Tax Benefit Rule Applies When Subsequent Events Show Deduction Was Incorrect

In certain circumstances, an apparently completed transaction is unexpectedly reopened in a subsequent tax year, rendering the initial reporting improper. In that event, the tax benefit rule ordinarily requires taxpayers to include in gross income the amount of a prior year's deduction that is recovered or refunded. However, a recovery or refund of an amount attributable to an earlier year's deduction is included in income only to the extent the deduction reduced the tax imposed in the earlier year.

Example 3G-1 Collection of a previously deducted bad debt.

Hillco, Inc. is a calendar year corporation that started business and elected S status ten years ago. In January 2015, Hillco finds that a note receivable is uncollectible and makes an entry in its books to record a bad debt deduction. The debtor makes an unexpected financial recovery in December 2016 and pays the debt. Although the corporation's initial deduction of the bad debt was correct, subsequent events have resulted in the deduction being improper.

Under the tax benefit rule, the debt repayment must be included in income in 2016 (to the extent that the bad debt deduction in 2015 reduced the tax imposed that year).

When an S corporation recovers an expense that it deducted when it was a C corporation, the recovery passes through to the S corporation's shareholders as taxable income to the extent that the C corporation benefited from the initial deduction.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. How do S corporations deal with charitable contributions?

    a. The corporation will take a charitable deduction at the entity level.

    b. The corporation is subject to the same limitations as C corporations.

    c. An adjustment must be made for alternative minimum tax (AMT) purposes.

    d. An acknowledgment from the charity is needed if the contribution is over $250.

16. Which of the following is deductible by an S corporation?

    a. A deposit held to secure the performance of a lessee that will be repaid at the termination of the lease.

    b. The costs for an advertising campaign intended to influence forthcoming legislation.

    c. Reasonable costs for research and experiments performed by the S corporation.

    d. Bribes paid to a government official that are an ordinary and necessary cost of doing business.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. How do S corporations deal with charitable contributions? **(Page 73)**

    a. The corporation will take a charitable deduction at the entity level. [This answer is incorrect. According to IRC Sec. 1364(b)(2), an S corporation is not entitled to deduct a contribution to a charitable organization. Instead, the total amount of contributions paid by the corporation during the tax year is reported on line 12a (Contributions) of Schedule K, and each shareholder's share of the contributions is reported on line 12, Codes A—G, of the shareholder's Schedule K-1.]

    b. The corporation is subject to the same limitations as C corporations. [This answer is incorrect. The limitation on charitable contributions by regular C corporations does not apply to S corporations. However, an individual shareholder's deduction in a tax year is subject to various limitations.]

    c. An adjustment must be made for alternative minimum tax (AMT) purposes. [This answer is incorrect. Charitable contributions are not adjustments for purposes of the AMT, per IRC Sec. 56. Thus, a contribution deduction allowed for the FMV of property applies in computing both regular tax and AMT.]

    d. An acknowledgment from the charity is needed if the contribution is over $250. [This answer is correct. According to IRC Sec. 170(f)(8)(A), taxpayers are allowed a deduction for charitable contributions of $250 or more only if the contribution is substantiated by a written acknowledgment from the charity. An S corporation satisfies the $250 or more substantiation requirement by obtaining from the charity a written acknowledgment that lists the amount of cash and describes (but does not value) any other property received from the corporation.]

16. Which of the following is deductible by an S corporation? **(Page 76)**

    a. A deposit held to secure the performance of a lessee that will be repaid at the termination of the lease. [This answer is incorrect. Generally, based on the *Clinton Hotel Realty* and *Barker Estate* court cases, if a deposit is held to secure the lessee's performance and must be repaid upon lease termination (assuming lessee compliance with the lease), the deposit is not taxable to the lessor or deductible by the lessee. Therefore, if an S corporation is the lessee in this scenario, it cannot deduct the amount of the deposit.]

    b. The costs for an advertising campaign intended to influence forthcoming legislation. [This answer is incorrect. Per Reg. 1.263(a)-4, advertising costs that relate to business activities are deductible at the corporate level as current operating expenses. Advertising expenses to influence legislation, however, are not deductible according to IRC Sec. 162(e)(1).]

    c. Reasonable costs for research and experiments performed by the S corporation. [This answer is correct. An S corporation can generally deduct its ordinary and necessary expenses paid or incurred in carrying on its trade or business. When it comes to research and experimental costs, an S corporation can deduct reasonable research and experimental costs as a current expense or elect to amortize them over 60 months.]

    d. Bribes paid to a government official that are an ordinary and necessary cost of doing business. [This answer is incorrect. According to IRC Sec. 162(c), payments made directly or indirectly to a government official or employee are not deductible if made in violation of the law. Furthermore, payments are not deductible if made to any person in violation of a federal or state law that provides a criminal penalty for loss of license or privilege to engage in a trade or business.]

Lesson 4: Schedules K and K-1—Pass-through

Introduction

Generally, an S corporation is not taxed at the corporate level. Rather, it passes through items of income, loss, deduction, or credit to its shareholders who report those items on their personal returns. Pass-through is a reporting process, and is distinguished from distributions that occur when the shareholder receives cash or property from the corporation. Pass-through items are reported in total on the Form 1120S, Schedule K, and each shareholder's prorata share of the pass-through items is reported on Schedule K-1.

Certain topics relating to Schedules K and K-1 are beyond the scope of this lesson. Alternative minimum tax items [including amounts subject to Section 59(e) election] are discussed in Lesson 5. Other topics (such as distributions, business credits, and foreign taxes) that are considered beyond the scope of this course are covered in *PPC's 1120S Deskbook*.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify how nonseparately stated income or loss, separately stated items, reporting the results of operations, and allocating pass-through to shareholders affects Schedules K and K-1.
- Recognize how to deal with allocating income and losses in an S termination year, passing through corporate-level tax to shareholders, reporting self-charged interest, disclosing inconsistent treatment on the shareholder's return, deducting corporate expenses paid by the shareholder, limitations on loss and deductions, considering a beneficial owner to be an S corporation shareholder, and the effects of the 3.8% net investment income tax and the 0.9% additional Medicare tax on S shareholders.

Considerations for Nonseparately Stated Income or Loss and Separately Stated Items

Two Categories of Pass-through Items

Items that pass through to shareholders are divided into two main categories: nonseparately stated income or loss and separately stated items. The key to differentiating between the two is that separately stated items potentially can be treated differently by different shareholders because of elections, limitations, and special rules that must be applied at the shareholder level.

Nonseparately Stated Income or Loss

Nonseparately stated income or loss includes all *ordinary* income and expense items (computed under tax accounting rules) that are attributable to a trade or business and that do *not* need to be separately stated to the shareholders. The nonseparately stated income or loss amount is the "bottom line" amount on page 1 of Form 1120S where it is labeled "Ordinary business income (loss)."

Separately Stated Items

All other S corporation items of income, loss, deduction, or credit are required to be separately stated, that is, segregated and allocated as separate items to each shareholder. These separately stated items are those that, by their character and nature, have some distinction in the way they are treated on Form 1040. For example, limitations may apply, separate disclosure may be necessary, or using the item on the shareholder's return may require an election. The following are the more common items that are taken into account separately:

1. Income and loss from each rental activity.
2. Portfolio income, including interest, dividends, and royalties.
3. Tax-exempt income.

4. Net long-term capital gains or losses.
5. Net short-term capital gains or losses.
6. Gains and losses from sale or exchange of Section 1231 assets (i.e., those used in the corporation's trade or business).
7. Charitable contributions.
8. The Section 179 deduction; that is, expensing of certain depreciable assets.
9. Investment interest expense.
10. Items used in the computation of oil and gas depletion.
11. Intangible drilling costs.
12. Nondeductible expenses (including the nondeductible portion of meals and entertainment expenses and sky box rental).
13. Information necessary to calculate the domestic production activities deduction under IRC Sec. 199.
14. Information necessary to determine credits (e.g., wages subject to the Work Opportunity Credit).

Reporting Pass-through Items

The following example illustrates how separately and nonseparately stated items are passed through on Schedules K and K-1.

Example 4A-1 Reporting pass-through items.

Ann and Dan each own 50% of the shares of AD, Inc., an S corporation. AD's net income from its advertising business is $50,000. It receives $4,600 of tax-exempt interest income and recognizes a $10,000 long-term capital gain during the year. The corporation receives total dividends during the year of $6,000, $5,500 of which qualifies for the maximum 20% tax rate (for 2016).The company also makes $2,000 of charitable contributions. The nondeductible portion of meal and entertainment expenses is $3,400.

The $50,000 is nonseparately stated income, and the capital gain, dividend income, charitable contributions, tax-exempt interest income, and nondeductible portion of meals and entertainment expense are separately stated items.

Cancellation of Debt Income

Special rules apply to debt discharge income of bankrupt or insolvent taxpayers. Under these rules, bankrupt and insolvent taxpayers exclude debt discharge income from gross income. (This nontaxable income is often referred to as "excluded COD income.") However, as the price for income exclusion, certain tax attributes must be reduced. In the case of S corporations, the first tax attribute normally subject to reduction is the carryover losses of the corporation's shareholders that have been suspended because they lacked sufficient basis.

An S Corporation's Excluded COD Income Does Not Pass Through. Income from the cancellation of indebtedness of an S corporation that is excluded from the S corporation's income because the corporation is bankrupt or insolvent is not a pass-through item and does not increase the basis of any shareholder's stock.

Pass-through Income Is Generally Considered Received Evenly throughout Tax Year

S corporation income or loss is passed through to shareholders on a daily basis. For estimated tax purposes, an S corporation shareholder generally must make estimated tax payments as if the S corporation's pass-through items were received evenly throughout the tax year. However, an annualization method allows the S shareholder to base estimated tax payments on the S corporation's actual income at the end of each quarter.

Reporting Income and Deductions on Schedule K-1

Items Are Reported on Schedule K-1 Using Lines and Codes. The more common types of income, loss, and deductions have specific lines dedicated to them. However, some less common items are identified by an assigned code with several items broken out and reported on the same line.

Statements may need to be attached to Schedule K-1 to further identify or classify items. Even common items such as ordinary trade or business income reported on line 1 might require additional information. For example, if the S corporation has more than one trade or business, the S corporation will need to provide the shareholders with a statement showing the stockholder's share of the income or loss from each activity. The shareholder uses this information to address issues such as at-risk or passive loss limitations. A similar statement is attached to the Form 1120S showing the S corporation's income or loss on an activity-by-activity basis.

Some Schedule K-1 lines are informational in nature. They contain amounts needed solely to compute limitations on deductions or credits, or amounts needed to compute AMT or tax credit recapture. These informational lines do not contain amounts directly included in determining the shareholder's regular taxable income. (However, they may affect the shareholder-level computation of income, gain, loss, or deduction that is directly included in calculating the shareholder's taxable income.)

Many of the lines on Schedule K-1 are self-explanatory; therefore, the following discussion focuses on those requiring more explanation.

Line 10, Other Income (Loss). Line 10 has the following coded items:

A—Other portfolio income (loss);

B—Involuntary conversions;

C—Section 1256 contracts and straddles;

D—Mining exploration costs recapture; and

E—Other income (loss).

Items that should be reported under line 10, code E, include the following:

- Ordinary income recapture from the disposition of farm property (Form 4797) and other items to which IRC Sec. 1252 applies.
- Ordinary income recapture from the disposition of an interest in oil, gas, geothermal, or other mineral properties. In addition, a supporting statement must be attached.
- Recoveries of tax benefit items.
- Eligible gain from the sale or exchange of qualified small business stock as defined in IRC Sec. 1202(c).

If only one type of income is being reported on line 10 under code E, enter the code with an asterisk (E*) and the dollar amount in the space on line 10 and attach a statement containing details. However, if there are multiple types of income being reported on line 10 under code E, enter the code with an asterisk and enter "STMT" in the space on line 10 and attach a statement that shows a detailed description for all items under this code.

Line 12, Other Deductions. Line 12 has a number of coded items. Code S of line 12 is for other deductions that do not have a specific code allotted to them. Items that should be reported under code S, Other deductions, of line 12 include the following:

- Amounts (other than charitable contributions and items reported elsewhere) paid by the S corporation that would be itemized deductions on any of the shareholders' income tax returns if they were paid directly by a shareholder for the same purpose.
- Soil and water conservation expenditures.
- Expenditures for the removal of architectural and transportation barriers to the elderly and handicapped that the S corporation has elected to treat as a current expense.
- Separately stated interest expense allocable to debt-financed distributions.
- Interest paid or accrued on debt properly allocable to the shareholder's share of a working interest in any oil or gas property (if the liability is not limited).
- Penalty on early withdrawal of savings.
- Taxes paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held to produce income.

If only one type of income is being reported on line 12 under code S, enter the code with an asterisk (S*) and the dollar amount in the space on line 12 and attach a statement containing details. However, if there are multiple types of income being reported on line 12 under code S, enter the code with an asterisk and enter "STMT" in the space on line 12 and attach a statement that shows a detailed description for all items under this code.

Line 13, Credits. Credits are reported on Schedule K-1 on line 13 using codes A–P.

Line 15, Alternative Minimum Tax (AMT) Items. AMT adjustments and preferences are consolidated on Schedule K-1, line 15, and identified with codes A–F.

Line 17, Other Information. Line 17 is the catch-all line. Credit recapture items are included on line 17, codes E–H.

Code V, other information, is included on line 17 in addition to the specific codes provided for that line. Items that should be included on line 17, code V, include the following:

- Any information needed for shareholders filing Form 8886 (Reportable Transaction Disclosure Statement).
- Gross farming and fishing income.
- Basis in qualifying advanced coal project property.
- Basis in qualifying gasification property.
- Other information needed to reconcile the shareholder's tax basis to the information on Schedule K-1.

Reporting the Results of Operations

When Pass-through Is Reported by the Shareholder

The shareholder reports the pass-through items in the tax year that includes the last day of the S corporation's tax year.

Example 4B-1 When pass-through is reported by the shareholder.

Phil, a calendar-year individual, owns all of the shares of Fixtures, Inc., an S corporation. The corporation's tax year ends on October 31, 2017. Phil reports the pass-through items from Fixtures on his 2017 Form 1040.

Example 4B-2 When pass-through is reported if S election terminates during the year.

Flip, a calendar-year individual, owns all of the shares of Topp, Inc., an S corporation that uses a September 30 fiscal year-end. On December 1, 2016, the S election is terminated. Accordingly, the shareholder reports the pass-through items in the year that the S corporation's termination year ends. Since the term *S corporation termination year* includes both the S and C short years, Topp's termination year ends on September 30, 2017. Therefore, Flip reports the pass-through items arising in the S corporation's termination year, which began October 1, 2016, on his 2017 Form 1040.

Passing through the Domestic Production Activities Deduction

The domestic production activities deduction under IRC Sec. 199 is not reported on the front page of Form 1120S. Instead, it is computed and claimed at the shareholder level on Form 8903 (Domestic Production Activities Deduction). Each shareholder's share of the S corporation's qualified production activities income and W-2 wages for the year are reported on the shareholder's Schedule K-1, line 12, codes P–R. From there, these items flow to the shareholder's Form 8903. The deduction was covered in Lesson 3.

Pass-through to an S Corporation Partner

S corporation restrictions generally revolve around the types of entity that can hold S corporation stock, not the types of investments that an S corporation can hold. Thus, an S corporation can hold stock in another corporation, a partnership interest, or an interest in an LLC.

If the S corporation owns an interest in a partnership, the partnership issues a Schedule K-1 to the corporation. The S corporation then reports the pass-through items on the appropriate lines of its Form 1120S. For example, any ordinary income or loss shown on the partnership Schedule K-1 is reported on Form 1120S, page 1, line 5 [Other income (loss)]. Interest and dividends passed through from the partnership are reported as separately stated items on lines 4 and 5, respectively, of Schedules K and K-1, Form 1120S. The corporation reports income or loss from rental activities other than real estate on line 3 of Schedule K and K-1. Income or loss from a rental real estate activity is entered on Form 8825 (Rental Real Estate Income and Expenses of a Partnership or an S Corporation) and carried to line 2 of Schedules K and K-1. A statement must be attached to the corporate return showing the partnership's name, address, and taxpayer identification number. Reporting of pass-through from a partnership is illustrated in Examples 4B-3, 4B-4, and 4B-5.

Reporting Multiple Activities on Schedule K-1

If the S corporation conducts more than one activity, the stockholder's share of income or loss from each activity must be reported separately to all shareholders. The schedule detailing the activity-by-activity pass-through is attached to each shareholder's Schedule K-1. (See Example 4B-3.)

Example 4B-3 Attachments to Form 1120S and Schedule K-1 when there is more than one activity.

Jack Cassidy is the sole shareholder in JC, Inc., an S corporation. JC conducts two business activities—manufacturing and operating a convenience store. JC also owns a rental building and holds portfolio investments that produce dividend income. During the year, it shows income or loss as follows:

Manufacturing	$ 40,000
Convenience store	(30,000)
Rental real estate	(12,000)
Dividend income	7,000

JC also owns an interest in ABC Partnership and receives a Schedule K-1 from the partnership showing nonseparately stated income of $25,000 and a long-term capital loss of $6,000. The partnership Schedule K-1 indicates that the $25,000 is net income from self-employment.

The income and deduction amounts from the manufacturing and convenience store activities are combined and entered on the appropriate lines on page 1 of Form 1120S.

The $25,000 of income from the partnership is included on Form 1120S, page 1, line 5 [Other income (loss)].

Entering the preceding items on page 1 of Form 1120S will result in a net ordinary income amount of $35,000 on line 21 [Ordinary business income (loss)].

The rental income is reported on Form 8825 (Rental Real Estate Income and Expenses of a Partnership or an S Corporation), which is attached to the Form 1120S.

The $6,000 long-term loss passed through by the partnership is reported on Form 1120S, Schedule D.

Jack materially participates in the manufacturing and convenience store activities and actively participates in the rental real estate activity. He does not materially participate in the partnership activity. The S corporation, however, has elected to combine the manufacturing, convenience store, and partnership activities. This means that, because Jack is materially participating in the manufacturing and convenience store activities, he is considered to materially participate in the partnership as well. Jack must treat these activities as a group on his personal return because a shareholder cannot treat activities grouped together by the S corporation as separate activities.

In accordance with the instructions to Form 1120S, a schedule should be attached to Jack's Schedule K-1 breaking down all relevant items on an activity-by-activity basis. With this information, Jack can determine whether he meets the material participation or active participation requirements and track all suspended losses and credits on an activity-by-activity basis.

S Corporation's Treatment of Self-employment Income Passed through by Partnership

Pass-through income and distributions from an S corporation are not subject to self-employment tax. Example 4B-4 illustrates how an S corporation that holds an interest in a partnership treats self-employment income passed through by the partnership.

Example 4B-4 Treatment of self-employment passed through by a partnership to an S corporation.

Assume the same facts as in Example 4B-3. How does JC treat the self-employment income passed through by ABC Partnership?

Income passed through by an S corporation is not subject to self-employment tax. The $25,000 of self-employment income passed through from ABC Partnership to JC is included in the $35,000 of nonseparately stated income from the S corporation that Jack reports on his Form 1040, Schedule E. If Jack's Form 1040 includes a Schedule SE on which the self-employment tax is calculated, none of the $35,000 passed through by the S corporation is reported on that form.

An S corporation must pay reasonable compensation to its shareholders. Thus, the $35,000 pass-through from the partnership will ultimately be subject to social security and other employment taxes if it is withdrawn from the S corporation as shareholder wages.

Applying Basis Limitations to Losses Passed through by Partnership

Normally, losses are not limited at the S corporation level. However, limitations may apply at the corporate level when losses are passed through to an S corporation by a partnership. (See Example 4B-5.)

Example 4B-5 Basis limitations on losses passed through by a partnership to an S corporation.

Assume the same facts as in Examples 4B-3 and 4B-4, except that JC, Inc. also owns an interest in GHI Partnership. The corporation's basis in GHI is $10,000, and the partnership passes through a $25,000 loss to the S corporation. Both the S corporation and Jack have sufficient at-risk basis to deduct the $25,000 loss, and the loss is not subject to the passive activity rules. How much of the loss passes through to Jack?

Losses generally are not limited at the S corporation level, but are instead applied at the shareholder level. An exception to this rule may occur, however, when another entity, such as a partnership, passes through losses

to the S corporation. JC (the S corporation partner) would be subject to the partnership rule that a partner can deduct losses only to the extent of the partner's basis. Thus, JC evidently deducts $10,000 of the loss and passes through that amount to Jack. The remaining $15,000 loss is carried over by JC and passed through to Jack as the S corporation acquires basis in its partnership interest in GHI. Jack is subject to the S corporation rules, so he can deduct the $10,000 loss to the extent he has stock and debt basis. Any of the loss that cannot be deducted by Jack because of a lack of basis carries over at the shareholder level to be deducted by him as he acquires basis.

The Allocation of Pass-through to Shareholders

Pass-through Items Are Generally Allocated on a Per-share, Per-day Basis

Pass-through items generally are allocated to shareholders on a per-share, per-day basis under IRC Sec. 1377(a)(1). This means that pass-through items for the entire year are allocated equally to each day of the tax year and then are allocated equally among the shares of stock outstanding on each day of the tax year. Unlike partnerships, S corporations are not permitted to make special allocations to shareholders. For example, if two shareholders each own 50% of the shares of an S corporation for the entire year, all of the pass-through items for that year, without exception, are allocated 50% to each shareholder. However, special rules require or allow the shareholders to allocate pass-through items based on the company's operations through a certain date when the S election terminates or an election to use specific accounting is made. The elections to use specific accounting are discussed later in this lesson.

Example 4C-1 Per-share, per-day rules.

Alice and Betty each own 50% of the shares of ABC, Inc., an S corporation. On July 31, Charlene acquires half of Betty's shares. Through July 31, the corporation's books showed $50,000 of income, but for the remaining five months of the year the corporation showed a $45,000 loss, resulting in $5,000 net income for the year. The only pass-through item on the corporation's Schedule K is income from the business in the amount of $5,000.

If Alice and Betty had retained their original shares all year, the $5,000 income would have been passed through 50% to Alice and 50% to Betty, and each would have reported $2,500 income on her individual tax return. However, the introduction of a new shareholder complicates the allocation process. According to the Code, each pass-through item is first divided by the number of days in the tax year, then that amount is allocated equally among the shareholders who held shares on each day. [A day is not counted if the corporation has no shareholders on that day.] The instructions to the Form 1120S, however, provide a simplified method that can be used. Under this method, the percentage of stock owned is multiplied by the percentage of the year that it is owned, as follows:

	(a) % of Stock	(b) % of Year	(c) (a) × (b)	(d) Total %
Alice	50%	100.00%	50.00%	50.00%[a]
Betty	50%	58.08%[b]	29.04%	
	25%	41.92%[c]	10.48%	39.52%[a]
Charlene	25%	41.92%	10.48%	10.48%[a]
Total				100.00%

The percentages from column (d) are applied to each item of pass-through, so the corporation's $5,000 of ordinary income is allocated and passed through as follows:

Alice	50.00%	$ 2,500
Betty	39.52%	1,976
Charlene	10.48%	524
Total		$ 5,000

Under the facts of this example, the corporation was not eligible to make a specific accounting election upon complete disposition of a shareholder's stock because only a portion of Betty's stock was sold. The corporation did

qualify, however, to make the election to use specific accounting upon a qualifying disposition of a shareholder's stock because Betty disposed of more than 20% of the corporation's outstanding shares during a 30-day period. These elections are discussed later in this lesson.

Notice that the corporation's income at the date Charlene acquired stock is inconsequential. The entire year's income is allocated to each shareholder on a per-share, per-day basis for the entire tax year unless the S election terminates or an election to use specific accounting is made. move paragraph here from above the example "Under the facts....

Notes:

[a] Instructions to Form 1120S indicate that these percentages should be used for Schedule K-1, item F, as percentages of stock ownership for the tax year.

[b] 212 days/365 days (The percentage would be based on 366 days in a leap year.)

[c] 153 days/365 days

Election to Use Specific Accounting upon Complete Disposition of a Shareholder's Stock

If a shareholder's entire interest in an S corporation is disposed of, the corporation can elect under IRC Sec. 1377(a)(2) to allocate pass-through items based on the actual transactions that occurred before and after the stock disposition took place. This election is referred to as the "specific accounting election." (It is also known as the "election to use normal accounting rules" and the "election to treat the tax year as if it consisted of two tax years.") All shareholders *affected* by the stock disposition must consent. The shareholders affected by the disposition include all shareholders who disposed of shares and all shareholders who acquired shares during the tax year. If the shares were transferred to the corporation, all shareholders who owned stock during the year are affected shareholders.

If the election is made, the first short tax year is considered to end on the last day the shareholder owned the shares. The corporation determines its income or loss through that day using its normal method of tax accounting, and the allocation to shareholders is based on the actual transactions that occurred during each period. The election affects allocation of pass-through only. The S election does not actually terminate; only one tax return (and one Schedule K-1 per shareholder) is filed for the entire year. If the election is not made, the pass-through to shareholders is a per-share, per-day allocation of the S corporation's pass-through amount.

The specific accounting election applies only if a shareholder's entire interest in the S corporation is sold or otherwise transferred. [As discussed later in this lesson, the Section 1368 regulations (covering distributions) authorize the corporation to make a similar election if a shareholder disposes of 20% or more of the corporation's outstanding stock or if certain other stock transactions occur.]

The specific accounting election is made by attaching a statement to a timely filed original or amended Form 1120S for the year in which the stock disposition occurred. The statement must declare that the corporation elects under IRC Sec. 1377(a)(2) and Reg. 1.1377-1(b) to treat the tax year as if it consisted of two tax years. The statement should say that all affected shareholders consent to the election. (The actual shareholder consents should be kept in the corporation's files and should not be attached to the Form 1120S.) It should also set forth the stock disposition date and other facts relating to the disposition (e.g., a sale of the shareholder's entire interest in the corporation).

Example 4C-2 Election to use specific accounting upon complete disposition of a shareholder's interest.

The stock of EFGH Corp. is held by Edna, Flo, and Gina, who each own 33 shares on January 1. Gina sells all of her stock to a new shareholder, Helen, on June 30 for $35,000. EFGH has been an S corporation since it incorporated several years ago. It reports on a calendar year, and all of the shareholders materially participate in the operations of the business. The corporation's income for the year ending December 31 is $60,000. No distributions were made during the year.

Gina had basis of $15,000 in her stock at the beginning of the year. The corporation had net income for the year of $60,000, made up of a loss of $40,000 through June 30 and income of $100,000 for the remainder of the year. Gina was paid $50,000 of salary during the year. She has other income that brings her into the 35% tax bracket.

Variation 1: Generally, items of corporate income, loss, deduction, and credit for the entire year are passed through to each shareholder on a per-share, per-day basis.

Using the above facts, income would be passed through using a per-share, per-day calculation based on a 365-day year (366 in a leap year), as follows:

Edna (33.3% of shares × 365/365 of year)	$ 20,000
Flo (33.3% of shares × 365/365 of year)	20,000
Gina (33.3% of shares × 181/365 of year)	9,919
Helen (33.3% of shares × 184/365 of year)	10,081
Total	$ 60,000

Variation 2: Since Gina disposed of all her shares during the year, EFGH can make the specific accounting election (i.e., elect to treat the year as if it consisted of two short years). The first short year would be considered to end at the close of business on June 30. The second short year ends on December 31. Gina and Helen are affected shareholders and must consent to the election. Edna and Flo need not consent.

If the specific accounting election is made, the loss for the short year ending June 30 is allocated to the shareholders during that period on a per-share, per-day basis (using the number of days in the short year). The income for the six months ending December 31 is likewise allocated to the shareholders during that period, as the following chart shows:

	1/1–6/30	7/1–12/31	Total
Edna	$ (13,334)	$ 33,334	$ 20,000
Flo	(13,333)	33,333	20,000
Gina	(13,333)	—	(13,333)
Helen	—	33,333	33,333
Totals	$ (40,000)	$ 100,000	$ 60,000

	Per-share, Per-day	Specific Accounting
Edna	$ 20,000	$ 20,000
Flo	20,000	20,000
Gina	9,919	(13,333)
Helen	10,081	33,333
Totals	$ 60,000	$ 60,000

The same amount of income ($20,000) is allocated to Edna and Flo, the two shareholders who held the same percentage of shares all year, under the per-share, per-day method and the specific accounting method. However, the two methods allocate significantly different amounts of income (or loss) to Gina and Helen, the two shareholders involved in the stock sale.

As discussed earlier, the specific accounting election is made by attaching a statement to a timely filed original or amended tax return (Form 1120S) for the year the stock disposition took place.

Deferring the Decision on Choice of Allocation Method until the Return Is Filed. Because the election to use specific accounting upon a complete disposition of a shareholder's interest is filed with the S corporation's tax return, Form 1120S, the election represents a post-year-end opportunity to benefit the shareholders. If, after the end of the year,

the practitioner determines that the specific accounting method provides the best results, the election can be made. Normally, however, the decision should be made before (or as soon as possible after) the complete disposition takes place so there will be adequate time to obtain the necessary shareholder consents. Also, if the decision is made promptly, the S corporation may provide shareholders with information that allows them to properly estimate income and submit appropriate quarterly tax estimate payments.

Example 4C-3 Deferring choice of allocation methods until the return is filed.

This example continues with the same facts as in Example 4C-2. Gina and Helen are affected shareholders and must consent to the election. In this example, if no election is made, Gina must pick up $9,919 of income. If the election to use specific accounting is made, Gina has a deductible $13,333 loss. Waiting until the end of the year to make a decision regarding the election, however, may not be the best course of action. At the end of the year, Gina may realize she is in a position she cannot change; that is, she is forced to recognize income based on the per-share, per-day method because Helen will not consent to the use of specific accounting.

Terminating Shareholder's Overall Income May Be the Same under Either Method. Because of the relationship of corporate income and basis, the shareholder who sells stock may recognize the same amount of gain or loss regardless of which allocation method is used. That is, regardless of the method used to allocate pass-through, the income that passes through increases basis, and therefore, reduces gain on the sale of stock. The following example illustrates this relationship.

Example 4C-4 Seller of stock's overall income may be the same, regardless of method.

This example continues with the same facts as in Example 4C-2. The impact on Gina, the terminating shareholder, can be computed as follows:

	Per-share, Per-day	Specific Accounting
Ordinary income (loss) passed through	$ 9,919	$ (13,333)
Basis:		
Basis, beginning of year	$ 15,000	$ 15,000
Income	9,919	—
Basis, before loss items and distributions	24,919	15,000
Loss	—	(13,333)
Distributions	—	—
Basis, end of year	$ 24,919	$ 1,667

	Per-share, Per-day	Specific Accounting
Capital gains:		
Sales price of stock	$ 35,000	$ 35,000
Basis, from above	(24,919)	(1,667)
Capital gain from stock sale	$ 10,081	$ 33,333

	Per-share, Per-day	Specific Accounting
Total income related to EFGH Corp.:		
Ordinary income:		
Wages	$ 50,000	$ 50,000
Ordinary income (loss) passed through	9,919	(13,333)
Total ordinary income	59,919	36,667
Capital gain on stock sale	10,081	33,333
Total	$ 70,000	$ 70,000

Even though the total income related to EFGH is the same regardless of which allocation method is used, the taxation of Gina's income will be significantly different.

Gina pays tax on ordinary income in the 35% bracket and is taxed at 15% on capital gains. Her tax for the year on the income related to EFGH is computed as follows:

	Per-share, Per-day	Specific Accounting
Tax on ordinary income (35% × $59,919 and $36,667)	$ 20,972	$ 12,833
Tax on capital gain (15% × $10,081 and $33,333)	1,512	5,000
Total tax	$ 22,484	$ 17,833

The difference is caused by the fact that Gina's ordinary income is taxed at 35%, while her capital gains are taxed at 15%. Thus, she saves $4,651 of tax in the current year if the specific accounting method is used. (However, obtaining Helen's consent to use the specific accounting method may prove difficult, because she is allocated $10,081 of income under the per-share, per-day method, while she is allocated $33,333 of income under the specific accounting method.)

Use of the per-share, per-day method or specific accounting method can also cause differences in taxable income and the resulting tax when the shareholder has capital losses either passed through or recognized from the sale of stock. Capital losses first offset capital gains, and any excess loss can be deducted only to the extent of $3,000. Any unused capital loss that remains is carried forward under IRC Sec. 1212.

In Helen's case, if the allocation is made on a per-share, per-day basis, her share of the corporation's income is $10,081. If the election is made to use specific accounting for the periods before and after the stock transfer, her share of the income is $33,333. If she is taxed on the larger amount, she receives basis for the income passed through to her, and that income can later be distributed to her tax free. But the additional basis provides no benefit until the income is distributed to her or until she disposes of her stock.

Stock Sale Agreement. Examples 4C-2 and 4C-4 show that differences in the shareholders' income or loss can arise from stock transactions. The stock sale agreement should reflect the decision of the buyer and seller regarding the election to allocate based on specific accounting or establish the procedures by which a decision is to be made.

Specific Accounting Election Is Irrevocable. The specific accounting election is irrevocable. It is effective only for the stock disposition to which it relates; i.e., if another shareholder disposes of her entire interest, a new election must be made if the specific accounting method is used. (See Example 4C-8.)

Election Year Treated as Two Short Years for Allocation Purposes Only. If the specific accounting election is made, the corporation treats its tax year as if it consisted of two separate tax years, with the first short year ending at the close of the day on which the shareholder's interest in the corporation is terminated. Treating the year *as if* it consisted of two years is a means of allocating pass-through items to the shareholders. The books are closed on an interim basis so that the income or loss can be determined as of the date of the qualifying stock transaction, but the tax year does not actually end at that point. Only one tax return (and one Schedule K-1 per shareholder) is filed for the entire year.

Under Reg. 1.1377-1(b)(3), the deemed short tax years are treated as separate years for purposes of:

1. allocating items of income, loss, deduction, and credit;
2. adjusting basis;
3. adjusting the accumulated adjustments account (AAA) and accumulated earnings and profits (AE&P); and
4. determining the tax effect of distributions to shareholders.

Because the deemed short tax years are treated as separate years for the purposes shown on the preceding list only, it may not be possible to calculate the amounts that will apply to each period until the end of the corporation's tax year. Decisions made at or after year-end, such as whether or not to claim the Section 179 deduction, can affect the entire tax year. Also, other factors, such as limitations applied at the corporate level, can change the income or loss at the date of the interim closing.

Example 4C-5 Conditions at year-end can affect interim closing of books.

Sam and Bud each own 50% of the stock in Greyco, Inc., a calendar-year S corporation. During March 2014, the corporation buys $100,000 of equipment eligible for the Section 179 deduction. On June 30, Bud buys all of Sam's stock. Bud and Sam sign consents to use specific accounting upon complete disposition of a shareholder's stock. An interim closing of the books at June 30 shows that Sam's 50% of the corporation's separately stated income will be $60,000. Because the $100,000 of equipment was purchased when Sam was a shareholder, he believes that his half share of the Section 179 deduction will pass through to him on his Schedule K-1. After reducing the $60,000 of nonseparately stated income by $50,000 of Section 179 expense, Sam expects to report $10,000 in income from the corporation. In November, the corporation buys additional Section 179 property that exceeds the "property-placed-in-service limitation" by more than $25,000. Because Greyco acquired the additional property of $2.1 million during the year, the allowable Section 179 deduction phases out to zero.

Sam's share of the pass-through income through June 30 is $60,000. No Section 179 deduction is allowable for the year.

Election to Use Specific Accounting upon a Qualifying Disposition of Stock

Under Reg. 1.1368-1(g)(2), an election to use specific accounting can also be made upon a "qualifying disposition" of stock. If the election is made, the S corporation treats the tax year as if it consists of separate years and passes through items of income, loss, deduction, and credit based on the corporation's actual books and records. A qualifying disposition occurs when:

1. a shareholder disposes of 20% or more of the corporation's issued stock in one or more transactions within any 30-day period during the corporation's tax year;
2. 20% or more of the corporation's outstanding stock is redeemed from a shareholder in one or more transactions within any 30-day period during the tax year, if the redemption is treated as an exchange under IRC Sec. 302(a) or 303(a); or
3. stock equal to or greater than 25% of the previously outstanding stock is issued to one or more new shareholders within any 30-day period during the corporation's tax year.

The first tax year is deemed to end on the date the 20% (or 25%) threshold is met. The election is referred to as the election to apply specific accounting rules in connection with a qualifying stock disposition. All shareholders who held stock during the taxable year must consent to the election. The election is effective for allocating income and loss; adjusting basis, the accumulated adjustments account (AAA), and accumulated earnings and profits (AE&P); and determining the tax effect of distributions.

Decision on Allocation Methods Can Be Deferred Beyond Year-end

The election to use specific accounting upon a qualifying disposition of stock is filed with the S corporation's tax return, and so represents a post-year-end opportunity to benefit the shareholders. If, after the end of the year, the

practitioner determines that the specific accounting method provides the best results, the election can be made. Normally, however, the decision should be made before (or as soon as possible after) the stock dispositions take place so there will be adequate time to obtain the necessary shareholder consents.

Example 4C-6 Allocating earnings after a qualifying stock disposition.

Jim and Tim each owned 50% of the stock in Greenco, Inc., a calendar-year S corporation. On June 30, Tim bought 80% of Jim's stock, giving him 90% of the total shares outstanding. For the year, Greenco reported $100,000 of ordinary income on page 1 of Form 1120S. According to the corporation's records, $20,000 of the income was generated from January 1 through June 30 and $80,000 arose in the last six months of the year.

Variation 1: The general rule for allocating income is the per-share, per-day rule of IRC Sec. 1377(a)(1), using the number of days in the entire tax year. Assuming it is a 365-day year, the corporation's income will pass through to Jim and Tim as follows:

Jim:		
$100,000 × 181/365 × 50%	$ 24,795	
$100,000 × 184/365 × 10%	5,041	
Total allocable income (to Schedule K-1)		$ 29,836
Tim:		
$100,000 × 181/365 × 50%	24,795	
$100,000 × 184/365 × 90%	45,369	
Total allocable income (to Schedule K-1)		70,164
Total allocable income		$ 100,000

Under the general prorata method, Jim's Schedule K-1 from Greenco will report ordinary income of $29,836, which he will report on his Schedule E. His stock basis will be adjusted (increased) by the same amount. Tim will report ordinary income of $70,164 on his Schedule E. Variation 2 shows the amounts allocable to the shareholders if the corporation elects to apply specific accounting rules in connection with a qualifying stock disposition.

Variation 2: Because more than 20% of the corporation's outstanding shares of stock were disposed of during a 30-day period, the sale is a qualifying disposition. As such, the corporation and the shareholders can elect to close the books as of June 30. If the election is made, the corporation's income will pass through to Jim and Tim as follows:

Jim:		
$20,000 (January–June) × 50%	$ 10,000	
$80,000 (July–December) × 10%	8,000	
Total allocable net income (to Schedule K-1)		$ 18,000
Tim:		
$20,000 (January–June) × 50%	10,000	
$80,000 (July–December) × 90%	72,000	
Total allocable net income (to Schedule K-1)		82,000
Total annual net income		$ 100,000

All shareholders who held stock in the corporation during the tax year must consent to the election to apply specific accounting rules in connection with a qualifying stock disposition. The election is made by attaching a statement to a timely filed original or amended income tax return (Form 1120S) for the year the disposition, redemption, or issuance of shares took place. The statement must state that the corporation is electing under Reg. 1.1368-1(g)(2) to treat the tax year as if it consists of separate tax years, and must state the facts relating to the disposition, redemption, or issuance of shares. It must also state that the corporation and all shareholders who held stock during the tax year consent to the election. (The actual shareholder consents should be kept in the corporation's files and should not be attached to the Form 1120S.) Once made, the election is irrevocable.

Example 4C-7 Allocating earnings after a qualifying stock disposition when the total number of outstanding shares changes.

Jim owns all the outstanding stock (100 shares) of Greenco, Inc., a calendar-year S corporation. On June 30, Tim contributes cash to Greenco in exchange for 100 shares of the corporation's stock. Jim and Tim now each own 100 shares. The corporation's records show that $20,000 of income was generated from January 1 through June 30, and $80,000 was generated during the last six months of the year.

Variation 1: The general rule for allocating income is the per-share, per-day rule of IRC Sec. 1377(a)(1), using the number of days in the entire tax year. Assuming it is a 365-day year, the corporation's income will pass through to Jim and Tim as follows:

Jim:		
$100,000 × 181/365 × 100%	$ 49,590	
$100,000 x 184/365 x 50%	25,205	
Total allocable income (to Schedule K-1)		74,795
Tim:		
$100,000 x 184/365 x 50%	25,205	
Total allocable net income (to Schedule K-1)		25,205
Total allocable income		$ 100,000

Under the general prorata method, Jim's Schedule K-1 from Greenco will show ordinary income of $74,795, which he will report on his Schedule E. His stock basis will be increased by the same amount. Tim will report $25,205 on his Schedule E. Variation 2 shows the amounts allocable to the shareholders if the corporation elects to apply specific accounting rules in connection with a qualifying stock disposition.

Variation 2: Because stock equal to at least 25% of the corporation's previously outstanding shares was issued to a new shareholder, the sale is a qualifying disposition. As such, the corporation and the shareholders can elect to close the books as of June 30. If the election is made, the corporation's income will pass through to Jim and Tim as follows:

Jim:		
$20,000 (January–June) × 100%	$ 20,000	
$80,000 (July–December) x 50%	40,000	
Total allocable income (to Schedule K-1)		60,000
Tim:		
$80,000 (July–December) x 50%	40,000	
Total allocable net income (to Schedule K-1)		40,000
Total annual net income		$ 100,000

All shareholders who held stock in the corporation during the tax year must consent to the election to apply specific accounting rules in connection with a qualifying stock disposition. The election is made by attaching a statement to a timely filed original or amended income tax return (Form 1120S) for the year the disposition, redemption, or issuance of shares took place

Multiple Ownership Changes

Multiple elections can be made for the year in which multiple stock dispositions occur.

Example 4C-8 Pass-through in year of multiple ownership changes.

Charlie and Daryl each own 50% of the shares of CDE Corp, a calendar-year S corporation. Charlie sells all of his shares to Eli on June 30. On November 30, Daryl sells all of his shares to Eli. If the books were closed as of June 30, CDE would pass through an operating loss of $20,000. For the next five months (through November 30) CDE earns $40,000, and it earns $10,000 of net income in December, resulting in $30,000 of ordinary income for the entire year. The ordinary income is CDE's only pass-through item.

Variation 1: If no election is made, the pass-through is allocated on a per-share, per-day basis using the number of days in the entire tax year. The $30,000 of net income would be allocated under that method (using the simplified calculation method in the Form 1120S instructions) as follows:

	(a) % of Stock	(b) % of Year	(c) (a) × (b)	(d) Total %
Charlie	50%	49.59%[a]	24.80%	24.80%[b]
Daryl	50%	91.51%[c]	45.75%	45.75%[b]
Eli	50%	41.92%[d]	20.96%	
	100%	8.49%[e]	8.49%	29.45%[b]
Total				100.00%

Thus, the $30,000 of income is allocated and passed through to the shareholders as follows:

Charlie	24.80%	$ 7,439
Daryl	45.75%	13,725
Eli	29.45%	8,836
Total		$ 30,000

Variation 2: As discussed in Example 4C-2, the corporation can elect to close the books and use specific accounting as of June 30 if the affected shareholders (i.e., Charlie and Eli) consent. It can also make a second election to close the books as of November 30 because of Daryl's disposition of all of his shares. Daryl and Eli must consent to this election. If both elections are made, the loss through June 30 is allocated to Charlie and Daryl, the income through November 30 is allocated to Charlie and Eli, and December's income is passed through to the remaining shareholder, Eli, as follows:

	Jan. 1–Jun.30	Jul. 1–Nov. 30	Dec. 1–Dec. 31	Total
Charlie	$ (10,000)	$ —	$ —	$ (10,000)
Daryl	(10,000)	20,000	—	10,000
Eli	—	20,000	10,000	30,000
Totals	$ (20,000)	$ 40,000	$ 10,000	$ 30,000

Notes:

[a] 181 days/365 days. (The percentage would be based on 366 days in a leap year.)

[b] Instructions to Form 1120S indicate that these percentages should be used for Schedule K-1, line F, as "percentages of stock ownership for the tax year."

[c] 334 days/365 days.

[d] 153 days/365 days.

[e] 31 days/365 days.

Pass-through on the Day the Shares Are Transferred

The transferor shareholder (rather than the acquiring shareholder) is considered to own the shares for pass-through purposes on the day the shares are transferred. Thus, allocations to the purchasing shareholder begin on the day following the date of purchase.

Example 4C-9 Pass-through on the day shares are transferred.

Assume the same facts as in Example 4C-8. Charlie's shares were transferred to Eli on June 30. Charlie is considered to own the shares through June 30 (the 181st day of the year). The transferee, Eli, is considered to own the shares on July 1.

Death of a Shareholder

When a shareholder dies, pass-through items are allocated to him through the date of death and are reported on his final return. The decedent shareholder is considered to own the shares on the date of death. In the simplest scenario, the shareholder for the remainder of the year is the deceased shareholder's estate or other person or entity that acquires the stock (i.e., heir or trust). The death of a shareholder is a complete termination of his interest in an S corporation, and the election to use specific accounting (discussed in Example 4C-2) can be made in a year in which the shareholder dies. The executor or administrator of the decedent shareholder's estate consents to the election on behalf of the shareholder.

Example 4C-10 Pass-through upon death of a shareholder.

Frank and George each own 50% of the shares of FG Corp, a calendar-year S corporation. George dies on June 30 and his shares are transferred to his estate. If the books were closed at the end of June 30, FG would pass through an operating loss of $20,000. During the remainder of the year, the corporation earns $50,000 of net income, resulting in $30,000 of ordinary income for the entire year.

George's death is considered to be a complete termination of his interest. If the specific accounting election is not made, pass-through to George's final Form 1040 is based on the income for the entire year as follows:

Frank (50% of shares × 365/365 of year)	$ 15,000
George (50% of shares × 181/365 of year)	7,438
Estate (50% of shares × 184/365 of year)	7,562
Total	$ 30,000

If the specific accounting election is made, pass-through to his final Form 1040 is based on the income or loss through June 30. (The executor or administrator of George's estate must consent to the election on behalf of both George and the estate.) The pass-through will be determined using the method shown in Example 4C-2, and will result in the following allocation to shareholders:

	Jan. 1–Jun. 30	Jul. 1–Dec. 31	Total
Frank	$ (10,000)	$ 25,000	$ 15,000
George	(10,000)	—	(10,000)
Estate	—	25,000	25,000
Totals	$ (20,000)	$ 50,000	$ 30,000

Fiscal Year S Corporation. It is not clear in which year a decedent shareholder reports the pass-through income when the S corporation uses a fiscal year and the shareholder dies between the end of the corporation's fiscal year and the beginning of the calendar year. It is a best practice for the decedent's share of the income for the S corporation's fiscal year in which the shareholder dies to be included in his or her final return.

Example 4C-11 Pass-through to decedent shareholder when corporation uses a fiscal year.

Bill and Tom each own 50% of the shares of Stopco, an S corporation, that uses a fiscal year ending October 31. Bill dies on December 1, 2017. The corporation passes through to Bill income of $20,000 for the tax year ending October 31, 2017 and $25,000 for the tax year ending October 31, 2018. How much income from Stopco is reported on Bill's final Form 1040 for the year ending December 31, 2017?

As discussed earlier in this lesson, the shareholder reports the pass-through items in the tax year that includes the last day of the S corporation's tax year. Thus, if Bill had disposed of his shares other than by death, he

would report $20,000 income from the S corporation on his 2017 Form 1040 and $25,000 on his 2018 Form 1040. However, since Bill's final return is filed for the year ending December 31, 2017, it appears that both the $20,000 and the $25,000 would appear on that return, even though Stopco does not pass through the $25,000 until October 31, 2018—the end of its tax year that includes the date of Bill's death.

It may be necessary to file an amended final return for Bill because the S corporation items of income, loss, deduction, and credit are not passed through (and Schedules K-1 are not issued) until the end of the fiscal year. If an amended return is required and shows a tax due, the underpayment of estimated tax penalty does not apply to the correction of tax reported on the original return.

If the requirements are met, either the election to use specific accounting (a) when a shareholder's entire interest is disposed of, or (b) when a qualifying disposition occurs can be made when shares are transferred from the estate to the beneficiary or beneficiaries.

Example 4C-12 Electing to use specific accounting when shares are transferred from estate to beneficiary.

Assume the same facts as in Example 4C-11. On March 31 of the following year, the estate transfers the stock to Bill's beneficiary, Barney. Because the estate has disposed of its entire interest in Stopco, the corporation can make the election to use specific accounting. If the specific accounting election is made, pass-through to the estate's income tax return (Form 1041) is based on the income or loss through March 31. Both Barney and the executor or administrator of Bill's estate must consent to the election.

Example 4C-13 Electing to use specific accounting when transfer from estate to beneficiary is a qualifying disposition of stock.

Assume the same facts as in Example 4C-12, except that Bill left 75% of his stock to Barney and 25% of his stock to Nan. On March 31, the estate distributes the shares inherited by Barney, and on October 31, it distributes Nan's stock to her. When the shares are distributed to Barney, the estate has disposed of 37.5% (50% × 75%) of the corporation's issued stock. The corporation can elect to use specific accounting because a shareholder (i.e., the estate) has disposed of 20% or more of the corporation's issued stock in one or more transactions within a 30-day period during the corporation's tax year. (See Example 4C-6.) All shareholders (Tom, Nan, and the estate through its executor or administrator) must consent to the election to use specific accounting because of a qualifying disposition.

The corporation can also elect to use specific accounting when the shares are distributed to Nan because the estate will have disposed of its entire interest in shares at that point. This is evidently true regardless of whether the corporation elects to use specific accounting as of March 31. In other words, the corporation can presumably make the specific accounting election because of a qualified stock disposition on March 31 and a specific accounting election of the total disposition of the estate's stock on October 31. (Multiple stock acquisitions and dispositions are discussed in Example 4C-8.)

Pass-through of Life Insurance Proceeds

Life insurance proceeds received by the S corporation because of a shareholder's death are generally tax-exempt. The proceeds are normally allocated to the shareholders on a per-share, per-day basis and increase each affected shareholder's stock basis. However, if the corporation so elects, it can make the specific accounting election to allocate pass-through items based on the actual transaction dates.

Pass-through upon Conversion of a QSST to an ESBT or *Vice Versa*

A qualified Subchapter S trust (QSST) or electing small business trust (ESBT) can be converted to the other type of trust if certain requirements are met.

When a QSST converts to an ESBT, the QSST is treated as terminating its interest in the S corporation and the ESBT is treated as a new shareholder. The QSST is considered to own the shares for pass-through purposes on the day before the ESBT election's effective date. The new ESBT is a shareholder beginning on the effective date of the election.

Similarly, when an ESBT converts to a QSST, the ESBT will be treated as terminating its interest in the S corporation and the QSST will be treated as a new shareholder. The ESBT is considered to own the shares for pass-through purposes on the day before the QSST election's effective date. The new QSST is a shareholder beginning on the effective date of the election.

Conversion of a QSST to an ESBT, or an ESBT to a QSST, generally does not result in the trust terminating its entire interest in the S corporation. Thus, the corporation generally cannot make the IRC Sec. 1377(a)(2) election to use specific accounting upon complete disposition of a shareholder's stock. However, an exception applies if the trust is one of two specific types. Specifically, if the trust was (1) a trust existing before death that was treated as a grantor trust under IRC Sec. 1361(c)(2)(A)(ii) or (2) a testamentary trust that received S stock under the terms of a will under IRC Sec. 1361(c)(2)(A)(iii), the corporation can make the Section 1377(a)(2) election to use specific accounting. The election to use specific accounting because of a qualified disposition of stock under Reg. 1.1368-1(g)(2) cannot be made because the trust conversion is not a qualified disposition.

Worthless Stock

If a stock or security becomes worthless during the year, the holder generally can claim the loss as a deduction during the year in which it becomes worthless. This loss normally will be a capital loss, although some shareholders may be entitled to ordinary loss treatment under IRC Sec. 1244.

IRC Sec. 1367(b)(3) provides that items of income, loss, or deduction are considered before any worthless stock loss is determined. This can be advantageous if there is stock basis at the beginning of the year because the shareholder can take pass-through losses from business operations as an ordinary deduction (subject to the loss limitation rules), while the loss on the stock may be capital in nature. A worthless stock loss is claimed for any remaining stock basis only after the basis has been adjusted for current pass-through items.

According to IRS Information Letter 2010-0157, the shareholder must show (1) that the stock was not worthless in a prior year but is now worthless, (2) balance sheet insolvency, and (3) a lack of future potential value. To show balance sheet insolvency, the taxpayer must show that liabilities exceed assets in the year of the deduction, with asset values "reflect(ing) any significant differences between the book value and the fair market value of the assets." Even though the balance sheet may show insolvency, the stock could have value in the future. Therefore, the shareholder must also show "the destruction of potential value . . . Generally, a series of events, which, in the context of what has happened previously, shows both current and future worthlessness would have to occur."

Example 4C-14 Pass-through when stock becomes worthless.

Vern owns 25% of the stock of Ernest, Inc., an S corporation in which he materially participates. Vern purchased his stock from another shareholder a few years ago and has a $20,000 adjusted basis in his stock at the beginning of the year. The corporation suffers severe business reversals and goes bankrupt in the current year. For the year, the corporation passes through a $15,000 loss from business activities to Vern. He first reduces his stock basis by the pass-through loss, and has a $5,000 long-term capital loss for his remaining adjusted tax basis in the stock.

IRS Rejects S Corporation's Attempt to Convert Worthless Stock Capital Loss to Ordinary Loss.

In CCA 201552026, the IRS rejected an S corporation's attempt to claim an ordinary loss deduction under IRC Sec. 165(g)(3) for losses incurred in connection with its QSub's conversion to a C corporation, which was effective one day before the S corporation's termination of its S status. First, the CCA concluded that the taxpayer's QSub termination, and deemed formation of a new C corporation, did not qualify for tax-free treatment under IRC Sec. 351 because the stock lacked value. The CCA then found that the taxpayer's attempted deduction under IRC Sec. 165(g)(3) was barred by Reg. 1.165-5(d)(2)(ii) because, even if the other requirements were satisfied, the taxpayer failed to offer any legitimate reason for why it acquired the C corporation stock in the QSub-to-C conversion other than to obtain an ordinary loss deduction. In addition, the IRS concluded that deductions under IRC Sec. 165(g)(3) are not available to S corporations.

Effect of Bankruptcy on S Election

A Chapter 7 or Chapter 11 bankruptcy petition filed by an S corporation does not cause the S election to terminate. Furthermore, an S corporation's bankruptcy does not create a new or separate taxable entity. This causes issues relating to whether income, loss, deductions, and credits pass through to shareholders or the bankruptcy estate.

The effect of the S corporation's or shareholder's bankruptcy on pass-through is beyond the scope of this course, but more information is available in *PPC's 1120S Deskbook*.

Stock Transfer Worksheet

Transfers of stock affect the pass-through to shareholders of corporate items of income, loss, deduction, and credit, and thereby also influence the calculation of stock basis. For these and other reasons, it is important to maintain an accurate record of stock transfers.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Which of the following is reported on Line 10 of Schedule K-1?

    a. The recovery of a tax benefit item.

    b. Expenditures for water conservation.

    c. Credits.

    d. AMT preferences and adjustments.

18. Which of the following statements best describes an aspect of how S corporations and their shareholders report the results of operations?

    a. The domestic production activities deduction is reported on the front page of Form 1120S.

    b. An S corporation is ineligible to receive a Schedule K-1 from another entity.

    c. S corporations with multiple activities must report about each separately to shareholders.

    d. S corporation losses are limited because so many of them pass through to shareholders.

19. Jennifer disposes of her entire interest in B-3, an S corporation. B-3 elects to allocate pass-through income items based on actual transactions that took place both before and after the stock disposition occurred. Which of the following has occurred?

    a. The specific accounting election.

    b. A stock sale agreement.

    c. The election to use specific accounting for a short year.

    d. A Section 338 election.

20. An S corporation's qualified Subchapter S trust (QSST) converts to an electing small business trust (ESBT). How will that conversion be treated?

    a. The ESBT becomes a shareholder as of the first day of the tax year.

    b. The QSST is treated as terminating its interest in the S corporation.

    c. The S corporation will make an election to use specific accounting for the complete disposition of the QSST's stock.

    d. The S corporation stock now owned by the ESBT will be considered worthless.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Which of the following is reported on Line 10 of Schedule K-1? **(Page 81)**

    a. The recovery of a tax benefit item. [This answer is correct. Line 10 of Schedule K-1 is used to report other income and loss and has the following coded items: (1) A—other portfolio income (loss), (2) B—involuntary conversions; (3) C—Section 1256 contracts and straddles, (4) D—Mining exploration costs recapture, and (5) E—Other income (loss). According to IRC Sec. 111, recoveries of tax benefit items are one of the items that should be coded under E on line 10.]

    b. Expenditures for water conservation. [This answer is incorrect. According to IRC Sec. 175, soil and water conservation expenditures should be recorded on line 12, which is used for other deductions.]

    c. Credits. [This answer is incorrect. Credits are reported on Schedule K-1 on line 13 using codes A–P.]

    d. AMT preferences and adjustments. [This answer is incorrect. AMT adjustments and preferences are consolidated on Schedule K-1, line 15, and identified with codes A–F.]

18. Which of the following statements best describes an aspect of how S corporations and their shareholders report the results of operations? **(Page 84)**

    a. The domestic production activities deduction is reported on the front page of Form 1120S. [This answer is incorrect. The domestic production activities deduction under IRC Sec. 199 is not reported on the front page of Form 1120S. Instead, it is computed and claimed at the shareholder level on Form 8903 (Domestic Production Activities Deduction).]

    b. An S corporation is ineligible to receive a Schedule K-1 from another entity. [This answer is incorrect. An S corporation can hold stock in another corporation, a partnership interest, or an interest in an LLC. If the S corporation owns an interest in a partnership, the partnership issues a Schedule K-1 to the corporation.]

    c. S corporations with multiple activities must report about each separately to shareholders. [This answer is correct. If the S corporation conducts more than one activity, the stockholder's share of income or loss from each activity must be reported separately to all shareholders. The schedule detailing the activity-by-activity pass-through is attached to each shareholder's Schedule K-1.]

    d. S corporation losses are limited because so many of them pass through to shareholders. [This answer is incorrect. Normally, per the Code, losses are *not* limited at the S corporation level.]

19. Jennifer disposes of her entire interest in B-3, an S corporation. B-3 elects to allocate pass-through income items based on actual transactions that took place both before and after the stock disposition occurred. Which of the following has occurred? **(Page 87)**

    a. The specific accounting election. [This answer is correct. If a shareholder's entire interest in an S corporation is disposed of, the corporation can elect under IRC Sec. 1377(a)(2) to allocate pass-through income items based on the actual transactions that occurred before and after the stock disposition took place. This election is referred to as the "specific accounting election." (It is also known as the "election to use normal accounting rules" and the "election to treat the tax year as if it consisted of two tax years." All shareholders *affected* by the stock disposition must consent.]

    b. A stock sale agreement. [This answer is incorrect. Differences in shareholder's income or loss can arise from stock transactions. The stock sale agreement should reflect the decision of the buyer and seller on how pass-through items should be allocated. However, while Jennifer and whomever she sold the shares to might have a stock sale agreement in this scenario, *stock sale agreement* is not the correct term for the decision made by B-3.]

c. The election to use specific accounting for a short year. [This answer is incorrect. According to IRC Sec. 1362(e)(3) and Reg. 1.1362-6(a)(5), a special election is available, under which the shareholders may consent to allocate termination-year income based on specific accounting (i.e., a closing of the books as of the day before the S termination). However, since B-3 did not terminate in this scenario, it would not need to make this particular election.]

d. A Section 338 election. [This answer is incorrect. Under a Section 338 election, certain stock purchases are treated as asset acquisitions. However, as that is not the case in this scenario, B-3 did not make a Section 338 election.]

20. An S corporation's qualified Subchapter S trust (QSST) converts to an electing small business trust (ESBT). How will that conversion be treated? **(Page 87)**

a. The ESBT becomes a shareholder as of the first day of the tax year. [This answer is incorrect. According to Reg. 1.1377-1(a)(2)(iii), the QSST is considered to own the shares for pass-through purposes on the day before the ESBT election's effective date. The new ESBT is a shareholder beginning on the effective date of the election.]

b. The QSST is treated as terminating its interest in the S corporation. [This answer is correct. Based on the guidance in Reg. 1.1377-1(a)(2)(iii), when a QSST converts to an EBST, the QSST is treated as terminating its interest in the S corporation, and the ESBT is treated as a new shareholder.]

c. The S corporation will make an election to use specific accounting for the complete disposition of the QSST's stock. [This answer is incorrect. Conversion of a QSST to an ESBT, or an ESBT to a QSST, generally does not result in the trust terminating its entire interest in the S corporation. Thus, the corporation generally cannot make the IRC Sec. 1377(a)(2) election to use specific accounting upon complete disposition of a shareholder's stock.]

d. The S corporation stock now owned by the ESBT will be considered worthless. [This answer is incorrect. If a stock or security becomes worthless during the year, the holder generally can claim the loss as a deduction during the year in which it becomes worthless, per IRC Sec. 165(g). However, this is not a direct consequence from the type of trust conversion discussed above. Therefore, there is a better answer to this question.]

The Allocation of Income and Losses in an S Termination Year

S Termination Year

The termination of an S election at any time other than the first day of the corporation's tax year results in the creation of an "S termination year." An S termination year must be separated into two short tax years, referred to as an "S short year" and a "C short year." The part of the S termination year ending on the day before the effective date of the termination is an S short year. The remainder of the year, beginning on the date the terminating event occurs, is a C short year.

Example 4D-1 Short tax years created upon termination.

Mike Stone, sole shareholder of Essco, Inc., a calendar-year S corporation, transferred 25% of his stock to a trust that was ineligible to own S stock on May 27. The transfer terminated the S election and created an S termination year in which Essco would file an S corporation return (Form 1120S) for January 1 through May 26 (146 days) and a C corporation return (Form 1120) for May 27 through December 31 (219 days).

Allocation of Pass-through Items

If the S election terminates at any time other than the first day of the corporation's tax year, items of income, loss, deduction, and credit must be allocated between the short S and C tax years. The general rule for S termination years requires a prorata allocation based on the number of days in each short tax year. Under this general prorata allocation rule, the amount of each item of separately stated income, deduction, and credit, as well as all of the nonseparately computed net income (or loss), is computed for the entire tax year. These are the numbers that would have been identified and reported to the shareholder(s) on the Schedule K-1 had the corporation remained an S corporation for the entire tax year. Each separately stated item of income, deduction, and credit, and the nonseparately stated net income is then allocated on a prorata basis to each short year using the ratios of the days in each short year to the days in both short tax years combined.

Example 4D-2 General prorata allocation method.

Assume that in Example 4D-1, Essco's nonseparately stated income for the entire year would have been $25,000 had it remained an S corporation, and that there were no separately stated items.

Under the general prorata allocation method, all income and deduction items are determined as if the corporation had remained in S status. The amounts so determined are then allocated among the two short periods based on the number of days in each. In this example, 40% (147 ÷ 365) of the $25,000 income, or $10,000, is allocated to the S short period and 60% (219 ÷ 365), or $15,000, is allocated to the C short period.

C Corporation Short Year Income Must Be Annualized

The taxable income for the C corporation short year is placed on an annual basis by multiplying the taxable income for the C short year by the number of days in the termination year, and dividing the result by the number of days in the short C year. After computing the corporate tax on this "grossed up" annualized income, the resulting corporate tax is then prorated back to a short period amount by multiplying the tax by the number of days in the short year and dividing the result by the number of days in the termination year. This annualization formula is intended to eliminate the full benefit of the graduated corporate tax rates (the lower 15% rate tier, etc.) for a short-period C return.

Example 4D-3 Annualization requirement for C short year.

Using the fact pattern developed in Examples 4D-1 and 4D-2, the tax on Essco's C short tax year is determined as follows using the annualization formula previously described:

Multiply taxable income of C short year by number of days in entire termination year	$	15,000
	×	365
	$	5,475,000
Divide by number of days in C short year	÷	219

	$	25,000
Compute tax using regular C rates	×	15%
	$	3,750
Multiply tax by number of days in C short year	×	219
	$	821,250
Divide by number of days in entire termination year	÷	365
Tax for short-period C return from annualized computation	$	2,250

Essco is required to make estimated tax payments on income earned after the termination of its S election (i.e., on income allocated to the short C period).

In this example, this annualized tax computation is not detrimental because the effective tax rate remains at the lowest corporate rate of 15%. In fact, the annualized tax result is the same as applying the 15% rate to the short-period income of $15,000; no increase in rates occurred because the annualized income remained beneath the $50,000 level at which the rates change.

Election to Use Specific Accounting for Each Short Year

A special election is available, under which the shareholders may consent to allocate the termination-year income based on specific accounting (i.e., a closing of the books as of the day before the S termination). This special election can be made only with the consent of all persons who were shareholders in the corporation at any time during the S short year and all persons who were shareholders in the corporation on the first day of the C short year. [The specific accounting method, however, is *required* if 50% or more of the stock is sold or exchanged in the termination year. (See Example 4D-5.)].

Example 4D-4 Election to close books at termination date.

Frank Smith was president and sole shareholder of Dayglow, Inc., a calendar-year S corporation. Frank sold 25% of his stock to an ineligible shareholder (a nonresident alien) on May 27 of the current year, terminating the S election. The S election is terminated as of the beginning of the day on which the disqualifying event occurs. For the S short year ended May 26, the corporation's accounting records reflect taxable income of $75,000. Due to the seasonal nature of its business, Dayglow incurred a $50,000 loss for the remainder of the year.

If Dayglow followed the general prorata allocation rule, the $25,000 net taxable income for the entire S termination year would be allocated to the S and C short tax years based on the number of days in each. As in Example 4D-2, $10,000 would be allocated to the S short period and $15,000 would be allocated to the C short period.

On the other hand, if the corporation made the election to use the specific accounting method, the Form 1120S for the S short year would report $75,000 of income that would pass through to the shareholders. The Form 1120 for the short C year would report a net operating loss (NOL) of $50,000, which would carry forward to apply against future C corporation income.

Assume that the shareholders are subject to a 28% marginal tax rate. Thus, if Dayglow has the capability to distribute all income during the S period, the specific accounting method produces a better result for the shareholders in the form of $54,000 of after-tax cash ($75,000 S income − 28% individual tax). (As shown in Example 4D-3, the C corporation would also be liable for tax of $2,250.) Under the prorata method, the after-tax cash flow to shareholders is $7,200 ($10,000 − 28% tax). However, if Dayglow is strapped for cash and expects to be in this position for several years, the prorata method may be preferable because it produces the smaller current tax liability.

Whichever method is elected, the shareholders should give strong consideration to extracting the accumulated adjustments account as tax-free cash.

Assume that Dayglow decides to allocate between the short tax years based on the specific accounting method by making the election not to use the general prorata method. A corporate election statement and

shareholder consent statement must be attached to Form 1120 for the C short period beginning May 27 and ending December 31. The shareholder consent statement should be signed by each shareholder who owned stock during the S short tax year and any shareholder who owned stock on the first day of the C short year.

The election to use specific accounting to allocate termination-year income between the S and C years is filed with the short-period C corporation tax return, and so represents a post-year-end opportunity to benefit the shareholders. If, after the end of the year, the practitioner determines that the specific accounting method provides the best results, the election can be made. Normally, however, the decision should be made before (or as soon as possible after) the termination becomes effective so there will be adequate time to obtain the necessary shareholder consents.

Specific Accounting Method Is Mandatory under Certain Circumstances

Sale or Exchange of Stock. If 50% or more of the stock is sold or exchanged during the S termination year, the specific accounting method is required. The general prorata method may not be used when allocating pass-through items between the short C and S years.

Example 4D-5 Effect of 50% ownership change.

Assume that in Example 4D-4, Frank sold 50% of his Dayglow stock to an ineligible shareholder. In this scenario, the specific accounting method would be required rather than elective. If there is a sale or exchange of 50% or more of the stock in an S corporation during an S termination tax year, the prorata method of allocating income between the S and C years cannot be used.

Mandatory Specific Accounting Method Requires Sale or Exchange. Use of the specific accounting method is mandatory if 50% or more of the corporation's stock is sold or exchanged during the year. This rule does not apply if the stock is transferred in a transaction that is neither a sale nor an exchange.

Example 4D-6 Gift of stock does not trigger mandatory use of specific accounting method.

Ken and Bill are shareholders in KB, Inc., a calendar-year S corporation. Each owns 50% of the corporation's issued and outstanding shares. On April 1 of the current year, Ken makes a gift of his entire shareholder interest to a trust that is not an eligible shareholder. The corporation's S election terminates March 31 and KB becomes a C corporation on April 1. As a result of the gift, the trust owns 50% of KB's issued and outstanding stock. However, because the trust acquired the stock by gift from Ken, there has not been a 50% or more change in ownership by sale or exchange.

Section 338 Election. In addition to the 50% sale or exchange rule discussed above, the prorata method cannot be used if a Section 338 election (treating certain stock purchases as asset acquisitions) is made in connection with a purchase of 80% or more of an S corporation's stock.

Pass-through to Shareholders in Year the S Election Terminates

Pass-through to shareholders in the year the S election terminates is illustrated in the following example.

Example 4D-7 Pass-through in year of termination.

Pam and Pat each own 50% of the stock of Pal, Inc., a calendar-year S corporation. On July 1, Pal revokes its S election. Through June 30, the S corporation shows net income from business operations of $40,000. The C corporation for the remainder of the year experiences a $30,000 loss, so overall income from business operations for the calendar year is $10,000. If no allocation election is made, items of income, loss, deduction, and credit are allocated prorata between the short years based on the 181 days in the S short year and the 184 days in the C short year. Under the prorata method, the S corporation would report $4,959 (181/365 × $10,000) of nonseparately stated income, and the C corporation would report $5,041 (184/365 × $10,000) of net income. After the corporate items of income, loss, deduction, or credit have been allocated between the S and C short years, the items allocated to the S short year are passed through to shareholders on a per-share, per-day basis using the number of days in the S short year. In this case, the $4,959 would be allocated 50/50 between Pam and Pat.

However, Pal can elect under IRC Sec. 1362(e)(3) to allocate items between the S and C short years using specific accounting from the actual books and records during each short period. Both Pam and Pat must consent to the election. If the election is made, the S corporation will pass through $40,000 of nonseparately stated income to the shareholders, and the C corporation will report a $30,000 loss. The $40,000 income will be reported on Schedule K and allocated $20,000 to Pam and $20,000 to Pat on their Schedules K-1.

If, for example, Pam sells all her shares or Pam and Pat each sell half of their shares during the calendar year, Pal would be required to use specific accounting for each short period because 50% or more of the corporation's stock was transferred during the termination year.

The C corporation short-year income must be annualized when calculating the tax for the year the S election terminates.

Allocating Income and Losses When QSub Parent Terminates Its S Election

When an entity terminates its S corporation election during the tax year, items of income, loss, deduction, and credit must be allocated between the short S and C tax years. The general rule for S termination years requires a prorata allocation based on the number of days in each short tax year. Alternatively, the shareholders may consent to allocate the termination-year income based on specific accounting under IRC Sec. 1362(e)(3). When an S corporation with a qualified Subchapter S subsidiary (QSub) terminates its S election, the "parent" and the former QSub become two separate C corporations. From that point on, the former QSub's income and loss items must be separately accounted for on its own tax return (unless an election is made to file on a consolidated basis). Thus, the former S corporation is not permitted to prorate any items of income, loss, deduction, or credit with the former QSub after the S election terminates unless both entities elect to file a consolidated return.

Passing Corporate-level Tax through to Shareholders

An S corporation can be subject to tax at the corporate level. (Specific corporate-level taxes are beyond the scope of this course, but they are discussed at length in *PPC's 1120S Deskbook*.)

Built-in Gains Tax

The built-in gains tax is deductible from the S corporation's income. This is accomplished by treating the built-in gains tax as a loss sustained by the S corporation during the tax year. The character of such loss is determined by allocating the loss proportionately among the built-in gains that give rise to the built-in gains tax. This effectively offsets the built-in gains tax against the built-in gain that caused the tax. However, this offset is not practical when the built-in gains (and the corresponding tax) are deferred and carried forward due to the taxable income limitation of IRC Sec. 1374(d)(2)(A). In that event, the built-in gains tax should be passed through as a loss for the year the tax is actually imposed.

Example 4E-1 Passing through built-in gains and deducting built-in gains tax.

Esscorp passes through $3,600 of built-in gains tax under IRC Sec. 1374 to Jan, its sole shareholder. The gain arose from the collection of cash-basis accounts receivable. Jan materially participates in the corporation's operations. The corporation's ordinary income from business activities (as reported on page 1 of Form 1120S before considering the tax) is $20,000. Since the gain that created the tax was ordinary (i.e., income from the collection of cash basis receivables), the tax is a deduction from the amount of ordinary income from business activities. The ordinary income reported on line 1 of Schedules K and K-1 is $16,400 ($20,000 − $3,600).

Tax on Excess Net Passive Income

If the Section 1375 tax on excess net passive income applies, the pass-through of the income that created the tax is reduced by the amount of tax paid at the corporate level. Each item of passive investment income is reduced by its proportionate share of the tax.

Example 4E-2 Tax on excess net passive income.

Esscorp has $35,000 of excess net passive income arising from interest income, and is subject to tax of $12,250 (35% × $35,000) at the corporate level. The $35,000 is reduced by the tax, and $22,750 is passed through to the shareholders on line 4 (interest income) of Schedule K-1.

Recapture of Business Credits

Recapture of business credits can cause tax at the S corporation level.

Self-charged Interest

Passive activity losses generally cannot be offset by portfolio income. However, Reg. 1.469-7 provides that all or part of a shareholder's "self-charged interest" income can be reclassified as passive activity income and thereby offset a passive activity loss passed through from an S corporation. Self-charged interest is interest on a loan by a shareholder to an S corporation if the corporation passes through a passive activity loss. The self-charged interest rules are beyond the scope of this course, but more information is available in *PPC's 1120S Deskbook*.

Inconsistent Treatment That Should Be Disclosed on a Shareholder's Return

Generally, an S shareholder must report items on Form 1040 as they are listed on the Schedule K-1. However, if any amounts are listed differently due to any of the following circumstances, a Form 8082 [Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)] must be attached to the shareholder's Form 1040:

1. The S corporation has not filed a tax return or issued a Schedule K-1 by the time the shareholder files Form 1040.

2. The shareholder believes that the Schedule K-1 is incorrect, requiring different reporting in either the original or an amended Form 1040.

3. The shareholder files an amended return to change an amount previously reported from a pass-through entity on the original tax return.

A Form 8082 does not need to be filed when the loss, deduction, or credit is not reported on the shareholder's tax return because the amount is limited by law, such as a loss limited by the at-risk or passive activity loss limitations.

Shareholder Required to Report Pass-through Income Even Though Amount Disputed

The Tax Court has ruled that an S shareholder was required to report pass-through income allocated to him even though he did not receive a distribution that year and claimed the K-1 was incorrect. In *DaltonDalton, Michael H.TC Memo 2017-432017*, Michael Dalton and his brother each owned 50% of Resort Builders, Inc., a calendar-year S corporation. During 2007, Michael told his brother that he wanted to resign from Resort Builders and turn in his stock. His brother changed the locks to the corporation's offices and withheld the corporation's books and records from Michael. The corporation was dissolved on July 24, 2008. Michael received a Schedule K-1 showing $451,531 as his share of the corporation's ordinary income for the short year ending on that date. Michael argued that he should not have to report the income shown on the final corporate return's K-1 because he did not receive a distribution and was not otherwise enriched by Resort Builders in 2008. In its ruling against the taxpayer, the court noted that Dalton did not call any witnesses to prove why the K-1 was incorrect. Also, a "check register" report and corporate bank statements submitted by Dalton did not necessarily reflect Resort Builders' taxable income for the short taxable year. Furthermore, the court cited Reg. 1.1366-1(a) and stated that the taxpayer "was required to report this income on his 2008 Form 1040 even if he did not receive a distribution that year."

How to Deduct Corporate Expenses Paid by Shareholder

Unreimbursed business expenses paid by a shareholder-employee on behalf of an S corporation are employee business expenses subject to the 2%-of-AGI floor. Furthermore, when a shareholder-employee is a controlling stockholder, the IRS often asserts that the shareholder cannot deduct the expenses in any event because they relate to corporate business rather than to duties as an employee.

Example 4I-1 Where to report corporate expenses paid by shareholder.

George is the sole shareholder of GBS, Inc., an S corporation. He personally paid expenses incurred in the corporation's business. GBS and George had agreed that the corporation would not reimburse expenses or pay salaries to him until the business started making a profit. George did not request reimbursement of the expenses, and deducted the expenses on Schedule C of his Form 1040.

Upon audit, the IRS disallowed the deductions. George argued that he was entitled to the deductions because, if the corporation had paid the expenses, they would have been passed through to him and deducted as business expenses on Schedule E. In a similar case, the Tax Court agreed with the IRS and ruled that a corporation and its shareholders are separate and distinct entities, and one entity cannot deduct the expenses of the other. In that case, the corporation could not deduct the expenses because they were paid by the shareholder. The shareholder could not deduct them either, because, under the facts, the shareholders were not employees of the S corporation, so the expenses were not unreimbursed employee business expenses. However, since the expenditures were on behalf of the corporation, they should increase George's basis in his stock, which could support a larger pass-through loss deduction.

Interest Incurred by Shareholder to Purchase Stock or Inject Capital into an S Corporation

When an S shareholder incurs debt and uses the proceeds to purchase an interest in or contribute capital to a pass-through entity, the debt and related interest are allocated among the assets of the entity using any reasonable method. If the taxpayer materially participates in the conduct of the S corporation's trade or business, and the underlying assets in the trade or business are business assets, the interest expense attributable to debt to acquire or carry that business is deductible as business interest. Such business interest expense is deductible in Part II of the shareholder's Schedule E. When the assets include portfolio investments, an allocation of the interest expense must be made between investment interest and business interest in proportion to the assets held by the pass-through entity.

Limiting on Losses and Deductions

Losses and deductions generally are not limited at the S corporation level. Rather, losses pass through to shareholders in full, and are subjected to limitations, if any, at the shareholder level. The exception to this rule is the Section 179 deduction, which is limited at both the corporate and shareholder levels. That is, under IRC Sec. 179(d)(8), the corporation passes through a maximum Section 179 deduction regardless of the number of shareholders, and each shareholder is limited to the same maximum deduction from all sources.

Another exception to the rule that S corporation losses are not limited at the corporate level may occur when another entity, such as a partnership, passes through losses to the S corporation, and the corporation does not have sufficient basis to deduct the entire loss.

Losses and deductions passed through to the shareholder can be deducted only to the extent of basis. (However, if losses exceed stock basis, they can be deducted against a shareholder's debt basis.) Losses limited by basis carry over indefinitely and are deducted in a later year to the extent the shareholder has basis at the end of that year.

Losses may also be limited by the passive activity loss rules and the at-risk rules.

Bankruptcy Trustee Could Not Force S Shareholders to Return Refunds Due to Pass-through Losses

As covered in the preceding discussion, losses generally are passed through to shareholders in full and are deducted, subject to certain limitations, at the shareholder level. Accordingly, a bankruptcy court held that an

insolvent S corporation cannot recover tax refunds made to shareholders based on pass-through losses from the S corporation. The bankruptcy trustee argued that the losses and the right to use them were property of the bankruptcy estate. The court, however, concluded that the losses and the right to use them automatically passed through from the corporation to the S corporation shareholders and, therefore, belonged to the shareholders and were not the corporation's property.

The Beneficial Owner as an S Corporation Shareholder

Beneficial Owner of S Stock Is Considered to Be Shareholder

The registered owner of S corporation stock may not be the beneficial owner (i.e., the person or entity that controls the stock or reaps the benefits of stock ownership). In that event, the beneficial owner, rather than the owner of record, is considered the shareholder (i.e., the owner of the S corporation stock). Thus, the person for whom S corporation stock is held by a nominee, guardian, custodian, or agent is considered the shareholder. Even though a partnership is not an eligible shareholder, a partnership may be a nominee for a person who is considered the shareholder.

Effect When No Shares Are Issued

Pass-through items are allocated to beneficial shareholders, even if no shares actually have been issued to that individual or entity. In *Pahl*, pass-through was properly allocated to a shareholder even though he paid nothing for stock and no shares were issued to him. The Tax Court ruled (and the Ninth Circuit agreed) that he was a shareholder because (1) he agreed to buy 25% of the stock (but made no payments), (2) he received a compensation package that was comparable to that of other shareholder-employees, (3) the firm's name was changed to include his name, and (4) he was shown as a shareholder on the corporation's Form 1120S.

Shares Held by Spouse as Community Property

If one spouse holds S corporation stock that is community property, the spouses (including legally married same sex spouses), report the pass-through in accordance with the community property rules.

Restricted Stock

A person who holds S corporation stock that is subject to restrictions (e.g., limiting the stock's sale or transfer) may not be considered the owner of the stock for pass-through purposes.

Eligible S Corporation Trusts

The deemed owner of the grantor trust is treated as the shareholder of the S corporation for eligibility purposes. Generally, the grantor trust is a nonfiling entity and the S corporation will provide the Schedule K-1 directly to the deemed owner. If a QSST election was made, the trust is treated as the shareholder and will receive the Schedule K-1—a QSST is not eligible for the alternative reporting directly to the deemed owner that can apply to other one-owner trusts. If an ESBT election was made, the S corporation portion of the trust is treated as the shareholder and receives the Schedule K-1.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Southern Properties, an S corporation, terminates an S election during the tax year. Its S short year has 265 days, and its C short year has 100 days. The corporation's taxable income for the C short year is $30,000. Southern Properties has a 15% tax rate for the C short year. How much tax will Southern Properties pay for its C short year?

    a. $4,500.

    b. $9,000.

    c. $16,425.

    d. $109,500.

22. Which of the following S corporations or S corporation shareholders has correctly addressed a reporting issue?

    a. Ion Flux treats its built-in tax gains as income received during the tax year.

    b. Jason deducts the full amount of losses passed through by the corporation on his tax return.

    c. Kettle Black reduces pass-through income by the Section 1375 tax.

    d. Lucy, an S shareholder, files a Form 8082 even though she did not report the S corporation loss on her tax return.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Southern Properties, an S corporation, terminates an S election during the tax year. Its S short year has 265 days, and its C short year has 100 days. The corporation's taxable income for the C short year is $30,000. Southern Properties has a 15% tax rate for the C short year. How much tax will Southern Properties pay for its C short year? **(Page 104)**

    a. **$4,500. [This answer is correct. The taxable income for the C corporation short year is placed on an annual basis by multiplying the taxable income for the C short year by the number of days in the termination year and dividing the result by the number of days in the C short year. After computing the corporate tax on this "grossed up" annualized income, the resulting corporate tax is then prorated back to a short period amount by multiplying the tax by the number of days in the short year and dividing the result by the number of days in the termination year. Therefore, the amount of taxes Southern Properties would pay for the entire year is calculated as follows: {($30,000 × 365) / 100} × 15% = $16,425. Then, the tax amount is broken down for the C short year as follows: ($16,425 × 100) / 365 = $4,500.]**

    b. $9,000. [This answer is incorrect. This calculation was made assuming a 30% tax rate. However, because the corporation's C short year has less than $50,000 of income, it is allowed to use the lowest corporate rate of 15%.]

    c. $16,425. [This answer is incorrect. This calculation was reached as follows: {($30,000 × 365) / 100} × 15% = $16,425. This is the tax on the corporation's "grossed up" annualized income. However, more calculations are necessary to get this amount correctly to the annualized tax amount for the C short year.]

    d. $109,500. [This answer is incorrect. This is the corporation's "grossed up" annualized income. The tax still needs to be calculated for this amount, and then more calculations are needed to make sure that tax amount is appropriately attributed to the C short year.]

22. Which of the following S corporations or S corporation shareholders has correctly addressed a reporting issue? **(Page 107)**

    a. Ion Flux treats its built-in tax gains as income received during the tax year. [This answer is incorrect. According to IRC Sec. 1366(f)(2), the built-in gains tax is deductible from the S corporation's income. This is accomplished by treating the built-in gains tax as a *loss* sustained by the S corporation during the tax year. The character of such loss is determined by allocating the loss proportionately among the built-in gains that give rise to the built-in gains tax.]

    b. Jason deducts the full amount of losses passed through by the corporation on his tax return. [This answer is incorrect. According to IRC Sec. 1366(d)(2), losses and deductions passed through to the shareholder can be deducted only to the extent of basis. However, if losses exceed stock basis, they can be deducted against a shareholder's debt basis. Losses limited by basis carry over indefinitely and are deducted in a later year to the extent the shareholder has basis at the end of that year. Therefore, if Jason cannot use all of his losses this year, he may be able to deduct them in a future year.]

    c. **Kettle Black reduces pass-through income by the Section 1375 tax. [This answer is correct. If the Section 1375 tax on excess net passive income applies, the pass-through of the income that created the tax is reduced by the amount of tax paid at the corporate level. Therefore, according to IRC Sec. 1366(f)(3) and Reg. 1.1355-4(c), each item of passive investment income Kettle Black has is reduced by its proportionate share of the tax.]**

    d. Lucy, an S shareholder, files a Form 8082 even though she did not report the S corporation loss on her tax return. [This answer is incorrect. A form 8082 does not need to be filed when the loss, deduction, or credit is not reported on the shareholders tax return. The amount is limited by law, such as a loss limited by the at-risk or passive activity loss limitations. Therefore, Lucy does not need to file Form 8082.]

Lesson 5: Alternative Minimum Tax

Introduction

The alternative minimum tax (AMT) constitutes a separate, independent tax system. Alternative minimum taxable income (AMTI) generally is computed in the same manner as regular taxable income; however, certain adjustments and preference items are includable and deductible for AMT purposes, but not for regular tax purposes.

As discussed in this lesson, an S corporation is not subject to the AMT. S corporation shareholders, however, may be subject to the individual AMT of IRC Sec. 55.

The starting point for determining AMT is the shareholder's "regular" taxable income. This amount is then modified for adjustments under IRC Sec. 56 (which are either added to or subtracted from taxable income) and preference items under IRC Sec. 57 (which are added to taxable income).

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the following about the alternative minimum tax (AMT): how it applies at the shareholder level, when S corporations are not subject to AMT, how to apply AMT rules to depreciation adjustments and preferences, how to make corporate and shareholder elections that will minimize AMT, how adjustments and preferences from passive activities are reported, how to calculate the shareholder's basis, how to apply noncorporate AMT rates for qualified dividend income and long-term capital gains, and how AMT affects business credits.

How the AMT Applies at the Shareholder Level

S corporations are not subject to the alternative minimum tax (AMT), but their shareholders may be subject to AMT on their individual income tax returns based on the income and deduction items passed through to them. Thus, S corporations must provide each shareholder with sufficient information to perform the AMT calculations with respect to items passed through from the company. This is done on the Schedule K-1 or an attachment. In turn, each shareholder must perform the AMT calculation to determine whether the tax applies and to maintain records for future years. Shareholders compute and report the AMT on Form 6251 (Alternative Minimum Tax—Individuals).

An S Corporation Is Not Subject to AMT

Small Corporation Exemption Does Not Apply to S Corporations

The exemption from the corporate AMT rules for a "small" corporation under IRC Sec. 55(e) does not apply to S corporations because they are not subject to the corporate AMT rules in any event. Thus, an S corporation passes through AMT adjustment and preference items to the shareholders regardless of its gross income.

AMT Exemption

Taxpayers are allowed an exemption amount when calculating the alternative minimum taxable income. The exemption amount is intended to prevent AMT from applying to taxpayers in lower tax brackets or with small amounts of adjustments or preference items. The exemption amount depends on the taxpayer's filing status and is phased out at the rate of 25% of the amount that alternative minimum taxable income (AMTI) exceeds certain thresholds.

Under IRC Sec. 1361(d)(1)(B), the beneficiary of a qualified Subchapter S trust (QSST) is treated as the owner of the S corporation stock held by the trust, so S corporation income and losses pass through to the beneficiary under IRC Secs. 671 and 1366, and the individual shareholder is allowed the AMT exemption. On the other hand, IRC Sec. 641(c) treats the portion of an electing small business trust (ESBT) consisting of S corporation stock as a separate trust. For AMT purposes, the deemed separate trust of an ESBT is not allowed an exemption amount.

The AMT Rules That Apply to Depreciation Adjustments and Preferences

Depreciation of Property Placed in Service after 1986

Generally, property placed in service after 1986 is depreciated under MACRS. As discussed later in this lesson, the depreciation methods and recovery periods used for AMT purposes may differ from those used for regular tax calculations. An AMT adjustment is required for the difference between regular tax depreciation (e.g., MACRS) and AMT depreciation.

Example 5C-1 Depreciation of property placed in service after 1986.

Loren is the sole shareholder in LL, Inc., an S corporation formed 12 years ago. Depreciation expense reported on page 1 of LL's Form 1120S (i.e., for regular tax purposes) is $23,875, and depreciation for AMT purposes is $15,000, resulting in an AMT adjustment of $8,875. Also, LL sold a machine that had been depreciated $1,650 for regular tax purposes and $1,000 for AMT purposes.

LL reports the depreciation adjustment on Schedule K on line 15a (Post-1986 depreciation adjustment). LL notifies the shareholder of the adjustment on Schedule K-1, line 15 [Alternative minimum tax (AMT) items], code A (Post-1986 depreciation adjustment). The adjustment to any gain or loss on the disposition is shown on Schedule K, line 15b (Adjusted gain or loss), and on Schedule K-1 on line 15, code B.

Regular Tax and AMT Depreciation Recovery Periods—Property Placed in Service after 1998

AMT Adjustment May Be Required. Effective for property placed in service after 1998, the depreciation recovery period is the same for both regular tax and AMT purposes. However, an AMT adjustment may still be required depending on the depreciation method used (e.g., 200% DB vs. 150% DB). The following rules apply to depreciable property placed in service after 1998:

1. For property otherwise eligible for MACRS depreciation under the 200% declining balance (DB) method, AMT depreciation is calculated using the 150% DB method over the MACRS recovery periods provided for regular depreciation. Therefore, if the taxpayer uses MACRS 200% DB depreciation for regular tax purposes, an AMT adjustment will be necessary to reflect the difference between the MACRS and 150% DB depreciation amounts.

2. For MACRS real property depreciated over 27.5 years (residential rental property) or 39 years (most other depreciable real estate) and placed in service after 1998, there is no AMT adjustment because the straight-line method is used for both AMT and regular tax purposes.

Property Not Depreciated under MACRS. Property that is depreciated under a method other than MACRS is not considered for purposes of the depreciation adjustment. For example, property depreciated under a units-of-production methods is not subject to the AMT depreciation adjustment.

Elections to Eliminate AMT Depreciation Adjustments

Instead of using MACRS, an S corporation can elect one of the following depreciation methods to eliminate the AMT adjustment:

1. *AMT Deprecation Method.* Under this method, the S corporation uses 150% declining balance over the MACRS recovery period for 3, 5, 7, or 10-year MACRS property.

2. *Straight-line over MACRS Recovery Period.* Under this method, the S corporation elects to use the straight-line method of recovery (over the normal MACRS recovery period) for one or more classes of property instead of the accelerated MACRS method.

3. *Alternative Depreciation System (ADS).* Under this system, the S corporation elects to depreciate property using the straight-line method over the appropriate asset depreciation range (ADR) class life (e.g., 40-year

straight-line for real property) rather than using the accelerated depreciation method, and generally shorter recovery period, of MACRS.

4. *Method Not Expressed in Term of Years.* A taxpayer can use the units-of-production or another method of depreciation not expressed in a term of years instead of cost recovery under MACRS.

5. *Bonus and Section 179 Deductions.* There is no AMT depreciation adjustment for qualified property recovered under IRC Sec. 168(k) (bonus depreciation—see the following paragraph) or IRC Sec. 179 (election to expense certain depreciable business assets).

Property for which bonus depreciation has been claimed is not subject to any AMT adjustment on the bonus amount or any remaining regular MACRS depreciation over the duration of the recovery period. If the S corporation elected out of (i.e., did not use) the additional bonus depreciation for a class of property placed in service in tax years ending prior to 2016, it also effectively made an election out of the exemption from AMT adjustment. In that event, the AMT depreciation adjustments applied to all property in the same class that was placed in service in the same year.

Corporate and Shareholder Elections to Minimize AMT

S corporations and their shareholders are allowed to make special elections that minimize the amount of certain AMT adjustments and preferences that must be added to taxable income in computing alternative minimum taxable income (AMTI). Although S corporations are not subject to the AMT, these elections usually affect the computation of the shareholder's taxable income for regular tax purposes. Thus, the election's effect on both the shareholder's taxable income and AMTI should be considered before the election is made.

Shareholder's Section 59(e) Election Can Eliminate Certain AMT Adjustments and Preferences

S corporation shareholders can eliminate certain AMT adjustments or preferences by electing under IRC Sec. 59(e) to capitalize and amortize all or part of their share of "qualified expenditures," which include:

1. Circulation expenditures,

2. Research and experimental expenditures,

3. Intangible drilling and development expenditures,

4. Development expenditures, and

5. Mining exploration expenditures.

Treatment of Qualified Expenditures at the S Corporation Level

If an S corporation incurs qualified expenditures listed in the preceding paragraph, each of the expenditures can be deducted by the corporation in the year it is paid or incurred. However, if the S corporation so elects, the expenditures, other than circulation expenditures, can be capitalized and amortized at the corporate level, based on the applicable rules for each type of expenditure. No shareholder AMT adjustment is required when the corporation elects to capitalize and amortize the expenditures.

Section 59(e) Election to Amortize Qualified Expenditures Is Made at the Shareholder Level

If the corporation deducts one of the qualified expenditures shown on the previous list, such expenditure can be deducted by the shareholder in the year the expenditures are paid or incurred. If they are currently deducted by the shareholder, an AMT adjustment or preference can result. IRC Sec. 59(e) allows a shareholder to eliminate the AMT adjustment or preference by electing to capitalize and amortize any or all of the stockholder's share of the expenditures.

The Section 59(e) election is made by completing the "Amortization" section of Form 4562 (Depreciation and Amortization). The Code does not require a specific election statement. However, some practitioners prefer to attach a separate election to the return.

Circulation Expenditures

S Corporation Can Deduct Circulation Expenses. Circulation expenditures can be deducted when paid or incurred. As previously noted, the option of capitalizing and amortizing circulation expenditures is evidently not available to S corporations. Thus, no deduction for circulation expense is taken at the corporate level. Rather, the expense is passed through separately on line 12c [Section 59(e)(2) deductions] of Schedule K. The expenditures are reported to the shareholder on line 12, code J, of Schedule K-1.

Shareholder Treatment of Circulation Expenses. The shareholder can deduct his or her share of the circulation expense currently. In that event, the shareholder must make an AMT adjustment for the amount of circulation expenditures deducted for regular tax purposes in excess of the amount that would be allowable if the regular tax deduction had been capitalized and amortized over three years.

An S corporation shareholder can avoid the AMT adjustment by making the Section 59(e) election. The election applies only to the current year and may be made for any or all of the expenditures. If the shareholder makes the election, the circulation expenditures are capitalized at the shareholder level and are amortized ratably over a three-year period. (If all of the costs are capitalized and amortized, there is no AMT adjustment.)

Example 5D-1 Making the Section 59(e) election for circulation expenditures.

John owns all of the shares of JJ, Inc. (JJI), an S corporation. JJI passes through $20,000 of nonseparately stated income and $10,150 of circulation expense. John materially participates in JJI's activities. To avoid the AMT adjustment, John makes the Section 59(e) election and deducts one-third of the expenditures ($3,383) in the current year. If John did not make the Section 59(e) election, he would deduct the $10,150 in circulation expenditures and have an AMT adjustment of $6,767 ($10,150 − $3,383). [This adjustment would increase alternative minimum taxable income (AMTI).] For each of the following two years (i.e., throughout the three-year amortization period), a negative AMT adjustment of $3,383 would be made. (This adjustment reduces AMTI.)

Research and Experimental Expenditures

S Corporation Can Deduct R&D Expenditures. Research and experimental (often referred to as research and development, or R&D) expenditures may be deducted in the year paid or incurred. As mentioned previously, if the corporation deducts R&D expenditures in the year paid or incurred, the deduction is passed through as a separately stated item on Schedule K-1 and is not included on page 1 of Form 1120S. The S corporation must adopt this method of deducting R&D expenditures in the first year such expenditures are paid or incurred. (In some cases, the corporation may adopt this method in a later year with the IRS's consent.)

Corporate Election to Amortize R&D Expenditures. If the corporation so elects, R&D expenditures that are (1) not currently deducted, and (2) chargeable to an asset that is not subject to depreciation or amortization may be amortized over a 60-month period. The amortization begins in the month in which the taxpayer first realizes benefits. This is a one-time election that can be revoked only with the IRS's consent. If the election to capitalize R&D expenditures and amortize them over 60 months is made, there is no shareholder AMT adjustment. The amortization expense is passed through as a component of nonseparately stated income on the "Other deductions" line on page 1 of Form 1120S.

Shareholder Treatment of R&D Expenditures. As stated in the preceding paragraph, an S corporation can deduct R&D expenditures in the year paid or elect to amortize them over 60 months. If the corporation makes the election to amortize them, the shareholders have no AMT adjustment. Furthermore, even if the R&D expenditures are deducted in the year paid or incurred, no AMT adjustment is required for shareholders who materially participate [as defined in IRC Sec. 469(h)] in the S corporation activity that gave rise to the expenditures. For shareholders who do not materially participate, an AMT adjustment must be made for the difference between (1) the shareholder's deduction for R&D expenditures deducted in the year paid or incurred and (2) the deduction that would result if the expenditures were capitalized and amortized over 10 years (beginning with the tax year in which the expenditures were made). As Example 5D-2 illustrates, in the year the R&D expenditures are paid or incurred, the AMT adjustment will be positive (i.e., increases AMTI), while adjustments through the remainder of the 10-year amortization period will be negative.

The Section 59(e) election, which is made at the shareholder level, allows a shareholder who does not materially participate in the S corporation's activity to capitalize and amortize R&D expenditures ratably over a 10-year period, so that no AMT adjustment will be required.

Example 5D-2 AMT adjustment for R&D expenditures from a passive activity.

Norman owns 50% of the shares of JPI, Inc., an S corporation. Norman does not participate in the corporation's operations. JPI reports $40,000 of nonseparately stated income from operations on page 1 of its Form 1120S. It also incurred $20,300 of R&D expenses in the only activity in which it engages, and did not elect to capitalize the expenditures. Norman has no other passive income or losses. Norman's share of the corporation's nonseparately stated income is $20,000, and his separately stated share of the R&D expenditures is $10,150. Norman's two choices regarding the expenditures are to—

1. deduct the $10,150 currently, or

2. make the Section 59(e) election and amortize the $10,150 over a 10-year period, resulting in a $1,015 deduction in the current year.

Norman's tax practitioner determines that the best results are achieved by taking the $10,150 deduction currently. That amount is reported as a deduction on Norman's Schedule E. (Since the corporation's nonseparately stated income and R&D expenditures result in overall passive income, the $10,150 R&D deduction is evidently entered in the same column of Schedule E as the nonseparately stated income.)

Because he deducted the $10,150, he will have an AMT adjustment in the current year of $9,135 ($10,150 − $1,015). In the following year, Norman will have a negative AMT adjustment of $1,015 ($10,150 × 10%). (This adjustment will reduce AMTI.) He will report a $1,015 negative adjustment throughout the remainder of the 10-year amortization period.

In this example, JPI is a passive activity because Norman does not materially participate in its operations. AMT adjustments and preferences included in passive activity income or loss must be accounted for in the AMTI calculation. IRS Ann. 88-45 AMT adjustments and preferences related to passive activities should be reflected only on line 19 (Passive activities) of Form 6251 (Alternative Minimum Tax—Individuals). (Passive activities for AMT purposes are discussed in more detail later in this lesson.

Assume now that the practitioner determines that it is favorable for Norman to amortize the R&D expenditures over a 10-year period. The "Amortization" section of Form 4562 (Depreciation and Amortization) is completed, with the amortization reported on Schedule E. Once made, the election to amortize a specific year's R&D expenditures cannot be revoked, but the election applies to that one year's expenditures only, and does not prevent the shareholder from deducting subsequent years' R&D expenditures.

Example 5D-3 R&D expenditures when shareholder materially participates in the activity.

Assume the same facts as in Example 5D-2, except Norman materially participates in JPI's operations. In that case, he can deduct the full $10,150 in R&D expenditures, and no AMT adjustment is required. The nonseparately stated income and research and experimental expenses are reported in the "Nonpassive income from Schedule K-1" column of Schedule E. No adjustment is necessary on Form 6251.

Intangible Drilling Costs

Generally, intangible drilling costs (IDC) must be capitalized by the S corporation and recovered through depletion deductions over the life of the mineral property. However, if the S corporation has made an election under IRC Sec. 263(c), the IDC is deducted when paid or incurred.

Any taxpayer other than an integrated oil company [as defined in IRC Sec. 291(b)(4)] can expense its IDC without treating any part of the deduction as an AMT preference item. In other words, it is not necessary for most taxpayers to elect to capitalize and amortize IDC over a 60-month period to avoid tax preference treatment. However, the taxpayers' alternative minimum taxable income (AMTI) cannot be reduced by more than 40% of

AMTI calculated (1) as if a preference item adjustment is required for the excess of the IDC deduction over the amount that would be deductible if the IDC were amortized for 60 months, and (2) without regard to the AMT net operating loss deduction. This limitation on the reduction of AMTI means the taxpayer must calculate the AMTI with and without an IDC preference to determine whether the limitation applies.

Mining Exploration and Development Costs

Mining exploration costs and mining development costs are treated separately and differently under the Code.

Generally, mining *exploration* costs must be capitalized at the S corporation level. However, IRC Sec. 617 provides a corporate-level election to expense these costs as they are paid or incurred. This is a one-time election and applies to all subsequent years unless revoked with the Commissioner's consent. Exploration expenditures are made before the beginning of the development stage of the mine or other natural deposit. They include expenditures for ascertaining the existence, location, extent, or quality of ore or other mineral.

Mining *development* costs paid or incurred in connection with a trade or business can be deducted under IRC Sec. 616. Alternatively, a corporate-level election can be made to capitalize mining development costs. This is a one-time election and applies to all subsequent years unless revoked with the IRS's consent. Development expenditures are made after deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer.

If mining exploration or development costs are expensed by the S corporation for regular tax purposes, the shareholder must make an AMT adjustment for the amount of the costs deducted in excess of the amount that would be allowable if the regular tax deduction had been capitalized and amortized over 10 years.

IRC Sec. 59(e) allows the shareholder to elect to capitalize mining exploration and development expenses. The election applies only to the current year and may be made with respect to any amount of expenditures the shareholder chooses. If the Section 59(e) election is made, all or a portion of the mining exploration and development expenditures can be capitalized and amortized over a 10-year period. (If all of the current-year costs are capitalized and amortized, there is no AMT adjustment.)

Mining and development costs are reported similarly to R&D and circulation expenditures. The AMT adjustment, if any, applies even if the shareholder materially participates in the corporation's activities.

Disposition of Property Subject to the Section 59(e) Election

If the shareholder makes the Section 59(e) election to minimize AMT adjustments and preferences on the expenditures covered in the preceding discussion, the corporation's basis in the property will differ from the shareholder's basis in that property. For example, if the S corporation makes an election to currently expense mining exploration costs under IRC Sec. 617, any shareholder can elect to capitalize all or any portion of the shareholder's distributive share of otherwise deductible mining exploration costs by making a Section 59(e) election. This allows the shareholder to capitalize and amortize the mining exploration costs (for both regular tax and AMT purposes) over a period of 60 months. The Section 59(e) election causes the capitalized amount to not be treated as an AMT preference item. The result is that the shareholder's basis in the property to which the election relates is different from the S corporation's basis (because the S corporation must assume that all amounts were deducted by the shareholders). Example 5D-4 illustrates how S corporation reporting is affected by this issue.

Example 5D-4 Disposition of property before amortization period expires.

George and Fred each own half of the shares of Palo Pinto Mining, Inc., an S corporation. During calendar year 2016, Palo Pinto incurred $200,000 of mining exploration costs. The corporation has made an election under IRC Sec. 617 to currently expense mining exploration costs. On each shareholder's Schedule K-1 for the year, $100,000 of mining exploration cost was reported. George deducted the full $100,000, while Fred elected under IRC Sec. 59(e) to capitalize and amortize the $100,000 of mining exploration costs. Thus, Fred deducted $10,000 of mining exploration costs on his income tax return ($100,000 ÷ 10 years). Palo Pinto sold the property on January 1, 2017, for a taxable gain of $210,000.

For 2017, Palo Pinto will report the gain on the sale of the mining property based on its tax accounting methods, which include the expensing of all mining exploration costs. Thus, for tax reporting purposes, Palo Pinto assumes that no shareholder made an election under IRC Sec. 59(e). The corporation reports the gain on the sale of the mining property on line 10 [Other income (loss)] Schedule K. The gain is reported to the shareholders on line 10, code E [Other income (loss)] of their Schedule K-1.

The S corporation should notify the shareholders that they need to recalculate their gains and losses if they made Section 59(e) elections. This can be done on a separate statement attached to the Schedule K-1. The notification could be worded as follows:

> "The Section 1254 gain reported on Line 10, code E, is attributable to a property for which mining development costs subject to a Section 59(e) election were incurred. For purposes of calculating the gain reported on this Schedule K-1, such expenditures were assumed to have been 100% deducted by the shareholders. If you made an election under IRC Sec. 59(e) to capitalize and amortize your distributive share of some or all of the mining development costs attributable to the property, you should consult your tax adviser regarding the proper calculation of gain or loss."

Due to Fred's Section 59(e) election, he has an additional $90,000 ($100,000 − $10,000) of basis in the mining property and must compute his gain accordingly.

Effect of the Section 59(e) Election on Stock Basis

Stock basis is reduced by pass-through items of loss or deduction. The basis reduction for nonseparately and separately stated items of loss and deduction occurs regardless of whether the shareholder can deduct the loss on the shareholder's current year personal return. Under this rule, must the shareholder reduce basis by the full amount of, for example, research and experimental expenses, even though the shareholder makes the Section 59(e) election and amortizes the expenditures over a 10-year period?

There is no authority precisely on point and the answer is unclear. If the amount reported on Schedule K-1, line 12, code J [Section 59(e)(2) expenditures] is a "separately stated item of loss or deduction," basis must be reduced by the full amount. If, however, the amount on that line is not an item of loss or deduction, but rather is construed as information necessary to allow the shareholder to determine the correct deduction, the practitioner may be able to justify reducing basis by the annual amortization amounts deducted under IRC Sec. 59(e). Further, the general basis rules provide that basis is reduced over the amortization period as the deductions are taken. The general basis rules of IRC Sec. 1016, however, may not apply to S corporation pass-through items. It seems logical that the stock basis would be properly reduced by the full amount of the expenditures subject to IRC Sec. 59(e) in the year the expenditures appear on Schedule K-1.

Example 5D-5 Effect of the shareholder's Section 59(e) election on stock basis.

Assume the same facts as in Example 5D-2. Norman's share of the corporation's nonseparately stated income is $20,000, and his share of the R&D expenditures is $10,150. The practitioner determines it is favorable for Norman to amortize the R&D expenditures over a 10-year period.

Norman's stock basis is apparently reduced by $10,150 in the current year even though the $10,150 will be deducted on Norman's return over a 10-year period.

Claiming the Minimum Tax Credit

The portion of AMT caused by deferral or timing preferences may generate a minimum tax credit (MTC) that can offset regular tax in future tax years. The MTC equals the difference between actual AMT and the AMT owed if only the exclusion preferences (permanent differences) were considered in computing AMT. Without the MTC, a taxpayer may never benefit from deferral item deductions that trigger AMT if the taxpayer pays regular tax in the year the deferral item reverses. The MTC has an unlimited carryforward period. It is claimed on Form 8801 (Credit for Prior Year Minimum Tax—Individuals) with allowable MTC carried to Form 1040.

Before making a depreciation or Section 59(e) election, the practitioner should consider other AMT adjustments and the MTC. If a shareholder's AMT results primarily from deferral or timing preferences, the AMT will likely

become an MTC carryforward that will offset future regular tax. Therefore, any AMT paid in the current tax year may be recovered as a credit against regular tax in the next few years. Here, electing a slower depreciation method or recovery of the deductions discussed previously would reduce the amount of the MTC carryforward in exchange for larger deductions in future years for regular tax purposes. Trading a credit for a deduction is generally not a good tradeoff. Instead, the shareholder is probably better off using the faster deduction recovery period and the resulting MTC to offset regular tax in future years [e.g., by not making the Section 59(e) election].

Alternately, if a shareholder's AMT is caused primarily by exclusion preferences for which no MTC carryforward is allowed, the AMT paid in the current year becomes a permanent tax. Here, electing a slower depreciation or other recovery period for the expenditures described previously may help save future regular tax deductions.

Certain C corporation carryovers, including the MTC, can be used to reduce the built-in gains tax. Also note that corporations can elect to accelerate certain pre-2016 minimum tax credits in lieu of claiming bonus depreciation for qualified property placed in service during the tax year. In addition to not claiming bonus depreciation on the qualified property, the straight-line depreciation method must be used. The election allows corporations to swap their bonus and accelerated depreciation deduction for an increased AMT credit limitation. A more detailed discussion of the AMT and MTC are beyond the scope of this course, but more information is available in *PPC's 1120 Deskbook*.

Reporting Adjustments and Preferences Related to Passive Activities

Passive Activities

Passive activity losses generally are deductible only (1) against income from passive activities, (2) when the entire interest in a passive activity is disposed of in a taxable transaction, or (3) under the $25,000 rental loss privilege for qualified rental real estate activities (subject to the $100,000 AGI phase-out).

An S corporation's nonseparately stated income or loss from business operations may include amounts from adjustment or preference items, such as depreciation. As discussed earlier in this lesson, amounts subject to the Section 59(e) election are passed through separately, and do not reduce nonseparately stated income.

Reporting Adjustments and Preferences from Passive Activities

If the corporation passes through passive income or loss, any AMT adjustments and preferences must be accounted for in the alternative minimum taxable income (AMTI) calculation. Under IRS Ann. 88-45, AMT adjustments and preferences related to passive activities are reported *only* on line 19 (Passive activities) of Form 6251 (Alternative Minimum Tax—Individuals). The instructions to Form 6251 also provide that this is the correct treatment.

Example 5E-1 Net income on Schedule K-1 may include adjustment and preference amounts.

Jim Jones bought 25% of the shares of JJ, Inc., an S corporation, on January 1, 2013. JJ conducts only one activity, a retail hardware store. Jim does not materially participate in the business. JJ passes through to Jim $10,000 in nonseparately stated income from the business activity. JJ also passes through a $500 AMT depreciation adjustment, which is shown on line 15a (Post-1986 depreciation adjustment) of Schedule K. The adjustment is reported to Jim on line 15 [Alternative minimum tax (AMT) items], code A (Post-1986 depreciation adjustment), of Schedule K-1. Jim has no other passive income or loss.

The $10,000 of passive income is reported on Jim's Schedule E. Since the $500 depreciation adjustment arose from a passive activity, it is entered on line 19 (Passive activities) of Jim's Form 6251, rather than on the depreciation line.

Example 5E-2 Adjustments and preferences relating to passive activity cause income or loss to be recalculated for AMT purposes.

Assume the same facts as in Example 5E-1. Since the $500 depreciation adjustment is included in Jim's AMTI, that amount increases Jim's income for AMT purposes. This means passive income or loss must be recalculated for AMT purposes as follows:

Passive income	$ 10,000
Depreciation adjustment	500
Passive income included in AMTI	$ 10,500

If the S corporation passes through passive losses that are not deductible by the shareholder, adjustments and preferences are not reported on Form 6251. Rather, the passive activity loss carryover is computed separately for regular tax and AMT purposes, as discussed in Examples 5E-3 and 5E-4.

Example 5E-3 Adjustments and preferences relating to nondeductible passive losses are not reported on Form 6251.

Assume the same facts as in Example 5E-1, except that JJ passes through a $10,000 nonseparately stated loss from business activities and a $500 depreciation adjustment. For AMT purposes, Jim's passive loss from JJ is $9,500 ($10,000 − $500). However, Jim has no passive income and cannot deduct any part of the loss, so no AMTI adjustment is necessary, and no entry is made on Form 6251 to reflect the adjustment. Rather, the loss carryforward is different for regular tax and for AMT purposes, as illustrated in Example 5E-4.

Example 5E-4 Shareholder may be required to maintain two carryforward passive loss schedules.

Assume the same facts as in Example 5E-3. The practitioner must maintain two passive loss carryforward schedules—one for regular tax purposes and one for AMT purposes.

	Regular Tax	AMT
Passive loss for the year	$ 10,000	$ 9,500
Loss deducted in the current year	—	—
Suspended loss carried forward	$ 10,000	$ 9,500

Example 5E-5 AMT passive activity adjustments when shareholder has loss from one activity and income from another.

During the year, Larry Phillips bought shares in two S corporations, AA, Inc. and BB, Inc. Both corporations conduct only one activity, retail sales. Larry is not a material participant in either corporation. His share of the loss from AA for the year is $10,000, and his share of AMT adjustments from AA is $4,000. His share of BB's income is $3,000, after considering his share of the S corporation's AMT adjustments and preferences of $1,500. The following table illustrates Larry's net passive loss for purposes of regular tax:

AA loss	$ (10,000)
BB income	3,000
Net passive loss	$ (7,000)

For AMT purposes, the following adjustments must be made to compute passive activity income or loss:

	AA, Inc.	BB, Inc.
Income (loss) from passive activity	$ (10,000)	$ 3,000
Add back AMT adjustments and preferences	4,000	1,500
Total AMT passive income (loss)	$ (6,000)	$ 4,500

No preference or adjustment entries are made on Larry's Form 6251 because the various AMT modifications attributable to these two activities have been included in the AMT passive loss calculation and are reflected in his AMT suspended passive loss carryforward.

The following table illustrates Larry's passive loss carryforwards for purposes of regular tax and AMT:

	Regular Tax	AMT
Passive activity loss (AA, Inc.)	$ 10,000	$ 6,000
Passive activity income (BB, Inc.)	(3,000)	(4,500)
Net passive loss	7,000	1,500
Loss deducted in the current year	—	—
Amount carried forward	$ 7,000	$ 1,500

Making the Election to Aggregate Activities at the Shareholder Level. In many situations, like the one in Example 5E-5, it may be possible for the shareholder to make an election to aggregate activities under Reg. 1.469-4 so that the shareholder can meet the material participation test in the one activity made up of both S corporations. If the shareholder then materially participates, the losses are not passive and are deductible against other nonpassive income, as well as passive income. (Groupings of activities, however, must remain consistent and cannot be changed unless the grouping is inappropriate.)

Disposition of a Passive Interest

If the shareholder disposes of a passive interest in an S corporation, the calculations become even more complicated. In this situation, the preparer must account for current year AMT adjustments and preferences, suspended losses triggered by the disposition, and possible AMT basis adjustments. For example, if the passive activity includes depreciable property for which there have been previous depreciation adjustments, the shareholder's AMT basis in the S corporation will differ from regular tax basis. This will result in differing amounts of gain or loss from the sale for purposes of regular tax and AMT, as discussed later in this lesson.

The Calculation of a Shareholder's Basis for Regular Tax and AMT Purposes

Alternative Minimum Tax Basis Adjustments

The alternative minimum tax is a taxing system separate from, but operating parallel to, the regular tax. This means that a taxpayer must calculate taxable income and tax liability each year under both the AMT and the regular tax. Furthermore, the S corporation basis limitations on losses set out in IRC Sec. 1366(d) are applied when determining alternative minimum taxable income (AMTI), after considering the AMT adjustments, preferences, and loss limitations in Sections 56, 57, and 58.

The shareholder's stock basis is increased by pass-through items of income and gain; it is decreased by items of deduction and loss. Because alternative minimum taxable income is based on regular taxable income adjusted for specific adjustment and preference items, pass-through items of income, gain, deduction, or loss affect basis for both regular tax and AMT purposes. Adjustments and preferences passed through to the shareholder, however, affect the calculation of basis for AMT purposes only.

Example 5F-1 Shareholder's stock basis can differ for purposes of regular tax and AMT.

On January 1, Cheryl bought all of the shares of CC, Inc. for $30,000. On that date, the accumulated adjustments account (AAA) has a zero balance and the corporation has $20,000 of accumulated earnings and profits (AE&P). Cheryl materially participates in the corporation's activities. At the end of the calendar year, the corporation passed through $10,000 of nonseparately stated income from operations and a depreciation

adjustment of $500. No distributions were made to Cheryl during the year. Her basis in the shares must be separately computed for regular tax and AMT purposes, as follows:

	Regular Tax	AMT
Stock basis, beginning of year	$ 30,000	$ 30,000
Nonseparately stated income	10,000	10,000
Depreciation adjustment	—	500
Stock basis, end of year	$ 40,000	$ 40,500

If Cheryl sold her shares for $45,000 before any further transactions take place, she would have a $5,000 gain for regular tax purposes and $4,500 gain for AMT purposes. Her Form 6251 would show a $500 negative amount on line 17 (Disposition of property).

Assume that the company breaks even the next year and distributes $60,500 to Cheryl. The corporation determines that $20,000 is a dividend (i.e., a distribution of AE&P) and $40,500 is a nondividend distribution (e.g., a distribution of the AAA). The corporation reports the $20,000 dividend to Cheryl on Form 1099-DIV, and Cheryl includes this amount in gross income on her Form 1040. The $40,500 nondividend distribution is reported to Cheryl on her Schedule K-1 from the corporation. Nondividend distributions are nontaxable to the extent of stock basis and are capital gain to the extent they exceed stock basis. Therefore, for regular tax purposes, Cheryl received a $40,000 nontaxable distribution (that reduced her stock basis to zero) and a $500 capital gain. For AMT purposes, however, her stock basis is $40,500 before considering the distribution, so she has no taxable distribution. Distributions in excess of basis are considered to be capital gains from the deemed disposition of stock. Thus, Cheryl's Form 6251 would show a $500 negative amount on line 17 (Disposition of property).

AAA and AE&P Adjustments

It is not clear whether an S corporation is required to maintain a separate accumulated adjustments account (AAA) and track accumulated earnings and profits (AE&P) for AMT purposes.

On June 1, 2011, the AICPA sent a letter to the Department of the Treasury. Practitioners should monitor this issue for developments. The letter included the following:

> "Guidance is needed as to when, for alternative minimum tax purposes, S corporations will have attributes which will be different for regular tax and alternative minimum tax purposes. For example, does an S corporation have an Accumulated Adjustments Account for alternative minimum tax purposes which would differ by the adjustments of sections 56, 57 and 58 from the Accumulated Adjustments Account for regular tax purposes? Assuming there are Accumulated Adjustment Accounts kept for each type of tax, if distributions in excess of the regular tax and AMT Accumulated Adjustments Accounts are made by an S corporation with accumulated earnings and profits, how much is taxable to the recipient shareholder for regular tax purposes and how much for AMT purposes? As more and more taxpayers become subject to the AMT, it is increasingly important for taxpayers to have guidance on how the regular tax and AMT interface with respect to common transactions."

Noncorporate AMT Rates That Can Be Applied for Qualified Dividend Income and Long-term Capital Gains

AMT is calculated at rates of 26% on net alternative minimum taxable income (AMTI) up to a certain inflation-adjusted amount and 28% on net AMTI above that amount. Qualified dividend income and long-term capital gain, however, are taxed at the same rate for regular tax and AMT purposes. This basically means that, for 2017, the AMT tax rates consist of a number of "layers," as follows:

1. AMTI, other than qualified dividend income and long-term capital gain, is taxed at 26% and 28%.

2. Qualified dividend income and long-term capital gain (other than gain on "collectibles" and gain from depreciation on Section 1250 real property) are taxed at 0% to the extent the gain would otherwise be subject to the 10% and 15% rate for regular tax purposes, 15% on the amount that would otherwise be subject to a tax rate above 15% and below 39.6% for regular tax purposes, and 20% on the amount that would otherwise be subject to a tax rate of 39.6% for regular tax purposes.

3. Long-term gain on Section 1250 property (to the extent of depreciation taken) is taxed at a maximum rate of 25%.

Gain on Collectibles

Gain on "collectibles" is subject to a maximum tax rate of 28% if the asset is held more than one year. A collectible is any piece of art, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, or other personal property designated by the IRS.

Section 1202 Small Business Corporation Stock

Gain on qualified small business corporation (QSBC) stock held for more than five years (i.e., Section 1202 gain) is subject to a maximum capital gains rate of 28% (for both regular tax and AMT purposes), but a certain percentage of the gain can be excluded from income, depending on when the stock was acquired.

Net Investment Income Tax Applies to Capital Gains and Qualified Dividend Income

For 2014, the 3.8% net investment income tax (NIIT) will cause the overall tax rate on capital gains and qualified dividend income to be 23.8% (20% + 3.8%) for some high-income taxpayers. The NIIT applies to individuals whose modified adjusted gross income (MAGI) exceeds $250,000 for joint returns and surviving spouses, $125,000 for separate returns, and $200,000 in all other cases. The 20% maximum tax rate applies to qualified dividend income and capital gains to the extent that income or gain would otherwise be subject to the 39.6% rate for regular tax purposes.

How AMT Can Affect Business Credits

The general business credit is limited to the taxpayer's "net income tax," which is—

- the regular tax, plus the AMT,
- less (among others) the nonrefundable personal credits and the credits of IRC Secs. 21 through 30C,
- less the larger of: the tentative minimum tax from Form 6251 (Alternative Minimum Tax—Individuals), or 25% of the net regular tax in excess of $25,000 (or $12,500 for married persons filing separately).

Under this calculation, general business credits (with certain exceptions) are not available to offset any of the taxpayer's AMT.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. HollowCorp eliminates its alternative minimum tax (AMT) adjustment for a piece of property by using a 150% declining balance over the MACRS recovery period. Which depreciation method did the S corporation use?

    a. The AMT depreciation method.

    b. Straight-line over MACRS recovery period.

    c. The alternative depreciation system (ADS).

    d. A method not expressed in a term of years.

24. Which of the following occurs when an S shareholder's basis for regular tax and AMT purposes is calculated?

    a. The shareholder chooses whether to use regular tax or AMT.

    b. S corporation basis limitations do not apply when AMT is calculated.

    c. Pass-through items of income and loss affect a shareholder's basis for regular tax and AMT.

    d. Adjustments passed through to the shareholder only affect shareholder basis for regular tax purposes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. HollowCorp eliminates its alternative minimum tax (AMT) adjustment for a piece of property by using a 150% declining balance over the MACRS recovery period. Which depreciation method did the S corporation use? **(Page 114)**

    a. The AMT depreciation method. [This answer is correct. Instead of using MACRS, an S corporation can elect one of several depreciation methods to eliminate the AMT adjustment. When the AMT depreciation method is elected, the S corporation uses 150% declining balance over the MACRS recovery period for 3, 5, 7, or 10-year MACRS property. By doing this, HollowCorp has used the AMT depreciation method.]

    b. Straight-line over MACRS recovery period. [This answer is incorrect. If HollowCorp chose this method, it would elect to use the straight-line method of recovery (over the normal MACRS recovery period) for one or more classes of property instead of the accelerated MACRS method. However, HollowCorp used a different method in this scenario.]

    c. The alternative depreciation system (ADS). [This answer is incorrect. HollowCorp did not use the ADS in this scenario. If it had, it would have elected to depreciation property using the straight-line method over the appropriate asset depreciation range (ADR) class life (e.g., 40-year straight-line for real property) rather than using the accelerated depreciation method, and generally shorter recovery period, of MACRS.]

    d. A method not expressed in a term of years. [This answer is incorrect. HollowCorp is using a MACRS recovery period, which means it is not using a method not expressed in a term of years. If it were, it would use the units-of-production or another method of depreciation not expressed in a term of years instead of cost recovery under MACRS.]

24. Which of the following occurs when an S shareholder's basis for regular tax and AMT purposes is calculated? **(Page 122)**

    a. The shareholder chooses whether to use regular tax or AMT. [This answer is incorrect. The AMT is a taxing system separate from, but operating parallel to, the regular tax. This means that a taxpayer must calculate taxable income and tax liability each year under *both* the AMT and the regular tax.]

    b. S corporation basis limitations do not apply when AMT is calculated. [This answer is incorrect. S corporation basis limitations on losses set out in IRC Sec. 1366(d) are applied when determining alternative minimum taxable income (AMTI), after considering AMT adjustments, preferences, and loss limitations in Sections 56, 57, and 58.]

    c. Pass-through items of income and loss affect a shareholder's basis for regular tax and AMT. [This answer is correct. According to IRC Sec. 1367(a)(2), the shareholder's stock basis is increased by pass-through items of income and gain; it is decreased by items of deduction and loss. Because alternative minimum taxable income is based on regular taxable income adjusted for specific adjustment and preference items, pass-through items of income, gain, deduction, or loss affect basis for both regular tax and AMT purposes.]

    d. Adjustments passed through to the shareholder only affect shareholder basis for regular tax purposes. [This answer is incorrect. Adjustments and preferences passed through to the shareholder, however, affect the calculation of basis for AMT purposes only.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1120S Deskbook—Course 1—Topics Related to Deductions and Pass-through to Shareholders (T2STG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($89 for email or fax; $99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     T2STG171 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price

for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **November 30, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1120S Deskbook—Course 1—Topics Related to Deductions and Pass-through to Shareholders (T2STG171)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Which of the following qualifications must be met for compensation paid to employees of an S corporation to be deductible?

   a. The compensation must not exceed the $500,000 threshold for employees and $1 million threshold for officers.

   b. At least 50% of the compensation paid to the individual must be in return for personal services rendered to the S corporation.

   c. Compensation is only deductible if the employee is not a shareholder in the S corporation.

   d. The compensation must be reasonable for the personal services provided to the S corporation by the individual.

2. Under what circumstances is the IRS most likely to examine an S corporation's wage payments to shareholders?

   a. The S corporation has three or fewer shareholders.

   b. The S corporation has more than 20 shareholders.

   c. Shareholders receive large distributions but are paid little in wages.

   d. Shareholders are paid high wages but seldom, if ever, receive distributions.

3. Jenkins & Taylor is an S corporation that uses the cash method of accounting. When should it deduct compensation paid to its employees?

   a. In the year the compensation was paid.

   b. When all events that determine the fact of the liability have occurred.

   c. When economic performance has occurred.

   d. When the payment is included in the employee's income.

4. Which of the following may occur if an S corporation has distributions to shareholders reclassified as wages?

   a. The shareholder is responsible for paying FICA and federal unemployment taxes (FUTA) on the wages.

   b. The corporation will have to pay income tax withholding on the wages even if the shareholder has already paid the proper income tax.

   c. The corporation could be subject to the failure to file penalty, the failure to deposit penalty, and the negligence penalty.

   d. A shareholder who is not yet of retirement age may yet still suffer a reduction in his or her future social security benefits.

5. Which of the following S corporations has correctly addressed an issue related to compensation or other payments made to shareholders?

   a. Corporation A classifies a payment to a shareholder as a loan because the shareholder performed a service for the corporation.

   b. Corporation B classifies distributions made to shareholders who did not perform services as wages subject to the self-employment tax.

   c. Corporation C classifies payments to officers performing their duties toward the corporation as distributions.

   d. Corporation D deducts payments for health insurance premiums for shareholder-employees holding more than 2%.

6. Wordsmith Inc. is an S corporation that runs on a calendar year and uses the accrual basis of accounting. Certain shareholder employees receive bonuses at the end of the year if specific performance goals are met. In December 20X1, the board authorizes the bonus payments and records them on the books as of December 31. The bonuses are paid to the appropriate employees on their first paycheck in 20X2. For which tax year can Wordsmith deduct the bonus payments?

   a. 20X1.

   b. 20X2.

   c. The bonuses cannot be deducted in any tax year as they are not considered compensation.

   d. The corporation is allowed to choose the tax year in which it is the most advantageous to deduct the bonuses.

7. Blankenship Ltd., an S corporation, compensates one of its employees for services rendered with unrestricted S corporation stock instead of with wages. Which of the following may occur?

   a. The fair market value of the stock is included in the employee's salary in the year the stock is sold.

   b. The fair market value of the stock is exempt from the corporation's responsibility to pay payroll taxes.

   c. The employee's basis in the shares will be the amount of compensation plus any additional amount paid for the stock.

   d. The corporation is allowed to impose restrictions for continued employment before the employee receives the stock.

8. Assuming all other qualifications are met, when would property become substantially vested?

   a. Risk of forfeiture is less than 50%.

   b. The property can be transferred.

   c. The corporation declines any associated deductions.

   d. The employee will lose the stock if future requirements are not met.

9. Rebecca receives stock from her S corporation employer in lieu of compensation. She wants to make a Section 83(b) election for this property. The stock is transferred on July 31 of the current year. When must Rebecca file the written request to make the Section 83(b) election?

    a. July 1.

    b. July 31.

    c. August 30.

    d. December 31.

10. Which of the following is true when determining how the employee fringe benefits of S corporation shareholders will be treated?

    a. Shareholders of more than 2% are generally treated like partners.

    b. S corporations are treated like C corporations.

    c. Members of an S shareholder's family are not allowed own the S shareholder's stock.

    d. The Code prohibits employees from excluding fringe benefits from gross income.

11. For which type of fringe benefit would a shareholder in an S corporation be treated as an employee?

    a. Contributions to qualified retirement plans.

    b. Qualified transportation fringe benefits.

    c. Meals and lodging furnished for the corporation's convenience.

    d. Payment of health insurance premiums.

12. Which of the following is considered a taxable fringe benefit for S corporation shareholders?

    a. Providing a cell phone for the corporation's benefit.

    b. Small holiday gifts.

    c. Job-related education.

    d. An adoption assistance program.

13. Which of the following statements regarding Health Savings Accounts (HSAs) is correct?

    a. Individuals are eligible to contribute to an HSA if he or she is not covered by a separate qualifying high-deductible health plan (HDHP).

    b. An employee can make tax-free HSA subsequent withdrawals to cover medical expenses.

    c. The maximum HSA contribution amount for an individual with family coverage is $6,550 for tax years beginning in 2017.

    d. For purposes of the ACA provisions, HSAs are considered a group plan.

14. FairCorp, an S corporation, provides certain employees with company cars for the corporation's convenience. What is the best way for the corporation to value this benefit?

    a. Using the general valuation rule in which FMV is determined based on the facts and circumstances.

    b. Using the optional rule for establishing the value of commuting in unsafe conditions.

    c. Using the automobile lease valuation rule or the vehicle cents-per-mile rule.

    d. Using the noncommercial flight valuation rule.

15. Fringe benefits have to be treated as if they were paid by what date?

    a. The date they are paid for on the employee's behalf.

    b. The date the employee uses them.

    c. January 1 of the year provided.

    d. December 31 of the year provided.

16. How do S corporations deal with qualified retirement plans?

    a. They establish specific retirement plans different from those C corporations use.

    b. The S corporation deducts contributions to qualified plans and the payments are tax-deferred to employees.

    c. The maximum amount of qualifying compensation eligible for retirement plan contributions is $500,000 per employee.

    d. Any 2% shareholders employed by the S corporation are excluded from being able to participate in the retirement plan.

17. The Lassiter Corporation, an S corporation, offers employees the chance to contribute to a retirement plan that will provide a definitely determinable retirement benefit. The corporation makes contributions to the plan. This is an example of what type of retirement plan?

    a. A defined benefit plan.

    b. A defined contribution plan.

    c. A 401(d) plan.

    d. An employee stock ownership plan (ESOP).

18. Which of the following S corporations is eligible to set up a SIMPLE retirement plan for its employees?

    a. EverCorp has 250 employees.

    b. FerrisCorp allows all employees to participate.

    c. GillumCorp maintains both a 401(k) plan and a SIMPLE 401(k).

    d. HustleCorp allows all contributions to be fully vested when made.

19. Which of the following statements best describes a nonqualified deferred compensation plan?

    a. They are subject to many restrictions under the Internal Revenue Code.

    b. They are generally provided to shareholder-employees and certain executives.

    c. The employer deducts deferred compensation in the tax year the executive earned the income.

    d. The individual specifies the period over which deferred compensation will be paid.

20. Which of the following S corporations has correctly addressed an issue related to retirement plans?

    a. IggyCorp recognizes more net unrealized built-in gain for Section 1374 purposes after deducting deferred compensation under Section 404(a)(5).

    b. JoCorp writes a qualified retirement plan and adopts it within 12 months of the time the corporation claimed its first related deduction.

    c. KelCorp maintains an ESOP and makes annual contributions of KelCorp stock and cash used to retire debt the ESOP used to acquire KelCorp stock.

    d. LoneCorp allows its employees and shareholders owning 2% or more of the corporation to participate in a cafeteria plan.

21. A taxpayer's domestic production activities deduction equals 9% of the lesser of which of the following?

    a. Qualified production activities income (QPAI) or taxable income.

    b. Domestic production gross receipts (DPGR) or taxable income.

    c. QPAI or DPGR.

    d. Qualified production property (QPP) or manufactured, produced, grown or extracted (MPGE) property.

22. Which of the following would be considered qualified production activities for the domestic production activities deduction if done in the United States?

    a. Selling real estate.

    b. Providing cleaning services.

    c. Manufacturing a line of clothing.

    d. Providing information technology services.

23. Which of the following S corporations has correctly addressed an issue related to the domestic production activities deduction?

    a. Maximum Production performs its manufacturing, producing, growing, or extracting (MPGE) activities in Mexico.

    b. Northern Limited performs demolition and clearing services under contract on a piece of property it does not own.

    c. Oliver Brothers includes receipts for food and beverages prepared at its facility and sold wholesale when calculating the deduction.

    d. Paisley Products bears the costs and risks of ownership of qualifying property but gives the deduction to its sister company, Polka Dots.

24. How do W-2 wages affect the domestic production activities deduction?

    a. The deduction is limited to half of the W-2 wages paid by an S corporation during the year that are allocated to DPGR.

    b. Wages associated with employee elective deferrals and employee designated Roth contributions are excluded when totaling W-2 wages for the deduction.

    c. S corporations must take the lesser of W-2 Box 1 (Wages, tips, other compensation) or Box 5 (Medicare wages).

    d. An S corporation can take the DPAD for regular tax purpose, but not for the purposes of the alternative minimum tax (AMT).

25. The Genesis Corporation, an S corporation, donates a piece of property worth $1,000 to a charitable organization. Which of the following will the corporation need to do?

    a. Complete Form 8283 (Noncash Charitable Contributions) and attach it to Form 1120S.

    b. Furnish a copy of Form 8283 to each of the S corporation's shareholders.

    c. Attach a completed Section B (Appraisal Summary) of Form 8283 signed by an appraiser to its tax return.

    d. Have the charitable organization fill out a portion of the S corporation's Form 8283.

26. Which of the following statements best describes one of the deductions associated with an S corporation?

    a. Ordinary and necessary business expenses are deducted by the shareholders.

    b. Directors fees are included in the "Other deductions" line on Form 1120S.

    c. If a fee or penalty is assessed against the S corporation, the expenses will be deducted by either the shareholders or the corporation.

    d. Payments to terminate a lease so the corporation can acquire new property are deductible by the corporation.

27. Under what circumstances would the tax benefit rule apply to an S corporation?

    a. When a charitable deduction is taken in the year it was paid.

    b. When directors' fees need to be reported on Form 1099-MISC.

    c. The corporation offers outplacement services to its employees.

    d. When subsequent events indicate a deduction was taken incorrectly.

28. Which of the following would be considered *nonseparately stated income or loss*?

    a. Income and loss from each rental activity.

    b. Interest, dividends, royalties, and other portfolio income.

    c. Ordinary income and expense items attributed to a trade or business.

    d. Gain or loss from selling/exchanging Section 1231 assets.

29. MegaCorp, an S corporation, is going through bankruptcy proceedings. Which of the following will occur?

    a. Debt discharge is included in the S corporation's gross income.

    b. Shareholder carryover losses suspended for lack of sufficient basis will be reduced.

    c. Shareholder stock basis will be increased for income from the cancellation of indebtedness awarded to the corporation.

    d. Income from the cancellation of indebtedness will be passed through to shareholders.

30. Hallie is a calendar year taxpayer. She is a shareholder in Gables Limited, an S corporation. Gables Limited's tax year ends on July 31, 2017. In which tax year should Hallie report pass-through items she receives from the corporation?

    a. 2016.

    b. 2017.

    c. 2018.

    d. Hallie can choose which year to report the items.

31. James is a shareholder in LittleCorp, an S corporation. The corporation passes both income and loss through to James during the year. How should it be allocated?

    a. On a per-share, per-day basis.

    b. As of January 1 of the year they occurred.

    c. As of December 31 of the year they occurred.

    d. On a date of the corporation's choosing if designated as a special allocation.

32. Which of the following will happen when an S corporation elects to have a tax year treated as two short years for allocation purposes?

    a. It will need to file two tax returns.

    b. It will need to send two Schedule K-1s to each shareholder.

    c. Adjusting basis will be done separately for each tax year.

    d. Decisions made after calendar year end will only affect the second short year.

33. Howard, a calendar year taxpayer, owns shares in SmallCo, an S corporation. He dies on October 3 of the current year. Howard will be considered to own the shares in SmallCo until what date?

    a. October 3.

    b. October 31.

    c. December 31.

    d. January 1.

34. S shareholders will need to attach Form 8082 [Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)] to their Form 1040 under which of the following circumstances?

    a. They have self-charged interest that they need to reclassify as passive activity income.

    b. The corporation terminated and 50% or more of the corporation's stock was sold during the termination year.

    c. They are the beneficial owner of S corporation stock, but they are not the owner of record of that stock.

    d. They have not received a Schedule K-1 from the corporation by the time they file their Form 1040.

35. Patrick has business expenses that were not reimbursed by the S corporation. Patrick is the S corporation's controlling shareholder, and he materially participates in the S corporation's business. Can he deduct these expenses?

    a. Yes, Patrick can deduct the business expenses in full.

    b. Yes, Patrick can deduct the expenses, but they are subject to the 2% of AGI floor.

    c. Yes, Patrick can deduct the expenses because they are considered related to his responsibilities as an employee.

    d. No, Patrick cannot deduct the expenses because they are considered to relate to corporate business.

36. Which of the following is true about a beneficial owner of S Corporation stock?

    a. Even though not an eligible shareholder, a partnership can be a nominee for a person considered a shareholder.

    b. The beneficial owner of S Corporation stock is always the registered owner.

    c. If no shares are actually issued, pass-through items are not allocated to beneficial shareholders.

    d. Community property rules do not apply to S corporation stock for pass-through purposes.

37. Which of the following statements best describes an aspect of how the alternative minimum tax (AMT) applies to S corporations and S corporation shareholders?

    a. Both S corporations and their shareholders are subject to AMT.

    b. S corporations are required to provide shareholders information to calculate AMT.

    c. Small S corporations can qualify for an exemption from the AMT rules.

    d. A single shareholder can qualify for an exemption from AMT if they fall into a high tax bracket.

38. Which of the following will allow an S corporation shareholder to minimize AMT?

    a. The general business credit as limited by the net income tax.

    b. A gain on qualified small business corporation (QSBC) stock held over five years.

    c. The Section 59(e) election to capitalize and amortize "qualified expenditures."

    d. Research and development expenditures that were deducted by the corporation.

39. Which of the following are deducted by an S corporation under IRC Sec. 616?

    a. Mining exploration costs.

    b. Mining development costs.

    c. Intangible drilling costs.

    d. Passive activities.

40. When does a minimum tax credit (MTC) arise?

    a. There is a difference between actual AMT and AMT owed because exclusion preferences were considered when AMT was calculated.

    b. A shareholder's stock basis is reduced by pass-through income that have associated loss or deduction.

    c. The election is made to aggregate activities at the shareholder level instead of the S corporation level.

    d. Property is disposed of using the Section 59(e) election to minimize AMT adjustments and expenditures.

GLOSSARY

Alternative depreciation system (ADS): The S corporation elects to depreciate property using the straight-line method over the appropriate asset depreciation range (ADR) class life (e.g., 40-year straight-line for real property) rather than using the accelerated depreciation method, and generally shorter recovery period, of MACRS.

Alternative minimum tax (AMT): A separate, independent tax system. Alternative minimum taxable income (AMTI) generally is computed in the same manner as regular taxable income, but certain adjustments and preference items are included and deductible for AMT purposes that are not for regular tax purposes.

AMT depreciation method: The S corporation uses 150% declining balance over the MACRS recovery period for 3, 5, 7, or 10-year MACRS property.

Beneficial owner: The person or entity that controls the stock or reaps the benefits of stock ownership.

***Bona fide* loan:** A loan is *bona fide* if the corporation and shareholder have a debtor-creditor relationship based on the shareholder's valid and enforceable obligation to pay a fixed or determinable sum of money to the corporation.

Cafeteria plans: Written plans that allow employees to choose from among two or more benefits consisting of cash (including cash equivalent benefits) and qualified taxable and nontaxable benefits.

***De minimis* fringe benefit:** One that normally would be a taxable fringe benefit, but because the goods or services have a nominal value, accounting for the item is unreasonable or administratively impractical.

Domestic production gross receipts (DPGR): The entity's gross receipts from the lease, rental, license, sale, exchange, or other disposition of QPP that was manufactured, produced, grown, or extracted in whole or significant part within the U.S.

Employee stock ownership plan (ESOP): A defined contribution plan that is either a stock bonus plan or a combination of a stock bonus and money purchase pension plan qualified under IRC Sec. 401(a) and designed to invest primarily in qualifying employer securities.

Fringe benefit: Any compensation or other benefit received by an employee that is not in the form of cash.

Leveraged ESOP: An ESOP that borrows funds to acquire employer securities.

Long-term unused minimum tax credit (MTC): MTC carried over from prior years attributable to tax years *before* the third tax year immediately preceding the current tax year.

Manufactured, produced, grown, or extracted (MPGE): Qualifying activities for the application of IRC Sec. 199 and include manufacturing, producing, growing, extracting, installing, building, developing, improving, and creating QPP.

Method not expressed in term of years: A taxpayer uses the units-of-production or another method of depreciation not expressed in a term of years instead of cost recovery under MACRS.

Net income tax: Regular tax, plus AMT, less (among others) the nonrefundable personal credits and the credits of IRC Secs. 21 through 30C, less the larger of (1) the tentative minimum tax from Form 6251 or (2) 25% of the net regular tax in excess of $25,000 (or $12,500 for married persons filing separately).

No-additional-cost service: One that is (1) normally offered to customers in the ordinary course of the line of business in which the employees perform services and (2) does not require the S corporation to incur substantial additional cost in providing the service to employees (including forgone revenues but excluding employee payments for the service).

Nonlapse restrictions: Restrictions that will never lapse and place a permanent limitation on the transferability of property.

Nonqualified plans: Plans typically provided to shareholder-employees and key nonfamily executives that defer the executive's income and the employer's deduction until the receipt of cash by the executive.

Nonseparately stated income or loss: All *ordinary* income and expense items (computed under tax accounting rules) that are attributable to a trade or business and that do *not* need to be separately stated to the shareholders.

Qualified production activities income (QPAI): The taxpayers DPGR for the year reduced by the cost of sales and other deductions and losses properly allocable to the DPGR.

Qualified production property (QPP): Tangible personal property, computer software, and sound recordings.

Reasonable: Reasonable compensation for S corporations is an amount paid for like service by like enterprise under like circumstances.

Section 132 fringe benefits: Qualified employee discounts, no-additional-cost services, working condition fringe benefits, *de minimis* fringe benefits, on-premises athletic facilities, qualified transportation fringe benefits, qualified moving expense reimbursements, and qualified retirement planning services.

Self-charged interest: Interest on a loan by a shareholder to an S corporation if the corporation passes through a passive activity loss.

Separately stated items: Items of income, loss, deduction, or credit that, by their character and nature, have some distinction in the way they are treated on Form 1040.

Simplified employee pension (SEP): A retirement program under which the employer makes contributions to the IRAs of employees.

Specific accounting election: Section 1377(a)(2) election to allocate pass-through items based on actual transactions that occurred before and after a stock disposition took place.

S termination year: Occurs when an S election terminates at any time other than the first day of the corporation's tax year. Will be separated into two short tax years—an S short year and a C short year.

Straight-line over MACRS recovery period: The S corporation elects to use the straight-line method of recovery (over the normal MACRS recovery period) for one or more classes of property instead of the accelerated MACRS method.

Substantially vested: Property is substantially vested when (1) it is not subject to a substantial risk of forfeiture and (2) it is transferable.

Tangible personal property: Any tangible property other than land; buildings (including items that are structural components of a building); qualified film produced by the taxpayer; electricity, natural gas, or potable water produced by the client; computer software; and sound recordings.

Working condition fringe benefit: Property or services provided to an employee that could be deducted by the employee as a work-related expense.

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COMPANION TO PPC'S 1120S DESKBOOK

COURSE 2

ELIGIBILITY, FILING AND REPAIRING THE S ELECTION, INCORPORATION AND CAPITALIZATION, AND ORGANIZATIONAL AND START-UP EXPENSES (T2STG172)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course covers various aspects of a corporation's initial S year. Lesson 1 covers the lengthy list of criteria for S eligibility. Lesson 2 describes how and when the S election should be filed. Lesson 3 addresses the compliance issues practitioners most frequently face when a business is incorporated. Lesson 4 concentrates on the specific expenditures incurred before an S corporation begins the active conduct of a trade or business.

PUBLICATION/REVISION DATE: November 2017

RECOMMENDED FOR: Users of *PPC's 1120S Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Experience with the preparation of Form 1120S

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP): This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.

CTEC CREDIT: 8 CTEC Federal Tax Law Hours

IRS EA CREDIT: 8 Federal Tax Law/Tax Related Matters Hours

IRS NCRP CREDIT: 8 Federal Tax Law Hours

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Eligibility

Completion of this lesson will enable you to:

- Identify the S corporation eligibility requirements,what types of shareholders are eligible to be an S corporation, and which trusts and estates qualify to hold S corporation stock and the requirements of each.

- Identify how family members and qualified retirement plan trusts are treated as one shareholder, how S corporations can own interests in partnerships, how LLCs are classified for federal tax purposes, and how to make a qualified subchapter S subsidiary (Qsub) election.
- Determine how certain banks elect S status, how small business corporations meet the one-class-of-stock requirement, and how the 3.8% net investment income tax (NIIT) applies to the net investment income of individuals estates, and trusts with income above certain thresholds.

Lesson 2—Filing and Repairing the S Election

Completion of this lesson will enable you to:
- Determine the deadlines and forms required when filing an S election.
- Recognize the methods for obtaining relief from a late or invalid S election, how to admit a new shareholder to an S corporation, and how to determine the requirements for an LLC to elect S status.

Lesson 3—Incorporation and Capitalization

Completion of this lesson will enable you to:
- Identify the Section 351 requirements regarding incorporation and partnerships electing S status, how incorporation can be taxable, and how S corporations file Form 1120S.

Lesson 4—Organizational and Start-up Expenses

Completion of this lesson will enable you to:
- Determine the tax treatment of organizational expenses and start-up expenses, and distinguish organizational and start-up expenses from other nondeductible preopening expenditures.

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Lesson 1: Eligibility

Introduction

Although filing an S election on Form 2553 (Election by a Small Business Corporation) is often viewed as a straightforward task, there is a lengthy list of criteria for S eligibility. These requirements must be met both at the time of initial election and continuously throughout the period of S status to preserve the election.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the S corporation eligibility requirements, what types of shareholders are eligible to be an S corporation, and which trusts and estates qualify to hold S corporation stock and the requirements of each.
- Identify how family members and qualified retirement plan trusts are treated as one shareholder, how S corporations can own interests in partnerships, how LLCs are classified for federal tax purposes, and how to make a qualified subchapter S subsidiary (Qsub) election.
- Determine how certain banks elect S status, how small business corporations meet the one-class-of-stock requirement, and how the 3.8% net investment income tax (NIIT) applies to the net investment income of individuals estates, and trusts with income above certain thresholds.

Meeting the S Corporation Eligibility Requirements

Eligibility Requirements

Small Business Corporation. Only a "small business corporation" can operate as an S corporation. To qualify as a small business corporation under the S corporation eligibility rules, the corporation must—

1. be a domestic corporation;
2. have no more than 100 shareholders (spouses and certain family members are treated as one shareholder;
3. have as shareholders only—
    a. individuals who are citizens or residents of the U.S.,
    b. estates,
    c. certain types of trusts, or
    d. certain tax-exempt charitable organizations;
4. have only one class of stock; and
5. not be an ineligible corporation by definition.

Banks. A bank (i.e., a depository financial institution as defined in IRC Sec. 581) is eligible to elect S status if it uses (or changes to) the specific charge-off method of accounting for bad debts.

Certain Tax-exempt Charitable Organizations. Section 501(c)(3) charitable organizations that are exempt from taxation under IRC Sec. 501(a) (item 3.d. in the preceding list) are eligible S corporation shareholders. IRC Sec. 512(e) provides that all items of income, loss, and deduction passed through by the S corporation and gains and losses from the disposition of the S corporation stock must be taken into account in computing the charitable organization's unrelated business taxable income (UBTI).

Retirement Plans and IRAs. Certain tax-exempt qualified retirement plan trusts (but generally not IRAs and SEPs) are eligible to hold stock in S corporations. However, certain grandfathered IRAs and Roth IRAs are allowed to hold

stock in an S corporation that is a bank. Also, certain IRAs are allowed to hold stock that has been rolled over from an ESOP.

Personal Service Corporations and Personal Holding Companies. Personal service corporations and personal holding companies that meet the S corporation requirements are eligible to elect S status. If the corporation is a personal holding company that has accumulated earnings and profits (AE&P), the practitioner must consider whether electing S status will cause the corporation to be subject to the tax on excess net passive income. Furthermore, the S election will terminate if an S corporation has both AE&P and passive investment income in excess of 25% of gross receipts for three consecutive tax years.

Ineligible Shareholders

As stated in item 3 in the preceding list, an S shareholder must be an individual, estate, a certain type of trust, or Section 501(c)(3) charitable organization. Thus, S corporation stock generally cannot be owned by a corporation, partnership, ineligible trust, nonresident alien, LLC, or LLP.

Charitable Remainder Trust. Charitable remainder annuity trusts and charitable remainder unitrusts are not eligible to hold S corporation shares.

S Corporations Can Own Interests in C Corporations and Certain Other Entities. The eligible shareholder rules discussed in the preceding paragraphs establish the types of entities that can hold S corporation stock, but do not restrict the ownership interests that the S corporation itself can hold. Thus, an S corporation can own shares in a C corporation or hold an interest in a LLC. Furthermore, an S corporation can be a partner in a partnership, and the other partners can be individuals or entities that would be ineligible to be shareholders of the S corporation.

Affiliated Group. An S corporation can own up to 100% of another corporation, and it can elect to treat certain subsidiaries as "qualified Subchapter S subsidiaries" (QSubs).

Number of Shareholders

An S corporation must not have more than 100 shareholders at any one time (item 2 in the preceding list).

Taxpayer and Spouse. Spouses (and their estates) are treated as one shareholder.

Family Members. Family members and their estates are treated as one shareholder.

Tenants in Common or Joint Tenants. Two or more individuals can own stock as tenants in common or as joint tenants with the right of survivorship. Provided the joint owners are not spouses and are unrelated, each individual is a separate shareholder for the 100-shareholder limit.

Trusts. The treatment of trusts under the "number of shareholders" rule is discussed later in this lesson.

Forming a Partnership of S Corporations. Two or more S corporations can form a partnership without violating the 100-shareholder limit, so long as each S corporation has fewer than 100 shareholders. (See Example 1E-1.)

Beneficial Owner of Stock Is Considered the Shareholder

The beneficial owner, rather than the owner of record, is considered the shareholder (i.e., the owner of the S corporation stock). Thus, the person for whom S corporation stock is held by a nominee, guardian, custodian, or agent is considered the shareholder. Even though a partnership is not an eligible shareholder, a partnership may be a nominee of S corporation stock for a person who is considered the shareholder. However, if the partnership is the beneficial owner of the stock, the partnership will be considered the shareholder and the corporation will not be eligible for S status. Furthermore, a minor child is considered the owner of any stock held by a custodian under the Uniform Gifts to Minors Acts.

Domestic Corporation Requirement

An S corporation must be a domestic corporation (item 1 in the preceding list). However, a domestic corporation can retain or elect S status, even if it is registered as a corporation in a foreign country, if the corporation meets the

other requirements [e.g., it has one class of stock and has no nonresident alien shareholders. Furthermore, an entity such as an LLC that uses the check-the-box election to be taxed as a corporation can elect S status if it is eligible to be treated as an S corporation.

Ineligible Corporations

A corporation can be ineligible for S status (item 5 in the preceding list) because it is classified as—

1. a financial institution that uses the reserve method of accounting for bad debts under IRC Sec. 585,
2. an insurance company subject to taxation under Subchapter L of the Code,
3. a corporation electing to use the possessions tax credit under IRC Sec. 936,
4. a domestic international sales corporation (DISC) or former DISC, or
5. a "taxable mortgage pool" (TMP). A TMP is any entity other than a real estate mortgage conduit (REMIC) if—
    a. substantially all of the entity's assets consist of debt obligations and more than 50% of such obligations consist of real estate mortgages,
    b. the entity is the obligor under debt obligations with at least two maturities, and
    c. payments on the debt obligations on which the entity is the obligor bear a relationship to payments on the debt obligations held by the entity.

    If a portion of a corporation is a TMP, that portion is considered a separate corporation. Evidently, this means the non-TMP portion of the S corporation is eligible for S status (if it meets the other requirements) but the TMP portion cannot elect or maintain S status.

Reelecting S Status after Termination of the S Election

If a corporation was formerly an electing S corporation but has reverted to C status, it generally must wait five years before it can reelect S status, unless IRS consent is received.

Using a Checklist to Ensure S Corporation Eligibility

Because the criteria for electing and maintaining S status are lengthy and detailed, the use of a checklist can efficiently ensure that all of the eligibility requirements are met. Also, by reviewing this list with the client, information is passed on to the officers/shareholders as to the eligibility rules, which must be followed as long as the corporation remains in S status.

Identifying Trusts and Estates Qualified to Hold S Corporation Stock

IRC Sec. 1361(b) specifically allows estates and certain trusts as eligible S corporation shareholders.

Estates

Shareholder's Estate. The estate of a deceased shareholder is eligible to hold stock in an S corporation, and the decedent and estate are considered to be one shareholder. Also, family members and their estates are treated as one shareholder. Thus, transferring shares to a shareholder's estate will not increase the number of shareholders for purposes of the 100-shareholder limit.

Example 1B-1 Deceased shareholder's estate is counted as a shareholder.

Cards, Inc., is a family controlled publishing company. Jane owns stock in the corporation, as does her husband, Jack, and a number of their children, grandchildren, and various spouses of the children and

grandchildren. Jack died and, according to his will, the stock will pass directly to Jane, but only after an anticipated two-year period of estate administration.

Jack, Jane, the family members, and spouses are counted as one shareholder. Upon Jack's death and the passage of his stock into his estate, the S corporation will still be considered to have one shareholder.

Other Estates. Estates of minors, incompetents, and persons under a disability are eligible shareholders, and so are bankruptcy estates of individuals.

Trusts

Permitted trusts include the following:

1. Voting trusts, which are created primarily to exercise the voting power of the owned stock. Each beneficiary of the trust is considered to be a shareholder for purposes of the 100-shareholder limitation.

2. Testamentary trusts that receive S stock pursuant to the terms of a will (but, in general, eligibility is limited to a two-year period of ownership). The estate is considered to be the shareholder for purposes of the 100-shareholder limitation.

3. Grantor trusts in which all income and corpus is treated as being owned by a U.S. citizen or resident. The deemed owner is considered to be the shareholder for purposes of the 100-shareholder limitation.

4. Trusts existing before death that met the grantor trust requirements of item 3 and that continue to exist after death (although eligibility is limited to a maximum two-year period of ownership). The estate is considered to be the shareholder for purposes of the 100-shareholder limitation.

5. Qualified Subchapter S trusts (QSSTs) that own stock in one or more S corporations and are treated as trusts described in item 3. The income beneficiary is considered to be the shareholder for purposes of the 100-shareholder limit. (The QSST rules are discussed in more detail later in this lesson.)

6. Electing small business trusts (ESBTs) that own stock in one or more S corporations. Each potential current beneficiary is considered to be a shareholder for purposes of the 100-shareholder limitation. However, a potential current beneficiary of an ESBT and that beneficiary's family members are counted as one shareholder. (The ESBT rules are discussed in more detail later in this lesson.)

7. Tax-exempt qualified retirement plan trusts under IRC Sec. 401(a) [e.g., an employee stock ownership plan (ESOP)]. Individual retirement accounts (including SEPs, SIMPLE IRAs, and Roth IRAs), however, are not qualified retirement plans under IRC Sec. 401(a) and thus are generally not eligible to hold S corporation stock.

Foreign trusts are not permitted trusts.

Voting Trusts

Voting trusts are created primarily to exercise the voting power of stock they hold. To qualify as a voting trust, the beneficial owners must be treated as the owners of their respective portions of the trust under Subpart E and the trust must have been created pursuant to a written trust agreement entered into by the shareholders that—

1. delegates to one or more trustees the right to vote;

2. requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock;

3. requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

4. terminates, under its terms or by state law, on or before a specific date or event.

Each beneficiary of the trust is considered to be a shareholder for purposes of the 100-shareholder limitation. Caution should be exercised in drafting the terms of the voting trust agreement and any related shareholder agreement to ensure that the 100-shareholder limitation is not exceeded.

Testamentary Trusts

A trust created by the terms of a will is known as a testamentary trust. The wills of many married couples direct the assets of the first decedent into a testamentary trust that provides an income stream to the surviving spouse while preserving the corpus for distribution to children after the surviving spouse dies. During the period of administration when S corporation shares are held by the estate, S eligibility is not a problem. However, upon transfer of the shares from the estate into such a testamentary trust, IRC Sec. 1361(c)(2) provides that a corporation's S status terminates if the trust continues to be a shareholder for longer than a two-year period. (A testamentary trust will remain an eligible shareholder beyond the two-year limitation if the trust is a QSST or an ESBT. See the following discussion.)

Only Certain Trusts Are Allowed to Name Successive Beneficiaries

Trusts eligible to hold S corporation stock are listed earlier in this lesson. These trusts are subject to special rules and restrictions; for example, testamentary trusts can be S corporation shareholders for only two years. Of the remaining types of eligible trusts, only two allow the trust to name successive beneficiaries—a qualified Subchapter S trust (QSST) and an electing small business trust (ESBT). The following discussion covers these trusts.

Qualified Subchapter S Trusts

A trust qualifies as a QSST if all the following criteria are met:

1. The trust has only one income beneficiary during the life of the current income beneficiary, and that beneficiary is a U.S. citizen or resident.

2. All of the income of the trust is, or is required to be, distributed currently to the one income beneficiary. [However, a trust provision authorizing the trustee to accumulate income if the trust no longer holds S corporation stock does not preclude the trust from being a QSST.]

3. Any corpus distributions that might occur, including a terminating distribution, must also go to that one income beneficiary if made during the beneficiary's lifetime.

4. The income interest of the beneficiary must terminate on the earlier of the beneficiary's death or the trust's termination.

5. An election to be treated as an eligible S corporation shareholder is made separately for the stock of each S corporation held by the trust.

Once a QSST election is made, it is revocable only with the consent of the IRS.

S Corporation Pass-through Items Are Included on Beneficiary's Personal Income Tax Return. The QSST income beneficiary is treated as the shareholder for purposes of the pass-through rules, distributions, and adjustments to stock basis. Thus, the income beneficiary reports the S corporation's pass-through items of income, gain, loss, or deduction on his or her individual Form 1040.

Current Distribution Rule. For purposes of the current distribution rule (item 2 in the preceding list), income of the QSST includes distributions from the S corporation but does not include the trust's prorata share of S corporation items of income, loss, deduction or credit (i.e., pass-through items). Thus, pass-through items do not have to be distributed annually. Distributions from the S corporation to the QSST and income from sources within the QSST (other than S corporation pass-through items) are subject to the annual distribution requirement.

Example 1B-2 Complying with the QSST current distribution rule.

Dottie is the sole beneficiary of the Burns Trust, a QSST. During the current year, ABC Inc. passes through $20,000 of income to the Burns Trust and makes distributions to the trust of $15,000.

The trust is required to distribute $15,000 to the beneficiary. The $20,000 of pass-through income is not under the annual distribution requirement. Dottie includes the $20,000 in gross income on her Form 1040, however.

If the trust is not required to distribute income currently, the trustee may elect to treat a distribution made in the first 65 days of a taxable year as made on the last day of the preceding taxable year. The income distribution requirement must be satisfied for the taxable year of the trust or for that part of the trust's taxable year during which it holds S corporation stock.

Making the Qualified Subchapter S Trust Election. The current income beneficiary of a QSST must elect to treat the QSST as an eligible S corporation shareholder. The QSST election can be made on Part III of Form 2553 (Election by a Small Business Corporation) if the S corporation stock is transferred to the QSST on or before the date that the S election is filed, and if the QSST election and S election have the same effective date. Otherwise, the QSST election is made by a separate statement filed with the IRS Service Center where the corporation files its tax return. The following examples illustrate the election procedures necessary to qualify a trust as a QSST.

Example 1B-3 Filing timely S corporation and QSST elections.

On January 1, 2017, stock of Highway, Inc., a calendar year C corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. On January 31, Highway files an election to be an S corporation effective on January 1, 2017. In order for the S election to be effective at the beginning of its first tax year, the QSST election must also be effective on January 1, 2017. (In other words, if the trust is not a QSST when the S election becomes effective, the trust will be an ineligible shareholder, and the S election will be invalid.) The trust must file its QSST election within the period beginning on January 1, 2017, and ending March 16, which is the two-month-and-16-day period beginning on the first day of the first tax year for which the election to be an S corporation is intended to be effective.

Example 1B-4 Making the QSST election.

Andy Baer is a shareholder in Alamo Corp., a successful S corporation. His mother, Doris, is an elderly widow requiring expensive nursing care. Andy decided to establish a trust to hold about 20% of his Alamo stock to deflect a stream of income to support Doris. Andy's minor child is the successor income beneficiary, with the trust terminating and the stock distributed to him when he reaches age 25.

For the QSST to be treated as an eligible S corporation shareholder, a special election had to be made and signed either by the current income beneficiary of the trust (Doris) or her legal representative. This election was filed within the 2-month-and-16-day period beginning on the date the stock of the S corporation was transferred to the trust. If the S corporation were a newly electing entity, the separate QSST election could be made as part of the election of S status on IRS Form 2553 (i.e., Part III of Form 2553 allows a QSST election, but only if the stock of the corporation has been transferred to the trust on or before the date the corporation elects S status).

Example 1B-5 Forming separate QSSTs for successor beneficiaries.

Assume the same facts as in Example 1B-4, except that Andy has two minor children. Andy wanted to designate them as successor income beneficiaries, with the trust terminating and the stock distributed to them when they each reach age 25.

Because a QSST is permitted to have only a single income beneficiary, Andy formed two QSSTs. Then, at Doris's death Andy's two minor children would become income beneficiaries. Each trust was drafted to provide income to Doris during her lifetime, income to a successor minor child of Andy's following Doris's death, and eventual corpus distribution of the stock to the child at the specified age.

Separate and Independent Subtrusts Can Qualify as QSSTs. For S shareholder eligibility purposes, substantially separate and independent shares of a single trust are treated as separate trusts under the QSST rules. Thus, separate and independent subtrusts can qualify for QSST status. However, from a drafting standpoint, it is normally preferable to create separate QSSTs.

When a QSST's assets were divided into two shares following the death of the current income beneficiary, with the income from each share payable to a different beneficiary, the IRS ruled that the two QSST shares were substantially separate and independent shares within the meaning of IRC Sec. 663(c). Therefore, each share could be considered a separate trust for QSST eligibility purposes. Furthermore, the trust's QSST election would continue and the income beneficiary of each share would not be required to file a QSST election for his or her separate share for the trust. Accordingly, the corporation's S election would remain in effect.

Example 1B-6 Treating separate shares of one QSST as multiple QSSTs.

Assume the same facts as in Example 1B-5. However, instead of forming two QSSTs, Andy created a single QSST for Doris's benefit that is comprised of two separate subtrusts. Doris is the sole income beneficiary of each subtrust, and upon her death, one child is the successor income beneficiary of each subtrust.

Upon Doris's death, the trust cannot authorize the distribution of trust assets from one subtrust to the child who is not the income beneficiary of that subtrust. The IRS has ruled that a separate and independent share of a trust cannot qualify as a QSST if there is even a remote possibility that the trust assets will be distributed during the lifetime of the current income beneficiary to someone else.

New Income Beneficiary. A new (successor) income beneficiary is not required to file an election to continue QSST status, just as a new shareholder in an existing S corporation is not required to consent to the S status. However, a new QSST beneficiary may affirmatively refuse to consent to the QSST election within the 2-month-and-15-day period after the date of becoming the successor income beneficiary. If the affirmative refusal is filed, the trust generally becomes an ineligible shareholder, which terminates the S corporation election. This capability of a new beneficiary of a QSST which may hold only a small amount of stock can be contrasted with the Section 1362(d)(1)(B) general revocation procedures for S corporations, which require more than 50% of the shareholders to consent to a termination of S status.

Example 1B-7 Beneficiary's refusal to consent to QSST election.

Continuing with the facts in Example 1B-4 assume that Doris Baer, as income beneficiary of Doris Baer Trust A (a QSST) died on August 18 of the current year. Under the terms of this trust, Doris's granddaughter, Susie, became the successor and sole income beneficiary of the Doris Baer Trust A. For the 2-month-and-15-day period following this change in the QSST income beneficiary, Susie (or her parent acting on her behalf, if she is still a minor) could file an affirmative refusal to consent to the QSST election. The refusal to consent would become effective on the day on which Susie becomes the income beneficiary of the QSST.

The beneficiary may refuse to consent to the S election because, for example, the corporation is passing through income but not making distributions to pay tax currently on the trust's share of the corporation's income.

Trust Cannot Be Retroactively Changed to Meet QSST Requirements. The IRS has ruled that retroactive changes to a trust instrument to qualify for QSST treatment will not be recognized for federal tax purposes.

Example 1B-8 Trust cannot be retroactively changed to meet QSST requirements.

Adam, Inc., a C corporation, filed an S election on March 15, 2016, to become effective on January 1, 2016. A trust held a portion of the corporation's stock on January 1, 2016, but the trust did not meet the definition of a QSST because its corpus could, under some circumstances, be distributed to a person other than the current income beneficiary. On January 31, 2017, the trust instrument was amended to fit the definition of a QSST by providing that only the current income beneficiary could receive distributions of corpus. Then, on February 15, 2017, the appropriate state court issued an order ruling that the trust was reformed retroactive to January 1, 2016.

Rev. Rul. 93-79 sets out facts similar to those in this example, and holds that the retroactive effect of a state court order reforming a trust will not be recognized for federal tax purposes. Therefore, Adam, Inc.'s S election never became effective because an ineligible trust held shares at the time the S election was filed. Under some circumstances, an ineffective election would take effect at the beginning of the corporation's next tax

year, but the provisions of IRC Sec. 1362(b)(2) do not apply in this example because the corporation was not an eligible small business corporation when the election was filed.

The corporation is an eligible small business corporation beginning on the date the trust amendments were made, January 31, 2017. Adam, Inc. is not required to wait five years before filing the new election because the waiting period under IRC Sec. 1362(g) does not apply to a corporation that has never been an S corporation.

Substantial Compliance. The IRS has employed the "substantial compliance" rationale to conclude that QSST elections not meeting the literal requirements of the regulations were still valid. For example, in one letter ruling the IRS held that a QSST election signed by the trustee, but not signed by the "deemed owner" of the QSST (a minor child), was valid where the child's parents indicated by their signatures on the S corporation election form (Form 2553) that the child was to be taxed as the owner of the shares held by the QSST.

Sale of Stock by a QSST. A QSST is treated as a grantor trust (at least with regard to the S corporation stock it owns). The QSST (rather than the income beneficiary) must recognize gain or loss if the QSST sells its S corporation stock. The trust reports the sale of the S stock on Schedule D of Form 1041.

If gain on the sale qualifies for taxation under the installment sale method, the QSST must use that method unless it elects to report all of the gain in the year of sale. When the installment method is used, the trust calculates the gain on Form 6252 (Installment Sale Income) and carries the current year's taxable gain to Form 1041, Schedule D.

Use of Passive Activity Losses and At-risk Amounts by QSST Beneficiaries. The disposition of S stock by a QSST is treated as a disposition by the QSST beneficiary for purposes of the Section 465 at-risk rules and the Section 469 passive activity loss rules. Thus, the QSST beneficiary is allowed to deduct losses previously suspended under the at-risk rules or the passive activity loss rules upon disposition of S stock by the QSST. Note that this provision applies only for purposes of the at-risk and passive loss rules, so the gain on the sale of the S corporation stock is still taxable to the trust, rather than the beneficiary.

Improper Reporting of Tax by QSST Did Not Terminate S Election. A QSST reported on its income tax return the items shown on the Schedule K-1 it received from an S corporation in which it held stock. The trust paid the resulting taxes rather than having the beneficiary report the items on his individual income tax return and pay the taxes as required under IRC Sec. 1361(d)(1)(B). The filing of an improper tax return and the payment of taxes by the QSST rather than the beneficiary were not circumstances described in IRC Sec. 1361(d)(4) (relating to trust disqualification) or IRC Sec. 1362(d)(2) (ceasing to operate as a small business corporation). Thus, improper filing and payment of the taxes by the QSST itself did not terminate either its QSST election or the corporation's S election.

Net Investment Income Tax

Individuals, estates, and certain trusts are subject to a net investment income tax (NIIT), which is an additional tax of 3.8%. The NIIT generally applies to estates and trusts if there is undistributed net investment income and the AGI exceeds the dollar amount at which the highest fiduciary income tax bracket for the year begins ($12,150 in 2014). The tax applies to QSSTs to the extent the net investment income is retained in the trust. Although the S corporation income of a QSST is taxed to the individual income beneficiary, capital gain on the sale of the S corporation stock is taxed at the trust level. If the QSST's AGI exceeds the threshold amount, the QSST will be subject to the NIIT on the capital gain.

Relief from Missed QSST Election

A trust that meets the requirements of a qualified Subchapter S trust (QSST) under IRC Sec. 1361(d) is permitted to own S corporation stock. As explained earlier in this lesson, a beneficiary of a QSST is required to file an election to have the trust treated as an eligible S shareholder. The election must be filed within two months and 16 days of the trust's receipt of stock. However, the IRS provides relief from inadvertent termination of S status caused by the beneficiary's failure to timely file a QSST election.

Relief Is Retroactive to Original Effective Date. If the IRS grants relief, the QSST election becomes effective on the date on which the QSST election was originally intended to be effective.

Example 1B-9 Missed QSST election.

John Smith, an S shareholder, died on January 14 of the current year. John's estate transferred his S stock to a trust created under his will. Marta Smith, John's widow, is the beneficiary of the trust and intended for the trust to meet the requirements of a QSST under IRC Sec. 1361(d).

As previously discussed, a beneficiary of a QSST is required to file an election to have the trust treated as an eligible S shareholder. Marta was not aware of this requirement until 14 months after the S stock was transferred to the trust. However, the omitted election would not cause the S election to inadvertently terminate because a testamentary trust is an eligible shareholder for a two-year period from when the stock is transferred to it. The QSST election can be filed at any time during the two-year period or the two-month-and-16-day period following the end of the two-year period.

No User Fee. The method for requesting relief under Rev. Proc. 2013-30 is in lieu of the letter ruling process ordinarily used for a late QSST election and no user fees apply. A taxpayer that does not meet the requirements of Rev. Proc. 2013-30 or is denied relief may seek relief by requesting a letter ruling.

Request Is Made by QSST Beneficiary. The application for relief is made by a trust beneficiary seeking to treat a trust as a QSST. The beneficiary files for relief by submitting a QSST election statement along with statements required by Rev. Proc. 2013-30 and covered in the following discussion.

Requirements for Relief. To qualify for relief from termination of the S election due to a late election, all of the following requirements must be met:

- The QSST beneficiary intended the trust to be classified as a QSST on the date the QSST election would have become effective if it had been made on time.
- The QSST beneficiary requests relief under Rev. Proc. 2013-30 within three years and 75 days after the intended effective date of the QSST election.
- The failure to qualify as a QSST was solely because the QSST election was not timely filed.
- The failure to make a timely QSST election was inadvertent and the S corporation and the trust acted diligently to correct the mistake upon its discovery.

General Rules for Requesting Relief. A QSST requests relief from a late election by properly completing the QSST election and attaching any supporting documents required by Rev. Proc. 2013-30. The election must include a statement (i.e., a "Reasonable Cause/Inadvertence Statement") from the QSST confirming that the failure to timely file the S election was inadvertent and describing the diligent actions of the S corporation and trust to correct the mistake upon its discovery.

Each of the following statements must be submitted with the QSST election:

- A statement from the trustee that the trust satisfies the QSST requirements of IRC Sec. 1361(d)(3) and that the income distribution requirements have been and will continue to be met.
- Statements from all shareholders (including the trust itself and the current income beneficiary of the electing QSST) during the period between the date the S corporation election was to have become effective or was terminated and the date the completed QSST election is filed that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and for all subsequent years. (This means that proper Schedules K-1 were issued to the shareholders and they reported the pass-through items on their tax returns as if a valid S election was in effect.)

The words "FILED PURSUANT TO REV. PROC. 2013-30" should be written at the top of the QSST election.

Perjury Declaration Required on All Statements. The Reasonable Cause/Inadvertence Statement and all other statements (such as shareholder declarations) required by Rev. Proc. 2013-30 must each contain a dated declaration

that states: "Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The current income beneficiary of the QSST must sign the declaration.

Filing the QSST Election. The QSST election is filed by—

1. attaching the election to the S corporation's current year Form 1120S,

2. attaching the election to one of the S corporation's late filed prior year Forms 1120S, or

3. filing the election independent of Form 1120S.

Attaching the Election to S Corporation's Current Year 1120S. If the S corporation has filed all Forms 1120S for tax years between the trust's intended effective date and the current year, then the QSST election can be attached to the current year Form 1120S, as long as the Form 1120S is filed within three years and 75 days after the trust's intended effective date. An extension of time to file the current year Form 1120S will not extend the due date for relief beyond three years and 75 days following the intended effective date. The Form 1120S must state at the top "INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30" or comply with specific instructions included with the Form 1120S instructions.

Attaching the Election to S Corporation's Late Filed Prior Year 1120S. If the S corporation has not filed Form 1120S for the tax year including the trust's intended effective date or any following year, a QSST election may be attached to the S corporation's Form 1120S for the year including the trust's intended effective date if filed within three years and 75 days after the trust's intended effective date, and all other delinquent Forms 1120S are filed simultaneously and consistently with the requested relief.

Filing QSST Election Independent of Form 1120S. The beneficiary can submit the QSST election directly to the applicable IRS Service Center (i.e., where the corporation files its tax return) within three years and 75 days after the trust's intended effective date.

Simultaneous Relief Requests. If both the S election and QSST election are late, both relief requests under Rev. Proc. 2013-30 can (but are not required to) be filed at the same time using one of the methods described in Rev. Proc. 2013-30, Sec. 4.03(2). When multiple requests for relief are submitted simultaneously, each application for relief must independently comply with the procedural requirements in Section 4.03(1).

Notification from IRS. The IRS will determine whether the requirements for granting additional time to file the QSST election have been satisfied and will notify the QSST of its determination.

Electing Small Business Trusts

An ESBT can own S corporation shares. An ESBT can provide that income will be distributed to (or accumulated for) one or more beneficiaries. Thus, an individual can establish a trust to hold S corporation stock and split income among family members or others who are trust beneficiaries. The price paid for this flexibility is that the trust (not the beneficiaries) is taxed on income related to the S corporation stock at the highest individual rate (for 2017—39.6% on ordinary income, 20% on long-term capital gains, 25% for unrecaptured Section 1250 gain, and 28% for collectibles gain). The trust can also be subject to the net investment income tax (NIIT).

To qualify as an electing small business trust, all trust beneficiaries must be individuals, estates, or charitable organizations eligible to be S shareholders. In addition, certain political entities are permitted as contingent beneficiaries so long as they are not potential current beneficiaries.

An ESBT beneficiary does not include the following:

1. A trust that is receiving or may receive a distribution from an intended ESBT, i.e., a "distributee trust" (but does include those persons who have a beneficial interest in the property held by the distributee trust).

2. A person in whose favor a power of appointment could be exercised.

Interest in ESBT Cannot Be Acquired by Purchase. No interest in the trust can be acquired by purchase (that is, with a cost basis determined under IRC Sec. 1012). Thus, an interest in the trust must generally be acquired by gift, bequest, or transfer in trust. (This provision means that the beneficiary cannot acquire an interest in the trust by purchase. However, the trust can purchase S corporation shares or other property to hold in the trust.)

Potential Current Beneficiaries. A potential current beneficiary is a person who is entitled to (or at the discretion of any person may) receive a distribution from the principal or income of the trust. A person entitled to receive a distribution only after a specified time or when a specified event occurs (such as the death of a holder of a power of appointment) generally does not become a potential current beneficiary until the time arrives or event occurs. Additionally, an ESBT has one year to dispose of the S stock to avoid disqualification after an ineligible shareholder becomes a potential current beneficiary. Each "potential current beneficiary" of the trust (and that beneficiary's family members) is counted as one shareholder for the 100-shareholder limitation. If there are no potential current beneficiaries, the trust is treated as the shareholder.

Current Powers of Appointment. Any unexercised powers of appointment are disregarded in determining the potential current beneficiaries of an ESBT.

Taxable Income. The taxable income of an ESBT consisting solely of stock in one or more S corporations includes: (1) the S corporation items of income, loss, or deduction allocated to it (i.e., passed through on Schedule K-1 of Form 1120S) as an S corporation shareholder; (2) gain or loss from the sale of the S corporation stock; and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses. Capital losses are allowed only to the extent of capital gains.

Under the "ordinary" trust rules, a trust is taxed on its taxable income reduced by a distribution deduction. A deduction for distributions to beneficiaries is allowable when calculating taxable income because the beneficiaries will include those distributions in income. An ESBT, however, is taxed on its income *before* considering distributions to beneficiaries. Therefore, distributions from an ESBT holding only S corporation stock are *not taxable at the beneficiary level*.

Grantor Trusts. Grantor trusts are permitted to make ESBT elections. However, an ESBT election does not alter the established tax treatment of items attributable to the grantor portion of the trust. Accordingly, IRC Sec. 671 requires that items of income, deduction, and credit attributable to the portion of the trust treated as owned by the grantor must be taken into account by the grantor. The ESBT rules of IRC Sec. 641(c), discussed earlier in this lesson, apply to the S portion of the trust, while normal trust taxation rules apply to the non-S portion of the trust.

Making the ESBT Election. The trustee files the ESBT election with the IRS Service Center where the corporation files its income tax return. If the corporation is electing S status simultaneously with making the ESBT election, the election may be attached to the corporation's Form 2553 (Election by a Small Business Corporation). The ESBT election must be filed within the 16-day-and-2-month period beginning on the date S corporation stock is transferred to the trust.

Example 1B-10 Making the electing small business trust election.

Jean Norman is chief executive officer and one of 15 shareholders in JN Corp., a successful S corporation. Jean's mother Myrna is an elderly widow who requires expensive, long-term nursing care. Jean is paying individual income tax at the top rates. She placed 20% of her JN stock in a trust providing income to Myrna as she needs it. Income not used for Myrna's care accumulates in the trust. At Myrna's eventual death, the trust designates Jean's two minor children as successor beneficiaries.

By using a trust that meets the criteria for an ESBT and properly electing ESBT status, Jean met her objectives.

Once an ESBT election is made, it is revocable only with the consent of the IRS.

Consent to S Election. The trustee makes the ESBT election (discussed earlier) and also consents to the S election. All shareholders must consent when a corporation elects S status. Even though each potential current beneficiary of an ESBT counts as a shareholder for the 100-shareholder limit, only the trustee is required to consent to the S

corporation election. If the ESBT has more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S election. Further, if the ESBT is a grantor trust, both the trustee and the deemed owner of the trust are required to consent to the S election.

Trust Holding Assets Other Than S Corporation Stock. When an ESBT holds other property as well as S corporation stock, the portion of the trust consisting of stock in one or more S corporations is treated as a separate trust when figuring the income tax attributable to the S corporation stock. The taxable income attributable to this portion includes the three items listed previously under the heading, "Taxable Income." Thus, the trust consists of two portions, which, for the sake of convenience, will be identified here as the "S Portion" and the "Non-S Portion." The S Portion items are disregarded when figuring the tax liability of the Non-S Portion. Distributions from the Non-S Portion are deductible in computing the taxable income of that portion, but no distribution deduction is allowed in arriving at the S Portion's taxable income.

Example 1B-11 ESBT holding assets other than S corporation stock.

The Smith Trust holds S corporation stock as well as other assets and elected to be an ESBT for the current tax year ended December 31. The trust is considered to have two portions, an S Portion and a Non-S Portion. The S Portion was allocated $10,000 of ordinary income from the S corporation, and $4,000 was distributed by the S Portion to the beneficiary. The Non-S Portion received $15,000 in interest income and distributed that amount to the beneficiary.

The S Portion receives no deduction for the $4,000 distribution to the beneficiary. Thus, the S Portion is taxed on $10,000 at 39.6% and pays $3,960 in tax. The beneficiary receives the $4,000 distribution tax-free.

The Non-S Portion receives a $15,000 deduction for the distribution in arriving at taxable income. Thus, the trust pays no tax on Non-S Portion's income, but the beneficiary includes the $15,000 distribution in income.

Pass-through in Year Trust Terminates. If the trust terminates before the end of the S corporation's tax year, the trust takes into account its prorata share of S corporation items of income, loss, and deduction for its final year.

Sale of ESBT's S Corporation Stock. An ESBT recognizes gain or loss at the trust level if it sells its S corporation stock. However, no deduction is allowed for capital losses that exceed capital gains. If the trust reports income from the sale of its S corporation stock on the installment method, the income recognized in each installment is reported by the S portion of the trust. Conversely, interest income on the installment obligation is included in the non-S portion of the trust.

An ESBT that disposes of all of its S corporation stock is not considered to be an ESBT on the day following the day of disposition unless it reports the income from the stock sale on the installment method. If the installment method is used, the trust continues to be an ESBT until the last installment payment is received or the trust disposes of the installment obligation.

Net Investment Income Tax of an ESBT. Individuals, estates, and certain trusts are subject to a net investment income tax (NIIT), which is an additional tax of 3.8%. The NIIT generally applies to estates and trusts if there is undistributed net investment income and the AGI exceeds the dollar amount at which the highest fiduciary income tax bracket for the year begins. The tax applies to ESBTs to the extent the net investment income is retained in the trust.

The S portion and non-S portion of an ESBT (discussed earlier in this lesson) are treated as separate trusts for computing undistributed net investment income, but are treated as a single trust for determining the amount subject to tax under IRC Sec. 1411. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion are included in the grantor's net investment income and not in the ESBT's computation of NIIT. The tax is computed as follows:

Step 1 The S portion and non-S portion compute each portion's undistributed net investment income as separate trusts and then combine these amounts to calculate the ESBT's undistributed net investment income.

Step 2 The ESBT calculates its adjusted gross income. The ESBT's adjusted gross income is the non-S portion's adjusted gross income, increased or decreased by the net income or net loss of the S portion, after taking into account all deductions, carryovers, and loss limitations applicable to the S portion, as a single item of ordinary income (or ordinary loss).

Step 3 The ESBT will pay tax on the lesser of (a) the ESBT's total undistributed net investment income or (b) the excess of the ESBT's adjusted gross income over the dollar amount at which the highest tax bracket in IRC Sec. 1(e) begins for the tax year.

Because ESBT income is taxed in the trust, the ESBT will be subject to the NIIT if it has net investment income and its adjusted gross income exceeds the threshold amount.

Relief from Inadvertent Termination Due to Failure to File ESBT Election

A trust that meets the requirements of an electing small business trust (ESBT) under IRC Sec. 1361(e) is permitted to own S corporation stock. As explained earlier in this lesson, the trustee of an ESBT must file an election to have the trust treated as an eligible S shareholder. The election must be filed within two months and 16 days of the trust's receipt of the stock. Under Rev. Proc. 2013-30, the IRS provides inadvertent termination relief under IRC Sec. 1362(f) to corporations whose S status has been terminated because stock in the corporation was transferred to a trust whose trustee inadvertently failed to file a timely ESBT election under IRC Sec. 1361(e)(3). Under Rev. Proc. 2013-30, the corporation is treated as if its S status had not terminated.

Relief Is Retroactive to Original Effective Date. If the IRS grants relief, the ESBT election becomes effective on the date on which the ESBT election was originally intended to be effective.

Example 1B-12 Missed ESBT election.

Will Johnson, an S shareholder, died on January 16 of the current year. Will's estate transferred his S stock to a trust that meets the requirements of an ESBT under IRC Sec. 1361(e).

As previously discussed, a trustee of an ESBT is required to file an election to have the trust treated as an eligible S shareholder. The trustee was not aware of this requirement until 15 months after the S stock was transferred to the trust. Upon discovery of the omission, the corporation notifies the trustee that the omitted election had caused the S election to inadvertently terminate. The trustee requests relief from the missed ESBT election under Rev. Proc. 2013-30. The IRS will examine the application for relief to determine whether the requirements for waiving the inadvertent termination have been satisfied and will notify the trust of its decision. If relief is granted, the trust will become an ESBT on January 16, its originally intended effective date.

No User Fee. The method for requesting relief under Rev. Proc. 2013-30 is in lieu of the letter ruling process ordinarily used for a late ESBT election and no user fees apply. A taxpayer that does not meet the requirements of Rev. Proc. 2013-30 or is denied relief may seek relief by requesting a letter ruling.

Request Is Made by ESBT Trustee. The application for relief is made by the trustee seeking to treat a trust as an ESBT. The trustee files for relief by submitting an ESBT election statement along with statements required by Rev. Proc. 2013-30 and covered in the following discussion.

Requirements for Relief. To qualify for relief from termination of the S election due to a late election, all of the following requirements must be met:

- The ESBT trustee intended the trust to be classified as an ESBT on the date the ESBT election would have become effective if it had been made on time.
- The ESBT trustee requests relief under Rev. Proc. 2013-30 within three years and 75 days after the intended effective date of the ESBT election.
- The failure to qualify as an ESBT was solely because the ESBT election was not timely filed.
- The failure to make a timely ESBT election was inadvertent and the S corporation and the trust acted diligently to correct the mistake upon its discovery.

General Rules for Requesting Relief. An ESBT requests relief from a late election by properly completing the ESBT election and attaching any supporting documents required by Rev. Proc. 2013-30. The election must include a statement (i.e., a "Reasonable Cause/Inadvertence Statement") from the ESBT confirming that the failure to timely file the ESBT election was inadvertent and describing the diligent actions of the S corporation and trust to correct the mistake upon its discovery.

Each of the following statements must be submitted with the ESBT election:

- A statement from the ESBT trustee that all potential current beneficiaries meet the shareholder requirements of IRC Sec. 1361(b)(1) and that the trust satisfies the requirements of an ESBT under IRC Sec. 1361(e)(1), other than the requirement to make an ESBT election.

- Statements from all shareholders (including the trust itself) during the period between the date the S corporation election was to have become effective or was terminated and the date the completed ESBT election is filed that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and for all subsequent years. (This means that proper Schedules K-1 were issued to the shareholders and they reported the pass-through items on their tax returns as if a valid S election was in effect.)

The words "FILED PURSUANT TO REV. PROC. 2013-30" should be written at the top of the ESBT election.

Perjury Declaration Required on All Statements. The Reasonable Cause/Inadvertence Statement and all other statements (such as shareholder declarations) required by Rev. Proc. 2013-30 must each contain a dated declaration that states: "Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The trustee of the ESBT must sign the declaration.

Filing the ESBT Election. The ESBT election is filed by—

1. attaching the election to the S corporation's current year Form 1120S,

2. attaching the election to one of the S corporation's late filed prior year Forms 1120S, or

3. filing the election independent of Form 1120S.

Attaching the Election to S Corporation's Current Year 1120S. If the S corporation has filed all Forms 1120S for tax years between the trust's intended effective date and the current year, then the ESBT election can be attached to the current year Form 1120S, as long as the Form 1120S is filed within three years and 75 days after the trust's intended effective date. An extension of time to file the current year Form 1120S will not extend the due date for relief beyond three years and 75 days following the intended effective date. The Form 1120S must state at the top "INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30" or comply with specific instructions included with the Form 1120S instructions.

Attaching the Election to S Corporation's Late Filed Prior Year 1120S. If the S corporation has not filed Form 1120S for the tax year including the trust's intended effective date or any following year, an ESBT election may be attached to the S corporation's Form 1120S for the year including the trust's intended effective date if filed within three years and 75 days after the trust's intended effective date, and all other delinquent Forms 1120S are filed simultaneously and consistently with the requested relief.

Filing ESBT Election Independent of Form 1120S. The trustee can submit the ESBT election directly to the applicable IRS Service Center (i.e., where the corporation files its tax return) within three years and 75 days after the trust's intended effective date.

Simultaneous Relief Requests. If both the S election and ESBT election are late, both relief requests under Rev. Proc. 2013-30 can (but are not required to) be filed at the same time using one of the methods described in Rev. Proc. 2013-30, Sec. 4.03(2). When multiple requests for relief are submitted simultaneously, each application for relief must independently comply with the procedural requirements in Section 4.03(1).

Notification from IRS. The IRS will determine whether the requirements for granting additional time to file the ESBT election have been satisfied and will notify the trust of its determination.

A Testamentary Trust's ESBT or QSST Election Can Preserve S Corporation Status

A testamentary trust that receives S stock pursuant to the terms of a will is permitted to hold the stock for a two-year period beginning on the date the stock is transferred to it. Similarly, a trust existing before death that met the requirements to be treated as a grantor trust is permitted to hold S stock for a two-year period beginning on the date of the death of the deemed owner of the trust. Electing ESBT or QSST status can keep the S election in effect after the two-year period expires. An ESBT or QSST election can be filed at any time during the two-year period or the two-month-and-16-day period following the end of the two-year period.

Example 1B-13 Preserving the S election by electing ESBT status for a testamentary trust.

Wesley was a 25% shareholder of Web, Inc., an S corporation, at the time of his death. His will provides that the S corporation stock is to be distributed to a trust for the benefit of his wife, Lynne. Their adult daughter, Vanessa, also has the right to receive distributions of income from the trust. When Lynne dies, the trust beneficiaries will be Vanessa and her two children. The trust will terminate and the stock will be distributed to the children at the later of (a) Vanessa's death, or (b) when the children reach the age of majority.

The trust is a testamentary trust and, as such, is eligible to hold S stock for only two years after the stock is transferred to the trust. Web's S status terminates if the testamentary trust continues to be a shareholder for longer than a two-year period.

If the trust qualifies and elects QSST or ESBT status, the two-year rule does not apply and the trust can hold S corporation stock as long as it remains an eligible S shareholder. Here, the trust does not qualify as a QSST because there is more than one income beneficiary. The trust does, however, qualify as an ESBT. It will be necessary to either distribute the stock to a qualifying shareholder or elect ESBT treatment during the two-year period (or by the end of the two-month-and-16-day period following the end of the two-year period) if the corporation is to remain an S corporation.

Extending S Corporation Status by Treating Revocable Trust as Part of Estate

The trustee of a qualified revocable trust and the executor of the grantor's estate can elect to treat the trust as a part of the estate rather than as a separate trust. If the Section 645 election is made, trust income and expense will be reported by the estate on the estate's income tax return, Form 1041.

If the decedent's estate is required to file an estate tax return, the Section 645 election allows the estate to own S corporation stock longer than the two-year time limit that applies to revocable trusts. When the Section 645 election is made, the trust can be treated as part of the estate (and remain an eligible S shareholder) for six months after the final determination of estate tax liability.

If the taxable estate is not required to file an estate tax return, the Section 645 election is only effective for two years from the date of the decedent's death.

Converting from One Type of Eligible Trust (QSST or ESBT) to the Other

A QSST or ESBT can be converted to the other type of trust if certain requirements are met.

Qualified Retirement Plan Trusts

A tax-exempt qualified retirement plan trust under IRC Sec. 401(a) [i.e., an employer's qualified pension, profit-sharing, or stock bonus plan, such as an employee stock ownership plan (ESOP)] is eligible to own S corporation stock. However, if such a trust (other than an ESOP) owns S shares, it may be subject to the tax on unrelated business taxable income (UBTI).

Individual retirement accounts (including SEPs, SIMPLE IRAs, and Roth IRAs) are generally not qualified retirement plans under IRC Sec. 401(a) and thus are not eligible to hold S corporation stock.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. A corporation must meet several basic requirements to elect small business corporation status. Which of the following qualifies as a small business corporation under the S corporation eligibility rules, assuming other requirements have been met?

   a. Sunshine Corporation is a domestic corporation.

   b. Moonlight Corporation has 210 shareholders.

   c. Meteor Corporation has two classes of stock.

   d. Stock is held by the Star Corporation.

2. Which of the following would **not** be allowed to be an S corporation shareholder?

   a. Charitable remainder trust.

   b. A bank using the specific charge-off method of accounting for bad debts.

   c. Personal service corporation.

   d. Qualified pension retirement plan trust.

3. There are certain types of trusts that are permissible shareholders. Which of the following trusts generally is limited to a two-year period of stock ownership in an S corporation?

   a. A tax-exempt qualified retirement plan trust.

   b. Testamentary trust.

   c. Voting trust.

   d. Grantor trust.

4. Matthew is setting up a trust using the stock of several investments for his sole grandchild, Ruth, and would like to design the trust to be a qualified subchapter S trust (QSST) so that the interest on the trust will pay for Ruth's college, but the original money will go to Matthew's daughter, Sarah, upon his death. QSSTs have several numerous criteria that must be met to qualify. Which of following is an accurate requirement of a QSST?

   a. Matthew will receive all income distributions from the trust, but Sarah will receive the terminating distribution.

   b. The trust may allocate income to either Matthew or Sarah at the trustee's discretion.

   c. Ruth's income distribution from the QSST will terminate when Matthew passes away.

   d. The trust will provide income to both Ruth and Sarah before Matthew's death.

5. Which of the following is a characteristic of electing small business trusts?

   a. Beneficiaries will be taxed on the income related to S corporation stock held in the ESBT.

   b. All beneficiaries of an ESBT are counted as one shareholder for the 100-shareholder limitation.

   c. Trust beneficiaries can only be family members of the person establishing the trust.

   d. Income from an established ESBT can be distributed to numerous family members or others who are trust beneficiaries.

6. A trust may elect treatment as an electing small business trust (ESBT). Which of the following statements is correct regarding the election?

   a. Beneficiaries owning more than a 50% interest in the trust may revoke the ESBT election.

   b. All potential current beneficiaries must consent to the ESBT election.

   c. A grantor trust may elect to be treated as an ESBT.

   d. An ESBT election must be made by the due date of the initial trust tax return, excluding extensions.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. A corporation must meet several basic requirements to elect small business corporation status. Which of the following qualifies as a small business corporation under the S corporation eligibility rules, assuming other requirements have been met? **(Page 147)**

   a. Sunshine Corporation is a domestic corporation. [This answer is correct. For a corporation to qualify as a small business corporation under the S corporation eligibility rules, it must be a domestic corporation per IRC Sec. 1361.]

   b. Moonlight Corporation has 210 shareholders. [This answer is incorrect. According to IRC Sec. 1361, a small business corporation may have no more than 100 shareholders to qualify as a small business corporation under the S corporation eligibility rules.]

   c. Meteor Corporation has two classes of stock. [This answer is incorrect. For a corporation to qualify as a small business corporation under the S corporation eligibility rules, it must have only one class of stock.]

   d. Stock is held by the Star Corporation. [This answer is incorrect. Permissible shareholders allowed to hold stock in a small business corporation as detailed in IRC Sec. 1361, include individuals who are citizens and residents of the U.S., estates, certain types of trusts, and certain tax-exempt charitable organizations.]

2. Which of the following would **not** be allowed to be an S corporation shareholder? **(Page 147)**

   a. Charitable remainder trust. [This answer is correct. Charitable remainder annuity trusts and charitable remainder unitrusts are not eligible to hold S corporation shares as stated in IRC Sec. 1361.]

   b. A bank using the specific charge-off method of accounting for bad debts. [This answer is incorrect. According to IRC Sec. 1361(b)(2), a bank (i.e., a depository financial institution as defined in IRC Sec. 581) that does not use the reserve method of accounting for bad debts can elect S corporation status.]

   c. Personal service corporation. [This answer is incorrect. Personal service corporations and personal holding companies that meet the S corporation requirements are eligible to elect S status according to the IRS rules.]

   d. Qualified pension retirement plan trust. [This answer is incorrect. As stated in IRC Sec. 401(a), certain tax-exempt qualified retirement plan trusts; including a qualified pension, profit-sharing, and stock bonus plan are eligible to hold stock in S corporations.]

3. There are certain types of trusts that are permissible shareholders. Which of the following trusts generally is limited to a two-year period of stock ownership in an S corporation? **(Page 149)**

   a. A tax-exempt qualified retirement plan trust. [This answer is incorrect. A tax-exempt qualified retirement plan trust under IRC Sec. 401(a) is a permitted shareholder {e.g., an employee stock ownership plan (ESOP)}. There is no time limitation on ownership by this type of trust.]

   b. Testamentary trust. [This answer is correct. According to IRC Sec. 1361(c)(2)(iii), a testamentary trust that receives S stock pursuant to the terms of a will is eligible to be an S corporation shareholder, but eligibility is limited to a two-year period of ownership.]

   c. Voting trust. [This answer is incorrect. Voting trusts are created primarily to exercise the voting power of the owned stock as stated in IRC Sec. 1361(c)(2)(iv). There is no time limit on ownership by a voting trust.]

   d. Grantor trust. [This answer is incorrect. A grantor trust in which all income and corpus is treated as being owned by a U.S. citizen or resident per IRC Sec. 1361(c)(2)(A)(I,) does not have a limited period of stock ownership in an S corporation.]

4. Matthew is setting up a trust using the stock of several investments for his sole grandchild, Ruth, and would like to design the trust to be a qualified subchapter S trust (QSST) so that the interest on the trust will pay for Ruth's college, but the original money will go to Matthew's daughter, Sarah, upon his death. QSSTs have numerous criteria that must be met in order to qualify. Which of following is a requirement of a QSST? **(Page 149)**

   a. Matthew will receive all income distributions from the trust, but Sarah will receive the terminating distribution. [This answer is incorrect. A criterion of a QSST is that any corpus distributions that might occur, including a terminating distribution, must also go to the one income beneficiary if made during the beneficiary's lifetime as detailed in IRC Sec. 1361(d).]

   b. The trust may allocate income to either Matthew or Sarah at the trustee's discretion. [This answer is incorrect. All of the income of the trust is, or is required to be, distributed currently to the income beneficiary. However, a trust provision authorizing the trustee to accumulate income if the trust no longer holds S corporation stock does not preclude the trust from being a QSST according to Rev. Rul. 92-20.]

   c. Ruth's income distribution from the QSST will terminate when Matthew passes away. [This answer is correct. According to IRC Sec. 1361(d), one of the criteria that must be met for a trust to qualify as a QSST is that the income interest of the beneficiary must terminate on the earlier of the beneficiary's death or the trust's termination.]

   d. The trust will provide income to both Ruth and Sarah before Matthew's death. [This answer is incorrect. The trust may only have one income beneficiary during the life of the current income beneficiary, and that beneficiary must be a U.S. citizen or resident as stated in IRC Sec. 1361(d).]

5. Which of the following is a characteristic of electing small business trusts? **(Page 149)**

   a. Beneficiaries will be taxed on the income related to S corporation stock held in the ESBT. [This answer is incorrect. The trust (not the beneficiaries) are taxed on income related to the S corporation stock at the highest individual rate (for 2016—39.6% on ordinary income, 20% on long-term capital gains, 25% for unrecaptured Section 1250 gain, and 28% for collectibles gain), as detailed in IRC Sec. 641(c)(2)(A).]

   b. All beneficiaries of an ESBT are counted as one shareholder for the 100-shareholder limitation. [This answer is incorrect. A potential current beneficiary generally is any person who is entitled to a distribution from the principal or income of the trust. Each potential current beneficiary of the trust (and that beneficiary's family member) is counted as one shareholder for the 100-shareholder limitation. If there are no potential current beneficiaries, the trust is treated as the shareholder.]

   c. Trust beneficiaries can only be family members of the person establishing the trust. [This answer is incorrect. To qualify as a small business trust, all trust beneficiaries must be individuals, estates, or charitable organizations eligible to be S shareholders. They do not have to be related to whomever is establishing the trust.]

   d. Income from an established ESBT can be distributed to numerous family members or others who are trust beneficiaries. [This answer is correct. An individual can establish an ESBT to hold S corporation stock and split income among family members or others who are trust beneficiaries as stated in IRS rules.]

6. A trust may elect treatment as an electing small business trust (ESBT). Which of the following statements is correct regarding the election? **(Page 149)**

   a. Beneficiaries owning more than a 50% interest in the trust may revoke the ESBT election. [This answer is incorrect. Once an ESBT election is made, it is revocable only with the consent of the IRS as stated in IRC Sec. 1361(c)(1)(B).]

   b. All potential current beneficiaries must consent to the ESBT election. [This answer is incorrect. The trustee makes the ESBT election and also consents to the S election. As detailed in Reg. 1-1361-1(m)(2), only the trustee is required to consent to the S corporation election.]

c. A grantor trust may elect to be treated as an ESBT. [This answer is correct. Grantor trusts are permitted to make ESBT elections. However, an ESBT election does not alter the established tax treatment of items attributable to the grantor portion of the trust. The ESBT rules are found in IRC Sec. 641(c).]

d. An ESBT election must be made by the due date of the initial trust tax return, excluding extensions. [This answer is incorrect. The ESBT election must be filed within the 16-day-and-2-month period beginning on the date S corporation stock is transferred to the trust. If the corporation is electing S status simultaneously with making the ESBT election, the election may be attached to the corporation's Form 2553 (Election by a Small Business Corporation).]

Treating Family Members as One Shareholder

Treating a Family Group as One Shareholder

All family members, including spouses, former spouses, and all their estates are treated as one shareholder solely for purposes of determining the number of shareholders in the corporation.

Defining the Family. A *family* is defined as the common ancestor and all lineal descendants of the common ancestor, as well as the spouses, or former spouses, of these individuals. An adopted child, child lawfully placed with an individual for adoption, or foster child is treated as a natural child.

Form 2553. Line G on Page 1 of the S election Form 2553 contains a box to check if the corporation actually has more than 100 shareholders but is still eligible for S corporation status because it meets the 100-or-less shareholder limit when family members are counted as one shareholder.

Identifying Family Members

Family members include the following:

- A common ancestor and all of that ancestor's lineal descendants, as well as the ancestor's and descendants' spouses and former spouses (see Examples 1C-1 and 1C-3).
- A taxpayer and spouse, as discussed later in this lesson.
- The estate of a deceased family member during the period in which the estate or a testamentary trust holds stock in the S corporation. (See "Shareholder's Estate" later in this lesson.)

The following are also treated as family members:

- The income beneficiary of a qualified subchapter S trust (QSST) who makes the QSST election, if that income beneficiary is a family member.
- Each potential current beneficiary of an electing small business trust (ESBT) who is a family member.
- Each family member who is a beneficiary of a trust created primarily to exercise the voting power of stock transferred to it.
- The family member for whose benefit an IRA was created to hold stock in a certain S corporation bank.
- The deemed owner of a grantor trust, if the deemed owner is a family member.
- The owner of a disregarded entity, such as a single-member LLC, if the owner is a family member.

Six-generation Limitation. An individual is not a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this rule) be members of the family. A spouse or former spouse is treated as in the same generation as the person to whom the individual is (or was) married.

The applicable date is the latest of (1) the effective date of the corporation's S election, (2) the earliest date that a family member holds stock in the S corporation, or (3) October 22, 2004.

The six-generation limitation applies only as of the applicable date. Lineal descendents (and spouses) who acquire stock after the applicable date will be treated as members of the family, even if they are more than six generations removed from the common ancestor.

Example 1C-1 Illustrating how a family group is treated as one shareholder.

ABC Corp. is an S corporation that has 99 unmarried and unrelated shareholders. On July 1, 2017, Bob transfers shares to his four children, his ex-spouse, his father, and his grandmother. Bob's grandmother is the

common ancestor because Bob, his father, and his children are the grandmother's lineal descendants. The spouses and former spouses of these individuals are also considered to be family members. The six-generation test is applied on the applicable date, which is the latest of (a) the effective date of the S election, (b) the earliest date that a family member holds stock in the S corporation, or (c) October 22, 2004. In this example, the applicable date is July 1, 2017, the date that a family member first holds stock in the S corporation. No family member is more than six generations removed from the common ancestor. Because all of the transferred shares go to family members who are treated as one shareholder, the corporation is still considered to have 99 shareholders for purposes of the maximum-number-of-shareholders test.

Family Member Rule Applies Only for Counting Shareholders. Treating separate shareholders as one shareholder applies only for the purpose of determining whether the corporation has exceeded the allowable number of shareholders. Shareholders are treated separately for other purposes, such as the pass-through of the S corporation's items of income, gain, loss, or deduction. Furthermore, if a corporation is making the S election, each person holding shares must separately consent to the S election.

Example 1C-2 Illustrating pass-through when a family group is treated as one shareholder.

Assume the same facts as in Example 1C-1. The corporation has 99 shareholders for purposes of the maximum-number-of-shareholders test. However, the corporation's pass-through items of income, gain, loss, deduction, and credit are allocated to all 106 stockholders on a per-share, per-day basis.

As illustrated in Examples 1C-1 and 1C-2, an S corporation can have significantly more than 100 shareholders because of the family-members-count-as-one-shareholder rule.

Example 1C-3 Counting family members as one shareholder.

Oval, Inc. is a very successful calendar-year S corporation founded years ago by Frank Jones. Over the years, Frank transferred a large portion of his stock in Oval to his children Eve and Pete.

The Jones family treats Frank as their common ancestor and treats all of Frank's descendents as one shareholder for purposes of the 100-shareholder limit. Oval is treated as having one shareholder (composed of the Frank, Eve, and Pete family group) for purposes of counting shareholders.

Variation 1: Assume now that Frank dies and Eve and Pete inherit his shares in the S corporation. Oval still has one shareholder because Eve and Pete are lineal descendents of a common ancestor, Frank.

Variation 2: Assume now that Eve and Pete formed the S corporation after Frank died. There is no requirement that the common ancestor be alive when determining the number of S corporation shareholders. Thus, Oval has one shareholder because Eve and Pete are Frank's lineal descendents.

Variation 3: Assume now that Eve and Pete each have children who own shares in the S corporation. Because Frank is a common ancestor of both Eve and Pete and their children, Oval still has one shareholder. This would continue to be true, even if Eve, Pete, or one of their children died and left his or her shares to the other stockholders. All of the remaining shareholders would be Frank's lineal descendents and would be counted as one shareholder. If the decedent, however, left the shares to an individual who was not a lineal descendent of Frank, Oval would be considered to have two shareholders. Frank's lineal descendents would be counted as one shareholder, and the individual would be the other.

Variation 4: Assume now that Oval was founded by Frank Jones and Mike Smith, who are not related. They each transfer stock to their children. Here, Frank and Mike are common ancestors of their respective families. The S corporation is considered to have two shareholders: Frank and his family and Mike and his family.

Taxpayer and Spouse

Spouses (and their estates) are automatically counted as one shareholder for purposes of the 100-shareholder limit. This is true whether or not they file a joint return or own the stock individually, or in a form of joint ownership (joint tenancy, community property, etc.).

Example 1C-4 Counting spouses as one shareholder.

Free Spirit, Inc. is an S corporation. The corporation has 99 unmarried and unrelated shareholders. In addition, Roger and Rhoda Ranger are married and each spouse owns shares of Free Spirit's stock. Since Roger and Rhoda count as one shareholder, the 100-shareholder limit has not been exceeded.

Counting Shareholders When Shareholders Are Divorced

Members of a family include a common ancestor, any lineal descendant of the common ancestor and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. The "or former spouse" wording in the Code and regulation evidently includes a divorced spouse under the "family member" umbrella, which allows spouses and former spouses of family members, together with the other family members, to be counted as one shareholder.

Example 1C-5 Divorced family members count as one shareholder.

Penn, Inc. has operated as an S corporation for ten years. It has 110 shareholders, made up of 90 unmarried and unrelated shareholders and 10 unrelated married couples who each own stock in Penn. For purposes of the 100-shareholder limit, Penn is considered to have 100 shareholders because each married couple counts as one shareholder. In the middle of the current year, Mel and Melba divorce, and each continues to own S corporation stock. Mel's common ancestor is his father, Fred. Mel and Melba are still considered to be family members under IRC Sec. 1361(c)(1)(B)(i) because Mel is the lineal descendant of the common ancestor (Fred), and Melba is the former spouse of that lineal descendant. Therefore, Mel and Melba evidently continue to be counted as one shareholder for purposes of the 100-shareholder limit.

Exceeding the Shareholder Limit Causes S Election to Terminate

When an S corporation's shareholder count reaches 100, the introduction of even one new stockholder, other than a family member, will cause the S election to terminate.

Example 1C-6 Transfer of stock to unrelated party can cause involuntary termination of S status.

Sill, Inc. has 110 shareholders made up of 90 unmarried and unrelated shareholders and 10 married couples who each own stock in the corporation. Sill is considered to have 100 shareholders under the family member rule. One of Sill's shareholders transfers a portion of her stock to an unrelated party during the year. The S corporation is now considered to have 101 shareholders (91 unrelated shareholders plus 10 married couples that count as one shareholder per couple). The S election terminates on the day the stock transfer to the unrelated party takes place.

Variation: Assume now that the shareholder transfers shares to her child instead of to an unrelated party. The child is a lineal descendent of the parent, so parent and child are counted as one shareholder for purposes of the 100-shareholder test. (The parent or a previously designated person will be the common ancestor.) The S corporation is still considered to have 100 shareholders.

Shareholder's Estate

Spouses (and their estates) are automatically treated as one shareholder. Furthermore, all members of a family (including spouses and former spouses) and their estates are treated as a single shareholder without the need to make an election.

Example 1C-7 Treating deceased shareholder's estate as a shareholder.

Gordon, Inc. is a family controlled publishing company that operates as an S corporation. It was formed about 25 years ago by three brothers who are now quite elderly. The stock is held by the three Gordon brothers and an assortment of their children, grandchildren, and various spouses of the children and grandchildren.

One of the elderly brothers is terminally ill. According to his will, the stock will pass directly to his surviving spouse, but only after an anticipated one-year period of estate administration. His wife is already a direct shareholder on her own.

The terminally ill brother and his wife are currently counted as one shareholder. Upon his death and the passage of his stock into his estate, the surviving spouse and the estate will still be considered one shareholder. Upon the termination of the estate and transfer of the stock to the surviving spouse, she will hold all shares as an individual.

Qualified Retirement Plan Trusts

Tax-exempt qualified retirement plan trusts are eligible to hold stock in S corporations. For purposes of the 100-shareholder limitation, a qualified retirement plan counts as one shareholder. In general, when a qualified retirement plan trust holds stock in an S corporation, the corporation's pass-through income flows through to the trust and is taxed under the unrelated business taxable income (UBTI) rules. However, special rules are provided for employee stock ownership plans (ESOPs) that exempt such plans from the UBTI rules.

Qualified Retirement Plans

A qualified retirement plan trust described in IRC Sec. 401(a) that is exempt from tax under IRC Sec. 501(a) is eligible to hold stock in an S corporation. Thus, qualified pension, profit-sharing, and stock bonus plans can hold stock in an S corporation.

S stock held by a qualified retirement plan trust is treated as an unrelated trade or business. The trust's share of the S corporation's pass-through income as well as any gain or loss on a disposition of the S stock is subject to taxation under the unrelated business taxable income (UBTI) rules.

If the qualified plan trust purchases stock in an S corporation (whether the stock was acquired when the corporation was a C or an S corporation) and receives a dividend distribution (i.e., a distribution of E&P), the trust must reduce its basis in the stock by the amount of the dividend. However, the IRS is permitted to issue regulations providing that the basis reduction would apply only to the extent the dividend is deemed to be allocable to E&P that accrued by the date of the acquisition.

Employee Stock Ownership Plans (ESOPs)

ESOPs are eligible to hold S corporation stock. An ESOP is a special type of defined contribution plan that invests primarily in employer securities. An ESOP may be a stock bonus plan or a combination of a stock bonus plan and a money purchase plan, which has been modified to include the various tax and regulatory requirements of an ESOP. S corporation ESOPs are not subject to the unrelated business taxable income (UBTI) rules.

An ESOP is counted as a single shareholder for the 100-shareholder limit, regardless of the number of ESOP participants.

Individual Retirement Accounts

General Rule Prohibits Holding S Stock in IRA. In general, a trust that constitutes a traditional or Roth individual retirement account (IRA) is ineligible to hold S corporation stock.

Grandfather Rule Permits Certain IRAs to Hold Stock in S Corporation Banks. An IRA or Roth IRA is allowed to hold shares of an S corporation that is a bank if the shares were held in the IRA or Roth IRA on October 22, 2004. If the IRA or Roth IRA holds such bank S stock, the individual for whose benefit the IRA or Roth IRA was created is treated as the shareholder.

The unrelated business taxable income (UBTI) rules that apply to other tax-exempt entities (other than ESOPs) will apply to IRAs and Roth IRAs holding S corporation stock. However, the prohibited transaction rules of IRC Sec. 4975 (imposing an excise tax on certain transactions between a retirement plan and a disqualified person) do not apply to the sale of stock by an IRA or Roth IRA to the individual beneficiary of the trust if certain requirements are met.

Limited Exception for S Stock Rolled over from an ESOP to an IRA. An ESOP can make a direct rollover of S corporation stock to an IRA if (1) the terms of the ESOP require that the S corporation repurchase its stock

immediately upon the ESOP's distribution of the stock to the IRA; (2) the S corporation actually repurchases the S corporation stock on the same day as the distribution; and (3) no income, loss, deduction, or credit items are passed through by the S corporation to the IRA.

Handling a Partnership with S Corporations as Partners

An S corporation is limited in the types of individuals and entities that can hold shares and in the number of allowable shareholders. The 100-shareholder limit can particularly present a problem when a larger group of investors joins together in a business venture.

An S Corporation Can Own an Interest in a Partnership

Rev. Rul. 94-43 provides that the purpose of the shareholder limit is to "obtain administrative simplicity in the administration of the corporation's tax affairs." The ruling holds that administrative simplicity is not affected by the corporation's participation in a partnership with other S corporation partners, so the S election will be respected when separate S corporations combine to form a partnership. If each S corporation has fewer than 101 shareholders, the 100-shareholder limit is not exceeded when two or more corporations combine to operate a single business as a partnership.

Example 1E-1 Two or more S corporations can form a partnership without violating the 100-shareholder limit.

Two groups of 55 unrelated individuals want to join together in a single active business. They recognize that a general partnership is not desirable because of liability aspects; similarly, they have discarded the idea of a limited partnership because none of the individuals are willing to act as general partner. Each group of 55 individuals forms an S corporation, and the two S corporations then form a partnership. The shareholder limit is not exceeded because each S corporation partner has only 55 shareholders. The IRS, relying on Rev. Rul. 94-431994-2 CB 198, ruled that two S corporations that become partners in a general partnership will not violate the 100-shareholder limit so long as each corporation individually has no more than 100 shareholders. Under the facts of the ruling, three corporations (Zee Company, Acorp, and Beecorp) have elected S status. The number of Zee Company's shareholders is nearing 100. Under a restructuring plan, Zee Company will become a general partnership under state law. Acorp and Beecorp together will own all of the interests in the partnership. Zee Company's shareholders will become shareholders in either Acorp or Beecorp. Following this restructuring, the parties anticipate that both Acorp and Beecorp will issue additional shares to new shareholders over time. After the new shares are issued, the two S corporations together are expected to have more than 100 shareholders. The IRS ruled that the partner corporations, Acorp and Beecorp, will not lose their S status so long as neither corporation exceeds the 100-shareholder limit.

S corporation restrictions generally revolve around the types of entity that can hold S corporation stock, not the types of investments that an S corporation can hold.

Example 1E-2 Forming a partnership between an S corporation and a C corporation.

Doug owns 100% of an S corporation. His business could use additional capital, and would benefit from an affiliation with another entity, which operates as a C corporation. Doug would like to sell 40% of the stock in his S corporation to this C corporation, but the C corporation is ineligible to hold stock in an S corporation. (Such a purchase would cause termination of the S status of Doug's corporation.) As an alternative, Doug has his S corporation contribute the assets of its business into a newly formed partnership, with 60% of the partnership owned by the S corporation and 40% by the C corporation (in exchange for capital injected by the C corporation). Doug's S corporation is permitted to be a partner in the partnership. Doug's personal position remains essentially unchanged from his original plan, as 60% of the earnings of the business will flow through from the new partnership to Doug's S corporation, which is now merely a shell. The amount is then shown on the S corporation's Form 1120S, Schedule K-1, to be reported on Doug's Form 1040.

Tiered Structures

Generally, an S corporation is a member of a tiered structure if it owns any portion of a partnership, personal service corporation, or trust. A member of a tiered structure may be barred from using a fiscal year because it is ineligible to make the Section 444 election, except under certain conditions.

Using a Limited Liability Company with an S Corporation

A single-member limited liability company (LLC) will generally be disregarded as an entity separate from its owner for federal tax purposes. However, an LLC with two or more members will generally be classified as a partnership for federal tax purposes. The unique advantage of LLCs under state law is that they can provide limited liability to all members (owners) even if they fully participate in the management of the enterprise. At the same time, many of the federal tax law restrictions that apply to S corporations can be avoided. However, S corporations still carry some advantage over LLCs.

LLCs May Elect to Be Treated as Corporations and May Elect S Status.

An LLC can file a check-the-box election to be taxed as a corporation. An LLC can make such a check-the-box election and elect S status, assuming the entity's members are eligible to hold S corporation stock, and the LLC meets the other eligibility requirements to be an S corporation.

A Single-member LLC Can Hold S Corporation Stock

An LLC generally is not an eligible shareholder and cannot hold S corporation stock. However, the IRS has ruled that a single-member LLC can be an S corporation shareholder. The LLC must be a domestic entity that is not classified as a corporation and must be disregarded as an entity separate from its owner. Furthermore, the owner of the LLC must be an individual or other entity eligible to hold S stock. If these requirements are met, the owner of the LLC is treated as owning the LLC's assets directly, so any S corporation shares held by the single-member LLC are treated as being owned by the LLC's owner. Thus, if the shares are transferred to the LLC before the S election is filed, the owner of the LLC (rather than the LLC itself) evidently consents to the S election.

An S Corporation Can Own an Interest in an LLC

S corporation restrictions generally revolve around the types of entity that can hold S corporation stock, not the types of investments that an S corporation can hold. Thus, an S corporation can hold stock in another corporation, a partnership interest, or an interest in an LLC.

Changing from S Corporation to LLC

If S corporation shareholders decide to change the entity's form of business to an LLC, the corporation generally must be liquidated and a new entity formed.

LLC Converting to S Status Must Conform to S Corporation Rules

If an S corporation reorganizes to become an LLC that operates as an S corporation, it must have only one class of stock. The IRS has ruled that an LLC agreement is a governing provision for purposes of the one-class-of-stock rules. Thus, it is important for the LLC to execute an agreement that defines the members' rights to distribution and liquidation proceeds. Each percentage of ownership should be given identical rights to these proceeds.

Making the Qualified Subchapter S Subsidiary Election

A Corporation's S Election Terminates When Its Shares Are Acquired by Another Corporation

An S corporation can own stock of another corporation. However, a corporation is generally not an eligible S corporation shareholder. (An exception allows charitable organizations under IRC Sec. 501(c)(3) to hold S corporation stock.) This means that a corporation's S election will terminate on the day another corporation (other than an eligible charitable organization) acquires its shares.

Example 1G-1 S election terminates when another corporation acquires stock.

On January 1, 2017, Bracket, Inc., an S corporation, purchased 80% of the stock of Sacket, an S corporation. Can Bracket and Sacket remain S corporations?

Bracket's S election is not affected by the stock purchase because an S corporation can hold the stock of another corporation. Since a corporation is not an eligible S shareholder, however, Sacket's S election terminates on January 1, 2017, the date its stock is acquired by Bracket. The last day of the S year is December 31, 2016, the day before the terminating event occurs.

Qualified Subchapter S Subsidiaries

If an S corporation owns all the shares of another corporation, it can elect to treat the wholly-owned corporation as a qualified subchapter S subsidiary (QSub). A QSub is a corporation that is owned 100% by an S corporation that has made the QSub election for that subsidiary. (An S corporation, for example, can own 100% of the stock of two subsidiaries and make a QSub election for either, neither, or both of them.) A QSub is technically neither a C corporation nor an S corporation. A QSub is not treated as a separate corporation for federal tax purposes but is treated as a separate corporation for other purposes.

Effect of the QSub Election. A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation. Therefore, transactions between the S corporation parent and QSub are not taken into account, and items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, and debt basis) are considered items of the parent. Only the parent is required to file a tax return, Form 1120S, and that return includes the QSub's assets, liabilities, and items of income, deduction, and credit.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Which of the following statements correctly describes the treatment of family members with regards to the 100-shareholder limit?

   a. A family member may include the owner of a disregarded entity, if the owner is a family member.

   b. Once a family member divorces, the former spouse is no longer treated as a family member.

   c. A foster child is not included in the definition of family member.

   d. The income beneficiary of a qualified subchapter S trust is treated as a separate shareholder, even if the beneficiary is a family member.

8. An S corporation may elect to treat a subsidiary as a qualified subchapter S subsidiary (QSub). Which of the following statements correctly describes QSub treatment?

   a. A QSub's assets and liabilities are treated as owned by the parent S corporation.

   b. An S corporation owning more than 80% of the outstanding stock of another corporation may make a QSub election for its subsidiary.

   c. Accumulated earnings and profits and passive investment income of the QSub do not impact the parent S corporation.

   d. A QSub is technically an S corporation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Which of the following statements correctly describes the treatment of family members with regards to the 100-shareholder limit? **(Page 168)**

   a. A family member may include the owner of a disregarded entity if the owner is a family member. [This answer is correct. A family is defined as the common ancestor and all lineal descendants of the common ancestor, as well as the spouses, or former spouses, of these individuals. The owner of a disregarded entity, such as a single-member LLC, is also treated as a family member if the owner is a family member as stated in Reg. 1.136-1(e)(3)(ii).]

   b. Once a family member divorces, the former spouse is no longer treated as a family member. [This answer is incorrect. Members of a family include a common ancestor, any lineal descendant of the common ancestor, and any spouse (or former spouse) of the common ancestor as explained in Reg. 1.136-1(e)(3)(i).]

   c. A foster child is not included in the definition of family member. [This answer is incorrect. As detailed in Reg. 1.136-1(e)(3), an adopted child, child lawfully placed with an individual for adoption, or foster child is treated as a natural child and included in the definition of family member.]

   d. The income beneficiary of a qualified subchapter S trust is treated as a separate shareholder, even if the beneficiary is a family member. [This answer is incorrect. According to Reg. 1.136-1(e)(3)(ii), a family member includes the income beneficiary of a qualified subchapter S trust (QSST) who makes the QSST election, if that income beneficiary is a family member.]

8. An S corporation may elect to treat a subsidiary as a qualified subchapter S subsidiary (QSub). Which of the following statements correctly describes QSub treatment? **(Page 173)**

   a. A QSub's assets and liabilities are treated as owned by the parent S corporation. [This answer is correct. A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation according to IRC Sec. 1361(b)(3). Therefore, transactions between the S corporation parent and QSub are not taken into account.]

   b. An S corporation owning more than 80% of the outstanding stock of another corporation may make a QSub election for its subsidiary. [This answer is incorrect. A QSub is a corporation that is owned 100%, not 80%, by an S corporation that has made the QSub election for that subsidiary. (An S corporation, for example, can own 100% of the stock of two subsidiaries and make a QSub election for either, neither, or both of them.)]

   c. Accumulated earnings and profits and passive investment income of the QSub do not impact the parent S corporation. [This answer is incorrect. Items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, and debt basis) are considered items of the parent.]

   d. A QSub is technically an S corporation. [This answer is incorrect. A QSub is technically neither a C corporation nor an S corporation. It is not treated as a separate corporation for federal tax purposes but is treated as a separate corporation for other purposes.]

Meeting the One-class-of-stock Requirement

Characterization of the income and loss as unrelated business income applies regardless of the nature of such income. For example, passive income of an S corporation will be treated as unrelated business income.

A small business corporation must, by definition, have only one class of stock. However, differences in voting rights among shares of common stock do not cause the S corporation to lose its eligibility.

Governing Provisions

An S corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock.

The determination of whether all outstanding shares of stock confer identical distribution and liquidation rights is based on the "governing provisions," which include the corporate charter, articles of incorporation, bylaws, applicable state law, and any binding agreements relating to distribution and liquidation proceeds.

Stock versus Debt in an S Corporation

It is well established under IRC Sec. 385 and related case law that corporate debt can at times be treated as equity by the IRS. Problems that can arise when debt is recharacterized by the IRS as equity are covered in the following discussion.

Debt as a Second Class of Stock

Under certain circumstances, debt owed by the S corporation to one or more shareholders will be a second class of stock. An obligation (whether or not designated as debt) will be a second class of stock if—

1. it constitutes equity or otherwise results in the holder being treated as a shareholder under general tax law, and

2. a principal purpose of the obligation is to circumvent the distribution or liquidation rights conferred by the outstanding stock or to circumvent the maximum shareholder limitation.

The S election terminates if an obligation "fails" the two previous tests and is determined to be a second class of stock. For this reason, the practitioner should be aware of factors the courts consider in determining whether an obligation is debt or equity. The Tax Court has applied various factors in concluding that the obligation under consideration was equity, including the intent of the parties, thin versus adequate capitalization, the source of repayment, and the right to enforce repayment.

Straight Debt Safe Harbor. Debt that meets the definition of "straight debt" is not a second class of stock, regardless of whether such debt is classified as equity under general tax law principles. Debt must meet the following four requirements to qualify as straight debt:

1. The debt must be a written, unconditional obligation to pay a sum certain on demand (or on a specified due date).

2. The interest rate and payment dates must not be contingent on profits, the borrower's discretion, or similar factors.

3. The debt cannot be directly or indirectly convertible into stock (or any other equity interest of the S corporation).

4. The debt must be held by (a) an individual, estate, or trust that is an eligible S corporation shareholder; or (b) creditors, other than individuals, that are actively and regularly engaged in the business of lending money (e.g., banks).

Debt does not have to be issued by an S corporation to meet the straight debt safe harbor. An obligation issued by a C corporation that satisfies the definition of straight debt is not treated as a second class of stock if the corporation later elects S status, even if the debt is considered equity under general tax law principles. In addition, conversion to S status is not treated as an exchange of debt for stock.

Interest paid or accrued with respect to a straight debt obligation generally is treated as interest by both the corporation and the recipient, and does not constitute a distribution to the shareholder that would be taxable or nontaxable under IRC Sec. 1368. If the obligation bears an unreasonably high interest rate, a portion of the interest may be recharacterized and treated as a payment that is not interest. However, this recharacterization will not result in a second class of stock.

Example 1H-1 Meeting the safe harbor debt requirements.

Pontiac, Inc., is incorporated on May 15 and immediately elects S status. Jo and Bob each buy half of the stock for $5,000. Jo loans the corporation $100,000, and Bob loans it $75,000. The loans are evidenced by written notes that bear 6% interest and call for payment on demand. The debt is not convertible into stock.

The notes fulfill all of the straight debt requirements. Therefore, under the straight debt safe harbor rules of IRC Sec. 1361(c)(5) and Reg. 1.1361-1(l)(4)(i), the debt will not be classified as a second class of stock.

Example 1H-2 How debt can be recharacterized as stock.

Assume the same facts as in Example 1H-1 except the loans are not evidenced by written notes.

Now, the corporate debt could be considered equity because of the high ratio of debt to stock investment. Also, the debt does not meet the straight debt requirements because there are no written notes. This renders the corporation vulnerable to an IRS argument that the debt is a second class of stock. The notes will not be considered a second class of stock, however, unless (a) the debt is considered equity under general tax law principles, and (b) a principal purpose of the debt is to circumvent the single class of stock limitation. To avoid any possibility that a second class could exist, the notes should be in writing and meet the other requirements of the straight debt safe harbor contained in IRC Sec. 1361(c)(5).

Short-term Unwritten Advances (Open Accounts Loans) and Proportionately Held Debt. In addition to the safe harbor for straight debt obligations, Reg. 1.1361-1(l)(4)(ii)(B) provides the following safe harbors to prevent having certain debt treated as a second class of stock:

1. *Unwritten Advances.* Unwritten advances that: (a) do not exceed $10,000 in the aggregate at any time; (b) are treated as debt by the parties; and (c) are expected to be repaid within a reasonable time are not treated as a second class of stock (even if considered equity under general tax law principles).

2. *Proportionately Held Debt.* Proportionately held debt includes any class of obligations that is considered equity under general tax law principles and held by the shareholders in the same proportion as the S corporation's outstanding stock. Note that debt held by a sole shareholder of an S corporation always meets the definition of proportionately held debt.

Example 1H-3 Safe harbor for unwritten advances and proportionately held debt.

Jane organizes Newco, Inc. and causes Newco to elect S status as of the beginning of its first tax year. She contributes $50,000 in exchange for all its outstanding stock. In addition, Jane makes several advances for Newco's working capital needs. These advances are unwritten, "open account" loans and have never exceeded $10,000 in the aggregate. The advances are recorded as shareholder loans on Newco's books, and Jane expects to be repaid within the company's normal working capital cycle. The advances are not treated as a second class of stock, even if they are treated as equity under general tax law principles. The loans satisfy the safe harbor for unwritten short-term advances (as well as the safe harbor for proportionately held debt).

If the advances did not meet requirements for either the safe harbor for unwritten advances or the safe harbor for proportionately held debt, they would not automatically be treated as a second class of stock, even if they

are considered equity under general tax law principles. Debt is not treated as a second class of stock unless it has a principal purpose of circumventing the rights conferred by the corporation's outstanding stock or the limitations on eligible shareholders (including the 100-shareholder limitation).

Debt versus Equity Regulations Do Not Apply to S Corporations

In October 2016, the IRS issued final and temporary regulations on when an interest in a corporation is treated as debt or equity under IRC Sec. 385. According to the IRS, the primary purpose of the regulations is the prevention of earnings stripping, a technique employed by multinational corporations to minimize U.S. taxes by paying deductible interest to a foreign parent in a low-tax jurisdiction. As a practical matter, these long and complex final regulations will primarily affect large, multinational corporations with related-party debt aimed at earnings stripping.

S corporations are excluded from all aspects of the final and temporary regulations because these entities are unlikely to engage in the types of transactions targeted by the regulations.

Disproportionate Distributions to Shareholders

Although a corporation is not treated as having more than one class of stock if the governing provisions (discussed earlier in this lesson) provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given "appropriate tax effect" in accordance with the facts and circumstances.

For example, a payment of excessive compensation may be recharacterized as a distribution for which no deduction is allowed; however, neither the payment nor the distribution created by the recharacterization results in a second class of stock, so long as the governing provisions call for identical distribution and liquidation rights. Similarly, a distribution may be recharacterized in whole or in part as deductible compensation (on which FICA and FUTA taxes may be due), but any difference in distribution rights resulting from such a recharacterization will not result in a second class of stock. This may lead one to believe that the corporation can make disproportionate distributions to shareholders without terminating the corporation's S election. However, the "binding agreement" language in the regulations presents a formidable barrier. The IRS has issued a letter ruling addressing how excessive compensation paid to an S corporation shareholder can cause the one class of stock requirement to not be met, potentially resulting in termination of the S corporation. Under the facts of the ruling, compensation that may have been excessive was paid to an at-will employee without a written compensation agreement. However, the board reviewed and approved the compensation of all employees on an annual basis. In deciding the ruling, the IRS found that the company's governing provisions did provide for identical distribution and liquidation rights. Also, the decision included that (1) employment agreements are not governing provisions, and (2) an employment agreement that results in excess compensation being paid does not violate the identical rights provision, provided that the principal purpose of the employment agreement was not to circumvent the one class of stock requirement. While the facts in this situation did not involve a written employment agreement, the ruling was in favor of the taxpayer because the principal purpose of the compensation paid was not to circumvent the one class of stock requirement. Therefore, the S corporation's election did not terminate.

The regulations do not require a binding agreement to be in writing. Although not explicitly stated in the regulations, it seems possible that a systematic pattern of distributions favoring one shareholder over another may create a binding agreement relating to distributions, and so terminate the corporation's S election. Furthermore, an effort to avoid classification as a "binding agreement" by including the distribution requirement in a commercial contract will not work because such a contract will be considered a "governing provision" if entered into to circumvent the one-class-of-stock requirement. Therefore, an S corporation should not make disproportionately large distributions to a shareholder on an ongoing basis.

Distributions Should Be Proportionate to Stock Ownership. Because distributions are based on the number of shares held by each shareholder, distributions should be, by their nature, proportionate to stock ownership. Aside from the possibility that disproportionate distributions will create a second class of stock, it is not clear how the accumulated adjustments account (AAA) and accumulated earnings and profits (AE&P) are treated when disproportionate distributions are made.

Example 1H-4 Determining whether stock confers identical rights to distribution and liquidation proceeds.

State X's law requires corporations to pay state income taxes on behalf of nonresident shareholders, but not on behalf of resident shareholders. Under that state's law, resident shareholders have the right to distributions that take into account the payments made on behalf of nonresident shareholders (e.g., if the corporation pays $2,000 state income tax for a nonresident shareholder, it would distribute $2,000 to a resident shareholder who owns the same number of shares). Because all shareholders have the right to equal distributions, state law is disregarded and the S corporation does not have a second class of stock.

Variation: The shareholders of an S corporation reside in different states that levy state income tax at various rates. To equalize after-tax distributions, the corporation and shareholders agree to increase distributions to shareholders who bear a heavier state income tax burden (e.g., the corporation distributes $2,000 to a shareholder who pays no state tax and $2,200 to an equal shareholder who will pay $200 state tax on the distribution). The agreement alters the rights to distributions conferred by the outstanding stock, and thus is a binding agreement relating to distributions that results in a second class of stock.

Distributions That Differ in Timing. As stated earlier, an S corporation is treated as having only one class of stock if the governing provisions provide all outstanding shares with identical rights to distribution and liquidation proceeds. Differences in the timing of distributions do not result in a second class of stock unless they occur because of a binding agreement that relates to distribution or liquidation proceeds.

Example 1H-5 Distributions that differ in timing.

Essco, Inc., an S corporation, has two equal shareholders, Al and Bill. Under Essco's bylaws, Al and Bill are entitled to equal distributions. Essco distributes $50,000 to Al during the year, but does not distribute $50,000 to Bill until the following tax year. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.

Under the regulations, the difference in timing of the distributions to Al and Bill does not cause Essco to be treated as having more than one class of stock. While the S election is unaffected, Bill may be treated as making a non-interest-bearing $50,000 loan to the corporation for the period between the dates of the two distributions. On the other hand, it is important to note that a systematic pattern of distributions favoring one shareholder or group of shareholders could be considered a "binding agreement relating to distributions" that would terminate the corporation's S election.

Correcting Erroneous Disproportionate Distributions. The IRS has held that erroneous disproportionate distributions do not cause a second class of stock if the governing provisions provide for identical distributions and liquidation rights. In these letter rulings, the shareholders were unaware that distributions had to be proportionate to stock ownership and the corporation incorrectly made disproportionate distributions for a period of years. After the errors were discovered, distributions were made to even out the original disproportionate distributions. The IRS ruled that neither the original nor the correcting disproportionate distributions resulted in a second class of stock because the shareholders were entitled to equal distributions under the corporation's governing provisions.

Example 1H-6 Correcting erroneous disproportionate distributions.

ABC Corp, an S corporation, has two equal shareholders, Art and Brenda. The corporation's governing provisions provide that each shareholder has equal distribution and liquidation rights. Each year for three years, the corporation distributes $10,000 to Art and $25,000 to Brenda. In the fourth year, the error is discovered and the corporation distributes $45,000 to Art and nothing to Brenda, so that over the four-year period, each shareholder received distributions of $75,000. Under the letter rulings referred to in the previous paragraph, the corporation does not have a second class of stock.

Employment Agreements and Other Commercial Contractual Agreements

A commercial contractual agreement (such as an employment agreement, lease, or loan agreement) is not a governing provision (discussed under "One Class of Stock—General Rules" earlier in this lesson) unless a principal purpose of the agreement is to circumvent the one class of stock requirement.

Example 1H-7 Waiver of distribution rights by shareholders contributing property.

Al, Brad, and Charlotte are unrelated individuals who agree to form ABC, Inc., which they intend to be an S corporation. Their agreement calls for Al and Brad each to contribute $20,000 cash and for Charlotte to contribute office equipment worth $20,000.

ABC, Inc. is organized in State A, which requires permission before the corporation can issue stock. ABC is granted permission to issue stock, subject to the restriction that any person who is issued stock in exchange for property other than cash must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions.

The conditions imposed by State A are "governing provisions" that alter the rights to distribution and liquidation proceeds so that those rights are not the same with respect to each outstanding share of stock. ABC is treated as having more than one class of stock and does not qualify as a small business corporation.

Variation: If Charlotte contributed $20,000 cash instead of office equipment, ABC would qualify for S status. The corporation could then use $20,000 of the contribution to buy the office equipment from Charlotte. The rules covering sales to related parties would not apply because Charlotte is not related to the other shareholders and does not own more than 50% of the corporation's shares.

Example 1H-8 Employment agreement is not a second class of stock.

Jane is the sole shareholder of JJ, Inc., an S corporation, and has been the corporation's chief executive officer for the last five years. JJ enters into an agreement with Jane that provides she will serve as the CEO for the next 10 years. She will receive a salary of $90,000 the first year, which will be adjusted to reflect the cost of living during the agreement's remaining years. Jane will continue to receive benefits existing at the date the agreement was signed and may receive bonuses as determined by the board of directors.

Jane will receive certain payments if she dies or becomes disabled or if there is a change in the control of JJ. If her employment is terminated for other reasons, she will receive no payments after the termination.

Under these facts, the IRS ruled that the agreement did not create a second class of stock. An employment agreement is not a binding agreement relating to distribution and liquidation proceeds, assuming that the principal purpose of the agreement was not to circumvent the one-class-of-stock requirement.

Shares Taken into Account

All outstanding shares of stock are taken into account in determining whether a corporation has more than one class of stock. Authorized but unissued shares are not considered outstanding stock. Therefore, they are not taken into account for second class of stock purposes.

Example 1H-9 Unissued shares are not outstanding stock.

Keyco was incorporated May 25 of the current year and immediately filed an S election. Keyco's organizing documents provided for Class A and Class B stock. The Class A stock was voting common stock with a right to distributions. The Class B stock was nonvoting common stock with no right to distributions. On May 25, Keyco issued 100 shares of Class A stock to each of its shareholders. No Class B stock was issued on May 25 or at any time thereafter. On December 10, Keyco eliminated all distribution preferences between the Class A stock and Class B stock. Because no Class B stock was outstanding from the date of incorporation to the date all distribution preferences were eliminated, it is disregarded in determining whether Keyco had a second class of stock outstanding.

Restricted Stock. Stock governed by IRC Sec. 83, commonly referred to as "restricted stock," may or may not be treated as outstanding. That is, stock issued in connection with the performance of services (including services that are not performed for the corporation) and substantially nonvested is not treated as outstanding unless the holder makes a Section 83(b) election.

Existing substantially nonvested stock that has been treated as outstanding is treated as outstanding for purposes of Subchapter S. However, the fact that such stock is substantially nonvested and no Section 83(b) election has been made does not cause the stock to be treated as a second class of stock. A history of issuing a Schedule K-1 with respect to the stock is evidence that the corporation has treated the nonvested stock as outstanding.

Shareholder Buy/Sell Agreements and Redemption Agreements

The following types of shareholder buy/sell or corporate redemption agreements are *disregarded* when determining whether the corporation has more than one class of stock:

1. *Bona fide* agreements to redeem or purchase stock on account of a shareholder's death, divorce, disability, or termination of employment.

2. Buy/sell agreements among the shareholders, agreements restricting the transfer of stock, and redemption agreements, unless a principal purpose of the agreement is to circumvent the one-class-of-stock requirement and the agreement establishes a purchase or redemption price (at the time the agreement is entered into) that is significantly in excess of or below the FMV of the stock. A safe harbor is provided for agreements that establish a purchase or redemption price between the book value and FMV of the stock. A determination of book value is respected if computed in accordance with Generally Accepted Accounting Principles (GAAP), or if used for any substantial nontax purpose. A good faith determination of FMV is respected unless the value is substantially in error and was not determined with reasonable diligence.

3. Buy/sell agreements, agreements restricting the transfer of stock, and redemption agreements that are entered into before May 28, 1992 and are not materially modified after that date.

Example 1H-10 Stock redemption agreement triggered by termination of employment.

Alice owns 25% of the outstanding shares of ABC, Inc., an S corporation. She is also an employee of ABC. (Alice's stock was not issued to her in exchange for services.) By agreement, ABC will redeem Alice's shares for an amount significantly below their FMV if Alice's employment is terminated or if ABC's sales fall below specified levels.

The portion of the agreement providing for the redemption of ABC's stock upon termination of employment is disregarded for purposes of the one-class-of-stock requirement. The portion of the agreement providing for the redemption of ABC's stock if sales fall below certain levels is also disregarded unless a principal purpose of that stipulation is to circumvent the one-class-of-stock requirement.

Options and Warrants

Under the regulations, a call option, warrant, or similar instrument will be treated as a second class of stock if it is substantially certain to be exercised and has a strike price substantially below the FMV of the underlying stock on the date the option is issued, transferred to an ineligible S corporation shareholder, or materially modified. Safe harbors are provided for the following options or warrants:

1. *Strike Price.* An option or warrant that has a strike price of at least 90% of the FMV of the underlying stock on the date the option is issued, transferred to an ineligible shareholder, or materially modified. The IRS must respect a good faith determination of FMV unless the value is substantially in error and was not determined with reasonable diligence. An option that does not meet this safe harbor will not automatically be treated as a second class of stock—for this to happen it must also be proven that the option is substantially certain to be exercised, based on all of the facts and circumstances.

2. *Employee or Contractor.* An option or warrant issued to an employee or independent contractor in connection with the performance of services for the corporation (or a related corporation) that is nontransferable and does not have a readily ascertainable FMV on the date that it is issued. (For these purposes, the regulations state that a corporation is "related" to the issuing corporation if more than 50% of the total voting power and total value of its stock is owned by the issuing corporation.)

3. *Commercial Lender.* An option or warrant issued to a commercial lender in connection with a commercially reasonable loan to the corporation. (A call option and accompanying loan can be transferred from one lender to another lender and remain within the scope of this safe harbor.)

In *Santa Clara Valley Housing*, on motion for reconsideration of its previous decision, the District Court determined that an instrument will not be treated as a second class of stock if it fits any of the safe harbors listed in Reg. 1.1361-1(l)(4)(i), including those listed in the preceding paragraph. Accordingly, even though warrants would be treated as a second class of stock because they were found to be equity and circumvent rights to distribution or liquidation proceeds, they nevertheless had to be tested under the strike price safe harbor.

Example 1H-11 Stock option with strike price less than FMV of underlying stock.

An S corporation issues an option to an individual who is neither a shareholder nor an employee of the corporation. The option has a strike price of $50 per share and is issued on a date when the FMV of the corporation's stock is also $50 per share. One year later the option is sold to a partnership at a time when the FMV of the corporation's stock is $70 per share. Since the strike price is less than 90% of the FMV of the underlying stock on the date the option is transferred to an ineligible shareholder, the call option is treated as a second class of stock if it is substantially certain to be exercised, based on the facts and circumstances.

Example 1H-12 Employee incentive stock option plans.

Swan Lake, Inc., an S corporation, adopted an incentive stock option plan. When the employees exercise their options, Swan Lake will issue common shares (the "Option Shares"). The Option Shares will be identical to all other outstanding shares and will entitle employees to the same voting, liquidation, title, and other rights held by all other shareholders. Option Shares, however, will be subject to a buy-back agreement that allows Swan Lake to repurchase the Option Shares at the option exercise price if an employee terminates employment before a certain date. The employee's right to transfer or pledge the Option Shares will be restricted until Swan Lake's right to repurchase expires.

Under similar facts, the IRS ruled that an employee who exercised the option and purchased Option Shares would be treated as a shareholder. Furthermore, the restrictions imposed on the Option Shares are disregarded when determining whether the shares confer identical rights to distribution and liquidation proceeds because they arise from a *bona fide* buy/sell agreement to redeem or purchase stock at the time of death, divorce, disability, or termination of employment.

Example 1H-13 Stock option issued to employee.

An S corporation issues an option to an employee in connection with the performance of services for the corporation. At the time it is issued, the option is not transferable and does not have a readily ascertainable FMV; however, the option becomes transferable before it is exercised. Once the option becomes transferable, the safe harbor no longer applies, and the general rules apply. Accordingly, the option will create a second class of stock if it (a) is transferred to an ineligible S corporation shareholder or materially modified, or (b) is substantially certain to be exercised and has a strike price substantially below the FMV of the underlying stock on the date the option is transferred or modified.

The regulations clarify that the safe harbor is not affected by termination of employment (or independent contractor status). If the employee terminates employment with the S corporation prior to the date the option becomes transferable, the safe harbor will continue to apply until the date the option becomes transferable.

Nonqualified Deferred Compensation Plans

The IRS has ruled that certain types of nonqualified deferred compensation plans do not create a second class of stock.

Availability of Inadvertent Termination Relief

A corporation that has elected S status and subsequently is treated as having more than one class of stock loses its S corporation status. In such a case, the corporation's S election terminates on the date the corporation is

treated as having more than one class of stock. Inadvertent termination relief pursuant to IRC Sec. 1362(f) will be available in appropriate cases.

3.8% Net Investment Income Tax

Net Investment Income Tax (NIIT)

A 3.8% net investment income tax (NIIT) applies to the net investment income of individuals, estates, and trusts with income above certain thresholds.

Treasury issued final regulations for the NIIT. The final regulations are effective for tax years beginning after December 31, 2013. Treasury also issued proposed regulations for applying the NIIT to dispositions of S corporation stock. The proposed regulations are effective for tax years beginning after December 31, 2013, but taxpayers can rely on them until the effective date of the final regulations. In addition, answers to frequently asked questions (FAQs) about the NIIT can be found on the IRS website (**www.irs.gov**) by entering the words "net investment income tax" in the search feature.

Net Investment Income Threshold Amounts

The NIIT is generally levied on income from interest, dividends, annuities, royalties, rents, and capital gains. For individuals, the tax is 3.8% of the lesser of—

1. net investment income for the tax year, or

2. the excess, if any, of modified adjusted gross income (MAGI) for the tax year over the applicable threshold amount.

The NIIT threshold amounts for individuals are $250,000 for married filing joint or surviving spouse returns, $125,000 for married filing separate returns, and $200,000 in other cases. In the case of an individual who has a tax year consisting of less than 12 months (short tax year), the threshold amount is not reduced or prorated. However, an individual who has a short tax year resulting from a change of annual accounting period must reduce the threshold amount by multiplying the full threshold amount by the number of months in the short tax year divided by 12. The threshold amounts are not indexed for inflation.

MAGI is adjusted gross income (AGI) increased by the excess of—

1. the income excluded under the Section 911(a)(1) foreign earned income exclusion, over

2. any deductions (if taken into account in computing AGI) or exclusions with respect to the excluded income in (1) that are disallowed.

The NIIT generally applies to estates and trusts if there is undistributed net investment income and the AGI exceeds the dollar amount at which the highest fiduciary income tax bracket for the year begins ($12,500 in 2017).

Net Investment Income (NII)

Generally, net investment income (NII) is—

1. the sum of—

    a. gross income from interest, dividends, annuities, royalties, and rents unless those items are derived in the ordinary course of a trade or business;

    b. all income derived from a trade or business that is a passive activity within the meaning of IRC Sec. 469, or a trade or business of trading in financial instruments or commodities, as defined in IRC Sec. 475(e)(2); and

c. net gain (to the extent taken into account in computing taxable income) from the disposition of property other than property held in a trade or business; over

2. the allowable deductions that are properly allocable to that gross income or net gain.

Properly allocable deductions include expenses such as rental expenses as well as the portion of state and local income taxes allocable to NII.

Understanding Which Trades or Businesses Are Subject to NIIT

Trade or business income earned under IRC Sec. 162 that is passed through from an S corporation to a shareholder who does not materially participate in the corporation's business will be subject to NIIT.

Example 1I-1 Passive income from S corporation can be subject to the 3.8% net investment income tax (NIIT).

Janelle owns 15% of the shares in ABC, Inc., an S corporation, but does not materially participate in the corporation's activities. She has wages of $180,000 and interest income of $3,200 from sources other than ABC. For 2017, the corporation passes through nonseparately stated income of $40,000 to Janelle. Her net investment income for the year is $43,200, made up of $3,200 of interest and $40,000 of passive activity income from ABC. Her MAGI is $223,200 ($180,000 + $3,200 + $40,000).

Her NIIT is $882, calculated as follows:

(1)	Net investment income	$ 43,200
(2)	MAGI in excess of threshold amount:	
	MAGI	$ 223,200
	Threshold amount	(200,000)
	Excess	$ 23,200
(3)	Net investment income tax:	
	Lesser of (1) or (2)	$ 23,200
	Rate	% 3.8%
	Tax	$ 882

Janelle could avoid the NIIT if she increased the number of hours she worked in ABC so that she legitimately materially participated in its business activity for the year.

In determining whether an activity is passive for NIIT purposes, the regulations state that, in general, a passive business activity is a trade or business activity within the meaning of IRC Sec. 162 (which deals with deductions for ordinary and necessary business expenses) that is also passive within the meaning of IRC Sec. 469 and related regulations (i.e., an activity in which the taxpayer does not materially participate).

For purposes of the 3.8% NIIT, trade or business is defined the same as for Section 162 purposes. The 3.8% NIIT regulations provide no specific guidance regarding what constitutes a Section 162 trade or business. Practitioners must rely on existing guidance in the Section 162 area.

Example 1I-2 Gross rental income included in net investment income.

Jill owns all of the outstanding stock of Jupiter, Inc., an S corporation that rents out a commercial building. For passive activity loss purposes, the rental activity is treated as passive. It does not qualify as a trade or business within the meaning of IRC Sec. 162. Therefore, the rental income is not derived in the ordinary course of a trade or business and Jupiter's gross rental income from the building and the related deductions must be included in calculating Jill's NII.

Similarly, if there is gain or loss from the sale of the commercial building, it is included in calculating Jill's NII because the gain or loss is not from property held in a nonpassive business activity.

Interest, Dividends, Annuities, Royalties, and Rents

The determination of whether interest, dividends, annuities, rents, or royalties from an S corporation are derived from a Section 162 trade or business that is a passive activity with respect to the shareholder is made at the shareholder level in accordance with IRC Sec. 469. On the other hand, determining whether a trade or business is one that trades in financial instruments or commodities is made at the S corporation level.

Example 1I-3 Interest income earned in the ordinary course of a trade or business.

James owns all of the stock of Granite Inc., an S corporation, and materially participates in its business activity. Granite charges interest to clients who are late paying bills owed to the corporation. Since the interest is earned in the ordinary course of Granite's trade or business activity and James materially participates in the business, the interest income is passed through to James as part of the ordinary business income and is evidently not subject to the NIIT.

Variation: Assume now that Granite earns interest income on invested working capital. Here, the interest income is passed through to James as a separately stated item on line 4 of Schedule K-1. In this case, the interest income is subject to the NIIT because it is not earned in the ordinary course of the corporation's trade or business. (See discussion of invested working capital later in this lesson.)

If an entity is not engaged in a trade or business, income passed through to a shareholder will not be considered to be from a trade or business even if the shareholder is engaged in a trade or business.

Example 1I-4 Interest income passed-through by passive entity to active shareholder is subject to NIIT.

Brock owns an interest in ABC, an S corporation engaged in a business activity. ABC owns an interest in GHI, a partnership that is not engaged in a business activity. GHI receives $10,000 in dividends, $5,000 of which is passed through to Brock via his interest in ABC. The $5,000 of passed-through dividend income is not derived from a business because GHI is not engaged in a business. Therefore, the $5,000 of dividend income is included in calculating Brock's NII whether he materially participates in ABC's business or not.

In addition, if an S corporation is not engaged in a trade or business and it has income from interest, dividends, annuities, rents, or royalties, the individual shareholder's status under IRC Sec. 469 is irrelevant.

Example 1I-5 Interest income from S corporation not engaged in a trade or business.

Donna owns an interest in DD Corporation. Donna materially participates in the corporation's activity that is not designed to make a profit. It does, however, earn some dividends and interest. Donna's share of dividend and interest income from DD will be subject to NIIT under IRC Sec. 1411(c)(1)(A)(i) because the income is not derived in a Section 162 trade or business and therefore cannot be excluded under the ordinary course of a trade or business exception.

S Corporation Distributions, Dividends, and Dispositions of S Stock. Distributions of accumulated earnings and profits (AE&P) by an S corporation are potentially subject to the NIIT. Furthermore, dispositions of S corporation stock (including distributions in excess of basis treated as stock sales) are potentially subject to the NIIT. On the other hand, tax-free distributions [such as distributions of the accumulated adjustments account (AAA)] are not subject to the NIIT.

Self-charged Interest. If a taxpayer receives interest income on a loan to a nonpassive activity (other than from a business of trading in financial instruments or commodities), that interest is treated as derived in the ordinary course of an active trade or business. As a result, the taxpayer's share of this interest is not subject to the NIIT. The rule cross-references the self-charged interest rule of Reg. 1.469-7 for the operative mechanics. The mathematical result is to exclude an amount of interest income from NII that is equal to the amount of interest income that would

have been considered passive income under Reg. 1.469-7 if the nonpassive activity were considered passive (preamble to the final Section 1411 regulations).

Example 1I-6 Self-charged interest.

Mark and Margo own S corporation MM, Inc. equally. Mark loans MM money and receives $1,500 of self-charged interest income during the year. For purposes of the 3.8% NIIT, Mark can exclude $750 of the $1,500 interest income from NII (i.e., Mark's allocable share of the nonpassive deduction). The remaining $750 is treated as NII to Mark.

Income from Working Capital. Income, gain, or loss on working capital is subject to the NIIT. The term *working capital* is not defined in either IRC Sec. 469 or 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business.

Example 1I-7 Earnings on working capital.

Anna owns all of the shares in Star, Inc., an S corporation operating a restaurant, and materially participates in its operations. Thus, Star is a Section 162 trade or business that passes through nonpassive income (for NIIT and other purposes) to Anna. Star is able to pay current obligations with cash flow generated by the restaurant. Star deposits the daily cash receipts in an interest-bearing checking account at a local bank and uses that account to pay the restaurant's recurring business expenses. The daily balance of the checking account averages $2,500, but it fluctuates depending on the short-term cash flow needs of the business.

In addition, Star has $20,000 in an interest-bearing savings account to use in case the daily cash flow into and from the checking account becomes insufficient to pay the restaurant's recurring business expenses.

Both the $2,500 average daily balance of the checking account and the $20,000 savings account balance are working capital and, thus, the interest generated by these balances is not treated as derived in the ordinary course of Star's restaurant business. The interest income from Star's checking and savings accounts is passed through to Anna as a separately stated item on line 4 of Schedule K-1 and will be included in her NII.

Rental Real Estate Activities of a Real Estate Professional. Taxpayers who are considered real estate professionals under IRC Sec. 469(c)(7)(A) can treat otherwise passive losses from rental real estate as nonpassive losses to offset other nonpassive income.

Exceptions to the Definition of Rental Activity under IRC Sec. 469. Temp. Reg. 1.469-1T(e)(3) includes a list of exceptions under which an activity involving customer use of tangible property is not treated as a rental activity. Examples of items included in this list include property rented for an average period of seven days or less (hotel rooms or rental cars) and situations where extraordinary personal services are provided (a hospital). When an activity meets one of the exceptions listed in Temp. Reg. 1.469-1T(e)(3), income from such activity is not treated as coming from a passive activity. If the activity is not a Section 162 trade or business, however, the gross rental income from the activity may still be subject to the NIIT under IRC Sec. 1411(c)(1)(A)(i) because the income items are rents that were not derived from the ordinary course of a trade or business. (See the preamble to the final Section 1411 regulations.)

Example 1I-8 Trade or business leasing activities are not subject to the NIIT.

Maria is a shareholder in EquipCo, an S corporation that engages in an equipment leasing activity. The average period of customer use of the equipment is seven days or less. She materially participates in the equipment leasing activity. The leasing activity constitutes a trade or business.

In 2017, Maria has MAGI of $300,000, all of which is derived from EquipCo. All the income from EquipCo is derived in the ordinary course of the equipment leasing activity, and all of EquipCo's property is held in the equipment leasing activity.

Of Maria's share of income from EquipCo, $275,000 is gross income from rents. While $275,000 of the gross income from the equipment leasing activity meets the definition of rents, the activity meets one of the

exceptions to rental activity and Maria materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to Maria, and because the rents are derived in the ordinary course of a trade or business to which the NIIT does not apply, the ordinary course of business exception applies. This means that the rents are included in nonseparately stated income and are not included in NII.

Because the equipment leasing trade or business is not a trade or business to which the NIIT applies, the $25,000 ($300,000 − $275,000) of other gross income is not included in NII. Furthermore, gain or loss from the sale of the property held in the equipment leasing activity is not included in NII because, although it is attributable to a trade or business, it is not a trade or business to which the NIIT applies.

Variation: Assume now that Maria does not materially participate in the equipment leasing trade or business and therefore the trade or business is a passive activity with respect to her. Accordingly, the $275,000 of nonseparately stated gross income from rents is included in calculating NII because the rents are derived from a trade or business to which the NIIT applies (that is, the ordinary course of business exception is not applicable). The $25,000 of other gross income from the equipment leasing trade or business is included in the calculation of NII because the gross income is derived from a trade or business to which the NIIT applies. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is included in NII because the trade or business is a passive activity with respect to Maria.

Example 1I-9 Nonrental passive activity subject to the NIIT.

Martin, an unmarried individual, is a shareholder in Esscorp, an S corporation engaged in a trade or business that does not involve a rental activity. Martin does not materially participate in Esscorp, and so the trade or business of Esscorp is a passive activity with respect to him for NIIT purposes.

Martin's $500,000 share of Esscorp's income consists of $450,000 of gross income from a trade or business and $50,000 of gross income from dividends and interest that is not derived in the ordinary course of the trade or business of Esscorp. Thus, Martin's allocable share of gross income from dividends and interest consists of portfolio income.

Martin's separately stated $50,000 share of Esscorp's income from dividends and interest is included in the calculation of NII because it is not derived in the ordinary course of a trade or business. Martin's nonseparately stated $450,000 share of Esscorp's income is included in the calculation of NII because it is gross income from a trade or business that is a passive activity.

Grouping Rules. Reg. 1.469-4 allows the grouping of passive activities if one or more trade or business activities or rental activities constitute an appropriate economic unit for the measurement of gain or loss for passive loss purposes. Reg. 1.469-4(e)(2) provides that once a taxpayer has grouped activities, he or she cannot regroup the activities unless it is determined that the original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping inappropriate.

One-time Regrouping Allowed. Because the 3.8% NIIT may cause taxpayers to reconsider their previous grouping determinations, shareholders may regroup their passive activities under Reg. 1.469-4 when they are first subject to the 3.8% NIIT for a tax year after 2013. For this purpose, the determination of whether the 3.8% NIIT would apply is made without regard to the effect of regrouping. The regrouping applies for both regular tax passive activity purposes and 3.8% NIIT purposes.

A shareholder could have regrouped his or her activities for a tax year that began during 2013 if the 3.8% NIIT applied for that year. However, if no election to regroup was made in 2013, the one-time regrouping privilege is available for the first tax year after 2013 in which the shareholder has NII and meets the applicable income threshold.

A shareholder may regroup activities only once. A regrouping applies to the tax year for which the regrouping is done and all subsequent years. However, shareholders can regroup on an amended return only if they were not subject to NIIT on the original return (or previously amended return) before changes or adjustments were made to adjusted gross income or NII.

Example 1I-10 Taking advantage of the NIIT regrouping privilege.

Carla owns an interest in an S corporation that engages in two related Section 162 business activities: Activity A and Activity B. Both activities produce taxable income. In 2013, Carla was subject to the NIIT but did not combine the activities into one group. Carla was not again subject to the NIIT until the 2017 tax year.

Because Carla did not regroup activities in 2013 and was not subject to the NIIT in the following years, she is eligible to regroup activities in 2017 (the first tax year after 2013 in which she is subject to the NIIT). She is not eligible to regroup activities in 2018 or a later year. Thus, tax year 2017 is the only year available for Carla to regroup her activities under Reg. 1.469-11(b)(3)(iv).

For 2017, Carla meets the material participation standard for Activity A because she spends 550 hours working in that business. She only spends 50 hours on Activity B.

If Carla regroups the two related activities into one group on her 2017 Form 1040, as permitted by Reg. 1.469-4 and the fresh-start exception, she will spend 600 hours on the combined group and meet the material participation standard for the combined group that year. Therefore, the combined group is treated as a nonpassive business activity for NIIT purposes and the gross income and related deductions are not included in calculating Carla's 2016 NII.

Note that 2017 is the only year available for Carla to regroup under Reg. 1.469-11(b)(3)(iv) because 2016 is the first tax year beginning after 2013 in which she is subject to the NIIT. (She could have regrouped in 2013, but chose not to do so. Thus, 2017 is the only chance she has to regroup under the regulations.)

Gain or Loss from Disposition of Property

When an individual, estate, or trust holds an interest in an S corporation and the entity passes through gain or loss from disposing of property, the gain or loss is taken into account in determining the amount of net gain that is included in the shareholder's net investment income for NIIT purposes—unless the gain or loss is from property held in a nonpassive business activity other than the business of trading in financial instruments or commodities.

For purposes of the 3.8% NIIT, the term *disposition* means a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition.

Example 1I-11 Passed-through gain from sale of business property.

Andy owns stock in Easy Corp., an S corporation engaged in a business activity. If Easy sells property for a gain, the determination of whether Andy's passed-through share of the gain is included in the calculation of his NII depends on (a) whether Easy held the property in its business and (b) whether Andy materially participates in that business. If Easy held the property in its business and Andy materially participates, his share of the gain from disposition of the property is not included in his NII.

Net gain cannot be less than zero. However, the rule under IRC Sec. 1211(b) allowing up to $3,000 of capital loss each year applies when calculating the NIIT.

Example 1I-12 Capital loss limitation and carryover.

Cassie, an unmarried individual, sells some publicly traded stock that she held for investment. She realizes a capital loss of $50,000 from the sale of AA stock and a gain of $20,000 from the sale of BB stock, resulting in a net capital loss of $30,000 ($50,000 − $20,000). These were her only capital transactions during the year. Cassie received a salary of $335,000 from her wholly owned S corporation and had $5,000 gross income from interest. For regular income tax purposes, she can use $3,000 of the $30,000 net capital loss against other income and carry the balance of $27,000 over to the following year. When calculating Cassie's NIIT, her $50,000 loss is offset by the $20,000 gain. In addition, she can reduce NII by $3,000 of the $30,000 excess of capital losses over capital gains.

During the following year, Cassie has a $30,000 capital gain from the sale of ZZ stock. She has no other capital gains or losses. For regular taxes, Cassie may reduce the $30,000 capital gain by the prior year's

$27,000 capital loss carryover, leaving her with a $3,000 taxable capital gain. For determining her NIIT, her $30,000 gain may also be reduced by the $27,000 capital loss carryover from the prior year. Therefore, Cassie has a $3,000 gain for calculating NII.

Treatment of Suspended Passive Losses

Suspended passive losses become deductible when a taxpayer disposes of his or her entire interest in the passive activity in a fully taxable transaction to an unrelated party. When calculating the 3.8% NIIT, suspended losses from passive activities can be taken into account in determining net gain, or as a properly allocable deduction, in the same manner as the losses are taken into account in computing taxable income.

Passive Activity Recharacterization Rule

Income from certain passive activities is treated as nonpassive under various recharacterization rules, such as the self-rented property provisions of Reg. 1.469-2(f)(6). The NIIT regulations generally follow the characterization of the income and gain for passive activity purposes (preamble to final Section 1411 regulations, T.D. 9644). However, recharacterized income or gain remains subject to the NIIT if it is recharacterized as not from a passive activity and is further characterized as portfolio income under Reg. 1.469-2(f)(10) or 1.469-2(c)(2)(iii)(F), e.g., income from the rental of certain land.

Recharacterized items that are not subject to the NIIT include (but are not limited to) those discussed in the following paragraphs.

Significant Participation Activities. Income or gain from significant participation activities that is recharacterized as not from a passive activity under Temp. Reg. 1.469-2(f)(2) is not passive activity income for NIIT purposes.

Self-rented Property. Income or gain from self-rented property that is recharacterized as not from a passive activity under Reg. 1.469-2(f)(6) is deemed to be derived in the ordinary course of a trade or business. Consequently, such income or gain is not passive activity income for NIIT purposes. Furthermore, any gain or loss from the disposition of assets associated with the rental activity that are recharacterized as nonpassive will also be treated as attributable to the disposition of property held in a nonpassive trade or business. Because gain on the disposition is treated as derived in the ordinary course of an active trade or business, it is not subject to the NIIT.

The self-rented property rules are mandatory and apply regardless of the activity groupings made by the taxpayer.

Example 1I-13 Net income from self-rented property.

Albert owns all of the stock of Alpine, Inc., an S corporation, and is employed full-time by the company. He rents a building to the corporation under a lease executed in the current year. The gross rental income is $36,000 for the year, and Albert incurs rental expenses of $10,000. Albert also has passive income of $18,000 from a partnership in which he does not materially participate. The expenses of $10,000 are deductible against the income from the rental; the remaining $26,000 of rental income is recharacterized as nonpassive. Thus, the $18,000 of passive income from the partnership is subject to the NIIT, but the $26,000 of rental income is not.

Property Rented Incidental to Development Activity. Income or gain from property rented incidental to a development activity that is recharacterized as not from a passive activity under Reg. 1.469-2(f)(5) is not passive activity income for NIIT purposes.

Rental Activity Grouped with Trade or Business Activity. Gross rental income is treated as not derived from a passive activity when a taxpayer properly groups a rental activity with a trade or business activity under Reg. 1.469-4(d)(1). Such rental income is deemed to be derived in the ordinary course of a trade or business and is therefore not subject to the NIIT. Additionally, any gain or loss from the assets associated with the rental activity that are treated as nonpassive will also be treated as attributable to the disposition of property held in a nonpassive trade or business.

Disposition of S Corporation Stock

If a shareholder materially participates in the S corporation's business activities, gains on the disposition of his or her S stock are subject to the NIIT only to the extent that the property within the S corporation is not related to its active trade or business. Conversely, all of the gain from the sale of S stock is potentially subject to the NIIT if the shareholder does not materially participate in the corporation's activities. Under a deemed sale rule, however, gain or loss from disposition of S corporation stock is included in NII only to the extent of the net gain or loss that the transferring shareholder would have taken into account if the S corporation had sold all of its property for FMV immediately before the disposition.

Application of Internal Revenue Code Provisions

Except as otherwise provided, all Internal Revenue Code provisions that apply for purposes of determining taxable income of a taxpayer also apply in determining the NIIT.

Any gain that is not recognized for income tax purposes for a tax year is not recognized for that year for NIIT purposes. For example, gain is not recognized for a tax year under the NIIT if it is deferred under the installment sales method or deferred or excluded as part of a like-kind exchange or involuntary conversion. Taxpayers can use the installment method to reduce or eliminate exposure to the NIIT. With an installment sale, gain is recognized in (and so is spread over) the years that payments are received.

Deferral or disallowance provisions used in determining AGI apply to the determination of NII. These provisions include the limitation on investment income, passive activity loss limitations, at-risk limitations, disallowance of expenses relating to tax-exempt interest, capital loss carryover limitations, and S corporation shareholder loss limitations.

A deduction carried over to a tax year and allowed for that year in determining AGI also is allowed in determining NII, even if the deduction is carried over from a pre-2013 tax year, i.e., a year that precedes the effective date of the NIIT. A portion of an NOL carryover, properly allocated in determining NII for a tax year, can be deducted from NII.

Both NIIT and 0.9% Medicare Tax May Apply

A taxpayer may be subject to both the NIIT and the additional 0.9% Medicare tax on earned income. The additional 0.9% Medicare tax applies to wages and self-employment income over certain thresholds, but these types of income are not included in NII. So, taxpayers who have high wages or self-employment income and high investment income may be subject to both taxes.

Self-employment Income

NII does not include any item taken into account in determining self-employment income and subject to the self-employment tax. The term *taken into account* means income included and deductions allowed in determining net earnings from self-employment. Amounts excepted when determining net earnings from self-employment, and so excluded from self-employment income, are not taken into account in determining self-employment income and therefore may be included in NII.

Reporting NIIT Information on Schedule K-1

Many of the items on the Schedule K-1 will be identified as NII by their placement on the K-1, and as with other K-1 items, a statement can be attached that describes, and provides the dollar amount of, NIIT-related items. Additional information relating to NII can be provided to the shareholder on line 17 (Other information), Code U (Net investment income) of the Schedule K-1. For example, if a shareholder disposes of stock, best practices suggest using a schedule keyed to line 17, Code U to provide details that will allow the shareholder to compute the deemed sale calculation.

The instructions to Form 1120S provide other examples of items that should be included on line 17, Code U, when the information is otherwise not identifiable on Schedule K-1. A statement describing and showing the dollar amount of each item should be attached to the Schedule K-1. The items listed in the instructions include, among

others, (1) net rental real estate income or other net rental income derived from an IRC Sec. 212 for-profit activity, (2) gains and losses from dispositions of assets attributable to a Section 212 for-profit activity, and (3) information necessary to determine the shareholder's self-charged interest.

The 0.9% Additional Medicare Tax

The employee portion of the Medicare tax rate is increased by 0.9% for employees who earn wages over $200,000 ($250,000 for married couples filing jointly or $125,000 for married filing separate). Thus, the employee's Medicare tax rate for 2017 is 1.45% on the first $200,000 of wages ($125,000 on a separate return, $250,000 of combined wages on a joint return) and 2.35% (1.45% + 0.9%) on wages in excess of those amounts.

Employer's Responsibility to Withhold 0.9% Medicare Tax

The additional 0.9% Medicare tax on wages applies only to employees, not employers. Nevertheless, employers are required to withhold the additional 0.9% Medicare tax on wages in excess of $200,000 paid to an employee. The employer considers only the amount of wages received by the employee and disregards wages earned by the employee's spouse.

Example 1J-1 Medicare tax on an unmarried shareholder's wages.

Bill, who is single, owns all the shares of Billco Inc., a calendar-year S corporation. The corporation pays Bill $500,000 during 2017. Bill pays Medicare tax of $2,900 on the first $200,000 of wages ($200,000 × 1.45%) and $7,050 on the excess of his wages over $200,000 ($300,000 × 2.35%), for a total Medicare tax of $9,950. Billco Inc. is required to withhold $9,950 of Medicare tax from Bill's wages.

Example 1J-2 Medicare tax on a married shareholder's wages.

Vicki owns all the shares of Vital Inc. Her husband, Mark, owns all the shares of March Inc. Both Vital and March are calendar year S corporations. Vital pays Vicki wages of $225,000 and March pays Mark wages of $175,000 during 2017.

Vital withholds Medicare tax of $2,900 on the first $200,000 of Vicki's wages ($200,000 × 1.45%) and $588 on the additional $25,000 of wages (2.35% × $25,000), for a total Medicare tax of $3,488. March withholds Medicare tax of $2,538 from Mark's wages ($175,000 × 1.45%). The total amount of Medicare tax withheld from the couple is $6,026 ($3,488 + $2,538)

On their 2017 personal income tax return, Vicki and Mark show wage income of $400,000 ($225,000 + $175,000). They are required to pay Medicare tax of $3,625 ($250,000 × 1.45%) on their first $250,000 of wages and $3,525 on the excess of their combined wages over $250,000 ($150,000 × 2.35%), for a total Medicare tax of $7,150. Vicki and Mark must pay $1,124 ($7,150 − $6,026) of Medicare tax with their Form 1040.

Vicki and Mark should adjust the federal withholding from their wages or make estimated tax payments to avoid underestimation penalties caused by the additional Medicare tax.

Self-employment Is Subject to the 0.9% Medicare Tax

The additional Medicare tax of 0.9% is imposed on self-employment income in excess of a threshold amount of $200,000 ($250,000 for married couples filing jointly or $125,000 for married filing separate). The threshold amount is reduced (but not below zero) by wages taken into account in determining the taxpayer's FICA tax.

Example 1J-3 Computing the 0.9% additional Medicare tax on self-employment income.

Rhonda, a single filer, owns 100% of the stock of Rings, Inc., and materially participates in its business activities. During the year, she receives $130,000 of wages from Rings and $145,000 of self-employment income from a separate business. Rings makes distributions of $50,000 to her during the year, and at the end of the year, passes through trade or business income of $90,000 to Rhonda.

Before calculating the 0.9% additional Medicare tax on self-employment income, the $200,000 threshold for single filers is reduced by Rhonda's wages of $130,000, resulting in a reduced threshold of $70,000. Rhonda must pay additional Medicare tax on $75,000 of self-employment income ($145,000 of self-employment income minus the reduced threshold of $70,000).

The $90,000 of trade or business income passed through to Rhonda and the distributions to her are not self-employment income and are not subject to the additional 0.9% Medicare tax.

Certain S Corporations Must File Schedule B-1 with Form 1120S

An S corporation that has a disregarded entity, trust, estate, nominee or person similar to a nominee as a shareholder must file Schedule B-1 (Information on Certain Shareholders of an S Corporation). The Schedule B-1 is attached to the S corporation tax return, Form 1120S, and is used to track which entities or individuals are reporting the pass-through items shown on the S corporation's Forms K-1. The Schedule B-1 must be filed by an S corporation that has a disregarded entity, trust, estate, nominee or person similar to a nominee as a shareholder. The Schedule B-1 asks for information (such as Social Security or Taxpayer Identification numbers) relating to the shareholder and the entity or individual responsible for reporting the shareholder's portion of the S corporation's pass-through items.

Thus, S corporations file Schedule B-1 if they have a shareholder that is (1) a disregarded entity, such as a single-member LLC; (2) a trust, such as a grantor trust, qualified Subchapter S trust (QSST), electing small business trust (ESBT), testamentary trust, or voting trust; or (3) an estate. Also, because the beneficial owner, rather than the owner of record, is considered to be the shareholder, an S corporation must file Schedule B-1 if it has a shareholder that is a nominee, guardian, custodian, agent, or similar person who represents the beneficial owner.

An S corporation that files Schedule B-1 must check the "Yes" box on line 3 of Schedule B, Form 1120S.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. There are four requirements that must be met for debt to qualify as straight debt. Which of the following is **not** one of those requirements?

    a. Debt payment dates and interest rate is not contingent on the borrower's discretion.

    b. The debt that can be indirectly converted to stock.

    c. The debt is a second class of stock.

    d. The debt must be held by creditors, such as banks.

10. Which of the following statements regarding 3.8% net investment income tax (NIIT) is correct?

    a. The final regulations are effective for tax years beginning after December 31, 2014.

    b. NIIT generally is gross income from dividends, royalties, and rents that are derived in the ordinary course of a business or trade.

    c. Practitioners must rely on 3.8% regulations for guidance regarding what constitutes a Section 162 trade or business.

    d. Only those shareholders who were not subject to NIIT on the original return before changes were made to AGI or NII can regroup on an amended return.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. There are four requirements that must be met for debt to qualify as straight debt. Which of the following is **not** one of those requirements? **(Page 177)**

    a. Debt payment dates and interest rate is not contingent on the borrower's discretion. [This answer is incorrect. For debt to qualify as straight debt, the interest rate and payment dates must not be contingent on profits, the borrower's discretion, or similar factors.]

    b. The debt that can be indirectly converted to stock. [This answer is incorrect. For debt to qualify as straight debt, the debt cannot be directly or indirectly convertible into stock (or any other equity interest of the S corporation.]

    c. The debt is a second class of stock. [This answer is correct. Debt that meets the definition of "straight debt" is not a second class of stock, regardless of whether such debt is classified as equity under general tax law principles.]

    d. The debt must be held by creditors, such as banks. [This answer is incorrect. For debt to qualify as straight debt, the debt must be held by (a) an individual, estate, or trust that is an eligible S corporation shareholder; or (b) creditors, other than individuals, that are actively and regularly engaged in the business of lending money (e.g., banks).]

10. Which of the following statements regarding 3.8% net investment income tax (NIIT) is correct? **(Page 184)**

    a. The final regulations are effective for tax years beginning after December 31, 2014. [This answer is incorrect. Treasury issued final regulations for the NIIT. The final regulations are effective for tax years beginning after December 31, 2013.]

    b. NIIT generally is gross income from dividends, royalties, and rents that are derived in the ordinary course of a business or trade. [This answer is incorrect. Generally, NIIT is gross income from interest, dividends, annuities, royalties, and rents unless those items are derived in the ordinary course of a trade or business.]

    c. Practitioners must rely on 3.8% regulations for guidance regarding what constitutes a Section 162 trade or business. [This answer is incorrect. For purposes of the 3.8% NIIT, trade or business is defined the same as for Section 162 purposes. The 3.8% NIIT regulations provide no specific guidance regarding what constitutes a Section 162 trade or business. Practitioners must rely on existing guidance in the Section 162 area.]

    d. Only those shareholders who were not subject to NIIT on the original return before changes were made to AGI or NII can regroup on an amended return. [This answer is correct. A regrouping applies to the tax year for which the regrouping is done and all subsequent years. However, shareholders can regroup on an amended return only if they were not subject to NIIT on the original return (or previously amended return) before changes or adjustments were made to adjusted gross income or NII.]

Lesson 2: Filing and Repairing the S Election

Introduction

Although filing an S election on Form 2553 (Election by a Small Business Corporation) is often viewed as a straightforward task, there are some practical questions associated with S election procedures. Measuring the 15th-day-of-the third-month deadline for election can often be confusing with newly formed entities. Severe consequences can result if the corporation is required to operate as a C corporation because of an ineffective S election. Fortunately, remedies may be available to mitigate the damage from a missed S election deadline.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the deadlines and forms required when filing an S election.
- Recognize the methods for obtaining relief from a late or invalid S election, how to admit a new shareholder to an S corporation, and how to determine the requirements for an LLC to elect S status.

Filing the S Election on Form 2553

Form 2553

A corporation elects to operate as an S corporation by filing Form 2553 (Election by a Small Business Corporation).

S Election Remains in Effect until Terminated

Once made, the S election remains in effect until it is voluntarily or involuntarily terminated. Changes in ownership of S corporation stock have no effect on the S election, so long as all of the stock is owned by individuals or other entities eligible to be S shareholders.

When S Election Form Is Filed

The deadline for filing the Form 2553 differs depending on whether the corporation is already in existence (i.e., operating as a C corporation) or newly formed.

Existing Corporations

For an existing C corporation electing S status, the election must be filed:

1. during the tax year preceding the first tax year the S election is to be effective, or

2. on or before the 15th day of the third month of the initial S year.

Thus, the S election can be retroactive to the first of the tax year if the election is filed within 2 months and 15 days after the beginning of the tax year. However, the S election is retroactive to the first day of the tax year only if the electing corporation qualifies as a small business corporation on the first day of the tax year and on each day until the election is filed.

When an existing corporation becomes an S corporation, S status begins on the day following the last day of the C corporation's tax year.

Newly Formed Corporations

For a newly formed corporation, the election must be filed on or before the 15th day of the third month following the "activation date" of the corporation. The regulations indicate that the activation date is the earliest date that the corporation has shareholders, acquires assets, or begins conducting business. Care must be taken to ensure that

the S election is not filed before the corporation is in existence (i.e., before the charter or articles are registered with and authorized by the Secretary of State in the state of incorporation—see Example 2A-3). Both IRS regulations and case law hold that an S election is not valid if the corporation is not in existence at the time the election is filed.

The S corporation's first tax year begins on its activation date. (See Example 2A-1.)

Example 2A-1 Determining the election deadline for a newly formed corporation.

CSM, Inc. is a newly formed corporation for which the three shareholders intend to file an S election. CSM was incorporated on March 9 of the current year (the date the articles of incorporation were accepted and authorized by the Secretary of State for the jurisdiction of incorporation). CSM opened its checking account on March 11; its shareholders had been investigating and preparing for business activity even before the articles were filed on March 9. The shareholders advanced their capital on March 11, but as of late May, the attorney still had not completed the paperwork to issue the shares of stock.

Before measuring the two-month-and-15-day deadline, CSM must identify its activation date. Usually, the earliest of the three dates (i.e., the date the corporation has shareholders, acquires assets, or begins doing business) will be determined by reference to the legal incorporation process. In a 1972 Revenue Ruling, the IRS looked to the law of the state in which the incorporation had occurred to determine the start of corporate legal existence. In that state, corporate existence began when the articles of incorporation were filed with the secretary of state. The stock subscribers were deemed to be shareholders as of that date, even though the corporate stock had not actually been issued. This interpretation was also applied in a 1969 Tax Court case (*Bone*).

Under its state law, CSM is considered to have shareholders on its incorporation date, March 9. For purposes of measuring the two-month-and-15-day deadline, the term *month* is defined as the period starting on the day within the calendar month that is numerically equal to the first day of the tax year and ending on the day before the same numerical day in the next calendar month. Since most newly formed corporations do not begin their first tax year on the first day of a calendar month, the election deadline will not necessarily fall on the 15th of a given month. Thus, to measure the two-month-and-15-day deadline from an activation date of March 9, the regulations consider April 8 as the end of the first month and May 8 as the second month end; the remaining 15 days would expire on May 23. CSM must file its S election (Form 2553) on or before May 23.

CSM elects to use a calendar year. Its first tax year begins on its activation date, March 9, and ends on December 31 of that year.

Example 2A-2 Filing the S election when first corporate year is 2$^1/_2$ months or less.

Bellco was incorporated on November 1 of Year 1 and intends to use a calendar tax year. If the shareholders intend to elect S status for the first short-year return, by when must the election be filed?

The regulations indicate that for a short year of 2$^1/_2$ months or less, the election must be made before the 16th day of the third month after the first day of the tax year. Accordingly, the shareholders and corporation would have until January 15 of Year 2 to elect S status. The period within which the election must be made is never shorter than 2$^1/_2$ months.

The shareholders have great flexibility in this situation. An S election filed between January 1 and January 15, Year 2, could specify an effective date of (a) November 1, Year 1(the corporation would be an S corporation for its first short year and thereafter); (b) January 1, Year 2 (the corporation would be a C corporation from November 1 through December 31, Year 1 and an S corporation thereafter); or (c) January 1, Year 3 (the corporation would be a C corporation for the short year ending December 31, Year 1, and the Year 2 calendar year, and an S corporation thereafter). The shareholders may wish to retain flexibility on this decision by not electing until early January to determine if the actual November and December Year 1 operating results of the corporation are best reported under C or S status.

If the corporation opts for either the second or third alternative (items b or c in the preceding paragraph), it will be a C corporation for a short time before the S election becomes effective. In that event, the S corporation will

be subject to the built-in gains tax, and the effects of that tax must be considered when deciding when S status should begin. Furthermore, the C corporation can generate accumulated earnings and profits (AE&P) that can cause distributions of taxable dividends to the S corporation shareholders.

Example 2A-3 Filing the S election before formal incorporation occurs.

The shareholders of a newly formed corporation mail Form 2553 to the IRS on March 2 of the current year. However, they do not file the articles of incorporation with the Secretary of State until March 13 (which under state law in the state of incorporation is the date the corporate existence begins and the corporation has shareholders). In this situation, the S election is invalid because it was filed before the company became a corporation.

The proper beginning of the S corporation's tax year is March 13. The two-month-and-15-day period beginning on that date ends on May 27 (see Example 2A-1). The corporation can file a new Form 2553 on or before May 27 showing an effective date of March 13. The new form should be completely filled out and include all of the required shareholder consents. A letter explaining that the first form was prematurely submitted should be attached to the Form 2553.

Example 2A-4 Filing the S election before the corporation begins business.

The shareholders of a newly formed corporation file the articles of incorporation with the Secretary of State on March 2 of the current year and mail Form 2553 to the IRS the next day. However, the corporation does not have shareholders until March 13 and does not acquire assets and begin transacting business until March 25. Although filed after the date of incorporation, the S election is invalid because it was filed before the beginning of the corporation's first tax year. [In some states, the filing of articles of incorporation with the Secretary of State begins the corporate existence, with the stock subscribers deemed to be shareholders as of that date, even though the corporate stock has not actually been issued.]

The proper beginning of the S corporation's tax year is March 13. The two-month-and-15-day period beginning on that date ends on May 27 (see Example 2A-1). The corporation can file a new Form 2553 on or before May 27 showing an effective date of March 13. The new form should be completely filled out and include all of the required shareholder consents. A letter explaining that the first form was prematurely submitted should be attached to the Form 2553.

The S Election Is Made on Form 2553

To make the election to become an S corporation, Form 2553 is filed with the IRS. Three separate compliance matters occur with the filing of this form: (1) the election of the corporation to adopt S status (evidenced by the signature of an officer at the bottom of the first page of the form), (2) the consent of all the shareholders of the corporation (evidenced by their signatures in column K), and (3) selection of the S corporation tax year (designated at line F. If not made on Form 2553, a shareholder consent can be made on a separate statement, which must be signed by the shareholder and include the name, address, taxpayer identification numbers of the corporation and the shareholder, the number of shares owned by the shareholder, the date of stock acquisition, and the date on which the shareholder's tax year ends.

Persons Required to Consent to the S Election

All persons who are shareholders on the date the S election is filed must consent to the election. Consents are also required from anyone who held shares at any time from the beginning of the tax year through the day the S election is filed. Shareholders who acquire stock after the S election is filed need not consent.

Shareholder consent is binding and may not be withdrawn after a valid election is made by the corporation. Once the S election is effective, pass-through of corporate income and loss items, as well as distributions to shareholders, must be based on each shareholder's proportionate stock ownership. This is true until the S election terminates, either voluntarily or involuntarily.

The following rules apply in determining who is required to consent to the S election:

1. *Spousal and Joint Ownership of S Stock.* Each person having a community interest in the stock (or income therefrom) and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. Each person with an interest in the stock must separately consent to the election, even though (as in the case of spouses and family members) the individuals are counted as one shareholder for purposes of the 100-shareholder limit. (See Example 2A-5 and "Obtaining Relief from Omitted Consent of Community Property Spouse" later in this lesson.)

2. *Minor.* A minor or the minor's legal representative must consent to the election. If no legal representative has been appointed and the minor cannot sign or is otherwise unable to consent, the consent is made by the minor's natural or adoptive parent.

3. *Estate.* The consent of an estate must be made by an executor or administrator thereof, or by any other fiduciary duly appointed and having jurisdiction over the administration of the estate. In the case of a bankruptcy estate, the trustee consents to the S election.

4. *Trust.* For a trust [other than an electing small business trust (ESBT)] that is an eligible S corporation shareholder, the persons treated as shareholders for purposes of the 100-shareholder limitation under IRC Sec. 1361(b)(1) must consent to the election. For married shareholders, both spouses must consent to the election if they have a community interest in the trust. The trustee of an ESBT consents to the election.

5. *Family Ownership.* All family members are treated as one shareholder for purposes of determining the number of shareholders in the corporation. For shareholder consent signatures, however, each person holding an interest in the S corporation's stock must sign the consent.

Example 2A-5 Obtaining proper spousal consents.

Essco, Inc. meets all the requirements necessary to qualify for S status, and the shareholders want the corporation to make the S election for the coming calendar year. The tax practitioner learns that the corporation has 1,000 shares outstanding. Keith and Mary Cousins hold 600 shares as joint tenants with right of survivorship (often abbreviated as JTROS or JTWROS). The remaining 400 shares are in the name of Joan Smith. Joan is married to Samuel Smith and the shares are community property under state law. While spouses are considered as one for S election purposes, this is only for purposes of the 100-shareholder limit. For shareholder consent signatures, each person holding an interest in the stock must sign the consent.

Thus, Keith and Mary Cousins, as well as Joan and Samuel Smith, must consent to the election.

Obtaining Relief from Failure to Obtain Shareholder Consents

If an invalid election is caused by a failure to obtain the necessary shareholder consents, the IRS has issued special rules that allow relief to be obtained through the Service Center with which the corporation files its income tax return.

Example 2A-6 Supplying an omitted shareholder consent signature.

Newco filed a timely Form 2553 to be taxed as an S corporation for its initial year ending December 31. However, in preparing the initial Form 1120S, the corporation's tax practitioner notes that none of the spouses of the shareholders signed the Form 2553 consent, even though all of the shareholders reside in a community property state. How may the S election be preserved in view of the omitted shareholder consents?

To comply with corrective procedures in Reg. 1.1362-6(b)(3), Newco must satisfy the IRS that it had reasonable cause for not including the signatures and submit the omitted signatures of the spouses, as well as new consents by the shareholders, within any extended period which may be granted by the IRS.

Obtaining Relief from Omitted Consent of Community Property Spouse

Automatic relief is available if the S election Form 2553 does not include the signature of a community property spouse who was a shareholder solely because of the state's community property law.

Beneficial Owner

The registered owner of S corporation stock might not be the beneficial owner (i.e., the person or entity that controls the stock or reaps the benefits of stock ownership). In that event, the beneficial owner, rather than the owner of record, is considered to be the shareholder (i.e., the owner of the S corporation stock). Thus, a beneficial owner of stock must consent to the S election.

Example 2A-7 Beneficial shareholder must consent to election even if no shares are issued.

Scoop, Inc. filed its S election on December 15 to be effective January 1. Earlier in the year, Patricia Knoll verbally agreed to buy 100 shares of Scoop for $4,875. (There is no written stock subscription agreement.) As of December 15, Patricia has paid $3,250 toward the $4,875 stock subscription, and no stock certificates have been issued to her. Must she consent to the S election?

Under similar facts, the 7th Circuit affirmed the Tax Court and ruled that an S election was invalid when the stock subscriber (i.e., Patricia) did not consent (*Cabintaxi Corp.*). Under the laws of the state of incorporation (Delaware), a person can be a shareholder even though stock certificates are not issued. Furthermore, the state's law provides that a corporation can issue dividends on shares to the extent they are paid for. The nature of the agreement between Scoop and Patricia was unclear, and the Court found that she could have been a beneficial stockholder on December 15. Since the corporation could not prove she was not a beneficial shareholder, the S election was disallowed.

The Court stated that the result may have been different if the agreement had clearly provided that Patricia would not be a shareholder and would have no rights of stock ownership until the stock was fully paid for. (The laws of some states provide that a person becomes a shareholder when he subscribes to stock. Also, as discussed in Example 2A-3, some states provide that a corporation is deemed to have shareholders on the date it is legally incorporated within the state.)

This case points out the importance of obtaining S election consents from anyone who is a beneficial owner of stock on the date the election is made. To be on the safe side, anyone who *may* have a beneficial interest in the stock should consent in order to protect the S election.

Family Members

Family members are treated as one shareholder for purposes of determining the number of shareholders in the corporation. For shareholder consent signatures, however, each person holding an interest in the S corporation's stock must sign the consent.

Example 2A-8 Obtaining S election consents from a family group.

MM Inc. is a C corporation that is electing S status. The corporation has 108 shareholders. Of these, 99 shareholders are unmarried and unrelated. The remaining 9 shareholders are Molly and her spouse, her five children, father, and grandmother. Molly and her family members (including her spouse) are treated as one shareholder for purposes of the 100-shareholder limit. Thus, the corporation is considered to have 100 shareholders for purposes of the maximum-number-of-shareholders test. However, all 108 shareholders must consent to the S election.

The box on line G of the S election Form 2553 should be checked to indicate that, under the family member rules, the corporation is within the allowable number of shareholders, even though more than 100 shareholders are required to consent to the S election.

Shareholders Acquiring Stock after the S Election Is Filed

Shareholders who acquire stock after the election is filed are not required to consent to the S election. However, if the IRS grants an extension of time to submit consents, a consent must be made by all persons who (1) were shareholders at any time during the period beginning on the date the election was filed and ending on the extended date for obtaining the consents, and (2) have not previously consented to the election. (See Example 2A-9.)

Deadline for Filing Shareholder Consents Can Be Extended

The IRS has authority to waive the effects of an invalid S election or accept an S election filed after the 15-day-of-the-third-month deadline has expired. Likewise, the deadline for obtaining a particular shareholder's consent to the S election can be extended with the approval of the IRS.

Example 2A-9 Extending the time for a shareholder consent.

Minnow Corporation, Inc. was formed eleven years ago, and has operated as a regular C corporation. Early in the year, the shareholders, with the assistance of their tax practitioner, decide to elect S status, to be effective on January 1, 2017. However, when the practitioner meets with the shareholders during February to secure the election, it is learned that a shareholder, William Wilson, is out of the country on foreign business travel and will not return until after the March 15 deadline.

Under Reg. 1.1362-6(b)(3), an extension to obtain a shareholder's consent may be granted if reasonable cause is shown for the request, the interest of the government is not jeopardized by the extension, and a valid consent to the S election is filed within the extended period granted by the IRS. Furthermore, the regulations state that consents must be filed within the extended period by all persons who have not previously consented to the S election and who were shareholders at any time during the period beginning on the first day of the tax year for which the S election was supposed to be valid, and ending on the extended date for obtaining the consent.

Accordingly, Minnow submits its S election (Form 2553) in a timely manner by March 15 and attaches to the Form 2553 a request for extension. In column K of Form 2553, in lieu of Wilson's signature, a notation is entered indicating that an extension request is attached. When he returns within the extended period, a new Form 2553 is submitted containing the signatures of consent of all persons who had not previously consented to the election and who were shareholders at any time from January 1 through the extended date for obtaining such consents, with a copy of the IRS letter approving the extension. Here, only Wilson's signature of consent is needed.

Relief from an invalid S election can also be requested when shareholder consents were inadvertently omitted when the original Form 2553 was filed. (See Example 2A-6.)

Effect of Defense of Marriage Act Repeal on Consents to the S Election

In June 2013, the U.S. Supreme Court ruled that Section 3 of the federal Defense of Marriage Act (DOMA) is unconstitutional (*Windsor*). As a result, lawfully married same-sex couples will be treated as married for federal tax purposes.

All persons who actually or beneficially own stock on the date an S election is filed and those who held stock from the beginning of the tax year through the day the S election is filed are required to consent to the S election. This consent requirement includes a spouse having a community interest in the stock (or income therefrom). Now, married same-sex spouses with a community interest in the stock must also consent. (See Example 2A-5.)

Filing the S Election by Mail, Private Delivery Service, or Fax

Mail. As with other IRS filings, a U.S. Postal Service postmark on a mailed election is evidence that the election was filed on that date. If the election is sent by certified or registered mail, the date stamped by the post office on the sender's receipt is considered to be the date of filing. Furthermore, the date-stamped sender's receipt for certified or registered mail will be proof that the election was actually delivered to the IRS if the IRS later claims that the election was not received.

If the IRS receives the Form 2553, it will accept a U.S. Postal Service postmark as the date the form was delivered to the IRS. However, if the election is not mailed as certified or registered and the IRS claims it did not receive the Form 2553 on time, the S election may be declared invalid even though the client or practitioner can provide evidence showing that the election was timely mailed (*Carroll*; *Sorrentino*). S elections submitted by mail should *always* be sent by certified or registered mail with a return receipt requested.

Sending the election by certified or registered mail is also important if a private postage meter stamp is used. If an election mailed with a timely private meter stamp is not received by the due date, timely filing is assumed if the election is received within the time that an envelope bearing a post office postmark and mailed from the same location ordinarily would have been received by the IRS. If the election is received outside the normal delivery time, the taxpayer must prove that the untimely filing was because of a delay in transmitting the mail. The taxpayer must also prove the cause of the delay. In applying this rule, one judge noted: "Given the vagaries of the postal system, a taxpayer seldom will be able to prove why his letter was delayed" (*Hechtman*; see also *Abney and Sanchez*).

Private Delivery Service. An approved private delivery service (PDS) may also be used for IRS filings. Under IRS Notice 2016-30, the following companies and specific types of services are "designated private delivery services" approved by the IRS:

Name	Types of Services
1. DHL Express (DHL)	DHL Express 9:00, DHL Express 10:30, DHL Express 12:00, DHL Express Worldwide, DHL Express Envelope, DHL Import Express 10:30, DHL Import Express 12:00, and DHL Import Express Worldwide;
2. Federal Express (FedEx)	FedEx First Overnight, FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2 Day, FedEx International Next Flight Out, FedEx International Priority, FedEx International First, and FedEx International Economy
3. United Parcel Service (UPS)	UPS Next Day Air Early AM, UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus; and UPS Worldwide Express

Only Designated Private Delivery Services Qualify. Only the delivery service identified for each private delivery service qualifies. The "timely mailing as timely filing/paying" and *prima facie* evidence rules discussed below do not apply to any other type of delivery service offered by these private delivery services.

In *Scaggs*, the IRS mailed a notice of deficiency to the taxpayer on April 8, 2011. Under IRC Sec. 6213(a), the taxpayer had 90 days from the date the notice was mailed to file a petition in Tax Court. (July 7, 2011 was the 90th day.) The taxpayer selected the Federal Express service, "Express Saver Third business day," for sending his petition. The court received the petition on July 12, 2011, in a Federal Express U.S. Airbill envelope. It held that the petition was not filed within the prescribed 90-day period because the Express Saver Third business day service was not a designated private delivery service approved by the IRS. The Tax Court also reached a similar result in *Eichelburg*.

Timely Mailing as Timely Filing/Paying Rule. The "timely mailing as timely filing/paying rule" applies when a document is received by the IRS after its prescribed due date. Under this rule, the postmark date on such a document is considered to be the date the document was delivered to the IRS.

Private Delivery Services and the *Prima Facie* Evidence of Delivery Rule. The *prima facie* evidence of delivery rule applies when the IRS has no record of receiving a document from a taxpayer. Under this rule, a document (but not a payment) is considered to be delivered to the IRS on the postmark date if the taxpayer can prove that it was properly sent by registered or certified mail. Furthermore, the Section 7502 regulations provide that proof of proper use of a PDS duly designated by the IRS can establish *prima facie* evidence of delivery of federal tax documents to the IRS. The Tax Court also reached a similar result in *Eichelburg*.

Private Delivery Service Postmark Date. For each designated private delivery service, the PDS records electronically the date on which an item was given to it for delivery. The date of this recording is treated as the postmark date

for purposes of IRC Sec. 7502. Therefore, if the IRS does not receive the document or receives it late, the taxpayer must provide information, such as a written confirmation produced and issued by the PDS, showing that the date recorded in the PDS's electronic database is on or before the due date.

Each PDS stores the date recorded in its database for a limited period, but for no less than six months. Senders or recipients using a designated private delivery service can obtain information concerning the date recorded by contacting the PDS. Contact information for each PDS is available on the company's website.

In *Estate of Cranor*, the taxpayer's attorney timely sent a Tax Court petition using FedEx. However, the attorney incorrectly completed the FedEx airbill document so the package was returned to him. He promptly resent the document even though the filing deadline had passed. The IRS argued that the taxpayer failed to timely file the petition. The Tax Court ruled that, based on the facts, the petition was timely mailed and therefore timely filed because the original mailing included the proper mailing address. The failure to properly complete the airbill and having to resend the document did not prevent it from being timely mailed based on when it was originally sent.

Fax. Form 2553 can be faxed to the appropriate IRS Service Center (Instructions to Form 2553). If the form is faxed, the practitioner retains the original Form 2553 in the files. The instructions also make it clear, however, that faxing the form does not provide proof of filing. Therefore, best practices suggest that the form be sent by U.S. mail (either certified or registered mail, with a return receipt) to provide proof that the form was timely filed.

Where Form 2553 Is Filed

Where to Mail or Fax Form 2553. The IRS has stated that some addresses for mailing tax forms or fax numbers may not match a particular instruction booklet or publication. The most current addresses and fax numbers for filing the S election and other tax forms can be found on the IRS website (**www.irs.gov**) by entering the words "where to file tax returns—addresses listed by return type" in the search feature.

Where to Send Tax Forms by Private Delivery Service. Form 2553 and other tax forms sent by private delivery service must be delivered to a physical address. The addresses can be found on the IRS website (**www.irs.gov**) by entering the words "submission processing center for private delivery service" in the search feature.

Filing the S Election by Delivering It to an IRS Taxpayer Assistance Center

The Form 2553 can be delivered to an IRS Taxpayer Assistance Center. If this is done, the practitioner should carry the original form and a copy to the IRS office. The IRS will date-stamp the copy, which should be retained by the practitioner as proof of the form's delivery.

The IRS National Office has concluded that for purposes of triggering the period of limitations on assessment, hand-delivered returns are considered filed only when hand-delivered to a person assigned the responsibility to receive hand-carried returns in a local IRS office, and evidential proof to support the hand-delivery, such as a date-stamped receipt, is provided.

Practitioners Should Follow Up with IRS, If Necessary

The instructions to Form 2553 state that the IRS generally acknowledges acceptance of the election within 60 days. Practitioners should mark their calendars to follow up with the IRS if acknowledgment is not timely received. Copies of the Form 2553 and IRS acceptance letter (also known as a CP261 Notice) should be retained in the client's permanent file.

Consequences If Form 2553 Is Not Properly Filed

Under many circumstances, a corporation that files its S election late or improperly can apply for a waiver of a late or invalid S election. If the IRS grants the waiver, the corporation may be treated as an S corporation from the date it originally intended to elect S status.

Failure to timely or properly file the S election could have severe consequences to the shareholders. The corporation may neglect to apply for a waiver (see the preceding paragraph) or, less commonly, the IRS may not approve

the waiver. Even without the benefit of a waiver, the corporation can normally qualify for S status for the following year, but even a one-year postponement could be detrimental. For example, a new entity denied S status for its first year may find an initial operating loss trapped within a regular corporate return. Or, a one-year C corporation that converts to S status exposes itself to the Section 1374 built-in gains tax on any appreciated assets as of the date of conversion. Furthermore, if the entity was a C corporation intending to convert to S status, it may have made distributions to its shareholders under the assumption it was an S corporation, and those distributions may become taxable as dividends. For new entities that miss the S election deadline, an initial short-period Form 1120 (U.S. Corporation Income Tax Return), with capitalization of organization and start-up costs, may be a solution. (See Example 2C-4.)

S Election May Be Revoked before It Becomes Effective

An S election can be revoked before it becomes effective by filing a revocation (1) before the date the S election is to become effective or (2) before the 16th day of the third month of the tax year. If the election is so revoked, and the C corporation is using a fiscal year, its fiscal year does not change. The revocation must be accompanied by the consent of shareholders who, at the time of the revocation, hold more than 50% of the issued and outstanding shares of the corporation's stock, including nonvoting stock.

Example 2A-10 Revoking the S election before it becomes effective.

LCL Corp. is a calendar-year C corporation. During November 2016, LCL files a Form 2553 electing S status as of January 1, 2017. Dina, the sole shareholder, consents to the election. On December 15, Dina finds out that the C corporation's carryover losses cannot be used if the corporation elects S status.

During January 2017, the corporation (with Dina's consent) terminates its S election by mailing a revocation with a retroactive effective date of January 1, 2017. Since the revocation was filed before the 16th day of the third month of what would have been the S corporation's first tax year, the S election never became effective. Furthermore, the five-year waiting period to re-elect S status does not apply to LCL because the original S election was terminated as of the first day on which it would have taken effect.

If LCL had been using a fiscal year and had elected to change to a calendar year in connection with its S election, it would retain its fiscal year after the revocation because the S election was terminated on the day it was to become effective.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. S status begins on which of the following when an existing corporation becomes an S corporation?

    a. On or before the 15th day of the third month of the initial S year.

    b. On the day after the last day of the C corporation's tax year.

    c. On or before the 15th day of the third month following the activation date.

    d. On its activation date.

12. There are specific rules that apply in determining who is required to consent to the S election. Which of the following statements with respect to these rules is correct?

    a. A minor's adoptive parent can consent to the S election.

    b. Only the executor of an estate can consent to the S election.

    c. For a trust, if the shareholders are husband and wife, only one must consent to the election if they have a community interest in the trust.

    d. In determining the number of shareholders in a corporation, family members are treated as individual shareholders.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. S status begins on which of the following dates when an existing corporation becomes an S corporation? **(Page 197)**

    a. On or before the 15th day of the third month of the initial S year. [This answer is incorrect. For an existing C corporation electing S status, the election must be *filed* on or before the 15th day of the third month of the initial S year.]

    b. On the day after the last day of the C corporation's tax year. [This answer is correct. When an existing corporation becomes an S corporation, S status begins on the day following the last day of the C corporation's tax year.]

    c. On or before the 15th day of the third month following the activation date. [This answer is incorrect. For a newly formed corporation, the election must be filed on or before the 15th day of the third month following the "activation date" of the corporation. This only applies to newly formed corporations.]

    d. On its activation date. [This answer is incorrect. For a newly formed S corporation, the S corporation's first tax year begins on the activation date.]

12. There are specific rules that apply in determining who is required to consent to the S election. Which of the following statements with respect to these rules is correct? **(Page 197)**

    a. A minor's adoptive parent can consent to the S election. [This answer is correct. A minor or the minor's legal representative must consent to the election. If no legal representative has been appointed and the minor cannot sign or is otherwise unable to consent, the consent is made by the minor's natural or adoptive parent according to Reg. 1.1362-6(b)(2)(ii).]

    b. Only the executor of an estate can consent to the S election. [This answer is incorrect. The consent of an estate must be made by an executor or administrator thereof, or by any other fiduciary duly appointed and having jurisdiction over the administration of the estate. In the case of a bankruptcy estate, the trustee consents to the S election.]

    c. For a trust, if the shareholders are husband and wife, only one must consent to the election if they have a community interest in the trust. [This answer is incorrect. For a trust that is an eligible S corporation shareholder, the persons treated as shareholders for purposes of the 100-shareholder limitation under IRC Sec. 1361(b)(1), must consent to the election. For married shareholders, both husband and wife must consent to the election if they have a community interest in the trust.]

    d. In determining the number of shareholders in a corporation, family members are treated as individual shareholders. [This answer is incorrect. All family members are treated as one shareholder for purposes of determining the number of shareholders in the corporation. For shareholder consent signatures, however, each person holding an interest in the S corporation's stock must sign the consent.]

Determining When the Initial Tax Year Begins

Beginning of First Tax Year for Newly Formed Corporation Electing S Status

A newly formed corporation's first S year begins on the date the S election is effective (i.e., the earliest date on which the corporation has shareholders, acquires assets, or begins doing business.) (See Example 2A-1.)

Beginning of First Tax Year for C Corporation Electing S Status

When an existing corporation becomes an S corporation, S status begins on the day following the last day of the C corporation's tax year.

Example 2B-1 Beginning of first S year for existing corporation.

ABC, Inc., a C corporation using a tax year ending August 31 decides to become an S corporation and change to a calendar year. The S year is effective on the day following the last day of the C corporation's normal tax year. Thus, the S election would be effective on September 1, 2017, if the S election is filed any time from September 1, 2016 (i.e., the beginning of the C corporation's tax year), through November 15, 2017 (i.e., the 15th day of the third month of the new tax year). The final C corporation return will be for the 12-month period ending August 31, 2017. The S corporation's first tax return will cover September 1 through December 31, 2017. The second S corporation return will be for the following calendar year.

Changing the C Corporation's Year before Electing S Status

A C corporation that meets certain requirements can automatically change its tax year to a calendar year (or other S corporation permitted year). This will cause the C corporation to have a short tax year for the year of the change. If the corporation elects S status effective for the tax year immediately following the C corporation's short period, the S corporation's first tax year will run for a full twelve months.

Example 2B-2 Changing fiscal year-end before electing S status.

XYZ Inc., a C corporation, uses a fiscal year that ends on June 30, 2017. XYZ meets all the requirements to automatically change to a tax year ending December 31. The corporation wants to elect S status. However, it intends to sell an asset, and needs to remain a C corporation through December 2017 to avoid the built-in gains tax that would apply if the sale took place after the S election became effective. To accomplish this, the corporation changes its year and elects S status effective January 1. This allows it to report the asset sale on its short year C corporation return for the period July 1 through December 31, 2017. The S corporation's first return will cover the 2018 calendar year.

Selecting the Initial Tax Year

The decision to file an S election requires consideration of the tax year to be used by the S corporation. At the time Form 2553 is filed, the corporation must designate its selected accounting period. In general, an S corporation must use a calendar year or make the Section 444 fiscal year election. As a result, a company that is incorporating and electing to be an S corporation from its inception has four choices relating to its tax year. The new S corporation can:

1. use a calendar year;
2. make the Section 444 election and use an acceptable fiscal year;
3. apply for a fiscal year that will be approved automatically (i.e., a year that is deemed to have a business purpose either because of conformity with its natural business year or because it coincides with the tax year of a majority of the corporation's shareholders); or
4. apply for a fiscal year for which there is a business purpose (based on facts and circumstances) that must be approved by the IRS.

For purposes of the S election, a 52-53 week tax year ending on a day other than the last day of the month is treated as ending on the last day of the month nearest the end of the 52-53 week year. Thus, a 52-53 week year ending on January 3 is considered to end on December 31.

Repairing a Late or Invalid S Election

Waiver of Invalid S Election

The S election is not valid unless the corporation is eligible for S status (i.e., is a "small business corporation" as defined in lesson 1). Furthermore, Form 2553 (Election by a Small Business Corporation) must be properly completed, signed by a corporate officer, accompanied by all shareholder consents, and filed by the appropriate deadline. If one or more of these requirements are not met, however, the IRS has authority to waive an invalid election and allow the S election to become effective.

When an S corporation election is ineffective because the corporation failed to qualify as a small business corporation, or obtain shareholder consents, the corporation will be treated as an S corporation during the period specified by the IRS if all the following conditions are met:

1. The IRS determines that the circumstances resulting in the ineffective election were inadvertent.

2. Within a reasonable period after discovering the circumstances causing the invalidity, steps are taken to qualify the corporation as a small business corporation, or to obtain the requisite shareholder consents [including elections for qualified Subchapter S trusts (QSST) or electing small business trusts (ESBT)].

3. During the period that the S election was ineffective, the corporation and each shareholder agree to adjustments required by the IRS pertaining to that period.

Methods of Obtaining Relief from a Late or Invalid S Election

The IRS has provided the following ways to obtain relief from invalid elections:

1. *Failure to Obtain Shareholder Consents.* If the election is invalid because shareholder consents were omitted, Reg. 1.1362-6(b)(3)(iii) provides that the S corporation can request an extension of time in which to furnish the consents. No user fee is required. (See Example 2A-6.)

2. *Relief for Late Election under Rev. Proc. 2013-30.* If the election is late, relief is provided under Rev. Proc. 2013-30, which allows the S corporation to file a late Form 2553, as discussed later in this lesson.

3. *Requesting a Letter Ruling to Waive the Effect of an Invalid Election.* The S corporation can request relief from an invalid election by obtaining a letter ruling. A user fee applies.

4. *Failure to File ESBT or QSST Election.* If an ESBT trustee or QSST beneficiary fails to make the ESBT or QSST election, S status can terminate. Rev. Proc. 2013-30 provides relief from S corporation termination when an ESBT or QSST election is inadvertently not filed. No user fee is required.

Relief for Late Election under Rev. Proc. 2013-30

Rev. Proc. 2013-30 consolidates and simplifies the rules for requesting and obtaining relief for late or invalid S elections (and other S corporation related elections). The procedure extends the time to apply for relief to three years and 75 days from the date the applicable election was originally intended to become effective. The December 2017 revision to Form 2553 allows corporations to provide the information required by Rev. Proc. 2013-20 2013-36 IRB 173. For example, line I provides space for explaining why the election was not made on time (the reasonable cause statement) and a description of the diligent actions taken to correct the mistake upon its discovery.

Relief Is Retroactive to Intended Effective Date. If the IRS grants relief, the S election becomes effective on the date the election was originally intended to be effective. That date is entered on line E of the S election Form 2553. (See Example 2C-1.)

No User Fee. The simplified method for requesting relief is in lieu of the letter ruling process ordinarily used for a late S election and no user fees apply. A taxpayer that does not meet the requirements of Rev. Proc. 2013-30 or is denied relief under its procedures may seek relief by requesting a letter ruling.

Requirements for Relief. To qualify for relief from a late S election or termination of the S election due to a late election, all of the following must apply:

- The corporation intended to be classified as an S corporation on the date the S election would have become effective if the Form 2553 had been submitted on time.
- The S corporation requests relief under Rev. Proc. 2013-30 within three years and 75 days after the intended effective date of the election, excluding extensions (although an exception to this three-year and 75-day requirement can apply, as discussed later in this lesson).
- The failure to qualify as an S corporation was solely because the S election was not timely filed by the due date of the S election.
- The S corporation had reasonable cause for its failure to make a timely S election and acted diligently to correct the mistake upon its discovery.

General Rules for Requesting Relief. An entity requests relief from a late S election by properly completing Form 2553 and attaching any supporting documents required by Rev. Proc. 2013-30. The Form 2553 must include a statement (i.e., a "Reasonable Cause/Inadvertence Statement") from the S corporation describing its reasonable cause for failure to timely file the S election and its diligent actions to correct the mistake upon its discovery. The Reasonable Cause/Inadvertence Statement and the required "under penalties of perjury" declaration are included on the face of the most recent Form 2553.

All other statements required by Rev. Proc. 2013-30 that are attached to Form 2553 must each contain a dated declaration that states: "Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." An officer of the S corporation authorized to sign or a shareholder, as applicable, must sign each specific declaration.

The words "FILED PURSUANT TO REV. PROC. 2013-30" should be written at the top of the Form 2553.

Using Form 2553 to Apply for Relief from Late S Corporation Elections. An S corporation that is seeking relief from a late S election must file a completed Form 2553, signed by (1) an officer of the corporation authorized to sign, and (2) all persons who were shareholders at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the completed S election Form 2553 is filed.

Shareholder Declarations. By signing Form 2553, the shareholders represent that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been filed and for all subsequent years. (This basically means that proper Schedules K-1 have been issued to the shareholders and they have reported the pass-through items on their tax returns as if a valid S election was in effect.)

Filing the Form 2553. The Form 2553 is filed by:

1. attaching the form to the S corporation's current year Form 1120S (as long as the current year Form 1120S is filed within three years and 75 days after the intended effective date, without considering extensions);
2. attaching the form to one of the S corporation's late filed prior year Forms 1120S; or
3. filing the form independent of Form 1120S.

Attaching Form 2553 to S Corporation's Current Year 1120S. If the S corporation has filed all Forms 1120S for tax years between the intended effective date and the current year, the Form 2553 can be attached to the current year Form 1120S as long as the current year Form 1120S is filed within three years and 75 days after the intended

effective date. An extension of time to file the current year Form 1120S will not extend the due date for relief beyond three years and 75 days following the intended effective date. The Form 1120S must state at the top "INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30" or comply with specific instructions included with the Form 1120S instructions.

Example 2C-1 Filing Forms 1120S and 2553 with the corporation's current year tax return.

Matrix Corp., a newly formed corporation, begins business on January 1, 2017. On March 1, 2018, the corporation's sole owner, Matt, advises his tax practitioner that the corporation has been formed and will be operated as a calendar year S corporation beginning on the date it started business. Matt was not aware of the S election requirements and no Form 2553 has been filed.

Matrix's 2017 Form 1120S is filed on March 5, 2018. A completed S election, Form 2553, is attached to the return. Matrix's Form 2553 should have "FILED PURSUANT TO REV. PROC. 2013-30" written or typed at the top of page 1 of Form 2553. A statement explaining the reason for the failure to timely file the corporation's election should be written in the space provided on the face of the Form 2553 or included as an attachment. The originally intended effective date, January 1, 2017, is entered on line E of the Form 2553. By signing Form 2553, the shareholders declare under penalties of perjury that they have reported pass-through items on all affected returns consistent with the S corporation election for the year for which the election should have been filed (the date entered on line E) and for all subsequent years. Each separate statement attached to Form 2553 must be dated and signed under penalties of perjury by the appropriate officer or shareholder.

The Form 1120S must state at the top "INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30" or comply with specific instructions included with the Form 1120S instructions.

Matrix is not subject to a user fee for requesting relief under Rev. Proc. 2013-30.

If the IRS determines Matrix had reasonable cause for its failure to timely file Form 2553, Matrix's S election will be effective on January 1, 2017, as planned.

Attaching Form 2553 to S Corporation's Late Filed Prior Year 1120S. Form 2553 may be attached to a late filed Form 1120S for the year that includes the intended effective date or any subsequent year if:

1. the Form 1120S for the year including the intended effective date is filed within three years and 75 days after the intended effective date;

2. all other delinquent Forms 1120S are filed simultaneously and consistently with the requested relief; and

3. the S corporation has not filed a Form 1120S, 1120, partnership, or any other income tax return or information return (within the meaning of IRC Secs. 6031–6040) for the tax year including the intended effective date or any year following that year.

Example 2C-2 Filing for relief under Rev. Proc. 2013-30 by filing Form 2553 with late filed prior year 1120S.

Ben formed BB Corp. on January 1, 2016. Ben intended to operate the company as an S corporation. However, the corporation did not file a Form 2553 and did not file its 2016 tax return, Form 1120S, either. During 2017 much of Ben's nonworking time is taken up by caring for an ill family member. In March 2018, Ben engages a tax practitioner, who files for an extension of time to file BB's 2017 tax return. The corporation's 2016 Form 1120S is filed in March along with a Form 2553 requesting relief from the late election.

BB qualifies under Rev. Proc. 2013-30 for relief from a late election because the 2016 Form 1120S is filed within three years and 75 days after the January 1, 2016, intended effective date, there are no other delinquent Forms 1120S, and BB has not filed any other types of tax return.

Ben consents to the election. All supporting statements are dated and signed under penalties of perjury with the words "FILED PURSUANT TO REV. PROC. 2013-30" written at the top of the Form 2553.

The Form 1120S must state at the top "INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30" or comply with specific instructions included with the Form 1120S instructions.

If the IRS approves the application, BB's S election will be effective on January 1, 2016, as originally planned.

Filing Form 2553 Independent of Form 1120S. The entity can submit Form 2553 directly to the applicable IRS.

Exception to the Three-year and 75-day Time Limit. Normally, the S corporation must request relief under Rev. Proc. 2013-30 within three years and 75 days after the date that the election was originally intended to become effective (excluding extensions). However, the three-year and 75-day limit does not apply to a corporation that fails to qualify as an S corporation if:

1. the corporation fails to qualify as an S corporation solely because the Form 2553 was not timely filed;

2. the corporation and all of its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent taxable year (if any);

3. at least six months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation;

4. neither the corporation nor any of its shareholders was notified by the IRS of any problem regarding the S corporation status within six months of the date on which the Form 1120S for the first year was timely filed,

5. the completed Form 2553 includes statements from all shareholders that they have reported their income consistent with S status (see item 2 of this list); and

6. the corporation is not applying for relief from both a late S corporation election and a late corporate classification election simultaneously under Rev. Proc. 2013-30.

Example 2C-3 Filing Form 2553 under Rev. Proc. 2013-30 after three years and 75 days have elapsed.

In February of 2014, DIF Corp. completed an S election adopting a calendar tax year that was supposed to be effective on January 1, 2014. The Form 2553 was inadvertently placed in a file and was not mailed. DIF was unaware that the election was not filed and timely filed its 2014, 2015, and 2016 tax returns (Form 1120S). All of the corporation's pass-through items were properly reported on each shareholder's Form 1040. During an office move in February 2018, the corporation finds the misfiled Form 2553 and applies for relief from the late election by filing Form 2553 along with DIF's 2017 Form 1120.

DIF qualifies under Rev. Proc. 2013-30 for relief from a late election because the corporation meets the requirements shown in the preceding list. If DIF properly applies for relief under Rev. Proc. 2013-30 (as covered in the earlier discussion), and the IRS approves the application, DIF's S election will be effective on January 1, 2014 as originally planned.

Notification from IRS. The IRS will determine whether the requirements for granting additional time to file the S election have been satisfied and will notify the corporation of its decision.

Penalty for Late Filing of Form 1120S May Apply. An S corporation that files Form 1120S after the return's due date may be subject to a penalty under IRC Sec. 6699(a)(1). This penalty can apply even though the corporation received IRS approval to file its S election late. If the IRS does assess the penalty, the S corporation can request first-time penalty abatement relief (if applicable) or seek relief under the reasonable cause provisions.

User Fee

According to IRS Ann. 97-4, the rules under Reg. 1.1362-4(c)–(f) relating to waiver of inadvertent termination of the S election also apply to relief from invalid elections. Under those regulations, a request for waiver of an inadvertent S termination requires payment of a user fee. Each year, a revenue procedure is issued describing the procedure for obtaining a private letter ruling.

Minor Errors Do Not Invalidate the S Election

An S election may be valid even though there are minor errors on Form 2553. The IRS has ruled that an incorrect disclosure of the number of shares owned by two shareholders on a Form 2553 did not invalidate an S election. Similarly, a timely filed S election that incorrectly disclosed the corporation's selected tax year did not preclude IRS approval.

Closing the First C Year of a Newly Formed Corporation to File a Timely S Election

When a practitioner encounters a newly formed corporation after the two-month-and-15-day deadline for submitting an S election has passed, a possible remedy (other than seeking relief through the IRS) may be filing an initial short-period C corporation return to start a new tax year for which a timely S election can be filed.

Example 2C-4 Closing the C year to file a timely S election.

Bill and Ted formed Excellent Adventures, Inc., (EA) and began business operations on January 2, 2017. They anticipate initial losses, and are generally aware that the filing of an S election will allow a pass-through loss that can be deducted on their personal income tax returns. However, they did not visit with their tax practitioner until March 26, 2017, 10 days beyond the deadline for the filing of the Form 2553. How might the practitioner salvage this situation by use of a short-period C return?

As discussed in the following paragraph, the corporation can establish a C corporation tax year ending January 31, so its first tax year will begin on January 2 and end January 31, 2016. If it then elects S status and uses a calendar year, the S corporation's first tax year will begin on February 1 and end December 31, 2016. The short years are allowable because both the C corporation and the S corporation are in existence only part of their respective first tax years.

A new C corporation is not restricted in its choice of a fiscal year. Thus, by filing an initial short-period C corporation tax return for the period January 2–31, EA can establish a new fiscal year beginning February 1, for which a timely S election can now be made. If there is insufficient time to compile the data for the preparation of the one-month initial short-period return, a timely extension request filed by April 15 would serve to fix the January 31 fiscal year-end. The S election in this situation would also be due by April 15, 2017 and would establish the end of the corporation's first S tax year as December 31, 2017.

In this manner, the practitioner will have limited the initial losses trapped in the C return to only a one-month period. To minimize the trapped losses, the practitioner should scrutinize the first month's transactions to identify any Section 195 start-up costs or any Section 248 corporate organizational costs that can be deducted and/or amortized.

Admitting a New Shareholder to S Corporation

Shareholders who acquire stock after the election is filed are not required to consent to the S election. The corporation's S status is not affected, assuming the shareholder is eligible to hold S stock. However, S status would terminate if the shareholder transfers stock to an ineligible shareholder or the shareholder owns more than 50% of the outstanding stock and voluntarily revokes the S election.

Pass-through of S Corporation Items

Under the normal pass-through rules, the new shareholder will be allocated his or her allocable share of the S corporation's pass-through items of income, loss, deduction, and credit under the normal per-share, per-day rules. The new shareholder is allocated pass-through items for each day during the year he or she held the corporation's stock. For the year of the stock acquisition, the new shareholder is allocated pass-through items beginning on the day he or she acquired the stock through the end of the corporation's normal tax year, assuming the shareholder held the stock continuously throughout that period.

Electing to Apply the Specific Accounting Rules

The new shareholder's stock acquisition may result in the complete disposition of an existing shareholder's stock (e.g., the new shareholder acquired all of another shareholder's stock). In that event, the corporation can elect to

apply specific accounting rules for purposes of allocating pass-through items to shareholders, including the new one.

The new shareholder's stock acquisition may result in a "qualifying disposition" of stock, allowing the corporation to elect to apply specific accounting rules for purposes of allocating pass-through items to shareholders, including the new one. A qualifying disposition of stock results when (1) a shareholder disposes of 20% or more of the corporation's issued stock in one or more transactions within any 30-day period during the corporation's tax year, or (2) stock equal to or greater than 25% of the previously outstanding stock is issued to one or more new shareholders within any 30-day period during the corporation's tax year.

Eligible LLC Can Elect S Status

Classifying LLC as a Corporation Can Be Section 351 Transfer

An entity [such as a limited liability company (LLC)] can elect under the check-the-box rules to be classified as a corporation. If the election is made, the entity is deemed to transfer all of its assets and liabilities to the corporation in exchange for the corporation's stock. The entity is then deemed to distribute the corporation's stock to its owners in complete liquidation. The deemed transfer to the corporation is tax-free, assuming IRC Sec. 351(a) applies and the LLC's liabilities do not exceed the basis of its assets.

Eligible LLC Electing Treatment as a Corporation Can Elect S Status

An LLC or other entity that has filed a check-the-box election to be taxed as a corporation is eligible for S status. But to do so, the entity's members must be eligible to hold S corporation stock.

Filing the Election to Be Treated as a Corporation. An LLC that is eligible to elect S status and timely files an S election (Form 2553) is considered to have made the election to be taxed as a corporation. These entities are not required to file Form 8832 (Entity Classification Election). Other entities file the election to be taxed as a corporation on Form 8832 in accordance with Reg. 301.7701-3(c).

Election on Form 8832 Can Be Prospective or Retroactive. Under Reg. 301.7701-3(c), the effective date of the classification election specified on Form 8832 cannot be more than *75 days* prior to the date on which the election is filed and can not be more than twelve months after the date on which the election is filed. This means that the classification change can be retroactive for up to 75 days before the Form 8832 is filed. Under the S corporation rules, however, a newly formed corporation must file the S election on or before the *15th day of the third month* following the *activation date* of the corporation, which is the earliest date that the corporation has shareholders, acquires assets, or begins conducting business. (See Example 2A-1.) If the entity plans to make the election to be treated as a corporation and become an S corporation on the same date, only Form 2553 is filed, and it should conform to the S corporation rules. Best practices indicate that the Form 2553 be filed by the *earlier* of 75 days or two months and 15 days after the date the S election is to become effective. In this way, the Form 2553 will be filed within both the Form 8832 and Form 2553 filing limits.

Election to Be Treated as a Corporation Remains Effective until Another Entity Classification Is Made. An entity that makes the deemed election to be taxed as a corporation by filing the S election, Form 2553, will be classified as a corporation on the date the S election is effective, and will continue to be treated as a corporation until it makes another entity classification. If an entity elects to change its classification, it cannot change its classification again during the 60 months after the effective date of the election without IRS permission. Before a change in classification takes place, the practitioner must consider the tax effects of the change. For example, the reclassification of a corporation to a partnership under the check-the-box regulations is a complete liquidation of the corporation.

Filing Form 2553 When an LLC Elects S Status

Effective Date of S Election If LLC Is Currently Treated as a Corporation. If the S election is being made by an LLC that is currently treated as a corporation under the check-the-box provisions, the rules relating to C corporations apply. The Form 2553 (Election by a Small Business Corporation) must be filed (1) during the tax year preceding the first tax year the S election is to be effective, or (2) on or before the 15th day of the third month of the initial S

year. S status begins on the day following the last day of the LLC's tax year, so the effective date of the S election will generally be January 1.

Effective Date of S Election If LLC Is Simultaneously Making Election to Be Treated as a Corporation. An LLC that is making the election to be treated as a corporation and become an S corporation on the same date is not required to have the S election become effective at the first of the tax year. Rather, the election can be retroactive or prospective within the time limits surrounding the date the Form 2553 is filed, which is generally (1) no more than 75 days prior to the date on which the election is filed and (2) no more than 12 months after the date on which the election is filed. (See "Election Can Be Prospective or Retroactive" earlier in this lesson.) The LLC makes the election to be classified as a corporation on Form 2553; no Form 8832 is required.

To recap, an LLC that is making the election to be treated as a corporation and become an S corporation on the same date can generally have the S election become effective retroactively up to 75 days before the Form 2553 is filed. Alternatively, the election can become effective on a specified date within 12 months after the Form 2553 is filed. (Allowing an LLC to make a mid-year S election makes sense because a newly electing S corporation can begin its first S year at any allowable date, as discussed earlier in this lesson.)

Date of Incorporation and Number of Shares. Completing Form 2553 can be challenging because no actual incorporation takes place and no shares are issued. The instructions to the Form 2553 offer some guidance on how to fill out the Form 2553 under these circumstances. However, the Form 2553 does not divulge how an LLC shows the effective date or state of incorporation. It would seem logical to show the effective date of the Form 8832 (if one is filed) as the "date incorporated" on Form 2553. If Form 8832 has been filed, best practices suggest that a copy of the Form 8832 be attached to the Form 2553, along with an explanatory statement that the entity has made the check-the-box election and is now making the S election. If Form 8832 is not filed, the effective date of the S election could be entered. The state of incorporation is evidently the state where the entity was formed. The instructions say that the number-of-shares and date acquired sections of Form 2553 should show each individual's percentage of ownership and the date (or dates) acquired. If Form 8832 is not filed, best practices suggest that a statement be attached to the Form 2553 stating that the entity is making an election to be classified as an association taxable as a corporation under Reg. 301.7701-3(c)(1)(v)(C).

Relief Provisions When Form 2553 or Form 8832 Are Not Timely Filed

The IRS provides a simplified method for requesting relief when an entity that intended to be classified as an association taxable as a corporation on the date the S election became effective failed to timely file Form 2553 (and Form 8832, if required). Relief under this procedure allows an entity that fits the requirements to be an S corporation from the date it originally intended to elect S status, even though the form(s) were not timely filed. Reasonable cause must be given for the failure to timely submit the Form 2553 or both forms.

Relief under Rev. Proc. 2013-30. Rev. Proc. 2013-30 allows the entity to elect S status by filing Form 2553 with its first Form 1120S. The forms must be filed within three years and 75 days after the original intended effective date of the election, excluding extensions. The information and statements required by Rev. Proc. 2013-30 and additional statements relating to a late corporate classification election (required by Rev. Proc. 2013-30, Section 5.03) must be submitted with the Form 2553. If this revenue procedure is followed, Form 8832 is not required to be filed; only Form 2553 and related statements are attached to the Form 1120S.

Electing S Status by LLC Treated as Partnership

When an LLC treated as a partnership files Form 8832 or Form 2553 and elects to be taxed as a corporation, the transaction is treated as a liquidation of the partnership and formation of a corporation. This can cause tax issues such as those encountered when a partnership incorporates.

LLC Converting to S Status Must Conform to S Corporation Rules

Once the LLC has elected S status, the entity is operating as an S corporation and, therefore, must conform to the S corporation rules. Furthermore, once the S election is effective, the LLC members will be treated as shareholders. Member/shareholders who provide services to the corporation are employees of the corporation and their compensation is subject to payroll taxes.

To meet the S corporation eligibility requirements, the operating agreement and any other pre-S election documents based on the LLC's treatment as a partnership must be amended or replaced. If, for example, the LLC's operating agreement allows special allocations of income or loss to be passed through to members, the LLC is not eligible to be treated as an S corporation because it would be considered to have more than one class of stock. [An S corporation has one class of stock only if all outstanding shares (which in the case of an LLC would be membership interests) confer identical rights to distribution and liquidation proceeds. Differences in voting rights are ignored.] Allocations based on anything other than percentage of ownership breach the one-class-of-stock rule.

The operating agreement of an LLC operating as a partnership may specify that certain members are general partners and other members are limited partners. The IRS has ruled that the general and limited partnership interests that confer identical rights to distribution and liquidation proceeds satisfy the one-class-of-stock requirement. However, the IRS will no longer issue advance rulings on whether state-law limited partnerships that check the box to be taxed as corporations have more than one class of stock.

S Corporation with Single-member LLC as Shareholder Must File Schedule B-1

When a disregarded entity, such as a single-member LLC, holds stock in an S corporation, the "Yes" box on line 3 of Form 1120S, Schedule B is checked. Furthermore, Schedule B-1 (Information on Certain Shareholders of an S Corporation) must be filed with the Form 1120S to provide specified information (such as Social Security numbers) relating to the shareholder and the entity or individual responsible for reporting the shareholder's portion of the S corporation's pass-through items.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. The IRS provides several ways to obtain relief from invalid elections. Which of the following methods described below requires a user fee?

    a. Request a letter ruling from the IRS to obtain relief from an invalid election.

    b. Extension for omitted shareholder consents.

    c. Relief under Rev. Proc. 2003-43 due to late election by the company.

    d. Relief from failure to file ESBT or QSST election.

14. The three-year and 75-day limit does not apply to corporations that fail to qualify as an S corporation when certain situations occur. In which of the following examples does the corporation fail to qualify as an S corporation?

    a. CorpA omitted statements from all shareholders that they have reported their income consistent with S status from their completed Form 2553.

    b. Under Rev. Proc. 2013-30, CorpB did not apply simultaneously for relief from a late corporate classification election and a late S corporation election.

    c. At least 90 days have passed since the date on which CorpC filed its tax return for the first year CorpC intended to be an S corporation.

    d. The IRS notified CorpD and its shareholders of problems concerning the S corporation status within three months of the date on which the Form 1120S for the first year was timely filed.

15. Which of the following statements is correct regarding admitting a new shareholder to an S corporation?

    a. Corporations are not allowed to elect to implement specific accounting rules for purposes of allocating pass-through items to shareholders.

    b. The IRS requires shareholders to consent to the S election if they acquire stock after the election is filed.

    c. S status is terminated if a shareholder transfers stock to a shareholder who owns more than half of the outstanding stock and voluntarily revokes the election.

    d. A qualifying stock disposition results when stock equal to or greater than 50% of the previously outstanding stock is distributed to one or more new shareholders within any 90-day period during the corporation's tax year.

16. Which of the following statements is correct regarding how eligible limited liability company's (LLCs) can elect S status?

    a. If an LLC elects under the check-the-box rules to be classified as a corporation, the entity is deemed to transfer all of its assets and liabilities to the corporation in exchange for the corporation's stock.

    b. An LLC should file the election to be taxed as a corporation on Form 2553.

    c. Forms 2553 and 8832 should be filed if the entity plans to make the election to become an S corporation and be treated as a corporation on the same date.

    d. An LLC that has filed a check-the-box election to be taxed as a corporation is not eligible for S corporation status.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. The IRS provides several ways to obtain relief from invalid elections. Which of the methods described below requires a user fee? **(Page 210)**

    a. Request a letter ruling from the IRS to obtain relief from an invalid election. [This answer is correct. The S corporation can request relief from an invalid election by obtaining a letter ruling. A user fee applies to this election.]

    b. Extension for omitted shareholder consents. [This answer is incorrect. If the election is invalid because shareholder consents were omitted, Reg. 1.1362-6(b)(3)(iii) provides that the S corporation can request an extension of time to furnish the consent. No user fee is required for this election.]

    c. Relief under Rev. Proc. 2003-43 due to late election by the company. [This answer is incorrect. If the election is late, relief is provided under Rev. Proc. 2013-30, which allows the S corporation to file Form 2553. No user fee is required.]

    d. Relief from failure to file ESBT or QSST election. [This answer is incorrect. If an ESBT trustee or QSST beneficiary fails to make the ESBT or QSST election, S status can terminate. Rev. Proc. 2013-30 provides relief from S corporation termination when an ESBT or QSST election is inadvertently not filed. No user fee is required.]

14. The three-year and 75-day limit does not apply to corporations that fail to qualify as an S corporation when certain situations occur. In which of the following examples does the corporation fail to qualify as an S corporation? **(Page 210)**

    a. CorpA omitted statements from all shareholders that they have reported their income consistent with S status from their completed Form 2553. [This answer is incorrect. The three-year and 75-day limit does not apply to a corporation that fails to qualify as an S corporation if the completed Form 2553 includes statements from all shareholders that they have reported their income consistent with S status.]

    b. Under Rev. Proc. 2013-30, CorpB did not apply simultaneously for relief from a late corporate classification election and a late S corporation election. [This answer is correct. According to Rev. Proc. 2013-30, Sec. 5.04, the three-year and 75-day limit does not apply to a corporation that fails to qualify as an S corporation if the corporation is not applying for relief from both a late S corporation election and a late corporate classification election simultaneously under Rev. Proc. 2013-30.]

    c. At least 90 days have passed since the date on which CorpC filed its tax return for the first year CorpC intended to be an S corporation. [This answer is incorrect. The three-year and 75-day limit does not apply to a corporation that fails to qualify as an S corporation if at least six months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation.]

    d. The IRS notified CorpD and its shareholders of problems concerning the S corporation status within three months of the date on which the Form 1120S for the first year was timely filed. [This answer is incorrect. The three-year and 75-day limit does not apply to a corporation that fails to qualify as an S corporation if neither the corporation nor any of its shareholders were notified by the IRS of any problem regarding the S corporation's status within six months of the date on which the Form 1120S for the first year was timely filed.]

15. Which of the following statements is correct regarding admitting a new shareholder to an S corporation? **(Page 214)**

    a. Corporations are not allowed to elect to implement specific accounting rules for purposes of allocating pass-through items to shareholders. [This answer is incorrect. A corporation can elect to apply specific accounting rules for purposes of allocating pass-through items to shareholders, including the new one when the new shareholder's stock acquisition may result in the complete disposition of an existing shareholder's stock (e.g., the new shareholder acquired all of another shareholder's stock).]

    b. The IRS requires shareholders to consent to the S election if they acquire stock after the election is filed. [This answer is incorrect. Shareholders who acquire stock after the election is filed are not required to consent to the S election. The corporation's S status is not affected, assuming the shareholder is eligible to hold S stock.]

    c. S status is terminated if a shareholder transfers stock to a shareholder who owns more than half of the outstanding stock and voluntarily revokes the election. [This answer is correct. S status would terminate if the shareholder transfers stock to an ineligible shareholder or the shareholder owns more than 50% of the outstanding stock and voluntarily revokes the S election.]

    d. A qualifying stock disposition results when stock equal to or greater than 50% of the previously outstanding stock is distributed to one or more new shareholders within any 90-day period during the corporation's tax year. [This answer is incorrect. A qualifying disposition of stock results when (1) a shareholder disposes of 20% or more of the corporation's issued stock in one or more transactions within any 30-day period during the corporation's tax year, or (2) stock equal to or greater than 25% of the previously outstanding stock is issued to one or more new shareholders within any 30-day period during the corporation's tax year.]

16. Which of the following statements is correct regarding how eligible limited liability companies (LLCs) can elect S status? **(Page 215)**

    a. If an LLC elects under the check-the-box rules to be classified as a corporation, the entity is deemed to transfer all of its assets and liabilities to the corporation in exchange for the corporation's stock. [This answer is correct. An entity, such as a limited liability company (LLC), can elect under the check-the-box rules to be classified as a corporation. If the election is made, the entity is deemed to transfer all of its assets and liabilities to the corporation in exchange for the corporation's stock.]

    b. An LLC should file the election to be taxed as a corporation on Form 2553. [This answer is incorrect. The entity normally files the election to be taxed as a corporation on Form 8832 (Entity Classification Election) in accordance with Reg. 301.7701-3(c). However, if an LLC that is eligible to elect S status timely files an S election (Form 2553); the entity is considered to have made the election to be taxed as a corporation.]

    c. Forms 2553 and 8832 should be filed if the entity plans to make the election to become an S corporation and be treated as a corporation on the same date. [This answer is incorrect. If the entity plans to make the election to be treated as a corporation and become an S corporation on the same date, only Form 2553 is filed, and it should conform to the S corporation rules.]

    d. An LLC that has filed a check-the-box election to be taxed as a corporation is not eligible for S corporation status. [This answer is incorrect. An LLC or other entity that has filed a check-the-box election to be taxed as a corporation is eligible for S status, but the entity's members must be eligible to hold S corporation stock.]

Lesson 3: Incorporation and Capitalization

Introduction

Many issues must be addressed when incorporating a business. The complexity of any incorporation increases significantly as additional factors such as multiple owners, property transfers, and assumption of liabilities are brought into consideration. Frequently, some of these issues are simplified if a business is incorporated with the intention of electing S status; however, because of the unique, limiting aspects of S corporation capital structure, additional intricacies continue to challenge practitioners.

This lesson focuses on the compliance issues practitioners encounter most frequently when a business is incorporated. Primarily, these issues are related to IRC Sec. 351 (i.e., recognition of gain or loss), corporate basis of assets transferred, and shareholder loans to the corporation. See lesson 1 for a discussion of S corporation eligibility requirements, including limitations on classes of stock, eligible shareholders, and corporate affiliations.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the Section 351 requirements regarding incorporation and partnerships electing S status, how incorporation can be taxable, and how S corporations file Form 1120S.

Incorporating Tax-free under IRC Section 351

Section 351 Requirements

IRC Sec. 351 provides that the transfer of assets and liabilities to a newly formed or existing corporation solely in exchange for stock generally does not result in recognition of gain or loss by the transferor/shareholder. (Under IRC Sec. 1032, the transferee/corporation also does not recognize gain or loss.) Nonrecognition of gain or loss on this type of transaction is mandatory rather than elective. The transfer of assets and liabilities to a corporation is tax free if the following conditions are fulfilled:

1. *Property.* The corporation must receive property for the transfer to be treated as tax-free. *Property* includes (but is not limited to) cash, stock, partnership interests, oil and gas interests, and intangible assets such as goodwill, patents, etc. Stock that is issued in exchange for services rendered or to be rendered to or for the benefit of the corporation will not be treated as having been issued in return for property. (However, a person who both renders services and transfers property to a corporation in exchange for its stock is not automatically excluded from the "control" determination. See item 3 and Example 3A-1.)

2. *Stock.* The transfer must be solely in exchange for stock of the transferee corporation. The term *stock* generally includes all types of common and preferred stock, but assuming the corporation wants to retain its S election, the outstanding shares must confer identical rights to distribution and liquidation proceeds but can have differences in voting rights. Stock rights, stock warrants, and debt instruments (such as corporate bonds or debentures) are not *stock* for the purposes of IRC Sec. 351. Note that a transferor who receives money or other property (i.e., "boot") in addition to stock may have to recognize part or all of any gain realized in the transfer.

3. *Control.* The persons making the transfer, taken as a group, must be in control of the transferee corporation immediately following the exchange. To be in control, the transferors must own immediately after the transfer: (a) at least 80% of the total combined voting power of all stock entitled to vote and (b) at least 80% of the total number of shares of all nonvoting stock issued by the corporation. [Remember, with the exception of differences in voting rights, an S corporation cannot have more than one class of stock.] All of the stock received by a person who obtains stock in exchange for property and services is considered for purposes of the control test if the fair market value (FMV) of the property transferred to the corporation is at least 10% of the FMV of the stock or securities received by that person for services rendered.

4. *Business Purpose.* Although not mentioned in either IRC Sec. 351 or the related regulations, the IRS has created an additional requirement for a tax-free incorporation. The requirement for the transaction to have a business purpose is ultimately based on the overlap of the Section 368 (reorganization) provisions, which specifically require a business purpose, with IRC Sec. 351. Providing for the orderly transfer of a business from one generation to the next is an acceptable business purpose. Incorporating to take advantage of the liability protection of the corporate form of doing business should also be an acceptable purpose. Certain tax shelter transactions, however, will fail the business purpose test.

Section 351 Is Not Elective. IRC Sec. 351 is not an elective provision. If the requirements of IRC Sec. 351 are met, the exchange of property for stock is tax free at the corporate and shareholder levels.

Required Disclosure. Each significant transferor who transfers property to and receives stock from the transferee corporation in a Section 351 incorporation must disclose certain facts pertinent to the exchange. The transferee corporation must file a similar disclosure statement.

Both the transferee corporation and any significant transferors must file the information statement. A significant transferor is a person who transfers property to a corporation in exchange for that corporation's stock in a Section 351 exchange and who, immediately after the transaction, owns at least 1% (by vote or value) (5% if the stock is publicly traded) of the corporation's outstanding stock. A transferee corporation is not required to file the information statement if all the information that would have been included is reported on a statement filed by a significant transferor in the same Section 351 exchange and that statement is attached to the same tax return (e.g., members of a consolidated group participate in a Section 351 exchange).

The statements must be attached to the tax returns of the significant transferors and of the transferee corporation for the year of the Section 351 exchange.

In addition, all parties to the transaction must retain permanent records with information regarding the amount, basis, and fair market value of all transferred property and relevant facts regarding any liabilities assumed or extinguished in the exchange. These records must be made available to the IRS if requested.

Example 3A-1 Section 351 requirements.

Ned and Ursula formed Nuco, a corporation that manufactures ball bearings. Ursula contributed $125,000 cash in exchange for 50 shares (33%) of Nuco's voting stock and 75 shares (75%) of Nuco's nonvoting stock. Ned contributed equipment valued at $100,000 in exchange for 100 shares (67%) of Nuco's voting stock. (His adjusted basis in the equipment is $60,000.) He also received 25 shares (25%) of Nuco's nonvoting stock in exchange for consulting services valued at $25,000 that he will provide in starting up the business. A summary of the transfers follows.

	Basis of Contribution	FMV of Contribution	Voting Shares Received	Nonvoting Shares Received
Ursula:				
Cash	$ 125,000	$ 125,000	50	75
Ned:				
Machinery and equipment	60,000	100,000	100	—
Future services	—	25,000	—	25
Totals			150	100

The transfers meet the requirements of IRC Sec. 351 and thus will be tax-free. As a group, Ned and Ursula have transferred property solely in exchange for stock that represents control. Nuco issued 150 shares (100%) of its voting stock and 100 shares (100%) of its nonvoting stock in exchange for property (equipment and cash) and services rendered by a person who also transferred substantial property in relation to services to be rendered.

Ned received stock in exchange for both property and services. Since the FMV of the property transferred by Ned ($100,000) is at least 10% of the FMV of the stock he received ($125,000), the stock received in exchange

for services is counted in determining whether the transferors are in control after the exchange. Ned realizes ordinary (compensation) income to the extent of the fair market value of the nonvoting stock he received (i.e., $25,000). Nuco is entitled to an ordinary deduction based on the fair market value of the nonvoting stock it issued in exchange for services. The timing of Nuco's deduction should be the same as if it paid for such services with cash.

Ned's basis in his stock is $85,000 ($60,000 + $25,000). Ursula's basis in her stock is $125,000. The corporation's basis in the property received from Ned is $60,000. (See "Basis to Transferor and Transferee" later in this lesson.)

The consequences of failing to meet the 80% control test after the exchange are illustrated below.

Example 3A-2 Lack of control immediately after the exchange.

Brad owns land that cost $50,000 but has a current FMV of $200,000. Brad transferred the land to Brick, Inc., an S corporation, in exchange for 75% of Brick's stock. The remaining 25% of Brick, Inc. is held by Patricia, who has owned the stock for several years. What are Brad's tax consequences?

Since Brad did not meet the 80% control test immediately following the exchange, he recognizes a taxable gain of $150,000. Brad's basis in the stock is $200,000 ($50,000 basis in land + $150,000 gain recognized). To avoid recognizing this gain, Brad could have negotiated with Patricia to contribute additional property or cash (along with the land) to the corporation in return for at least 80% control.

Voting Stock. An S corporation can have only one class of stock. However, differences in voting rights among shares of common stock do not cause the S corporation to lose its eligibility.

Receipt of Boot

A transferor who receives money or other property (boot) in addition to stock in a transaction that would otherwise be tax-free may be required to recognize part or all of the gain realized on the transfer. The gain recognized under IRC Sec. 351(b) is the lesser of the gain realized on the transfer, or the amount of boot (i.e., money plus the FMV of other property) received. A loss is never recognized by a transferor in an incorporation, even if boot is received.

When several assets are transferred to a corporation in a partially taxable transaction, each asset is considered transferred separately in exchange for a proportionate share of each of the various categories of consideration received. To determine the gain, the boot is allocated among the various assets in proportion to the relative fair market values of the assets transferred. The recognized gain is then determined by taking the lesser of the realized gain or boot received for each separate asset. Proposed regulations support this allocation and treatment of gain recognized; however, the guidance will not be effective until finalized. Practitioners should monitor developments in this area.

Example 3A-3 Recognition of gain upon receipt of boot.

Brenda transferred the following assets to newly formed Zeno Corporation in exchange for 100 shares of Zeno stock (all of the outstanding stock) worth $45,000 and Zeno's $20,000 note.

Description of Assets	Adjusted Basis	FMV	Gain (Loss) Realized
Equipment	$ 10,000	$ 20,000	$ 10,000
Building	20,000	40,000	20,000
Land	5,000	5,000	—
	$ 35,000	$ 65,000	$ 30,000

Brenda's recognized gain is $18,462, the lesser of the gain realized or the amount of boot received determined separately for each asset. [For example, for the equipment, the recognized gain is the lesser of the boot received ($6,154) or the realized gain ($10,000).]

Description of Assets	Transferor's Adjusted Basis	FMV of Stock Received[a]	Boot Received[a]	Realized Gain	Recognized Gain	Corporate Basis
Equipment	$ 10,000	$ 13,846	$ 6,154	$ 10,000	$ 6,154	$ 16,154
Building	20,000	27,692	12,308	20,000	12,308	32,308
Land	5,000	3,462	1,538	—	—	5,000
	$ 35,000	$ 45,000	$ 20,000	$ 30,000	$ 18,462	$ 53,462

Note:

[a] Allocation is based on FMV of assets transferred, e.g., ($20,000 ÷ $65,000) × $45,000 = $13,846.

To the extent the transaction is taxable, the character of the gain will be the same as if IRC Sec. 351 had not applied.

Loss Is Not Recognized

Loss is never recognized on an incorporation exchange even if boot is received.

Assumption of Liabilities

The assumption of liabilities by the transferee corporation is treated as boot if either of the following applies:

1. The amount of debt assumed by the corporation exceeds the transferor shareholder's aggregate basis in the property transferred. (Each transferor is considered separately for purposes of determining whether there has been a transfer of liabilities in excess of basis.)

2. There is no *bona fide* business purpose for the assumption, or the transfer is motivated by tax avoidance.

Cash-basis Accounts Payable Are Excluded When Determining if Transferred Liabilities Exceed Assets. If payment by the transferor would have resulted in a tax deduction, a cash-basis transferor's trade accounts payable (and other liabilities that relate to a business transferred) are excluded in determining whether there has been a transfer of liabilities in excess of basis. The liability is not excluded if the basis in any property has been increased by the liability.

Example 3A-4 Liabilities assumed in excess of shareholder basis.

Mike transferred land, a building, and equipment collectively worth $100,000 that have a $25,000 tax basis to Newco, Inc., a newly formed S corporation. The land is encumbered by a $60,000 bank debt that the corporation assumed. The net amount transferred, determined by using adjusted tax basis and fair market value of the property transferred, is calculated as follows:

	Basis	FMV
Land	$ 10,000	$ 75,000
Building	5,000	20,000
Equipment	10,000	5,000
Assets transferred	25,000	100,000
Liabilities transferred	(60,000)	(60,000)
Net transfer	$ (35,000)	$ 40,000

Mike receives Newco stock worth $40,000. Under IRC Sec. 357(c), he recognizes a gain of $35,000 (i.e., the amount of liabilities assumed in excess of basis, $60,000 – $25,000). See Example 3A-5.

Gain Limitation on Assumption of Liabilities. If the transfer has a business purpose and a motive other than tax avoidance for the debt assumption, the gain recognized is limited to the amount of liabilities assumed in excess of

the basis of the assets transferred. The entire amount of debt assumed is treated as boot if the transfer has no business purpose or if the transfer of debt is motivated by tax avoidance.

Transferring Recourse Liabilities. A recourse liability transferred as part of a Section 351 transfer will be treated as having been assumed by the transferee to the extent, based on all the facts and circumstances, the transferee has agreed to, and is expected to, pay the liability. This is the case whether or not the transferor has been relieved of the liability. Thus, a corporation does not automatically assume a liability simply because an asset subject to that liability is transferred to the corporation. As a result, the transferor will not be deemed to have received boot to the extent the liability is not actually assumed, but neither will the corporation receive a step-up in basis for the liability that it did not actually assume.

Transferring Nonrecourse Liabilities. A nonrecourse liability will be treated as having been assumed by the transferee of any asset subject to such liability. However, the amount of the liability assumed must be reduced by the lesser of (1) the portion of the liability to which an owner of assets, subject to the same liability but not transferred to the corporation, has agreed to personally satisfy, or (2) the fair market value of such other assets subject to the same liability.

Characterization of Gain Recognized

The character of any gain recognized by the transferor depends on the nature of the assets transferred and must be considered separately. Therefore, gains recognized on the transfer of inventory items are ordinary gains; gains recognized on the transfer of capital assets are capital gains; and gains recognized on the transfer of depreciable business assets are Section 1231 gains (subject to Section 1245 and Section 1250 recapture).

Example 3A-5 Characterization of gain recognized on transfer for stock.

Assume the same facts as in Example 3A-4. For reporting purposes in Mike's tax return, the $35,000 recognized gain will take on the character of the assets transferred. Under Reg. 1.357-2(b), the gain recognized is allocated to each asset using relative fair market values. Given the bases and values shown below, this allocation is accomplished as follows:

	FMV	Allocated Gain
Land	$ 75,000	$ 26,250
Building	20,000	7,000
Equipment	5,000	1,750
Totals	$ 100,000	$ 35,000

In general, the gain allocated to each asset will be recognized without regard to what the gain would be if each separate asset were treated as separately exchanged for stock. Thus, the $35,000 gain allocated under Reg. 1.357-2 will be recognized even if the basis of any individual asset in Mike's hands exceeded the asset's FMV (as is the case with the equipment). Given that the gain allocated to the equipment will be recognized, its character apparently must be determined as if the equipment had a FMV sufficient to generate a $1,750 gain. Accordingly, if $1,000 of depreciation had been claimed on the equipment prior to its transfer, the gain presumably will consist of $1,000 of ordinary income (i.e., depreciation recapture) and $750 of Section 1231 gain (which generally results in capital gain).

Cash method farmers have particular exposure to the problem of assumed liabilities exceeding transferred assets because such a farmer's raised inventory (e.g., livestock or grain) has zero tax basis. When liabilities assumed by the corporation exceed transferred assets, the recognized gain takes on the character of the assets transferred. (See Example 3A-4.) In *Seggerman Farms, Inc.*, the income recognized was treated as ordinary income because it related to zero-basis raised grain and depreciated equipment.

Reporting Gain Realized on Boot Received in a Section 351 Exchange. A transferor who receives boot in addition to stock in a Section 351 exchange may have to recognize part or all of any gain realized in the transfer on his or her Form 1040. Gain on sales or exchanges of most business assets other than capital assets and inventory are shown on an individual's Form 4797 (Sales of Business Property). Gain on sales or exchanges of capital assets are shown on Schedule D. Gain on sales or exchanges of inventory or stock in trade are shown on Schedule C or Schedule F and thus are included in the taxpayer's self-employment (SE) tax calculation. SE income does not include gains or losses (whether capital, Section 1231, or ordinary) from sales of business property that is other than inventory or stock in trade.

Basis to Transferor and Transferee

Transferor Shareholder. When no gain is recognized in a transfer because of the provisions of IRC Sec. 351, the basis of the stock received by the transferor is the same as the basis of the property contributed to the corporation (i.e., the stock has a substituted basis). When a transfer involves boot (i.e., stock and other property, including securities), the basis of stock received by the shareholder equals the basis of the property transferred, plus any gain recognized by the shareholder, less the amount of money and FMV of other property received by the shareholder.

Transferee Corporation. The basis of the property received by a transferee corporation in exchange for its stock is equal to the transferor's basis in the property. The corporation's basis in the property is increased by the amount of gain recognized by the shareholder when a shareholder receives boot or when the corporation assumes liabilities in excess of basis. However, the transferee corporation's basis in the acquired property cannot exceed the actual FMV of that property. For purposes of this provision, the rule under IRC Sec. 7701(g) that treats property subject to a nonrecourse debt as having a FMV of at least the amount of that debt does not apply.

If the transferor reports the wrong amount of gain, the amount of gain to be taken into account in determining the corporation's basis is the amount that is properly recognizable, not the amount actually recognized—regardless of whether the amount properly recognizable is more or less than the erroneous amount actually recognized. If no gain is recognized, the corporation's basis in each asset is the same as it had been in the transferor's hands.

Example 3A-6 Corporation's basis in transferred property and shareholder's basis in stock.

Assume the same facts as in Example 3A-4. Newco's basis in the assets is $60,000, determined as follows:

Transferor's basis in transferred property	$ 25,000
Transferor's recognized gain on the transfer	35,000
Corporation's basis in transferred property	$ 60,000

If Newco had not assumed the liability, Newco's basis in the assets would be $25,000 (i.e., Mike's adjusted basis). Example 3A-7 illustrates how to allocate the corporation's basis in transferred property.

Mike's basis in the stock received from Newco is zero, calculated as follows:

Transferor's basis in transferred property	$ 25,000
Liabilities assumed by the corporation	(60,000)
Net transfer	(35,000)
Transferor's recognized gain on the transfer	35,000
Transferor's basis in stock	$ -0-

Example 3A-7 Allocating corporation's basis in transferred property.

Don transferred two assets to Donco for stock and $25,000 cash. The assets are (1) land valued at $45,000 and having a basis of $5,000 in the hands of the transferor, and (2) a building valued at $55,000 and having an adjusted basis of $5,000 in the hands of the transferor. Don recognizes gain to the extent of the boot ($25,000). Don's gain is allocated based on the relative fair market values of the contributed property (see

Example 3A-5). As shown in the following calculation, his $25,000 gain is made up of $11,250 on the land and $13,750 on the building. The corporation's basis in the assets is $35,000 [i.e., Don's adjusted basis ($10,000) plus his $25,000 gain]. The relative values and bases are:

	Land	Building	Total
FMV of assets transferred	$ 45,000	$ 55,000	$ 100,000
Relative FMV	45%	55%	100%
Adjusted basis in the hands of the transferor	$ 5,000	$ 5,000	$ 10,000
Relative adjusted basis	50%	50%	100%
Basis to corporation if allocation is based on relative FMV of assets:			
Carryover element of basis	$ 5,000	$ 5,000	$ 10,000
Gain allocation (45/55)	11,250	13,750	25,000
Basis to corporation	$ 16,250	$ 18,750	$ 35,000
Basis to corporation if allocation is based on relative pre-exchange basis:			
Carryover element of basis	$ 5,000	$ 5,000	$ 10,000
Gain allocation (50/50)	12,500	12,500	25,000
Basis to corporation	$ 17,500	$ 17,500	$ 35,000

Without considering any additional factors (such as how long Donco plans to hold each asset), the corporation will benefit from allocating as much of the gain as possible to the building because this maximizes depreciation deductions. Thus, Donco uses an allocation based on the relative FMV of the assets.

Holding Period

The holding period of stock received by the shareholder in a tax-free exchange includes the shareholder's holding period for the property transferred, if the property was either a capital asset or real or depreciable property used in a business and held for more than 12 months. The holding period for stock constructively received in exchange for ordinary income assets does not include the transferor's holding period. That stock has a holding period beginning on the day after the exchange. The corporation's holding period for property received in an exchange includes the holding period of the transferor. This can cause each share of stock to have a "split" holding period.

Bankruptcy and Investment Company Exceptions to the Nonrecognition Rule

The Section 351 tax-free exchange provisions do not apply to (1) certain transfers by debtors in bankruptcy or (2) certain transfers to a regulated investment company (defined in IRC Sec. 851), a real estate investment trust (defined in IRC Sec. 856), or a corporation with more than 80% of its assets (excluding cash and nonconvertible debt obligations) being readily marketable assets held for investment.

Section 351 Transfers to an Existing Corporation

IRC Sec. 351 allows nontaxable transfers of assets to a corporation after its initial incorporation. As discussed earlier in this lesson, IRC Sec. 351 requires that the transferor shareholders own immediately after the transfer at least (1) 80% of the total combined voting power and (2) 80% of the total nonvoting shares. A common problem with these subsequent transfers occurs when either an existing or new shareholder who does not meet the 80% control requirement intends to contribute assets to the corporation in exchange for additional stock. This problem can be solved if other shareholders contribute additional assets to the corporation, so that the group of transferor shareholders has at least 80% control. Reg. 1.351-1(a)(1)(ii) provides, however, that the stock issued for contributed property cannot be of relatively small value in comparison to the stock already owned (or issued for services) if the primary purpose of the property transfer is to qualify the transfers of other shareholders as tax free.

Neither the Code nor the regulations specifically state what "relatively small value" means, but the IRS clarified that if the FMV of the property transferred equals or exceeds 10% of the FMV of the stock already owned (or to be

received for services) by that shareholder, the transfer of property will not be considered to be of relatively small value. Therefore, the existing shareholders must transfer assets with a value of greater than 10% of their present stock holdings for the transaction to qualify as a tax-free exchange under IRC Sec. 351.

Example 3A-8 Section 351 treatment of property transferred for stock of existing corporation.

Four D's, Inc., is an S corporation with 400 shares of voting common stock outstanding. Diane, Digby, Dee, and David each own 100 shares with a value of $50 a share, or $5,000. Diane received another 100 shares in exchange for property that she transferred to the corporation. The transfer does not qualify for tax-free treatment under IRC Sec. 351 because Diane only has 40% (200/500) of the shares after the transfer. If Digby and Dee also contribute property in exchange for, say, 20 shares of stock each, after the transfers Diane will hold 200 shares, Digby and Dee will each own 120 shares, and David will hold 100 shares. Thus, IRC Sec. 351 will apply because the transferor shareholders will own 81% (440/540) of the outstanding stock and will pass the control test. The FMV of the property transferred to the corporation by Digby and Dee will need to be more than $500 each (10% of their $5,000 stock value) so that their property transfers will not be considered to be of relatively small value, in which case Digby's and Dee's shares would not be counted when performing the 80% control test.

Expenditures Paid to Facilitate a Section 351 Transfer Are Capitalized

Expenditures paid to facilitate (i.e., an amount paid in the process of investigating or otherwise pursuing) a Section 351 transfer must be capitalized under IRC Sec. 263. However, taxpayers can elect to deduct or amortize traditional organizational costs incurred in a Section 351 transaction under IRC Sec. 248, as discussed in lesson 4.

Incorporating a Proprietorship or Partnership and Electing S Status

Accounts Receivable and Payable Assumed by Corporation

The incorporation of a proprietorship or partnership frequently involves the transfer of accounts receivable and payable to the new corporation. When the proprietorship or partnership is on the cash method of accounting, the receivables and payables will have a zero basis in the proprietorship's or partnership's hands.

In general, a corporation's basis in assets received in a Section 351 exchange equals the basis of such assets in the hands of the transferor immediately prior to the exchange. If subject to IRC Sec. 351, the transfer of accounts receivable and payable will not trigger transferor-shareholder gain or loss recognition. The transferee corporation must report in its income the cash-basis accounts receivable when collected and will be able to deduct payments of cash-basis liabilities that qualify for deduction under IRC Sec. 162.

Facts that appeared to be critical in the IRS rulings allowing Section 351 treatment to cash-basis accounts receivable and accounts payable were: (1) all assets and liabilities of an ongoing business were transferred; (2) there were valid business reasons for the transfer; (3) the transfer did not constitute an assignment of income; and (4) there was not an inappropriate separation of income from related expenses. Transfers of liabilities that fall outside the scope of these rulings may be capital expenditures instead of deductions (*Leavitt*).

Cash-basis Accounts Receivable and Payable Assumed by an Accrual-basis Corporation

Accounts Receivable. A proprietorship or partnership is generally not subject to gain recognition when the entity transfers accounts receivable to a corporation, and this includes a corporation that will use the accrual method. Thus, if all assets and liabilities of an ongoing business were transferred, and the other requirements are met, the transferor proprietorship or partnership recognizes no gain on the transfer of the cash-basis accounts receivable. The corporation reports income from the accounts receivable as they are collected. (See *Kniffen*.)

Accounts Payable. Cash-basis accounts payable (like cash-basis accounts receivable) can generally be transferred to a corporation under IRC Sec. 351 without gain recognition at the transferor proprietorship or partnership level. All assets and liabilities of the ongoing business should be transferred, and the other requirements discussed earlier in this section should be met. The IRS has ruled that, if the incorporation is bona fide and the new cash-basis

corporation carries on an active business, it will obtain a deduction when it pays the payable. Although the IRS will generally follow the position it took in this ruling, it is still possible for the IRS to take a contrary stance if it determines that the assignment of income or the clear reflection of income doctrines apply or that the transfer was motivated by tax avoidance reasons.

Payment of Payables. There is some uncertainty about the deductibility of the cash basis payable when it is later paid by an accrual-basis corporation. Unfortunately Rev. Rul. 80-198 does not address the issue when the transferee is on the accrual basis. The IRS has successfully defended its position that the deductibility of the underlying expenses by the transferee corporation is not allowed because the corporation was not the taxpayer who incurred the expenses (*Holdcroft Transportation Co.*). This position results in a complete disallowance of the deductibility of the expenses because the proprietor, who incurred but did not pay the expenses, would also not be allowed a deduction. However, the IRS does not follow the ruling in the *Holdcroft Transportation Co.* case in situations where the liability assumed by the corporation is related to property the corporation received in a Section 351 transaction, and the expense would have been deductible by the proprietor (i.e., not a capital expenditure). Thus, such expenses should be deductible when paid by the transferee corporation.

Example 3B-1 Incorporating a cash-basis business and transferring accounts receivable and accounts payable to an accrual-basis corporation.

For many years, Joan operated a computer consulting business as a sole proprietorship using the cash method. This year she incorporated her business. The new corporation uses the accrual method of accounting. Because all but a few thousand dollars of her receivables are collected before year-end, she does not anticipate this will accelerate taxation of income. The following is an accrual-basis balance sheet for the business as of the end of the year:

Assets	
Cash	$ 25,000
Accounts receivable	5,000
Supplies	3,000
Equipment	300,000
Accumulated depreciation—equipment	(70,000)
Total assets	$ 263,000
Liabilities	
Accounts payable—supplies	$ 2,000
Accounts payable—payroll taxes	500
Loan payable—Joan	25,000
Note payable—Bank	25,000
Total liabilities	52,500
Owner's equity	210,500
Total liabilities and equity	$ 263,000

The transfer of the receivables to the corporation does not cause a problem. The corporation will include them in income as they are received.

However, the accounts payable are a different matter. If the IRS takes the position that the deductibility of the underlying expenses by the transferee corporation is not allowed because the corporation was not the taxpayer who incurred the expenses, this position would result in a complete disallowance of the deductibility of the expenses. Because Joan could have deducted the supplies or payroll taxes had she paid for them, the corporation should be able to deduct the expenses when economic performance occurs for the items. Alternatively, Joan could have retained enough of the cash-basis receivables to pay the cash-basis payables rather than transfer the payables to the corporation, thereby assuring deductibility.

Transferring Accounts Payable While Retaining Accounts Receivable. Tax benefits can be gained by transferring accounts receivable to the corporation, but retaining the accounts payable.

Example 3B-2 Transferring accounts receivable and retaining accounts payable when incorporating.

Mark operated his business as a cash basis sole proprietorship. He elected a tax year ending September 30 for his newly formed cash basis corporation and transferred accounts receivable (but not accounts payable) to the corporation. He will be able to deduct the expenses arising from the payables on his personal return several months before the corporation is required to report the income on its tax return.

Mark should be prepared to show that there was a business reason for retaining the accounts payable. For instance, he might claim that he wanted the new corporation to have sufficient working capital from its inception to operate independently. Therefore, the decision was made to burden the corporation with as little debt as possible.

However, when a shareholder retains accounts payable without a valid business reason, the IRS may assert a tax avoidance purpose because the transfer separates income from related expenses. The tax burden that might result from Mark's original transfer of assets being recharacterized by the IRS as a taxable sale or exchange should be weighed before deciding to retain the accounts payable.

Basis of Stock and Property Received by Shareholder

A Section 351 tax-free incorporation, like other tax-free exchanges, is actually a tax-deferred exchange. The transfer of property in a Section 351 transaction delays the recognition of gain until a taxable event occurs (e.g., sale of the property or the stock of the corporation, or liquidation of the corporation). When no gain is recognized in a transfer because of the provisions of IRC Sec. 351, the basis of the stock received by the transferor is the same as the basis of the property contributed to the corporation (i.e., the stock has a substituted basis). When a transfer involves boot (i.e., stock and other property, including securities), the basis of stock received by the shareholder equals the basis of the property transferred, plus any gain recognized by the shareholder, less the amount of money and FMV of other property received by the shareholder.

Allocation of Transferor Shareholder's Basis and Holding Period

When more than one asset is transferred to the corporation in exchange for stock, the IRS takes the position that the transferor shareholder's total basis in the property transferred must be allocated proportionately to the stock received. High-basis and low-basis property must be allocated proportionately to each share of stock. This prevents the possibility that shortly after the transfer the shareholder would "cash out" some shares without recognizing gain. The same proportionate allocation rule applies to the determination of holding period. For example, if 15% of the assets transferred have a holding period that began on June 1, then 15% of each share of stock is treated as having a holding period that began on the same date, June 1.

Corporate Basis of Transferred Assets

The basis of property received by a corporation in a Section 351 transfer generally is a carryover basis. That is, the corporation's basis is the same as it was in the hands of the transferor; however, the corporation's basis is increased by the amount of any gain recognized by the transferor.

Incorporating a Partnership

The business assets, liabilities, and operations of a partnership (including an LLC treated as a partnership) can be incorporated in a transaction meeting the requirements of IRC Sec. 351 in one of three ways. The form selected for incorporating a partnership determines the tax consequences of the transaction.

1. The partnership transfers its assets and liabilities to the corporation in exchange for stock of the corporation, which is then distributed to the partners in liquidation of the partnership.

2. The partnership distributes its assets and liabilities to the partners in a liquidating distribution. The partners, in turn, transfer them to the corporation in exchange for stock in the corporation.

3. The partners transfer their partnership interests to the corporation in exchange for stock in the corporation. The partnership automatically liquidates since there are no longer two or more partners; all of the partnership's assets and liabilities become assets and liabilities of the corporation.

Alternative 1 is preferable when the basis of the assets to the partnership is higher than the aggregate basis of the partnership interests to the partners. This results in the corporation taking a carryover basis in the assets on the date of the exchange. A problem with Alternative 1 is that the stock would not be considered Section 1244 stock in the hands of the individual partners. A requirement for ordinary loss treatment under IRC Sec. 1244 is that the stock must be held by the same individual from the time of issuance to the time of disposition. Even if the partnership held the stock for only an instant before it was distributed to the partners, IRC Sec. 1244 ordinary loss treatment would be denied.

Alternatives 2 and 3 may be preferable when the partners' basis in their partnership interests are higher than the basis of the assets to the partnership. In these cases, the assets received in liquidation of the partnership will be stepped up to the aggregate basis of the partners' interests in the partnership.

Partnership Can Become a Corporation and Simultaneously Elect S Status. When an eligible entity classified as a partnership elects under the Section 7701 check-the-box regulations to be treated for tax purposes as a corporation (or converts into a corporation under a state law conversion statute), the partnership is treated as contributing all of its assets and liabilities to the corporation in exchange for stock. It is also considered to have liquidated by distributing the stock of the corporation to its partners immediately before the close of the day before the election is effective. Thus, if the conversion from partnership to corporation takes place at the beginning of the year, the deemed contribution and liquidation are treated as if they took place immediately before the close of the previous tax year. This means that the entity will be a partnership until the end of the previous year and a corporation at the beginning of the new tax year. If the corporation makes a timely S corporation election for its first year, the corporation will be an S corporation for that year and there will be no intervening period during which the entity was a C corporation. If, for example, the partnership becomes a corporation on January 1, it can elect to be an S corporation on that day if the S election, Form 2553, is filed by March 15.

Payments to Retired Partner. Payments by the corporation to a retired partner (or spouse of a deceased partner) made under a former partnership agreement are deductible by the corporation.

Avoiding Abusive Tax Shelter Transactions

An area in which great caution should be exercised pertains to the use of Section 351 transfers as part of what the IRS perceives to be abusive tax shelter transactions. These transactions involve the transfer of high basis assets to a controlled corporation and the transferee corporation's assumption of a contingent liability that the transferor has not yet recognized for tax or financial purposes.

The intent of the transaction is to have the transferor receive a high basis in the transferee's stock while the FMV of the stock is much lower due to the existence of the contingent liability. The transferor can then sell the stock for its FMV, generating an immediate loss for the transferor. In addition, the transferee would be able to take a deduction for the contingent liability when, and if, it is finally paid.

Basis Reduction Rule. To address the situation outlined in the preceding paragraphs, IRC Sec. 358(h) provides that if the basis of property transferred in a Section 351 exchange exceeds the FMV of the stock received, the stock's basis must be reduced by the liabilities assumed in the exchange (including the value of any contingent liabilities assumed). This provision does not apply where the trade or business associated with the liability is transferred along with the liability.

Example 3B-3 Reducing basis in transferor's stock.

Action Corp. transfers assets with an adjusted basis and FMV of $100,000 to Battle Corp. in exchange for 100% of Battle's stock in a Section 351 exchange. Battle also assumes $30,000 of Action's contingent liabilities. Normally, the $30,000 assumed by Battle would be treated as money received by Action, reducing Action's basis in stock received. However, if Battle is able to deduct the $30,000 liability, then Action does not have to reduce its basis in stock received.

Without IRC Sec. 358(h), a double deduction for the same liability could occur. Battle would be allowed to deduct the $30,000 liability when it was paid (if deductible). In addition, Action would also be able to deduct the $30,000 when it sells its stock because it did not have to reduce its basis in the Battle stock because of IRC Sec. 358(d)(2).

The basis of the stock received by Action ($100,000) exceeds its FMV ($70,000) resulting in the application of IRC Sec. 358(h)(1). Action must reduce its basis in Battle stock to $70,000 (by the amount of liabilities assumed, but not below its FMV).

Determining Whether Taxpayer Has Tax Avoidance Intent. In *Coltec Industries*, the court established four principles to determine whether a taxpayer's intent is tax avoidance or a bona fide business purpose when transferring liabilities to a corporation in an otherwise tax-free transfer. The principles are:

1. *Whether the Transferor Incurred the Debt Prior to Contemplating a Transfer.* A debt incurred by the transferor after deciding to participate in a tax-free transfer may indicate a tax avoidance motive.

2. *Whether the Debt Is Associated with the Corporation's Customary Business.* A transfer of real property with the underlying liability to a corporation involved in real estate indicates a business purpose. A debt incurred by a transferor to purchase tax-exempt securities in his on her spouse's name, and transferred to a corporation involved in real estate, indicates a tax avoidance motive.

3. *Whether the Transferor Incurred the Debt Well before the Transfer of Stock.* A debt incurred by the transferor three months before a transfer may indicate a tax avoidance motive. A debt incurred four years before the transfer may indicate a business purpose.

4. *Whether the Corporation Is Likely to Repay the Debt.* The corporation must have sufficient assets and earning potential to repay the debt.

The IRS appealed the original decision in the *Coltec Industries* case. The Federal Circuit Court of Appeals found that in addition to the four factors previously mentioned, a transaction involving the assumption of liabilities must also have economic substance; that is, it must effect a real change in the flow of economic benefits, provide a real opportunity to make a profit, and appreciably affect the taxpayer's beneficial interest aside from creating a tax advantage. The Federal Circuit Court decided in favor of the IRS that the assumption of liabilities in this case lacked economic substance.

Potential Penalties. The IRS may impose penalties under IRC Secs. 6662A and 6707A on participants, advisers, promoters, or return preparers who become involved in abusive tax shelter arrangements and fail to meet the disclosure and reporting requirements of IRC Secs. 6011 and 6111.

Incorporating in a Taxable Transaction

Incorporation May Be Taxable

Incorporation can be partially or wholly taxable if the parties to the exchange do not meet all of the requirements of IRC Sec. 351. Sometimes circumstances make it impossible to satisfy all of the Section 351 requirements and a taxable event is unavoidable. In other situations, taxpayers intentionally design incorporations to be taxable. For example, a fully taxable transfer may be beneficial in the following situations:

1. when appreciated investment property (e.g., land) is about to be converted to ordinary income property (e.g., because of real estate development);

2. when the owners of depreciated assets want to recognize losses (when the related party rules of IRC Sec. 267 will not apply) without sacrificing control of the property; or

3. when the shareholder has expiring net operating losses or tax credits.

Because tax-free treatment is mandatory if certain requirements are met, a taxpayer who wants a taxable incorporation must avoid one or more of the conditions of IRC Sec. 351.

Example 3C-1 Intentionally avoiding a tax-free incorporation to obtain tax benefits.

Ernest has been holding land for investment but wants to build residences on the property, which will generate ordinary income when the property is sold. Because he has been planning to incorporate for the past year, he has been able to collect all receivables and satisfy all liabilities. The following is a summary of the assets he plans to transfer or sell to the corporation:

	Cost	Adjusted Basis	FMV
Cash	$ 5,000	$ 5,000	$ 5,000
Land (to be sold)	10,000	10,000	70,000
Equipment	50,000	30,000	30,000
	$ 65,000	$ 45,000	$ 105,000

The provisions of IRC Sec. 351 are mandatory when assets are transferred to a corporation solely in exchange for stock of the corporation. If Ernest transfers his assets to the corporation solely in exchange for stock, he will not recognize gain at the time of transfer, and the assets will retain the same basis they had in Ernest's sole proprietorship. Any gain on the sale of those assets at a later date will be taxed to the corporation.

However, assets can be sold to the corporation in a taxable transaction. By selling the land with a basis of $10,000 and a FMV of $70,000 to the corporation for $70,000, the transfer would be reported as a taxable transaction. He would pay tax at capital gains rates on $60,000 of income, but the sale would increase the corporation's basis in the land to $70,000, which would reduce the ordinary income when the developed land is sold.

An exchange is also fully taxable if certain assets are transferred to an investment company or if the transfer occurs pursuant to a bankruptcy proceeding.

Sales Recharacterized as Tax-free Transfers

Transactions intended to be taxable sales by the shareholder to the corporation are sometimes recharacterized by the IRS and the courts as tax-free contributions to capital under IRC Sec. 351. Thus, taxpayers should carefully document transactions between themselves and their corporations. The existence of a sales contract, a promissory note with definite terms, and corporate minutes detailing the transaction are helpful in supporting a *bona fide* sale.

Failure to successfully classify a transaction as a taxable sale rather than as a contribution to capital can have severe tax consequences to both parties (e.g., the corporation's payments to the shareholder may be treated as nondeductible corporate dividends, resulting in a taxable dividend to the shareholder).

Determining Basis of Transferred and Imported Built-in Loss Property

When built-in loss property is transferred in certain tax-free transfers, the transferee's basis in property acquired in the transfer will be limited to its FMV. In other words, the transferee will not be able to take a full carryover basis in the property it receives in the exchange. There are two types of built-in losses subject to these rules, transferred built-in losses and imported built-in losses.

Transferred Built-in Loss

A transferred built-in loss occurs when (1) a person (or entity) transfers property with an aggregate adjusted basis exceeding its aggregate FMV, (2) to a person or entity, in a Section 351 transfer or as a contribution to capital, and (3) the loss is not an imported built-in loss (discussed later in this lesson).

Example 3D-1 Limiting basis to FMV on the transfer of a built-in loss.

RioCo (a Texas S corporation) owned property in Texas that it transferred to CoastCo (a California S corporation) in exchange for 100% of CoastCo's stock in a qualified Section 351 transfer.

RioCo's basis in the property before the transfer was $100,000. Immediately after the transfer, the property had a FMV of $60,000. The property has a transferred built-in loss because CoastCo's basis in the property exceeded the property's FMV immediately after the transfer.

CoastCo's basis in the property is limited to $60,000. RioCo's basis in the stock it receives is $100,000, the same as the adjusted basis of the assets it transferred to CoastCo.

Variation: CoastCo could avoid the application of the basis limitation rules if the transferor, RioCo, transfers additional property with a low basis and higher FMV to offset the built-in loss because IRC Sec. 362(e)(2) is applied to the aggregate adjusted basis of properties transferred. However, there should be a business purpose for the transfer of the additional property.

Unlike an imported built-in loss (where the transferor is not subject to U.S. tax), a transferred built-in loss occurs in situations where the transferor is subject to U.S. tax. In addition, the transferred built-in loss rules do not apply to corporate reorganizations.

Electing to Apply Basis Limitation to the Transferor's Stock Basis

For transferred built-in losses (but not imported built-in losses), the transferee and transferor can elect under IRC Sec. 362(e)(2)(C) to apply the built-in loss limitation to the transferor's stock basis instead of applying the limitation to the transferee's basis in the property received. If the election is made, the transferee's basis in the property it receives would equal the transferor's basis, and the transferor's basis in the stock received would equal the FMV of the property transferred. A reduction to the shareholder's basis in the stock as a result of the election is treated as an expense under IRC Sec.1367(a)(2)(D).

Example 3D-2 Electing to apply the limitation on a transferred built-in loss to the transferor's stock.

Assume the same facts as in Example 3D-1. Assume further that RioCo and CoastCo elected to apply the limitation on the transferred built-in loss to the transferor's stock. Under these revised facts, CoastCo's basis in the property it receives is $100,000 (rather than $60,000), and RioCo's basis in the stock it receives is $60,000 (rather than $100,000).

The election may be advisable when (1) the transferor has no intention of selling the stock it receives in the Section 351 transfer, or (2) the transferor is an individual whose descendents are likely to qualify for a step-up in basis of the stock in the near future due to the transferor's death.

The election, once made, is irrevocable. The transferor includes a statement on or with its tax return filed by the due date (including extensions) for filing its original return for the tax year in which the transaction occurred. The statement should state the name and tax identification number of the taxpayer filing the return, state the name and tax identification number of both the transferor and transferee, and certify that both the transferor and transferee make the election under IRC Sec. 362(e)(2)(C) with respect to a transfer of property described on the date of the transfer. Prior to the filing of the statement, the transferor and transferee must enter into a written, binding agreement to elect to apply IRC. Sec. 362(e)(2)(C).

Imported Built-in Loss

An imported built-in loss occurs under when (1) a person (or entity) who is not subject to U.S. tax (e.g., a foreign corporation, partner, or individual, or a domestic tax-exempt organization) transfers property with an adjusted basis exceeding its FMV (2) to a person or entity subject to U.S. tax in a tax-free Section 351 transfer, tax-free corporate reorganization, or as a contribution to capital.

Unlike a transferred built-in loss (where the transferor is subject to U.S. tax), an imported built-in loss occurs in situations where the transferor is not subject to U.S. tax.

Avoiding Treatment of Stock as Debt in an S Corporation

It is well established under IRC Sec. 385 and related case law that corporate debt can at times be treated as equity by the IRS. Accordingly, S corporation debt that resembles equity is potentially troublesome because of the Section 1361(b)(1)(D) limitation that prevents an S corporation from having more than one class of stock.

Avoiding Recapture of Business Credits

An S election does not cause recapture of previously claimed business credits. Similarly, business credit recapture is not triggered when a proprietorship or partnership incorporates and immediately elects S status, if the corporation retains the property as trade or business property and the taxpayer acquires a substantial interest in the corporation.

Filing the Initial S Corporation Tax Return, Form 1120S

An S corporation files its tax return on Form 1120S. The return is originally due on or before the 15th day of the third month following the close of the S corporation's tax year. However, the original due date for Form 1120S can be extended for six months by timely filing Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns).

Unless a fiscal year is used, the S corporation's first tax year will end on December 31 of the year in which the S election became effective.

The "Yes" box on line G should be checked on the S corporation's first return.

Schedule L of Form 1120S shows balance sheets at the beginning and end of the S corporation's tax year.

Information Reporting for Organizational Actions That Affect Basis

Information Reporting Requirement

Issuers of specified securities must file an information return relating to organizational actions that affect the basis of the security. Form 8937 (Report of Organizational Actions Affecting Basis of Securities) is used for this purpose. It is due on or before the 45th day following the organizational action, or, if earlier, January 15 of the year following the calendar year of the organizational action.

The term *specified security* generally means any share of stock in an entity organized as, or treated for federal tax purposes as, a corporation (foreign or domestic), and any security classified as stock by the issuer.

Organizational actions include corporate reorganization transactions, such as stock splits, mergers, and acquisitions as organizational transactions that affect the basis of specified securities.

Exception Allows S Corporations to Report on Schedules K-1

An exception to these reporting requirements is provided for S corporations. Under this exception, an S corporation is deemed to satisfy the reporting requirements for any organizational action affecting the basis of its stock if the corporation reports the effect of the organizational action on a timely filed Schedule K-1 (Form 1120S) for each shareholder and timely furnishes copies of these schedules to all proper parties.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Certain conditions must be met for the transfer of assets and liabilities to a corporation to be tax free. Which of the following statements regarding those conditions is correct?

    a. Property must be received for the transfer to be treated as tax-free.

    b. For the purposes of IRC Sec. 351, the term stock includes stock rights and stock warrants.

    c. Immediately following the exchange, the persons making the transfer, individually, must be in control of the transferee corporation.

    d. Incorporating to take advantage of the liability protection of the corporate form of doing business fails the business purpose test.

18. Which of the following statements is correct regarding accounts receivable and payable assumed by corporation?

    a. The transfer of accounts receivable and payable will not trigger transferor-shareholder gain or loss recognition if subject to IRC Sec. 351.

    b. The receivables and payables will have a zero basis in the partnership's proprietorship's hands when the partnership or the proprietorship is on the accrual method of accounting.

    c. Transfers of liabilities that fall outside the scope of the IRS rulings (*Leavett*), allowing Section 351 treatment to cash-basis accounts receivable and accounts payable, will be considered deductions.

    d. One critical fact that appeared in the IRS rulings (*Leavett*), allowing Section 351 treatment to cash-basis accounts receivable and accounts payable, was that the separation of income from related expenses was considered appropriate.

19. The business assets, liabilities, and operations of a partnership can be incorporated in a transaction meeting the requirements of IRC Sec. 351 in one of three ways. Which of the following examples is considered preferable when the basis of the assets to the partnership is higher than the aggregate basis of the partnership interests to the partners?

    a. Partnership A transfers its assets and liabilities to CorpA in exchange for stock of the corporation, which is then distributed to the partners in liquidation of the partnership.

    b. Partnership B distributes its assets and liabilities to the partners in a liquidating distribution. The partners, in turn, transfer them to CorpC in exchange for stock in the corporation.

    c. Partners XY&Z transfer their partnership interest to CorpD in exchange for stock in the corporation.

20. There are certain circumstances in which taxpayers intentionally design incorporations to be taxable. A fully taxable transfer may be beneficial in all of the following situations **except:**

    a. Land is about to be converted to ordinary income property because of real estate development.

    b. When the rules of IRC Sec. 267 apply.

    c. A shareholder's tax credits are expiring.

    d. To avoid self-employment tax.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Certain conditions must be met for the transfer of assets and liabilities to a corporation to be tax free. Which of the following statements regarding those conditions is correct? **(Page 223)**

    a. **Property must be received for the transfer to be treated as tax-free. [This answer is correct. According to IRC Sec. 351(a); Reg. 1.351-1; Rev. Rul. 55-36; the corporation must receive property for the transfer to be treated as tax-free. *Property* includes (but is not limited to) cash, stock, partnership interests, oil and gas interests, and intangible assets such as goodwill, patents, etc.]**

    b. For the purposes of IRC Sec. 351, the term stock includes stock rights and stock warrants. [This answer is incorrect. The transfer must be solely in exchange for stock of the transferee corporation. The term *stock* generally includes all types of common and preferred stock, but assuming the corporation wants to retain its S election, the outstanding shares must confer identical rights to distribution and liquidation proceeds but can have differences in voting rights. Stock rights, stock warrants, and debt instruments are not *stock* for the purposes of IRC Sec. 351.]

    c. Immediately following the exchange, the persons making the transfer, individually, must be in control of the transferee corporation. [This answer is incorrect. The persons making the transfer, taken as a group, must be in control of the transferee corporation immediately following the exchange.]

    d. Incorporating to take advantage of the liability protection of the corporate form of doing business fails the business purpose test. [This answer is incorrect. The requirement for the transaction to have a business purpose is ultimately based on the overlap of the Section 368 (reorganization) provisions, which specifically require a business purpose with IRC Sec. 351. Incorporating to take advantage of the liability protection of the corporate form of doing business should also be an acceptable purpose. Providing for the orderly transfer of a business from one generation to the next is also an acceptable business purpose.]

18. Which of the following statements is correct regarding accounts receivable and payable assumed by corporation? **(Page 230)**

    a. **The transfer of accounts receivable and payable will not trigger transferor-shareholder gain or loss recognition if subject to IRC Sec. 351. [This answer is correct. According to IRC Sec. 362, if subject to IRC Sec. 351, the transfer of accounts receivable and payable will not trigger transferor-shareholder gain or loss recognition.]**

    b. The receivables and payables will have a zero basis in the partnership's or the proprietorship's hands when the partnership or the proprietorship is on the accrual method of accounting. [This answer is incorrect. When the proprietorship or partnership is on the cash method of accounting, the receivables and payables will have a zero basis in the proprietorship's or partnership's hands.]

    c. Transfers of liabilities that fall outside the scope of the IRS rulings *(Leavett)*, allowing Section 351 treatment to cash-basis accounts receivable and accounts payable, will be considered deductions. [This answer is incorrect. Transfers of liabilities that fall outside the scope of these rulings may be capital expenditures instead of deductions.]

    d. One critical fact that appeared in the IRS rulings *(Leavett)*, allowing Section 351 treatment to cash-basis accounts receivable and accounts payable, was that the separation of income from related expenses was considered appropriate. [This answer is incorrect. Facts that appeared to be critical in the IRS rulings allowing Section 351 treatment to cash-basis accounts receivable and accounts payable were: (1) all assets and liabilities of an ongoing business were transferred; (2) there were valid business reasons for the transfer; (3) the transfer did not constitute an assignment of income; and (4) there was not an inappropriate separation of income from related expenses.]

19. The business assets, liabilities, and operations of a partnership can be incorporated in a transaction meeting the requirements of IRC Sec. 351 in more than one way. Which of the following examples is considered preferable when the basis of the assets to the partnership is higher than the aggregate basis of the partnership interests to the partners? **(Page 230)**

    a. Partnership A transfers its assets and liabilities to CorpA in exchange for stock of the corporation, which is then distributed to the partners in liquidation of the partnership. [This answer is correct. It is preferable for the partnership to transfer its assets and liabilities to the corporation in exchange for stock of the corporation, which is then distributed to the partners in liquidation of the partnership when the basis of the assets to the partnership is higher than the aggregate basis of the partnership interests to the partners. This results in the corporation taking a carryover basis in the assets on the date of the exchange.]

    b. Partnership B distributes its assets and liabilities to the partners in a liquidating distribution. The partners, in turn, transfer them to CorpB in exchange for stock in the corporation. [This answer is incorrect. One of the ways business assets, liabilities, and operations of a partnership can be incorporated in a transaction meeting the requirements of IRC Sec. 351 is when a partnership distributes its assets and liabilities to the partners in a liquidating distribution. However, this is not the preferred transaction when the basis of the assets to the partnership is higher than the aggregate basis of the partnership interests to the partners.]

    c. Partners XY&Z transfer their partnership interest to CorpXY&Z in exchange for stock in the corporation. [This answer is incorrect. One of the ways business assets, liabilities, and operations of a partnership can be incorporated in a transaction meeting the requirements of IRC Sec. 351 is when partners transfer their partnership interests to the corporation in exchange for stock in the corporation. However, this is not the preferred transaction when the basis of the assets to the partnership is higher than the aggregate basis of the partnership interests to the partners.]

20. There are certain circumstances in which taxpayers intentionally design incorporations to be taxable. A fully taxable transfer may be beneficial in all of the following situations **except: (Page 234)**

    a. Land is about to be converted to ordinary income property because of real estate development. [This answer is incorrect. A fully taxable transfer may be beneficial when appreciated investment property (e.g., land) is about to be converted to ordinary income property (e.g., because of real estate development).]

    b. When the rules of IRC Sec. 267 apply. [This answer is correct. A fully taxable transfer may be beneficial when the owners of depreciated assets want to recognize losses (when the related party rules of IRC Sec. 267 will not apply) without sacrificing control of the property.]

    c. A shareholder's tax credits are expiring. [This answer is incorrect. A fully taxable transfer may be beneficial when the shareholder has expiring net operating losses or tax credits.]

    d. To avoid self-employment tax. [This answer is incorrect. A taxpayer may want an exchange to be taxable in order to provide an opportunity to avoid self-employment tax prior to incorporation.]

Lesson 4: Organizational and Start-up Expenses

Introduction

Certain expenditures incurred before an S corporation begins the active conduct of a trade or business are capitalizable and, absent proper elections to amortize, nondeductible. These preopening capital expenditures can generally be placed in two categories: (1) organizational expenses and (2) start-up expenses.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the tax treatment of organizational expenses and start-up expenses, and distinguish organizational and start-up expenses from other nondeductible preopening expenditures.

Understanding the Tax Treatment of Organizational Expenses

Limited Deduction for Organizational Expenses

In general, corporate taxpayers are currently allowed to elect to deduct the lesser of (1) the amount of organizational expenses incurred, or (2) $5,000, reduced (but not below zero) by the amount by which the organizational expenses exceed $50,000. Any remaining organizational expenses will be amortized ratably over a 180-month period beginning with the month in which the taxpayer begins business.

Corporate Organizational Expenses

Corporate organizational expenditures are incurred when a corporation is formed.

Expenses Incurred. Organizational expenses are subject to a 180-month amortization period. This period is consistent with the 15-year amortization period for Section 197 intangibles. However, taxpayers may deduct up to $5,000 of organizational expenditures (subject to the phase-out rule discussed in the following paragraph) in the tax year in which the business begins.

Phase-out Rule. The $5,000 amount is reduced, but not below zero, by the amount by which the cumulative cost of the organizational expenditures exceeds $50,000. Accordingly, after incurring $55,000 of organizational costs, no amounts are currently deductible (although the costs can still be amortized over 180 months).

Electing to Deduct and Amortize Organizational Expenditures

The deemed election under IRC Sec. 248 is made by deducting the allowable amounts on the corporation's tax return. In this case, the corporation can deduct up to $5,000 of organizational expenses (subject to the phase-out rule) and amortize the balance over 180 months beginning with the month the corporation begins business. The deemed election provisions of the regulations can also be applied to organizational expenses, provided the statute of limitations on assessment remains open for the year of the deemed election.

Example 4A-1 Expenditures of $5,000 or less.

Newco is a calendar year S corporation that begins business in July 2017. In May 2017, it paid the law firm of Lennon and McCartney $2,500 to draft its articles of incorporation and one month later paid $500 to register the corporation with the Secretary of State. Newco is deemed to have elected to deduct its organizational expenditures. Accordingly, it may deduct the $3,000 of the organizational expenditures in 2017, the tax year in which it begins business.

Example 4A-2 Expenditures of more than $5,000 but less than or equal to $50,000.

Assume the same facts as in Example 4A-1, except Newco incurs organizational expenditures of $41,000 (instead of $3,000). Newco is again deemed to have elected to deduct and amortize its organizational

expenditures. Under these revised facts, Newco may deduct $5,000 plus the portion of the remaining $36,000 ($41,000 – $5,000) of organizational expenditures allocable to July through December of 2017. The allocable portion is $1,200 ($36,000 ÷ 180 months × 6 months). Thus, Newco's total deduction for 2017, the tax year in which it begins business, is $6,200 ($5,000 + $1,200).

Newco reports the $5,000 current year deduction on the "Other deductions" line on page 1 of its Form 1120S. The $1,200 current year amortization is reported in Part VI of Form 4562 (Depreciation and Amortization).

Example 4A-3 Expenditures of more than $50,000 but less than or equal to $55,000.

Assume the same facts as in Example 4A-1, except Newco incurs organizational expenditures of $54,500 (instead of $3,000). Newco is again deemed to have elected to deduct and amortize its organizational expenditures. Under these revised facts, Newco may deduct $500 [$5,000 – ($54,500 – $50,000)] plus the portion of the remaining $54,000 ($54,500 – $500) of organizational expenditures allocable to July through December of 2017. The allocable portion is $1,800 ($54,000 ÷ 180 months × 6 months). Thus, Newco's total deduction for 2017, the tax year in which it begins business, is $2,300 ($500 + $1,800).

Example 4A-4 Expenditures of more than $55,000.

Assume the same facts as in Example 4A-1, except Newco incurs organizational expenditures of $450,000 (instead of $3,000). Newco is again deemed to have elected to deduct and amortize its organizational expenditures. Under these revised facts, Newco may deduct the portion of its organizational expenditures allocable to July through December of 2017. Thus, Newco's total amortization deduction for 2017, the tax year in which it begins business, is $15,000 ($450,000 ÷ 180 months × 6 months).

Electing to Forgo the Deemed Election

A corporation may choose to forgo the deemed election by affirmatively electing to capitalize its organizational expenditures on a timely filed federal income tax return (including extensions) for the tax year in which the corporation begins business. If the corporation chooses to capitalize its organizational expenditures, it cannot amortize them over the 180-month amortization period.

Elections Are Irrevocable

The election either to amortize organizational expenditures or to capitalize them is irrevocable and applies to all organizational expenditures of the corporation.

Change in Method of Accounting

Change in Characterization of an Item. A change in the characterization of an item as an organizational expenditure is treated as a change in method of accounting to which IRC Secs. 446 and 481(a) apply if the corporation treated the item consistently for two or more tax years.

Example 4A-5 Change in the characterization of an item.

Assume the same facts as in Example 4A-2, in which Newco began business in 2017 and incurred $41,000 of organizational expenditures during the year. In 2019, Newco determines that it incurred $10,000 for an additional organizational expenditure in 2017, but erroneously deducted that amount in 2017 as a business expense.

Under these revised facts, Newco is deemed to have elected to deduct and amortize its organizational expenditures in 2017, including the additional $10,000 of organizational expenditures. However, Newco is using an impermissible method of accounting for the additional $10,000 of organizational expenditures. Accordingly, Newco is not allowed to file an amended return, but instead must change its method of accounting for the misclassified $10,000 expenditure under Reg. 1.446-1(e) and the applicable administrative procedures in effect for 2019.

Change in Year in which Business Begins. A change in the determination of the tax year in which the corporation begins business also is treated as a change in method of accounting if the corporation amortized organizational expenditures for two or more tax years.

Example 4A-6 Subsequent redetermination of the year in which business begins.

Assume the same facts as in Example 4A-2, in which Newco began business in 2016 and incurred $41,000 of organizational expenditures during the year. In 2018, Newco deducted the organizational expenditures allocable to January through December of 2018. Accordingly, it deducted $2,400 ($36,000 ÷ 180 months × 12 months) of such expenditures in 2018.

In 2019, Newco determines that it actually began business in 2018 (rather than in 2017). Under these revised facts, Newco is deemed to have elected to deduct organizational expenditures in 2018 (rather than in 2017). Thus, Newco impermissibly deducted organizational expenditures in 2017, and incorrectly determined the amount of organizational expenditures deducted in 2018. Accordingly, Newco is using an impermissible method of accounting for its organizational expenditures and must change its method of accounting under Reg. 1.446-1(e) and the applicable administrative procedures in effect for 2019.

Commonly Encountered Organizational Expenditures

To qualify as an organizational expenditure, the expenditure must be:

1. incident to the creation of the corporation,
2. chargeable to the capital account of the corporation, and
3. of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

An expenditure that fails to meet each of these three tests may not be considered an organizational expenditure for purposes of IRC Sec. 248.

Organizational expenditures include legal fees incurred incident to the corporation's organization, such as drafting the articles of incorporation, filing fees for registering the corporation with state and local authorities, and related costs. They also include preformation accounting services, expenses of temporary directors, and organizational meetings of directors or stockholders.

Organizational expenditures must be incurred by the corporation to be deductible and amortizable under IRC Sec. 248. If the organizational costs are paid by the shareholder, they are evidently capitalized as part of the shareholder's stock basis. (See *Robertson*.)

Expenditures That Do Not Qualify

The provisions of IRC Sec. 248 do not cover all expenditures incurred in forming a corporation.

Assets Transferred to the Business. Expenditures connected with transferring assets to a corporation, such as surveys, appraisals, etc., are not organizational expenditures. These costs should be added to the basis of the transferred asset(s).

Stock or Securities. Expenditures connected with issuing or selling shares of stock or other securities, such as commissions, professional fees, and printing costs, are not organizational expenditures. The costs of issuing or selling stock or other securities are not deductible when incurred, are not amortizable, and are not deductible if the corporation is liquidated. The costs are treated as a discount from the amount of property received in the issuance of stock or other securities.

Reorganizations. Expenditures connected with the reorganization of a corporation are not organizational costs within the meaning of IRC Sec. 248 unless they are directly incident to the creation of a new corporation.

Expenditures of Forming a QSub. Expenditures paid to facilitate (i.e., an amount paid in the process of investigating or otherwise pursuing) the formation or organization of a disregarded entity, such as a QSub, must be capitalized under IRC Sec. 263. (See Example 4C-1.)

Cash-basis Corporations

A cash-basis corporation can amortize organizational costs incurred within the first tax year, even if it does not pay for them in that year.

Example 4A-7 Organizational expenses incurred by a cash-basis S corporation.

MNO, Inc. was formed in August 2017 and began business the next month. It immediately elected S status and elected to file its tax returns on the cash method of accounting. In September 2017, it incurred $10,400 of organizational expenses, but it did not pay the expenses until 2018.

Under these facts, MNO may deduct $5,000 plus the portion of the remaining $5,400 ($10,400 − $5,000) of organizational expenditures allocable to September through December of 2017. The allocable portion is $120 ($5,400 ÷ 180 months × 4 months). Thus, MNO's total deduction for 2017, the tax year in which it begins business, amounts to $5,120 ($5,000 + $120).

When Does a Corporation's Business Begin?

A corporation will often be in existence for some period of time before it begins business. Ordinarily, a corporation is considered to begin business (for the purpose of amortizing organizational expenses) in the month in which it starts the business operations for which it was organized. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. The acquisition of operating assets necessary to conduct the type of business contemplated is a primary factor in determining when the corporation's business begins. Mere "administrative" actions, such as signing articles of incorporation or registering to do business in a state, do not constitute the beginning of business.

The date a corporation's business begins (1) determines the proper year for making the amortization election, if needed, and (2) determines when the corporation can begin amortizing the expenses.

Example 4A-8 Beginning of business operations.

ABC, Inc. was incorporated in September 2017 and immediately thereafter began negotiations to acquire the Shortstop convenience store. The acquisition was not finalized until July 2018. Under IRC Sec. 248, the corporation is considered to begin business in 2018 when the operating assets of its trade or business are acquired. ABC's organizational expenses are amortizable over a period of 180 months beginning in July 2018.

Therefore, no organizational expense is deductible for tax purposes in 2017, and amortization in 2018 is equal to the total qualifying organizational expenses (less the amount deducted in 2018—up to $5,000, subject to the phase-out rule) divided by 180 months and multiplied by 6 months (the number of months in 2018 after the corporation began its business, including the month in which business began).

Presenting Amortization Expense on Form 1120S

Part VI of Form 4562 (Depreciation and Amortization) is used to report the amortizable tax basis of the corporation's qualifying organizational expenses, the amortization period, and the allowable amortization expense for a particular year. Section 248 is cited on line 42, column d, as authority for the deduction on the Form 4562. (See Example 4A-2.)

Treatment of Unamortized Organizational Costs When S Corporation Liquidates

When a corporation winds up its affairs, unamortized organizational expenses can be deducted as an ordinary loss under IRC Sec. 165. The corporate entity must be dissolved to obtain this treatment. These unamortized costs are

written off as a Section 165 ordinary loss deduction at the time of liquidation. The deduction should be included as an "Other deduction" on page 1 of Form 1120S.

Understanding the Tax Treatment of Start-up Expenses

Limited Deduction for Start-up Expenses

Expenditures that would be deductible as ordinary and necessary trade or business expenses if the corporation were actively engaged in a trade or business must be capitalized if they are incurred during the start-up period. However, a limited deduction is provided for start-up expenses.

Expenditures Incurred. Start-up expenditures are subject to a 180-month amortization period. This period is consistent with the amortization period for Section 197 intangibles. However, taxpayers may be allowed to deduct up to $5,000 of start-up costs (subject to the phase-out rule discussed in the following paragraph) in the tax year in which active conduct of the trade or business begins.

Phase-out Rule. Under a phase-out rule, the $5,000 amount is reduced, but not below zero, by the amount by which the cumulative cost of the start-up expenditures exceeds $50,000. Accordingly, after incurring $55,000 of start-up costs, no amounts are currently deductible (although the costs can still be amortized over 180 months).

Example 4B-1 Deducting and amortizing start-up costs.

Upstart, Inc., is a calendar year S corporation. During 2017, it incurred $40,000 of training costs in connection with starting a new business. Upstart may deduct $5,000 of start-up costs, with the remaining $35,000 amortized over 180 months, beginning with the month active conduct of the business begins. Upstart reports the $5,000 deductible amount on the "Other deductions" line on page 1 of its Form 1120S. The amortizable amount is reported in Part VI of Form 4562 (Depreciation and Amortization).

Commonly Encountered Start-up Costs. The types of costs affected by this rule commonly include amounts paid or incurred in connection with:

1. investigating the creation or acquisition of an active trade or business;
2. creating a new active trade or business; or
3. any "preopening" activity of an investment activity that occurs in anticipation of the commencement of an active trade or business. (Start-up expenses of an investment activity are discussed later in this lesson.)

The limitation on the deductibility of start-up expenditures generally applies only to costs that would have otherwise been deductible in the year they were paid or incurred, but only if they had been paid or incurred in connection with the operation of an existing active trade or business.

For example, marketing expenses and the costs of training employees are deductible under IRC Sec. 162 if the corporation is already engaged in the trade or business to which they relate. (See Example 4B-4.) However, if such expenses are incurred before business begins, they are subject to the Section 195 start-up expense rules. (See Examples 4B-2 and 4B-3.) IRC Sec. 195 does not apply to interest and taxes that are deductible under IRC Secs. 163 and 164) whether or not the corporation is engaged in an active trade or business. (See Example 4B-2.)

Intangible Contract Rights. Amounts paid or incurred to acquire or create intangible contract rights must be capitalized under the Section 263(a) regulations. Such amounts do not qualify as amortizable Section 195 expenses. Instead, these capitalized amounts may be eligible for amortization or depreciation under other tax rules. (See Example 4C-1.)

Defining the Start-up Period

Start-up Period. For purposes of IRC Sec. 195, a corporation is considered to be in the "start-up period" with respect to a particular activity until the active conduct of the associated trade or business begins.

Active Conduct of a Trade or Business. Active conduct of a trade or business occurs when the business has begun to function as a going concern and perform the activities for which it is organized. Thus, the question of when a taxpayer has begun the active conduct of a trade or business is a facts and circumstances determination that must be made on a case-by-case basis. Generally, the taxpayer must have begun to function as a going concern and perform the activities for which it was organized in order for the start-up period to end. For example, if obtaining a local business license is a prerequisite to commencing the legal operation of a trade or business, the taxpayer will be considered to remain in the start-up period at least until the license is obtained.

Example 4B-2 Start-up expenses for a newly created business.

Risky Bid, Inc. was formed in 2016 and acquired its operating assets in July 2017. In January 2017, Risky Bid incurred $6,200 in business investigation expenses and $2,000 for a demographic study. In June 2017, the corporation incurred $3,000 for preopening advertising costs. In addition, it incurred $7,700 in salary expenses in training its employees before beginning the active conduct of its trade or business in July 2017. During the same period of time, Risky Bid incurred $3,200 of interest and taxes.

Since the corporation was not conducting an active trade or business at the time the expenses were incurred, the business investigation, demographic study, advertising, and salary costs cannot be deducted as ordinary and necessary business expenses under IRC Sec. 162. Instead, they must be capitalized under IRC Sec. 195. The $3,200 of interest and taxes incurred during the same period can be deducted on a current basis since IRC Sec. 195 does not apply to amounts that are deductible under IRC Sec. 163 or 164.

Risky Bid reports the $5,000 deductible amount on the "Other deductions" line on page 1 of its Form 1120S. The amortizable amount is $13,900 ($6,200 + $2,000 + $3,000 + $7,700 – $5,000) and is reported in Part VI of Form 4562.

In determining when active business begins, the IRS follows the concept of carrying on a trade or business under IRC Sec. 162. However, the Court of Federal Claims has held that a corporation was actively engaged in an active trade or business because it was conducting the software development activities for which it was organized (*Lamont*). The court further pointed out that the company need not make a single sale, or earn a single penny for it to be considered an active trade or business.

Identifying New Business Activity

Since the start-up period relates to a particular trade or business, a corporation that has multiple trade or business activities may also have multiple start-up periods. As a result, even a corporation that has been in existence for many years may become subject to IRC Sec. 195 for any start-up expenses associated with a new line of business. Treasury has not yet provided regulations on what constitutes a separate line of business for these purposes; however, the IRS and the courts have made the following rulings:

1. Because commercial real estate development is sufficiently similar to residential real estate development, no new trade or business is created (*Malmstedt*).

2. Modernizing manufacturing facilities does not constitute a new trade or business (*Cleveland Electric Illuminating Co.*).

3. Opening or constructing additional facilities in different locations that are similar to existing operations does not constitute a new trade or business.

4. Establishing a similar business in a separate legal entity (i.e., the subsidiary of a corporation or a tiered partnership entity) will result in the creation of a new trade or business.

Business Expansion. An existing taxpayer operating in a particular industry or segment, such as manufacturing, will be considered to be entering a new trade or business, requiring a Section 195 election, if it expands into a different industry or segment, such as wholesaling or retailing. However, expenses associated with opening additional stores in new locations, which conduct the same activity or same line of business, do not constitute start-up expenditures subject to capitalization and amortization.

Example 4B-3 Existing business creating a new business activity.

Frolic, Inc. is an S corporation that manufactures fragrances and cosmetics. It sells its products entirely through wholesale distributors. However, early during the current year Frolic decides to open a retail boutique and engage in the sale of its product through retail activity.

During the three or four months prior to opening the retail boutique, Frolic incurs preopening expenditures such as hiring, training, store decorating, merchandising, and promotional activities. Frolic is considered to be commencing a new business activity through its retail boutique and is required to capitalize the start-up expenditures under IRC Sec. 195. Frolic is deemed to have made a Section 195 election for the current year. The 180-month amortization begins with the month in which the boutique opens.

Example 4B-4 Expanding an existing business activity.

After opening its initial retail boutique, Frolic, Inc. (the manufacturer discussed in Example 4B-3) decides to expand its retail business by opening additional boutiques in other cities throughout the country. As with its initial location, the new boutiques have a three- to four-month preopening period, during which expenditures are incurred for personnel hiring, training, store set-up, and promotion.

Because Frolic already conducts the retail activity, the expansion into new locations is not considered the start-up of a new business activity, and the expenditures of expanding to additional retail locations may be claimed as current trade or business deductions. A Section 195 amortization election is not required for the additional locations.

The costs Frolic incurs for training and building its workforce are currently deductible ordinary and necessary business expenses. Similarly, Frolic's other preopening expenditures remain currently deductible trade or business expenses, even though they may provide some incidental future benefit. They are not subject to capitalization under IRC Sec. 263 because they are recurring in nature as Frolic opens additional boutiques.

Expansion Using a Separate Entity. Using separate entities for expanded activities is generally advisable for legal reasons because the liabilities of the current and expanded operations can each be "contained" within their respective entities. However, when the expansion is accomplished by setting up a separate taxable entity, such as a corporate subsidiary, start-up expenditures must be capitalized and amortized under IRC Sec. 195, regardless of whether the expansion is within the same line of business or into a new line of business. Each separate new taxable entity will be deemed to have made a Section 195 election. Amortization begins with the month each new business begins.

Investigatory Expenses

In Rev. Rul. 99-23, the IRS covered three scenarios in which a taxpayer acquired a business *unrelated* to its existing business. In all three cases, the IRS concluded that general investigatory expenses (also commonly referred to as due diligence costs) incurred to determine *whether* to enter a new line of business and *which* line of business to enter can be amortized as start-up expenses under IRC Sec. 195. However, due diligence costs incurred after focusing on a specific target must be capitalized under IRC Sec. 263 as nonamortizable costs to facilitate the acquisition (i.e., the costs must be included in the basis of the target assets or stock acquired, rather than amortized under IRC Sec. 195).

Forming an S Corporation to Investigate a New Business

Individual taxpayers who are not engaged in a trade or business but are investigating the potential creation or acquisition of a new business should consider forming an S corporation to facilitate and conduct all the activities related to the investigation. Expenses incurred in the course of a general search or a preliminary investigation of a new business are personal in nature and are not deductible by individual taxpayers. Alternatively, an S corporation would treat those expenses as start-up expenditures under IRC Sec. 195. Once the S corporation begins the active conduct of the trade or business, it can deduct/amortize the costs as provided by IRC Sec. 195. If the investigation is unsuccessful or the business ultimately fails, the S corporation would recover any unamortized costs as an ordinary deduction. In addition, the S corporation shareholders may be entitled to an ordinary Section 1244 deduction on the disposition of any IRC Sec. 1244 stock.

Electing to Deduct and Amortize Start-up Expenditures

For start-up expenses paid or incurred after August 16, 2011, the deemed election under IRC Sec. 195 is made by deducting the allowable amounts on the corporation's tax return. In this case, the corporation can deduct up to $5,000 of start-up expenses (subject to the phase out rule) and amortize the balance over 180 months beginning with the month the corporation's active trade or business begins. The deemed election provisions of the regulations can also be applied to start-up expenses, provided the statute of limitations on assessment remains open for the year of the deemed election.

Electing to Forgo the Deemed Election

A corporation may choose to forgo the deemed election by affirmatively electing to capitalize its start-up expenditures on a timely filed federal income tax return (including extensions) for the tax year in which the corporation begins business. If the corporation chooses to capitalize its start-up expenditures, it cannot amortize them over the 180-month amortization period.

Elections Are Irrevocable

The election either to amortize start-up expenditures or to capitalize them is irrevocable and applies to all start-up expenditures of the corporation.

Change in Method of Accounting

Change in Characterization of an Item. A change in the characterization of an item as a start-up expenditure is treated as a change in method of accounting to which IRC Secs. 446 and 481(a) apply if the corporation treated the item consistently for two or more tax years.

Change in Year in which Business Begins. A change in the determination of the tax year in which the active trade or business begins also is treated as a change in method of accounting if the corporation amortized start-up expenditures for two or more tax years.

Presenting Amortization Expense on Form 1120S

Start-up expenses are included within the definition of "amortizable property" in the instructions to Form 4562 (Depreciation and Amortization). The required information is entered in Part VI, "Amortization," of Form 4562. Section 195 is cited on line 42, column d, as authority for the deduction on Form 4562. (See Example 4B-2.) From there the current year's deduction for a *nonrental* trade or business activity flows to the "Other deductions" line of Form 1120S (not the "Depreciation" line). Therefore, the current year's deduction for start-up expenses is included in the computation of the corporation's ordinary income or loss from operations for the year. However, if the corporation's activity to which the start-up costs relate is an active rental trade or business (for Section 195, not Section 469 passive loss purposes), the amortization expense must be carried to Form 8825 (Rental Real Estate Income and Expenses of a Partnership or an S Corporation), line 15 "Other".

Disposing of a Trade or Business with Unamortized Start-up Expenditures

Much like organizational costs that have not been fully amortized at the time a corporation is liquidated, unamortized start-up expenses can be deducted as an ordinary loss at the time of a complete disposition of the trade or business. An in-kind distribution of the operating assets of a trade or business to one or more shareholders in liquidation of their interest(s) should be considered a complete disposition of the trade or business for these purposes.

Distinguishing Organizational and Start-up Expenses from Other Nondeductible Preopening Expenditures

Asset Acquisition Costs

Before beginning the active conduct of a trade or business, a corporation may incur other types of nondeductible expenditures in addition to its organizational and start-up expenses. For example, a corporation may incur costs

associated with the acquisition of property that will ultimately be used in the corporation's trade or business (e.g., broker's fees). Even if these costs are incurred at the time the corporation is being organized or during the start-up period, they are ineligible for treatment as either organizational costs or start-up costs. As a result, such costs are not permitted to be amortized over 180 months. Instead, they must be capitalized under IRC Sec. 263 into the basis of the property acquired and, where applicable, depreciated over the property's useful life.

Additionally, costs to facilitate a business acquisition or reorganization transaction could be subject to capitalization and amortization as start-up expenses or deducted as an ordinary business expense.

Significant Long-term Benefits

The Supreme Court's 1992 *INDOPCO* decision requires capitalization under IRC Sec. 263 of expenditures that produce significant long-term benefits (i.e., lasting for more than one year). The applicable regulations, sometimes called the *INDOPCO* regulations, explain when certain amounts must be capitalized under IRC Sec. 263(a).

The Section 263(a) regulations require the taxpayer to capitalize amounts paid to:

1. acquire or create certain intangible assets (e.g., intangible contract rights),
2. create or enhance a separate and distinct intangible asset,
3. create or enhance future benefits that may be identified in IRS guidance as intangible assets that require capitalization under IRC Sec. 263(a), and
4. facilitate the acquisition or creation of an intangible asset described in the preceding items 1–3.

Start-up Expenditures. Amounts that must be capitalized under the Section 263(a) regulations simply do not qualify as start-up expenditures amortizable under IRC Sec. 195. Instead, the capitalized amount may be eligible for amortization or depreciation under other tax rules.

Organizational Costs of a QSub. Expenditures paid to facilitate (i.e., an amount paid in the process of investigating or otherwise pursuing) the formation or organization of a disregarded entity, such as a QSub, must be capitalized under IRC Sec. 263. A *de minimis* exception is provided when, in the aggregate, such expenditures do not exceed $5,000. However, it appears that the traditional organizational costs incurred in the process of forming or organizing a QSub continue to qualify for amortization under IRC Sec. 248.

Example 4C-1 Distinguishing organizational and start-up expenditures from other nondeductible preopening expenditures.

Essco is an S corporation that provides airframe and power plant services for aircraft. Early in the current year, Essco pays $7,000 to investigate whether to form a QSub for the purpose of expanding its business to include a retail business. The investigation makes a strong business case for organizing a QSub to conduct a retail business. Accordingly, Essco forms a corporation (Subco) and immediately makes a QSub election for it. Subco then establishes a new retail store to sell a complete line of pilot supplies. In establishing the new retail business, Subco makes various other pre-opening expenditures. These include expenditures totaling $16,000 to recruit and train employees for the new retail store and expenditures to advertise the new store. Subco also pays $9,000 to acquire a 10-year lease agreement for the new store.

The $7,000 expenditure incurred in investigating whether to establish a QSub must be capitalized under IRC Sec. 263. However, traditional organizational expenditures (such as attorney fees and fees paid to the state of incorporation) incurred in the process of organizing Subco evidently qualify for deduction and amortization under IRC Sec. 248.

The $16,000 paid for employee recruitment and training, and the expenditures for advertising qualify as start-up expenditures and are deductible and amortizable under IRC Sec. 195.

The $9,000 paid to acquire the lease must be capitalized under IRC Sec. 263 because they create an intangible contract right. These payments do not qualify for amortization under IRC Sec. 195. However, they can be amortized over the 10-year life of the lease.

Variation: If the investigative expenditures total $4,700 (instead of $7,000), the investigative expenditures qualify for a *de minimis* exception. Because the regulations exclude payments aggregating $5,000 or less, the $4,700 of investigative expenditures are not required to be capitalized under IRC Sec. 263. Presumably, these expenditures are currently deductible under Section 162.

Under these revised facts, the investigative expenditures qualify for a *de minimis* exception. Because the regulations exclude payments aggregating $5,000 or less, the $4,700 of investigative expenditures would not be capitalized under IRC Sec. 263. Presumably, these expenditures would be deductible under Section 162.

For additional discussion of IRS guidance and court decisions affecting the deductibility of traditional business expenditures.

Construction Costs

The corporation may incur, immediately after formation, costs relating to the construction of property to be used in the trade or business. These costs do not qualify as either organizational or start-up costs—even if they are incurred during the organizational or start-up periods. Instead, the uniform capitalization principles of IRC Sec. 263A may require the capitalization of these costs into the basis of the constructed property.

Under IRC Sec. 263A, some of the corporation's general and administrative expenses incurred during the construction period may be attributable to activities of the corporation that are not directly related to the construction of the property under the allocation rules contained in the Section 263A regulations. For example, if the corporation is constructing an office building that it intends to hold as rental property, it will usually place newspaper advertisements and conduct other marketing activities to attract prospective tenants while the building is still under construction. In this situation, some of the corporation's general and administrative costs during this period must be allocated between construction and marketing.

The portion of these costs allocated to the corporation's construction activities must be capitalized under IRC Sec. 263A as previously discussed. However, the portion of these costs allocated to the corporation's marketing activities is not subject to the Section 263A capitalization rules. Instead, these costs would most likely be classified as Section 195 start-up expenses since they represent expenditures that would qualify as ordinary and necessary business expenses (under IRC Sec. 162) if the corporation were already engaged in an active trade or business. However, the corporation may not be viewed as having begun actively conducting a trade or business until the building is occupied (*Aboussie*; *Fishman*).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Which of the following does **not** qualify as an organizational expenditure?

    a. Incurred by the corporation.

    b. Occurring as a result of creation of the corporation.

    c. Chargeable to the corporation's capital account.

    d. Possess a character which, if expended incident to the creation of a corporation of a corporation having limited life, would be amortizable over such life.

22. Which of the following statements regarding when a corporation business begins is correct?

    a. A company is deemed to have begun business once it signs its articles of incorporation.

    b. The month in which a corporation begins business operations for which it was organized is the date it begins business.

    c. A company is deemed to have begun business once it has registered to do business in a state.

    d. Acquiring the necessary assets necessary to conduct the type of business contemplated should not be the main objective in determining when the corporation's business begins.

23. Corporations that have existed for many years may still be subject to IRC Sec. 195 for any start-up expenses associated with a new line of business. What is the IRS ruling regarding what constitutes a separate line of business for corporations that identify a new business activity?

    a. If a corporation constructs an additional facility in a different location that is similar to its existing operations, it is automatically deemed a new trade or business.

    b. If a corporation establishes a similar business in a separate legal entity, it will result in the creation of a new trade or business.

    c. Since commercial real estate development is different from residential development, new trade and businesses must be created.

    d. If a corporation renovates a similar business in a separate legal entity, that entity will be deemed as a new trade or business.

24. Which of the following statements is correct regarding how corporations elect to deduct and amortize start-up expenditures?

    a. If a corporation's deemed election under IRC Sec. 195 is made by deducting the allowable amounts on the corporation's tax return, the start-up expenditures are incurred or paid after August 16, 2011.

    b. The corporation must treat an item consistently for at least three tax years for a change in the characterization of an item as a start-up expenditure to be treated as a change in method of accounting to which IRC Secs. 446 and 481(a) apply to occur.

    c. Corporations that choose to capitalize its start-up expenditures have the option to amortize them over the 180-month amortization period.

    d. A corporation that elects to amortize or capitalize start-up expenditures may reverse the election.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Which of the following does **not** qualify as an organizational expenditure? **(Page 243)**

    a. Incurred with the reorganization of a corporation. [This answer is correct. Expenditures connected with issuing or selling shares of stock or other securities, such as commissions, professional fees, and printing costs, are not organization expenditures for purposes of IRC Sec. 248.]

    b. Occurring as a result of creation of the corporation. [This answer is incorrect. According to Reg. 1.248-1(b)(1), to qualify as an organizational expenditure, the expenditure must be incident to the creation of the corporation.]

    c. Chargeable to the corporation's capital account. [This answer is incorrect. According to Reg. 1.248-1(b)(1), to qualify as an organizational expenditure, the expenditure must be chargeable to the capital account of the corporation.]

    d. Possess a character which, if expended incident to the creation of a corporation of a corporation having limited life, would be amortizable over such life. [This answer is incorrect. According to Reg. 1.248-1(b)(1), to qualify as an organizational expenditure, the expenditure must be of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.]

22. Which of the following statements regarding when a corporation business begins is correct? **(Page 243)**

    a. A company is deemed to have begun business once it signs its articles of incorporation. [This answer is incorrect. Mere "administrative" actions, such as signing articles of incorporation, do not constitute the beginning of business.]

    b. The month in which a corporation begins business operations for which it was organized is the date it begins business. [This answer is correct. A corporation will often be in existence for some period of time before it begins business. Ordinarily, a corporation is considered to begin business (for the purpose of amortizing organizational expenses) in the month in which it starts the business operations for which it was organized as stated in Reg. 1.248-1(d).]

    c. A company is deemed to have begun business once it has registered to do business in a state. [This answer is incorrect. Ordinary "administrative" actions, such as registering to do business in a state, do not constitute the beginning of business.]

    d. Acquiring the necessary assets necessary to conduct the type of business contemplated should not be the main objective in determining when the corporation's business begins. [This answer is incorrect. The acquisition of operating assets necessary to conduct the type of business contemplated is a primary factor in determining when the corporation's business begins.]

23. Corporations that have existed for many years may still be subject to IRC Sec. 195 for any start-up expenses associated with a new line of business. What is the IRS ruling regarding what constitutes a separate line of business for corporations that identify a new business activity? **(Page 247)**

    a. If a corporation constructs an additional facility in a different location that is similar to its existing operations, it is automatically deemed a new trade or business. [This answer is incorrect. Opening or constructing additional facilities in different locations that are similar to existing operations does not constitute a new trade or business.]

    b. If a corporation establishes a similar business in a separate legal entity, it will result in the creation of a new trade or business. [This answer is correct. According to Ltr. Rul. 8423025, establishing a similar business in a separate legal entity (i.e., the subsidiary of a corporation or a tiered partnership entity) will result in the creation of a new trade or business.]

c. Since commercial real estate development is different from residential development, new trade and businesses must be created. [This answer is incorrect. Because commercial real estate development is sufficiently similar to residential real estate development, no new trade or business is created.]

d. If a corporation renovates a similar business in a separate legal entity, that entity will be deemed as a new trade or business. [This answer is incorrect. Modernizing manufacturing facilities does not constitute a new trade or business according to the ruling in *Cleveland Electric Illuminating Co.*]

24. Which of the following statements is correct regarding how corporations elect to deduct and amortize start-up expenditures? **(Page 247)**

a. If a corporation's deemed election under IRC Sec. 195 is made by deducting the allowable amounts on the corporation's tax return, the start-up expenditures are incurred or paid after August 16, 2011. [This answer is correct. For start-up expenses paid or incurred after August 16, 2011, the deemed election under IRC Sec. 195 is made by deducting the allowable amounts on the corporation's tax return, according to Reg. 1.195-1.]

b. The corporation must treat an item consistently for at least three tax years for a change in the characterization of an item as a start-up expenditure to be treated as a change in method of accounting to which IRC Secs. 446 and 481(a) apply to occur. [This answer is incorrect. A change in the characterization of an item as a start-up expenditure is treated as a change in method of accounting to which IRC Secs. 446 and 481(a) apply if the corporation treated the item consistently for two or more tax years, not three or more tax years.]

c. Corporations that choose to capitalize its start-up expenditures have the option to amortize them over the 180-month amortization period. [This answer is incorrect. If the corporation chooses to capitalize its start-up expenditures, it cannot amortize them over the 180-month amortization period.]

d. A corporation that elects to amortize or capitalize start-up expenditures may reverse the election. [This answer is incorrect. The election either to amortize start-up expenditures or to capitalize them is irrevocable and applies to all start-up expenditures of the corporation.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1120S Deskbook—Course 2—Eligibility, Filing and Repairing the S Election, Incorporation and Capitalization, and Organizational and Start-up Expenses (T2STG172)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

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   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($89 for email or fax; $99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

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     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more

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EXAMINATION FOR CPE CREDIT

Companion to PPC's 1120S Deskbook—Course 2—Eligibility, Filing and Repairing the S Election, Incorporation and Capitalization, and Organizational and Start-up Expenses (T2STG172)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. A corporation elects to be treated as an S corporation by filing which of the following forms?

   a. Form 2553.

   b. Form 3115.

   c. Form 6252.

   d. Form 1120S.

2. Which of the following is **not** considered a permitted trust for purposes of IRC Sec. 1361(b)?

   a. Foreign trust.

   b. Qualified Subchapter S trust (QSST).

   c. Voting trust.

   d. Electing small business trust (ESBT).

3. Which of the following trusts may name successive beneficiaries?

   a. Electing small business trust (ESBT).

   b. Testamentary trust.

   c. Grantor trust.

   d. Voting trust.

4. Denzel is the sole beneficiary of the Washington Trust; a qualified subchapter S trust (QSST). During the year, Glory International, Inc. passes through ordinary income of $25,000 and tax-exempt income of $10,000 to the Washington Trust and makes distributions to the trust of $17,000. What amount is the trust required to distribute to Denzel to comply with the current distribution rule?

   a. $10,000.

   b. $17,000.

   c. $25,000.

   d. $35,000.

5. Which of the following statements is true regarding the sale of stock by a QSST?

   a. A QSST is treated as a testamentary trust.

   b. The income beneficiary must recognize gain or loss unless the QSST sells its S corporation stock.

   c. The sale of the S stock must be reported on Schedule K-1.

   d. If gain on the sale qualifies for taxation under the installment method, the QSST must use that method if it elects to report all of the gain in the year of the sale.

6. All of the following requirements must be met to qualify for relief from termination of the S election due to a late election **except:**

    a. The trust is intended to be classified by the QSST beneficiary as a QSST on the date the QSST election would have become effective had it been made on time.

    b. The QSST beneficiary requests relief under Rev. Proc. 2013-30 within two years and 75 days after the projected effective date of the QSST election.

    c. The failure to qualify as a QSST election was solely because the QSST election was not timely filed.

    d. The failure to make a timely QSST election was unintentional and the S corporation and the trust acted carefully to correct the mistake upon its discovery.

7. An S corporation files a QSST election by doing all of the following **except:**

    a. Attaching the election to their current year Form 1120S.

    b. Attaching the election to one of their late filed, prior-year Forms 1120S.

    c. Attaching the election to their Form 1120S, if filed within two years and 75 days after the trust's intended effective date.

    d. Filing the election independent from 1120S.

8. The trustee of an ESBT is required to file an election to have the trust treated as an eligible S shareholder. This election must be filed within what amount of time of the trust's receipt of the stock?

    a. 60 days.

    b. 2 months and 15 days.

    c. 2 months and 16 days.

    d. 6 months.

9. An individual is not a common ancestor if, on the applicable date, the individual is more than how many generations removed from the youngest generation of shareholders who would be members of the family?

    a. Two.

    b. Three.

    c. Five.

    d. Six.

10. Corpus Corp. is a calendar year S Corporation with 102 shareholders, made up of 88 unmarried and unrelated shareholders and 7 unrelated married couples who each own stock in the company. In the last month of the calendar year, Lorene and Lawrence finalize their divorce and each continues to own shares in Corpus. How many shareholders does Corpus have for purposes of the 100-shareholder limit after the divorce is finalized?

    a. 95.

    b. 96.

    c. 102.

    d. 103.

11. Which of the following statements is correct regarding qualified retirement plan trusts?

    a. S corporation employee stock ownership plans (ESOPs) generally are subject to the unrelated business taxable income (UBTI) rules.

    b. Gain or loss on the disposition of S stock is not subject to UBTI.

    c. A qualified retirement plan trust may hold S corporation stock.

    d. ESOPs may not hold S corporation stock.

12. Which of the following statements regarding the use of a limited liability company (LLC) with an S corporation is correct?

    a. Even if members fully participate in the management of the enterprise, LLCs can provide limited liability to all members.

    b. LLCs are not taxed the same as a corporation.

    c. A single-member LLC can hold S corporation stock and is considered an eligible shareholder.

    d. An S corporation cannot hold stock in a partnership interest.

13. Zcorp., an S corporation, is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds; and if Zcorp has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. This determination is based on the "governing provisions." Which of the following is **not** included in the governing provisions?

    a. Employment agreement.

    b. Corporate bylaws.

    c. Corporate charter.

    d. Articles of incorporation.

14. The Tax Court has applied various factors when determining if S corporation debt is a second class of stock, including all of the following **except:**

    a. Amount of debt owed.

    b. Intent of the parties.

    c. Right to enforce repayment.

    d. Thin versus adequate capitalization.

15. A part of the payment received on a straight debt obligation which carries an excessive high interest rate will be treated as interest. How will the other portion be treated?

    a. As a second class of stock.

    b. As tax-exempt interest.

    c. As a payment that is not interest.

    d. As taxable interest.

16. Reg. 1.1361-1(l)(4)(ii)(B) provides safe harbors to prevent having certain debt treated as a second class of stock. One of those includes unwritten advances that do not exceed which of the following?

    a. $5,000.

    b. $10,000.

    c. $15,000.

    d. $20,000.

17. What is the net investment income tax (NIIT) threshold amount for married individuals filing separate returns?

    a. $250,000.

    b. $200,000.

    c. $125,000.

    d. $100,000.

18. Which of the following examples is correct regarding NIIT?

    a. Shareholder A is not subject to NIIT if business or trade income earned under IRC Sec. 162 is passed through from Dinocorp, an S corporation, to Shareholder A who does not materially participate in Dinocorp's business.

    b. If Entity Z is not engaged in a trade or business, income passed through to Shareholder B is considered to be from a trade or business if Shareholder B is engaged in a trade or business.

    c. Distributions of accumulated earnings and profits (A&E) from Greentree, Inc., an S corporation, are not subject to the NIIT.

    d. Because of the enactment of the NIIT, shareholder C can make a one-time regrouping of activities under Reg. 1.469-4.

19. Which of the following compliance matters normally is included on Form 2553, but can be made on a separate statement, as long as additional information is included from each shareholder?

    a. The consent from each shareholder.

    b. The election by the corporation to adopt S status.

    c. The selection of the S corporation tax year.

    d. The IRS states that all compliance matters must be included on Form 2553 and cannot be made separately.

20. ThompsonCo has one owner for purposes of the 100-shareholder limit, Patrick Thompson. The following individuals own shares in ThompsonCo: Patrick, his seven children, and his 16 grandchildren. His wife, Vanessa, does not own shares in the company, but she does have a community property interest in the stock. ThompsonCo would like to operate as an S corporation. How many shareholders must consent to the election?

    a. 25.

    b. 24.

    c. 8.

    d. 1.

21. Which of the following statements regarding filing the S election by mail, fax, or private delivery service is correct?

    a. Private delivery services are not approved by the IRS when filing the S election.

    b. The IRS may claim it did not receive the Form 2553 in a timely manner and the S election may be declared invalid if the Form 2553 was not mailed as registered or certified.

    c. The IRS does not accept forms that are faxed to the IRS Service Center.

    d. The delivery rule, *prima facie*, only applies when the IRS does not receive the S election in a timely manner.

22. According to the instructions to Form 2553, the IRS generally acknowledges acceptance of the election within how many days?

    a. 30.

    b. 60.

    c. 90.

    d. 120.

23. If a new entity misses the S election deadline, which of the following forms may be filed with capitalization of organization and start-up costs as a solution?

    a. Schedule B-1 with Form 1120S.

    b. Form 1040.

    c. Schedule K-1.

    d. Form 1120.

24. An S election may be revoked before it becomes effective as long as the revocation is accompanied by the consent of shareholders who, at the time of the revocation, hold more than what percentage of the issued and outstanding shares of the corporation's stock, including nonvoting stock?

    a. 25%.

    b. 35%.

    c. 40%.

    d. 50%.

25. Panther Heights, LLC, elects to be treated as a corporation and subsequently elects S status. After three years of operating as an S corporation, Panther Heights decides to revoke its S election. How long must Panther Heights wait to reelect S status without IRS permission?

    a. Panther Heights may reelect S status in the year following the revocation of the S election.

    b. Thirty months after revocation of the S election.

    c. Sixty months after the revocation of the S election.

    d. One hundred and twenty months after the revocation of the S election.

26. Green Springs, LLC, elects to be treated as a corporation and becomes an S corporation on the same date. Green Springs is not required to have the S election become effective at the first of the tax year. Green Springs' election can be retroactive or prospective within the time limits surrounding the date the Form 2553 is filed, which generally is which of the following?

    a. No more than 50 days prior to the date on which the election is filed; no more than 6 months after the date on which the election if filed.

    b. No more than 65 days prior to the date on which the election is filed; no more than 12 months after the date on which the election if filed.

    c. No more than 75 days prior to the date on which the election is filed; no more than 6 months after the date on which the election if filed.

    d. No more than 75 days prior to the date on which the election is filed; no more than 12 months after the date on which the election if filed.

27. QCo, a single-member LLC, holds stock in an S corporation. QCo should check the "Yes" box on line 3 of Form 1120S, Schedule B. Which of the following should QCo file with its 1120S to provide specific information relating to the shareholder?

    a. Schedule B.

    b. Schedule K-1.

    c. Schedule D.

    d. Schedule B-1.

28. Persons making a transfer must be in control of the transferee corporation immediately following the exchange of stock. To be in control, the transferors must immediately own, after the transfer, which of the following?

    a. At least 50% of the total combined voting power of all stock entitled to vote and at least 50% of the total number of shares of all nonvoting stock issued by the corporation.

    b. At least 50% of the total combined voting power of all stock entitled to vote and at least 80% of the total number of shares of all nonvoting stock issued by the corporation.

    c. At least 80% of the total combined voting power of all stock entitled to vote and at least 50% of the total number of shares of all nonvoting stock issued by the corporation.

    d. At least 80% of the total combined voting power of all stock entitled to vote and at least 80% of the total number of shares of all nonvoting stock issued by the corporation.

29. Which of the following statements is correct regarding the transfer of property to a corporation in exchange for that Corporation's stock in a Section 351 exchange?

    a. Only the transferee corporation is responsible for filing the information statement.

    b. A significant transferor is an individual who transfers property to a corporation in exchange for that corporation's stock in a Section 351 exchange and who, immediately after the transaction, owns at least 1% of the corporation's publicly traded outstanding stock.

    c. If all the information that would have been included is reported on a statement filed by a significant transferor in the same Section 351 exchange and that statement is attached to the same tax return, a transferee corporation is not required to file the information statement.

    d. An information statement must be attached to the current year tax return of the transferee corporation.

30. How many classes of stock can an S corporation have?

    a. One.

    b. Two.

    c. Three.

    d. Five.

31. Which of the following S corporations correctly filed its tax return?

    a. PrimCo files its tax return on Form 1120S on or before the 15th day of the third month following the close of its tax year.

    b. MiCo files its tax return on Form 7004 on or before the date the corporation elects S status.

    c. ProCo files its tax return on Form 1120S on or before December 31.

    d. DreamCo files its tax return on Form 1040 on or before the 15th day of the third month following the close of its tax year.

32. Which of the following forms should Strong, Inc. file if it issues specific securities and needs to file an information return relating to its organizational actions that affect the basis of the security?

    a. Form 1120.

    b. Form 1120S.

    c. Form 7004.

    d. Form 8937.

33. IRC Sec. 248 does not cover all expenditures incurred in forming a corporation. Which of the following qualifies as an organizational expenditure under IRC Sec. 248?

    a. Organizational director meetings.

    b. Appraisals.

    c. Expenditures connected with printing costs.

    d. Surveys.

34. Which of the following is **not** considered an organizational expenditure under IRC Sec. 248?

    a. Filing fees.

    b. Drafting articles of incorporation.

    c. Costs of selling stock.

    d. Accounting services.

35. XYZ, Inc. was formed in August 2016 and began business in September. It immediately elected S status and elected to file its tax returns on the cash method of accounting. In September 2016, it incurred $10,500 of organizational expenses, but it did not pay expenses until 2017.

    Under these facts, XYZ may deduct $5,000 plus the portion of the remaining $5,500 ($10,500 – $5,000) of organizational expenditures allocable to September through December of 2016. What is XYZ's approximate allocable portion?

    a. $122.

    b. $244.

    c. $367.

    d. $730.

36. A taxpayer may deduct up to which of the following amounts in the tax year in which active conduct of the trade or business begins?

    a. $3,000.

    b. $5,000.

    c. $10,000.

    d. $15,000.

37. Lilacs & Lavender, Inc. is an S corporation that grows a variety of flowers and plants. It sells its plants entirely through wholesale distributors. However, early during the current year, Lilacs & Lavender decides to open a floral shop and engage in the sale of its plants through retail activity. During the three or four months prior to opening the floral shop, Lilacs & Lavender incurs preopening expenditures such as hiring, training, merchandising, store decorating, and promotional activities.

    Which of the following statements is correct regarding the above example?

    a. The 180-month amortization begins 30 days after the floral shop opens.

    b. Lilacs & Lavender is deemed to have made a Section 263 election for the current year.

    c. Lilacs & Lavender is expanding a new business activity through its retail floral shop.

    d. Lilacs & Lavender is required to capitalize the start-up expenditures under IRC Sec. 195.

38. Which of the following is true when using separate entities for expanded activities?

    a. For legal reasons, it is generally advisable to use separate entities for expanded activities.

    b. Start-up expenditures must be capitalized and amortized under IRC Sec. 263 when expanding by setting up a separate tax entity, such as a corporate subsidiary.

    c. Each separate new taxable entity will be considered to have made a Section 263 election.

    d. Amortization for expanded activities begins 180 days after each new business begins.

39. How are start-up expenses handled when incurred at the time a corporation is being organized?

    a. They are amortized over 180 months.

    b. They are amortized over 90 months.

    c. They are amortized over 60 months.

    d. They are capitalized under IRC Sec. 263 into the basis of the property acquired.

40. Start-up costs paid as part of the process of investigating the formation of a QSub must be capitalized under which of the following?

    a. IRC Sec. 165.

    b. IRC Sec. 195.

    c. IRC Sec. 248.

    d. IRC Sec. 263.

GLOSSARY

Charitable remainder trust: A "split-interest" trust in which one party receives an income interest for a term of years (which could be measured by reference to someone's life), and a qualified charitable organization receives the remainder interest. If properly structured as an annuity trust or a unitrust, a charitable contribution deduction is allowed at the time that the trust is funded. The contribution deduction is based on the present value of the remainder interest to be transferred to the charity.

Corporation: A form of business that is a legal entity separate and apart from its owners. In the United States, corporations may be formed under state law, can sue and be sued, can own property and be taxed, and are responsible for their own debts and torts and the torts of their officers, agents, or employees during the course and within the scope of their corporate duties. Owners (shareholders) are subject to limited liability only (i.e., to the extent of their investment). The shareholders annually elect a board of directors to set policy for the corporation. The board appoints officers to carry out the day-to-day management of the corporation. Except for electing directors, the shareholders have no authority to manage the business.

Distribution: Money a taxpayer withdraws from a retirement plan such as an individual retirement account or an employer-maintained pension plan.

Election: An affirmative choice subject to a particular tax law provision. Elections often require the filing of a specific statement or form.

Employee stock ownership plan (ESOP): A stock bonus plan that is qualified, or a stock bonus and a money purchase plan, both of which are qualified under IRC Section 401(a) and that are designed to invest primarily in qualifying employer securities. In addition, the participant is entitled to demand that benefits be distributed in the form of employer securities. If the stock is not readily tradable on an established market, the participant has a right to require that the employer repurchase the securities under a fair valuation formula.

Estate: A taxable, organizational entity used to wind up the affairs and distribute the property of a deceased person. It comes into existence only upon a person's death and holds title to the property of the deceased and exists for a limited time. An estate succeeds to the title of all property of the deceased and is liable for debts. It must pay federal estate tax, applicable state inheritance tax, federal income tax, and any other tax that becomes due on the real and personal property of the estate.

Estimated tax: The amount of tax a taxpayer expects to owe for the year after subtracting expected amounts withheld and the amount of any expected credits. For taxpayers who have earnings not subject to withholding, the IRS requires deposits of the estimated tax four times a year.

Fiscal year: An accounting year ending on the last day of any month except December.

Organizational actions: Corporate reorganization transactions, such as stock splits, mergers, and acquisitions as organizational transactions that affect the basis of specified securities.

Property: Includes (but is not limited to) cash, stock, partnership interests, oil and gas interests, and intangible assets such as goodwill, patents, etc.

PTTP: Post-termination transition period.

Revenue procedure: An official statement of procedures that affect either the rights or duties of taxpayers under the IRC and related statutes, treaties, and regulations. A Revenue Procedure is issued only by the National Office of the IRS and is published in the Internal Revenue Bulletin.

S corporation: A tax status election for corporations that meet the specified requirements under which they are taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). S corporations do not pay the corporate income tax, and corporate losses can be claimed by the shareholders, subject to the basis and passive loss rules. The requirements are located in Subchapter S of the Internal Revenue Code (IRC).

Shareholder: An individual or entity that owns shares of capital stock.

Short tax year: A calendar or fiscal year that is less than 12 months. This may occur in three circumstances. The first instance would be in the first year of operations if the corporation desires to elect a fiscal year ending on a date other than the date (the day before) on which it was incorporated or desires to elect a calendar year and it was not incorporated on January 1.

Specified security: Any share of stock in an entity organized as, or treated for federal tax purposes as, a corporation (foreign or domestic), and any security classified as stock by the issuer.

Stock: All types of common and preferred stock, but assuming the corporation wants to retain its S election, the outstanding shares must confer identical rights to distribution and liquidation proceeds but can have differences in voting rights.

Testamentary: Describes a trust, bequest, or gift created by will that takes effect when the creator dies.

Trust: A fiduciary relationship in which one person holds legal title to property subject to an equitable obligation to safeguard or use the property for the benefit of another. A trust represents a separation of legal and equitable title and may be of two types—inter vivos or testamentary. A trust may have different characteristics, such as accumulation, charitable, Clifford, complex, constructive, irrevocable, living, private, or revocable.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1120S Deskbook—Course 1—Topics Related to Deductions and Pass-through to Shareholders (T2STG171)

CTEC Course No. 3039-CE-2146

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Course Acronym: T2STG171

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1120S Deskbook—Course 2—Eligibility, Filing and Repairing the S Election, Incorporation and Capitalization, and Organizational and Start-up Expenses (T2STG172)

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Course Acronym: T2STG172

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Satisfaction Level:	**Low (1) . . . to . . . High (10)**									
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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