TSCT10

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Companion to PPC's

Tax Planning Guide—S Corporations

Fort Worth, Texas
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Interactive Self-study CPE

Companion to PPC's Tax Planning Guide—S Corporations

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INTRODUCTION

Companion to PPC's Tax Planning Guide—S Corporations consists of three interactive self-study CPE courses. These are companion courses to PPC's Tax Planning Guide—S Corporations 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 **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **May 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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Each course is divided into lessons. Each lesson addresses an aspect of tax planning for S Corporations. 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 which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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COMPANION TO PPC'S TAX PLANNING GUIDE—S CORPORATIONS

COURSE 1

PASS-THROUGH TO SHAREHOLDERS AND BASIS AND LOSSES (TSCTG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course covers important tax planning topics for S corporations and shareholders. Lesson one discusses the basic of pass-through to shareholders Lesson two deals with basis and losses in S corporations.

PUBLICATION/REVISION DATE: May 2010

RECOMMENDED FOR: Users of *PPC's Tax Planning Guide—S Corporations*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of S corporations

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

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Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **May 31, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Pass-through to Shareholders

Completion of this lesson will enable you to:

- Identify the tax planning strategies and techniques for allocation of pass through items; the pass-through rules; the differences between nonseparately stated income or loss and separately stated items; and how to assign pass-through to shareholders on a per-share, per-day basis.
- Determine the tax accounting rules when a stockholder disposes of an entire interest in an S corporation in connection with a qualifying stock disposition or shareholder death.
- Determine which pass-through items and distributions are not subject to the self-employment tax, the various rules relating to interest that is paid by an S corporation or its shareholders, the active or passive nature of pass-through for passive activity loss purposes, and how to increase passive activity loss deductions with self-charged interest.
- Recognize the necessity of reporting multiple activities and maximizing the Section 179 expense deduction.
- Identify tax planning methods such as decreasing the overall tax in a family by paying reasonable salaries, establishing the beneficial owner of S corporation stock and avoiding estimated tax underpayment penalties.

Lesson 2—Basis and Losses

Completion of this lesson will enable you to:

- Identify stockholder basis planning strategies and basis rules.
- Recognize tax planning strategies to deduct losses to the extent of basis, carry over loss items that exceed basis, structure loans to provide shareholders with debt basis and time the deductibility of losses using capital contributions or loans from shareholders.
- Identify the unique tax planning strategies for debt basis and losses allowed under the IRS rules for S corporations.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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Lesson 1: Pass-through to Shareholders

INTRODUCTION

An S corporation, like a partnership, is a reporting entity. The S corporation reports the results of its operations to the shareholders, and this reporting process is called *pass-through*. The shareholders then report the pass-through items of income, loss, credit, or deduction on their individual income tax returns. Pass-through is different from distributions, which occur when the shareholder actually receives cash or property from the corporation.

Pass-through amounts are entered on Schedule K of Form 1120S. These amounts are then allocated to shareholders (generally on a per-share, per-day basis) and each shareholder's share is entered on the shareholder's Schedule K-1.

Unlike a partnership, an S corporation can be subject to tax.

Completion of this lesson will enable you to:

- Identify the tax planning strategies and techniques for allocation of pass through items; the pass-through rules; the differences between nonseparately stated income or loss and separately stated items; and how to assign pass-through to shareholders on a per-share, per-day basis.
- Determine the tax accounting rules when a stockholder disposes of an entire interest in an S corporation in connection with a qualifying stock disposition or shareholder death.
- Determine which pass-through items and distributions are not subject to the self-employment tax, the various rules relating to interest that is paid by an S corporation or its shareholders, the active or passive nature of pass-through for passive activity loss purposes, and how to increase passive activity loss deductions with self-charged interest.
- Recognize the necessity of reporting multiple activities and maximizing the Section 179 expense deduction.
- Identify tax planning methods such as decreasing the overall tax in a family by paying reasonable salaries, establishing the beneficial owner of S corporation stock and avoiding estimated tax underpayment penalties.

ALLOCATION OF PASS-THROUGH—PLANNING STRATEGIES

An S corporation is a reporting entity that notifies its shareholders of their respective shares of pass-through items of income, loss, deduction, and credit. Tax planning strategies to minimize a shareholder's taxable income generally revolve around the following techniques.

Making Elections to Use Specific Accounting Rules

S corporation pass-through items of income, loss, deduction, or credit are normally allocated to shareholders on a per-share, per-day basis. However, an S corporation can elect to use specific accounting rules and thus allocate pass-through items based on the portion of the year that the transactions actually took place. Making these decisions can make a significant difference in each shareholder's income or loss.

An S corporation can elect to allocate pass-through items based on specific accounting when:

a. a shareholder disposes of his entire interest in the S corporation, or

b. there is a qualifying stock disposition, which occurs if, in any 30-day period during the corporation's tax year:

   (1) a shareholder disposes of stock totaling 20% or more of the corporation's outstanding stock;

   (2) the corporation redeems 20% or more of its outstanding stock from a shareholder; or

   (3) the corporation issues stock totaling 25% or more of the previously outstanding stock to one or more new shareholders.

Shareholders must properly consent to these elections.

Death of a shareholder is a complete termination of a shareholder's interest in an S corporation; therefore, the election to use specific accounting rules can be made in the year a shareholder dies.

Timing the Purchase or Sale of S Corporation Stock

Because of the elections to allocate stock based on specific accounting, timing of the purchase or sale of S corporation stock can have a significant effect on the shareholder's pass-through income or loss from the corporation.

Paying Reasonable Salaries to Family Members

Reasonable salaries can be paid to family members in order to reduce the overall tax within a family.

Timing the Sale of Section 1231 Property

Property used in a trade or business or held for the production of rental income represents Section 1231 property if held for more than one year. Upon disposition of depreciable real property held for such purposes, ordinary income resulting from depreciation recapture is calculated first. Any remaining gain is considered Section 1231 gain and receives preferential capital gain treatment [i.e., taxed at a maximum rate of 25% to the extent it is unrecaptured Section 1250 gain and 15% thereafter (for 2010)].

Any net Section 1231 gain for the year is recaptured (treated as ordinary income rather than capital gain) to the extent the taxpayer has nonrecaptured Section 1231 losses. Nonrecaptured Section 1231 losses are defined as net Section 1231 losses deducted in the five tax years prior to the current tax year minus the amount of such losses applied against net Section 1231 gains during the same period.

With proper planning, taxpayers can still achieve preferential capital gain treatment for their Section 1231 gains, even when Section 1231 losses exist. The two key points to consider when planning to avoid the recharacterization rule are that nonrecaptured Section 1231 losses (a) carry over for five years then expire and (b) are not carried back. Therefore, when possible, a taxpayer with a nonrecaptured Section 1231 loss carryover should defer the recognition of Section 1231 gains to the tax year following the expiration of the five-year carryover period. Taxpayers who do not have Section 1231 loss carryovers should try to recognize Section 1231 gains in tax years before Section 1231 losses occur.

Example 1-1: Deferring the recognition of a Section 1231 gain to avoid recapture.

Binder, Inc., an S corporation, claimed a Section 1231 ordinary loss of $50,000 in 2005. The corporation has not had any other Section 1231 gains or losses since that time. In December 2010, the corporation finds a buyer for a small apartment building it owns. If the building is sold, Binder will realize a $75,000 Section 1231 gain. However, if the gain is recognized in 2010, Binder must recharacterize $50,000 of the gain as ordinary income because that is the final year of the nonrecaptured Section 1231 loss carryover period. If the sale is deferred until 2011 (e.g., by using an installment sale or escrow arrangement), Binder will treat the entire $75,000 Section 1231 gain as capital gain.

Example 1-2: Recognizing Section 1231 gains before Section 1231 losses.

Redstar, Inc., an S corporation, intends to sell two Section 1231 assets in 2010, one generating a $50,000 Section 1231 loss and one producing a $50,000 Section 1231 gain. The corporation has no nonrecaptured Section 1231 losses carrying over to the current year. The most advantageous tax strategy for Redstar is to recognize the gain in 2010 and defer recognizing the loss to the following year. Doing so enables Redstar to obtain preferential capital gain treatment on the $50,000 Section 1231 gain in 2010 and ordinary loss treatment on the $50,000 Section 1231 loss in the following year. The Section 1231 loss is not carried back, and therefore does not affect previous Section 1231 gains.

Timing Sales of Capital Gain Property to Minimize Taxes

Carefully timing when securities (e.g., stocks and bonds) and other capital gain-producing assets are sold can result in significant tax savings for S corporation shareholders because of the maximum 15% long-term capital gains rate. If the S corporation can hold an asset for more than one year, shareholders in the top ordinary tax bracket can reduce their tax rate on the gain from 35% to 15% (for 2010) by recognizing a long-term rather than a short-term capital gain.

The first-in, first out (FIFO) method or the specific identification method can be used to identify shares sold when an S corporation sells less than its entire holdings in a particular stock or security.

FIFO Method. If the stock or securities have been acquired on different dates or at different prices and the S corporation does not or cannot identify the specific shares sold, the shares are considered to be sold in the order they were purchased under the FIFO method.

Specific Identification Method. If the corporation specifically identifies the shares sold, the basis and holding period of those shares is used in computing the character (short-term or long-term) and amount of the gain or loss.

Taxpayers can use the specific identification method to sell shares with the highest basis, thereby reducing the recognized gain or increasing the recognized loss. Additionally, shares with specific holding periods can be selected in order to obtain favorable long-term capital gain treatment.

Taking Advantage of the Current Capital Gains Rates

The maximum capital gains rate of 15% is scheduled to expire after 2010, and given the uncertainty in Washington, an increase in the rate might happen earlier. S corporations that are holding long-term capital gain assets may want to sell (to the extent desirable and practical) those assets by December 31, 2010, or earlier to take advantage of the maximum 15% rate.

PASS-THROUGH RULES

Defining Pass-through

Pass-through is the process an S corporation uses to report to shareholders the results of its operations. Pass-through amounts are entered on Schedule K of Form 1120S. These amounts are then allocated to shareholders (generally on a per-share, per-day basis) and each shareholder's portion is entered on the shareholder's Schedule K-1. The shareholders use this pass-through information to report their respective portions of the pass-through items of income, loss, credit or deduction on their individual income tax returns.

Passing through Nonseparately Stated Income or Loss and Separately Stated Items

Items that pass through to shareholders are divided into two main categories: nonseparately stated income or loss and separately stated items.

Nonseparately Stated Income or Loss. Nonseparately stated income or loss includes all ordinary income and expense items (computed under tax accounting rules) attributable to a trade or business 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. Any item of income, loss, deduction, or credit not included in the calculation of nonseparately stated income or loss is stated separately; that is, it is segregated and allocated separately to each shareholder. Examples of separately stated items include income and loss from rental activities, interest, dividends, charitable contributions, and the Section 179 deduction.

Determining When Pass-through Is Reported

The shareholder reports the pass-through items in the tax year that includes the last day of the S corporation's tax year. If, for example, the S corporation is using a year ending December 31, 2010, shareholders report pass-through items of income, gain, loss, deduction, and credit on their 2010 personal income tax returns.

Passing Losses through to Shareholders

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 the corporate and shareholder levels.

Allocating Pass-through on a Per-share, Per-day Basis

Pass-through items are generally allocated to shareholders on a per-share, per-day basis. In general, per-share, per-day allocation means that pass-through items for the entire tax year are allocated equally to each day of the tax year and are in turn allocated equally among the shares of stock outstanding on each day of the tax year. A partnership, on the other hand, can specially allocate items to partners under certain conditions. There is no provision for special allocations by an S corporation.

Electing to Use Specific Accounting When a Shareholder Disposes of Entire Interest in the Corporation

If a shareholder's entire interest in an S corporation is disposed of, the corporation can elect 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 election must consent.

Electing to Use Specific Accounting When a Qualifying Disposition Occurs

An S corporation can elect to use specific accounting when a qualifying disposition occurs. Under the qualifying disposition rules, if 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, the corporation can elect to treat the tax year as if it consists of two separate years. (The first tax year is deemed to end on the date the 20% threshold is met.) The election can also be made when certain stock is issued or redeemed.

Determining Who Owns Shares on Transfer Date

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.

Pass-through Affects Each Shareholder's Stock Basis

S corporation shareholders adjust their basis in stock by the pass-through items. Each shareholder's ability to deduct the losses and deductions may be limited because of basis.

Dividends Received Deduction Is Not Allowable

An S corporation that owns the shares of another corporation is not entitled to the dividends received deduction. IRC Sec. 1363(b) provides that an S corporation's income is computed (with certain exceptions) as if the corporation were an individual. Thus, the dividends received deduction available to C corporations is not allowable.

Passing through Meals and Entertainment Expense

The deduction for meals and entertainment expense is generally limited to 50% of the related expenditure. The deductible portion is an operating expense of the corporation and reduces the nonseparately stated income; that is, ordinary income from trade or business activities.

The nondeductible portion of meals and entertainment expense and other nondeductible expenditures are reported on Schedule K-1 so the shareholders can adjust their stock bases.

NONSEPARATELY STATED INCOME OR LOSS AND SEPARATELY STATED 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 may be treated differently by the individual shareholders because of elections, limitations, and special rules that must be applied at the shareholder level.

Nonseparately stated income or loss includes all ordinary income and expense items (computed under tax accounting rules) attributable to a trade or business 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)." This amount is carried to line 1 of Schedule K and allocated to shareholders on Schedule K-1 (Shareholder's Share of Income, Credits, Deductions, etc.).

Only trade or business income and expenses are included in the nonseparately stated income or loss. All other income and expense items are stated separately, as discussed in the following paragraphs.

Identifying Separately Stated Items

Any item of income, loss, deduction, or credit not included in the calculation of nonseparately stated income or loss is stated separately; that is, it is segregated and allocated separately to each shareholder. Separately stated items are reported on Schedule K of the Form 1120S. The more common items taken into account separately are:

a. Income and loss from each rental activity.

b. Portfolio income, including interest, dividends, and royalties.

c. Tax-exempt income.

d. Net long-term capital gains or losses.

e. Net short-term capital gains or losses.

f. Gains and losses from sale or exchange of Section 1231 assets (i.e., those used in the corporation's trade or business).

g. Charitable contributions.

h. The Section 179 deduction; that is, expensing of certain depreciable assets.

i. Investment interest expense.

j. Items used in the computation of oil and gas depletion.

k. Intangible drilling costs.

l. Nondeductible expenses (including the nondeductible portion of meals and entertainment expenses and sky box rentals).

m. Information necessary to calculate the domestic production activities deduction under IRC Sec. 199.

n. Information necessary to determine credits (e.g., improvements qualifying for the Disabled Access Credit).

o. Corporate-level tax.

Separately stated items, by their character and nature, have some distinction in the way they are treated on Form 1040. Some of these items must be stated separately because limitations may apply, separate disclosure is

necessary, or use of the item on the shareholder's return requires an election. Others must be stated separately for purposes of computing shareholder basis.

Example 1-3: Reporting pass-through items.

Diane and Nate each own 50% of the shares of DN, Inc., an S corporation. DN's net income from its advertising business is $50,000. It receives $4,600 of tax-exempt interest income during the year and recognizes a $10,000 long-term capital gain. Also, the company 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, charitable contributions, tax-exempt interest income, and nondeductible portion of meals and entertainment expense are separately stated items.

ALLOCATION OF PASS-THROUGH TO SHAREHOLDERS ON A PER-SHARE, PER-DAY BASIS

Pass-through items from an S corporation are allocated on a per-share, per-day basis. There is no provision for special allocations. Generally, this means pass-through items for the entire year are allocated equally to each day of the tax year and are in turn allocated equally among the shares of stock outstanding on each day of the tax year.

Example 1-4: Allocating Pass-through when no corporate shares change hands.

GHI Corp. is an S corporation that reports on a calendar year. The corporation's shares are owned 50% by George and 50% by Harry. For the four months ending April 30, the company showed a $60,000 loss; but, during the next three months of the year, it had net income of $30,000. During the final five months, GHI had net income of $20,000, resulting in a net loss of $10,000 for the year. The loss is the only pass-through item for the year. How is the income or loss allocated to the shareholders?

Under the per-share, per-day method, nonseparately stated income or loss and separately stated items for the entire tax year are allocated among the shareholders. Here, the net loss for the year ($10,000) is allocated 50% ($5,000) to George and 50% ($5,000) to Harry. The $10,000 loss is reported on Schedule K of Form 1120S, and each shareholder's $5,000 portion is passed through on a separate Schedule K-1.

As illustrated in Example 1-5, the allocation is more complex when ownership changes.

Planning Tip: Example 1-5 also illustrates that use of the per-share, per-day method can benefit new shareholders if the corporation reports losses for the portion of the year preceding the stock transfer.

Example 1-5: Allocating pass-through to shareholders on a per-share, per-day basis when shares change hands during the year.

Assume the same facts as in Example 1-4, except that on May 1, 2010, Ike begins working for GHI and enters negotiations to buy stock in GHI. On July 31, Ike acquires half of Harry's shares. All of the shareholders actively participate in the business. (GHI did not make an election relating to the allocation of pass-through. Ike asks his tax practitioner if he can report part of the loss on his individual return, even though the loss occurred before he acquired his shares. Can Ike benefit from the loss incurred before he purchased his shares?

When shares change hands during the year, application of the per-share, per-day method is very cumbersome. The instructions to Form 1120S, however, set out a simplified method that can be used. The allocation under this simplified method is made by multiplying the percentage of stock owned by the percentage of the year it is owned and applying the resulting percentage to the corporation's income for the year. Using that method, the pass-through to George, Harry, and Ike is as follows:

	(a) (% of Stock)	(b) (% of Year)	(c) (a) × (b)	(d) (Total %)
George	50.0%	100.00%	50.0%	50%
Harry	50.0%	58.1%[a]	29.0%	
	25.0%	41.9%[b]	10.5%	39.5%
Ike	25.0%	41.9%[c]	10.5%	10.5%
Total				100.0%

Notes:

[a] [212 ÷ 365 days. (The percentage is based on 366 days in a leap year.)]

[b] (153 days ÷ 365 days.)

[c] (153 days ÷ 365 days.)

Each item of pass-through is allocated to the shareholders based on these percentages. Here, the only item is ordinary loss of $10,000, and it is passed through as follows:

George	$10,000 × 50.0%	$ (5,000)
Harry	$10,000 × 39.5%	(3,950)
Ike	$10,000 × 10.5%	(1,050)
Total		$ (10,000)

The shareholders report the pass-through losses on their 2010 returns (i.e., in the tax year that includes the last day of the S corporation's tax year).

Because of the allocation method used, Ike benefits from the loss incurred before he purchased his shares. The allocation of pass-through from the S corporation is calculated on a per-share, per-day basis for the entire year because the corporation did not make the election to use specific accounting. Ike, therefore, is passed through his proportionate share of loss for the tax year. This result produces a substantially lower pass-through to Ike than would have been allocated to him if the corporation had elected to use the specific accounting method. (See Example 1-11.)

Passing through Losses to Shareholders Who Cannot Deduct the Losses Because of Limitations

Losses and deductions are passed through to the shareholders in full, even though the shareholder's ability to deduct the losses and deductions may be limited because of basis, the passive activity loss rules, or the at-risk rules. The exception to this rule is the Section 179 deduction, which is limited at the corporate and shareholder levels.

SELF-STUDY QUIZ

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

1. The election to use specific accounting may be made upon a qualifying disposition of stock. A qualifying disposition of stock occurs when which of the following occurs?

   a. A shareholder disposes of 20% or more of the corporation's stock during any 30-day period during the corporation's taxable year.

   b. Stock equal to or greater than 20% of the previously outstanding stock is issued to one or more new shareholders during a 30-day period during the corporation's taxable year.

2. Which of the following is a separately stated item on an S corporation tax return?

   a. Tax-exempt income.

   b. Mortgage interest expense.

   c. Section 1245 gain or loss.

   d. Depreciation.

3. Charles is a calendar year individual. He owns an interest in an S corporation with a November 30th year end. In which year would Charles report the items of income and loss passed through from the S corporation's operations for the year December 1, 2008 through November 30, 2009?

   a. Fiscal year November 30, 2009.

   b. Calendar year 2010.

   c. Calendar year 2009.

   d. Calendar year 2008.

4. Which of the following losses or deductions are limited at the S corporation level and then passed through to the shareholder?

   a. Section 179 deduction.

   b. Charitable contributions.

   c. Investment interest expense.

   d. Capital losses.

5. Frank and Cecil own an equal interest in Dante Corporation, a calendar year S corporation. On October 1st of the current year, Frank sells his entire interest in the S corporation to Louie. The S corporation reported ordinary income of $100,000 for the entire year. However, for the period January 1st through September 30th, Dante incurred a taxable loss of ($10,000). Using a per-share per-day allocation method, compute the allocation of income or loss to Frank for the calendar year. (Hint: Assume no other elections are made.)

   a. $(5,000).

   b. $50,000.

   c. $37,397.

   d. $0.

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. The election to use specific accounting may be made upon a qualifying disposition of stock. A qualifying disposition of stock occurs when which of the following occurs? **(Page 3)**

   a. A shareholder disposes of 20% or more of the corporation's stock during any 30-day period during the corporation's taxable year. [This answer is correct. If a shareholder disposes of 20% or more during any 30-day period, then a qualifying disposition occurs per Reg. 1.1368-1(g)(2).]

   b. Stock equal to or greater than 20% of the previously outstanding stock is issued to one or more new shareholders during a 30-day period during the corporation's taxable year. [This answer is incorrect. For a qualifying disposition to occur, according to Reg. 1.1368-1(g)(2) stock equal to or greater than 25% must be issued during such a 30-day period.]

2. Which of the following is a separately stated item on an S corporation tax return? **(Page 5)**

   a. Tax-exempt income. [This answer is correct. Tax-exempt income is a separately stated item per IRC Sec. 1366(a); Reg. 1.1366(a).]

   b. Mortgage interest expense. [This answer is incorrect. Mortgage interest expense is included in ordinary income. Other types of interest expense may be separately stated, but mortgage interest is an ordinary business expense.]

   c. Section 1245 gain or loss. [This answer is incorrect. Section 1245 gain or loss is part of the ordinary income or loss computation. Other types of gain and loss are separately stated, but Section 1245 gain or loss is not separately stated.]

   d. Depreciation. [This answer is incorrect. Depreciation is included in the computation of ordinary income or loss and is not separately stated.]

3. Charles is a calendar year individual. He owns an interest in an S corporation with a November 30th year end. In which year would Charles report the items of income and loss passed through from the S corporation's operations for the year December 1, 2008 through November 30, 2009? **(Page 5)**

   a. Fiscal year November 30, 2009. [This answer is incorrect. Charles is a calendar year taxpayer and will report his flow through items from the S corporation during his calendar year, not the S corporation's fiscal year.]

   b. Calendar year 2010. [This answer is incorrect. Reporting income or loss flowing through from the S corporation for the year ended November 2009 would not be delayed until 2010.]

   c. Calendar year 2009. [This answer is correct. Charles will report his flow through items from the S corporation's taxable year end November 30, 2009, in the tax year that includes the last day of the S corporation's tax year, which would be 2009.]

   d. Calendar year 2008. [This is incorrect. Charles would already have filed his 2008 tax return when receiving his Form K-1 with his flow through information from the year end November 30, 2009. Although part of the S corporation's tax year is in 2008, per the IRS rules, Charles would not report any of these pass-through items in 2008.]

4. Which of the following losses or deductions are limited at the S corporation level and then passed through to the shareholder? **(Page 6)**

   a. Section 179 deduction. [This answer is correct. The Section 179 deduction is limited at the S corporation level, passed through to the shareholders, and then limited at the shareholder level.]

   b. Charitable contributions. [This answer is incorrect. Limitations on charitable contributions are applied at the shareholder level.]

   c. Investment interest expense. [This answer is incorrect. The total amount of investment interest expense is passed through to the shareholders and then any limitations are applied at the shareholder level.]

   d. Capital losses. [This answer is incorrect. The total amount of capital loss is passed through to the shareholders and then any limitations are applied at the shareholder level.]

5. Frank and Cecil own an equal interest in Dante Corporation, a calendar year S corporation. On October 1st of the current year, Frank sells his entire interest in the S corporation to Louie. The S corporation reported ordinary income of $100,000 for the entire year. However, for the period January 1st through September 30th, Dante incurred a taxable loss of ($10,000). Using a per-share per-day allocation method, compute the allocation of income or loss to Frank for the calendar year. (Hint: Assume no other elections are made.) **(Page 8)**

   a. $(5,000). [This answer is incorrect. If the specific accounting election were made, then Frank's allocation would be ($5,000), but the question asks to use the per-share per-day allocation.]

   b. $50,000. [This answer is incorrect. Frank's ownership percentage is 50% but only through September. According to the Code, if no other elections are made, his income allocation must be pro-rated for the number of days he owned his shares.]

   c. $37,397. [This answer is correct. Frank's allocation of income using a per-share per-day allocation is $37,397 computed: $100,000 × 50% × 273/365 days per the IRS Code.]

   d. $0. [This answer is incorrect. According to the Code, Frank will receive an allocation of income for his percentage owned through September.]

APPLYING SPECIFIC ACCOUNTING RULES WHEN STOCKHOLDER DISPOSES OF AN ENTIRE INTEREST IN AN S CORPORATION

Planning Considerations When Shareholder Disposes of Entire Interest in the S Corporation

If a shareholder entirely disposes of his or her S corporation stock, a corporate election can be made to treat the tax year as if it consisted of two tax years (i.e., the election to apply specific accounting rules in connection with the termination of a shareholder's entire interest). The specific accounting election allows the departing shareholder to be allocated only pass-through items attributable to the specific period of time the stock was owned. The election requires the consent of shareholders affected by the stock disposition and is made with the corporate tax return, allowing the shareholders to use hindsight to select the most beneficial method of allocating pass-through items. However, if the election is beneficial to the departing shareholder, it probably will be detrimental to the new shareholder. Therefore, the shareholders should consider the election when preparing the terms of the stock sale agreement. (An election to apply specific accounting rules in connection with a qualifying stock disposition can be made when certain stock is issued, redeemed, or otherwise transferred.)

Some of the factors to consider when determining which method to use are:

a. What items of income or loss were recognized before the stock sale took place?

b. What items of income or loss were (or are projected to be) recognized after the stock sale took place?

c. How much cash can be distributed before the sale of stock takes place?

d. What effect does the basis adjustment for pass-through of income or loss have on the seller's gain or loss on the sale of stock?

e. What other income or loss items appear on the shareholder's return?

f. Are pass-through income or loss and the gain or loss on the sale of stock active or passive in nature?

g. Does the shareholder have other capital gains or losses?

h. Does the shareholder have capital loss carryovers?

i. Is the S corporation using the cash or accrual method?

When the specific accounting election is made, the income, loss, deduction, and credit items are allocated between the deemed short years. The allocation is based on the specific transactions in each period using the corporation's books and records under normal accounting rules. Thus, the company's accounting methods (e.g., cash or accrual) are applied to each period. If the corporation uses the cash method, it might be possible to manipulate income or expenses into the period that provides the best results. For example, delaying payment of an expense until the departing shareholder has disposed of the shares will defer the expense deduction into the second short year. Conversely, accelerating the payment reduces income in the first short year.

Changes in the pass-through income or loss may have no effect on the overall income or loss of the departing shareholder, but will affect the new shareholders. When an S corporation's shareholder is going to dispose of all of his or her shares, a cash-basis corporation can accelerate or delay income or expenses to the extent possible (without ignoring good business practices) to obtain the most favorable income tax results.

Pass-through When Shareholder Disposes of an Entire Interest in an S Corporation

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. However, if a shareholder's entire interest in the corporation is disposed of, the corporation can elect to allocate pass-through items based on the actual transactions that occurred before and after the stock disposition took place. The election is referred to as the "election to apply specific accounting

rules in connection with the termination of a shareholder's entire interest." If the specific accounting method is elected, the tax year is treated as if it consisted of two tax years. The first is deemed to end on the date that the shareholder terminated her interest in the corporation, and the second ends on the last day of the normal tax year. The corporation's actual books and records are used to specifically account for transactions in each period under normal tax accounting rules.

The election to use specific accounting is effective for (a) allocating income and loss; (b) adjusting basis, the accumulated adjustments account (AAA), and accumulated earnings and profits (AE&P); and (c) determining the tax effect of distributions.

Shareholder Consent. Shareholders affected by the stock disposition must consent to the specific accounting election. The shareholders affected by the stock disposition include all shareholders who disposed of shares and all shareholders acquiring shares during the tax year. If the shares are transferred to the corporation (e.g., the corporation redeems stock from the shareholder), all shareholders who owned stock during the year are affected shareholders.

Tax Year Does Not Terminate When Specific Accounting Election Is Made. 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 annual pass-through amount.

Death of a Shareholder

Death of a shareholder is a complete termination of his or her interest in an S corporation, so the election to use specific accounting rules can be made in the year a shareholder dies.

Making the Election to Apply Specific Accounting Rules

The election to apply specific accounting rules in connection with the termination of a shareholder's entire interest is made by attaching a statement to a timely filed original or amended tax return (Form 1120S) for the year the disposition of shares occurred. The statement must state that the corporation is electing under IRC Sec. 1377(a)(2) to have the rules provided in IRC Sec. 1377(a)(1) applied as if the tax year consists of separate tax years, and must state the facts relating to the disposition of shares. It must also state that the corporation and all shareholders affected by the stock disposition consent to the election. (The actual shareholder consents should be kept in the corporation's files and do not have to be attached to the Form 1120S.) Once made, the election is irrevocable.

Example 1-6: Electing to apply specific accounting rules when stockholder disposes of an entire interest in an S corporation.

The stock of ABCD Corp. is held by Ann, Bea, and Chris, who each own 33 shares on January 1, 2010. Chris sells all of her stock to a new shareholder, Dena, on June 30 for $35,000. ABCD reports on a calendar year, and all of the shareholders materially participate in the operations of the business.

Chris has basis of $15,000 in her stock at the beginning of 2010. 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.

Chris has a $35,000 capital loss carryover at the beginning of 2010. She was paid $50,000 of salary during the year. Chris asks how she can minimize her tax. She says that as of June 30 the company had incurred a loss, and she should not have to pay tax on the corporate income that was earned after she sold her stock. No distributions were made during the year. Can pass-through items from an S corporation be allocated to a departing shareholder based on the operating results as of the date the stock disposition occurred?

Using the per-share, per-day allocation method, income would be passed through as follows:

Ann	(33.3% of shares × 365/365 of year)	$ 20,000
Bea	(33.3% of shares × 365/365 of year)	20,000

Chris	(33.3% of shares × 181/365 of year)	9,919
Dena	(33.3% of shares × 184/365 of year)	10,081
Total		$ 60,000

If the corporation elects to use the specific accounting method, 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
Ann	$ (13,334)	$ 33,334	$ 20,000
Bea	(13,333)	33,333	20,000
Chris	(13,333)	—	(13,333)
Dena	—	33,333	33,333
Totals	$ (40,000)	$ 100,000	$ 60,000

	Per-share, Per-day	Specific Accounting
Ann	$ 20,000	$ 20,000
Bea	20,000	20,000
Chris	9,919	(13,333)
Dena	10,081	33,333
Totals	$ 60,000	$ 60,000

The same amount of income ($20,000) is allocated to Ann and Bea, the two shareholders who held the same percentage of shares all year, under the two methods. However, the two methods allocate significantly different amounts of income (or loss) to Chris and Dena, the two shareholders involved in the stock sale. As affected shareholders, Chris and Dena must consent to the election.

Example 1-7: Ensuring that seller and purchaser of stock will consent to the election to use specific accounting.

In Example 1-6, if no election is made, Chris must pick up $9,919 of income. If the election is made, Chris 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, Chris 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 Dena will not consent to the use of specific accounting.

To guard against this, at the time the sale takes place, Chris could have Dena sign an agreement that Dena will consent to the election. Making such an agreement ensures that the departing shareholder has no involvement in income or deductions after the date of the stock disposition. If such an agreement is not made, disputes between the affected shareholders can arise later because it is not possible to know at the date the sale takes place what the year-end amounts will be if the per-share, per-day method is used. The agreement between the affected shareholders that specific accounting will be used, made as part of the stock sales transaction, can remove the potential for these disputes.

Seller's Overall Result May or May Not Be Affected by the Election

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, income that passes through increases basis and, therefore, reduces gain on the sale of stock.

Example 1-8: Seller's overall result might not be affected by the election to use specific accounting.

Chris, in Examples 1-6 and 1-7, disposed of her shares. The tax effect of the per-share, per-day method and specific accounting method can be computed as follows:

	Per-share Per-day	Specific Accounting
Taxable income (loss)	$ 9,919	$ (13,333)
Basis:		
Basis, beginning of the year	$ 15,000	$ 15,000
Income	9,919	—
Basis, before distributions and loss items	24,919	15,000
Distributions	—	—
Loss	—	(13,333)
Basis, end of year	$ 24,919	$ 1,667
Capital gains and losses:		
Sales price of stock	$ 35,000	$ 35,000
Basis, from above	(24,919)	(1,667)
Capital gain from stock sale	10,081	33,333
Capital loss carryover	(35,000)	(35,000)
Gain (loss limited to $3,000)	$ (3,000)	$ (1,667)
Total income related to		
Total income related to ABCD Corp.:		
Taxable income (loss)	$ 9,919	$ (13,333)
Gain on stock sale	10,081	33,333
Total	$ 20,000	$ 20,000

Even though the total income related to ABCD is the same regardless of which allocation method is used, the taxation of Chris's income will be significantly different. First, the character of the income Chris will recognize varies under the two methods, which could be significant for several reasons:

1. Eligibility for the 0% or 15% maximum tax rates (for 2010) on long-term capital gains from selling capital assets held for more than 12 months.

2. Use of capital loss carryforwards and current year capital losses (which otherwise may be subject to the $3,000 annual limit).

3. Timing of income recognition if an installment sale occurs because only the capital gain portion is eligible for installment reporting.

Second, Chris's adjusted gross income is different under each method, as follows:

	Per-share, Per-day	Specific Accounting
Wages	$ 50,000	$ 50,000
ABCD income (loss)	9,919	(13,333)
Capital gain (loss	(3,000)	(1,667)
Adjusted gross income	$ 56,919	$ 35,000

The difference occurs because of the IRC Sec. 1211 capital loss limitation. 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. Use of the specific accounting method allows Chris to use all of her capital loss carryover, while she benefits from only $13,000 of the $35,000 capital loss carryover under the usual per-share, per-day allocation method. However, obtaining Dena's consent 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.

Obtaining Shareholder Consent by Distributing Current Income

As illustrated in Example 1-8, a shareholder who owns shares part of the year may be reluctant to agree to the specific accounting method. (Dena, in Example 1-8, is allocated $10,081 of income if the specific accounting method is not used, and $33,333 if it is used.) Some practitioners mitigate or eliminate the reluctance by recommending that the corporation agree to make distributions during the year in amounts equal to each shareholder's pass-through income. That way, if Dena was allocated $10,081, she would receive a distribution of $10,081 during the year. If she received pass-through of $33,333, she would receive a distribution of that amount. The other shareholders would also receive distributions equal to their pass-through incomes. Assuming that cash is available to make the distributions, each shareholder has the funds to pay the income tax on the income allocated to the shareholder.

Effect of Specific Accounting Election on Purchaser of Stock

In many instances (as illustrated in Example 1-8), the seller of S corporation stock will experience the same overall amount of income or loss whether pass-through is allocated by the per-share, per-day method or the specific accounting method. However, this usually is not true for the purchaser of the stock.

Example 1-9: Effect of specific accounting election on purchaser of stock.

Dena is the purchaser of stock in Examples 1-6 through 5-8. In Dena'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, her share of the income increases to $33,333.

Unless the corporation can distribute cash to pay the resulting tax, Dena would obviously prefer to be taxed on the lesser amount. It is true that 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 she disposes of her stock.

Making Elections to Use Specific Accounting When There Are Multiple Ownership Changes

More than one election to use specific accounting because of the disposition of an entire interest can be made for a year in which multiple stock dispositions occur.

Example 1-10: Electing to use specific accounting when there are multiple ownership changes.

Abe and Barney each own 50% of the shares of ABC Corp, a calendar-year S corporation. Abe sells all of his shares to Chuck on June 30. On November 30, Barney sells all of his shares to Chuck. If the books were closed as of June 30, ABC would pass through an operating loss of $20,000. For the next five months (through November 30) ABC 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 ABC's only pass-through item.

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 %
Abe	50%	49.59%[a]	24.80%	24.80%[b]
Barney	50%	91.51%[c]	45.75%	45.75%[b]
Chuck	50%	41.92%[d]	20.96%	
	100%	8.49%[e]	8.49%	29.45%[b]
Total				100.00%

Notes:

[a] 181 days/365 days. (The percentage is based on 366 days in a leap year.)

[b] Instructions to Form 1120S indicate that these percentages should be used for Schedule K-1 as "shareholder's percentage of stock ownership for the tax year."

[c] 334 days/365 days.

[d] 153 days/365 days.

[e] 31 days/365 days.

Thus, the $30,000 of income is allocated and passed through to the shareholders as follows:

Abe (24.80% × $30,000)	$ 7,439
Barney (45.75% × $30,000)	13,725
Chuck (29.45% × $30,000)	8,836
Total	$ 30,000

The corporation can elect to close the books and use specific accounting as of June 30 if the affected shareholders (i.e., Abe and Chuck) consent. It can also make a second election to close the books as of November 30 because of Barney's disposition of all of his shares. Barney and Chuck must consent to this election. If both elections are made, the loss through June 30 is allocated to Abe and Barney, the income through November 30 is allocated to Abe and Chuck, and December's income is passed through to the remaining shareholder, Chuck, as follows:

	1/1-6/30	7/1-11/30	12/1-12/31	Total
Abe	$ (10,000)	$ —	$ —	$ (10,000)
Barney	(10,000)	20,000	—	10,000
Chuck	—	20,000	10,000	30,000
Total	$ (20,000)	$ 40,000	$ 10,000	$ 30,000

APPLYING SPECIFIC ACCOUNTING RULES IN CONNECTION WITH A QUALIFYING STOCK DISPOSITION

Planning Considerations when There Is a Qualifying Stock Disposition

Under the per-share, per-day allocation method, a shareholder who disposes of stock cannot determine the tax consequences of the disposition or of distributions received prior to the disposition until the end of the corporation's tax year. To alleviate this uncertainty, the Section 1368 regulations (relating to distributions) authorize the S corporation to elect to use specific accounting and treat the tax year as if it consists of separate years. If a qualifying stock disposition takes place, a corporate election can be made to treat the tax year as if it consisted of two tax years.

The specific accounting election allows the shareholder to be allocated pass-through items based on the specific period of time the various stock ownership percentages were held. The election requires the consent of all shareholders during the year and is made with the corporate tax return, allowing the shareholders to use hindsight to select the most beneficial method of allocating pass-through items. However, if the election is beneficial to one departing shareholder, it may be detrimental to another. Therefore, the shareholders should consider the election when preparing the terms of the stock transfer agreements. (An election to apply specific accounting rules in connection with a qualifying stock disposition can also be made when there is a disposition of a shareholder's entire interest in the corporation.)

Making the Election to Apply Specific Accounting Rules in Connection with a Qualifying Stock Disposition

An S corporation can elect to use specific accounting and treat the tax year as if it consists of separate years when 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. (The first tax year is deemed to end on the date the 20% threshold is met.) The regulations also allow an S corporation to make the election to use specific accounting when the following qualifying dispositions take place:

a. 20% or more of its outstanding stock is redeemed from a shareholder within any 30-day period during the tax year, if the redemption is treated as an exchange under IRC Sec. 302(a) or IRC Sec. 303(a).

b. 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.

All shareholders who held stock during the tax year must consent to the election. (This differs from the election to use specific accounting when a shareholder disposes of an entire interest in the corporation, which requires that only affected shareholders must consent.)

The election is effective for (a) allocating income and loss; (b) adjusting basis, the accumulated adjustments account (AAA), and accumulated earnings and profits (AE&P); and (c) determining the tax effect of distributions.

Example 1-11: Making the election to use specific accounting in connection with a qualifying stock disposition.

GHI Corp. is an S corporation that reports on a calendar year. The corporation's shares are owned 50% by George and 50% by Harry. For the four months ending April 30, the company showed a $60,000 loss; but, during the next three months of the year, it had net income of $30,000. During the final five months, GHI had net income of $20,000, resulting in a net loss of $10,000 for the year. On May 1, Ike begins working for GHI and enters negotiations to buy stock in GHI. On July 31, Ike acquires half of Harry's shares. All of the shareholders actively participate in the business.

The corporation elects to use the specific accounting method in connection with a qualifying stock disposition. (A qualifying disposition was made because Harry sold more than 20% of the corporation's issued and outstanding stock within a 30-day period.) If the election is made, the corporation treats the tax year as if it consisted of two tax years. The first short tax year is considered to end on the date the shares are transferred. In effect, the books are closed at the end of that day (using normal tax accounting rules), and the allocation to shareholders is based on the actual transactions that occurred during each shareholder's period of ownership. The specific accounting election affects only allocations to shareholders; the tax year does not actually terminate, and only one tax return is filed for the year.

Under the specific accounting method, allocations to the shareholders are as follows:

	1/1-7/31	8/1-12/31	Total
George	$ (15,000)	$ 10,000	$ (5,000)
Harry	(15,000)	5,000	(10,000)
Ike	—	5,000	5,000
Total	$ (30,000)	$ 20,000	$ (10,000)

See Example 1-5 for the pass-through amounts to these shareholders when the per-share, per-day method is used.

How Election to Use Specific Accounting Is Made in Connection with a Qualifying Disposition

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.

ALLOCATION OF PASS-THROUGH WHEN A SHAREHOLDER DIES

Using Prorata or Specific Accounting Methods on Decedent's Final Return

When an S corporation shareholder dies, pass-through items are allocated to him through the date of death and are reported on his final return. The pass-through items for the remainder of the S corporation's year are allocated to the deceased shareholder's estate or to the person or other entity that acquires the stock. The allocation of pass-through items is made on a prorata (per-share, per-day) basis using the entire corporate year unless the corporation elects to use specific accounting from the actual books and records as of the date of death. If the specific accounting election is made because of a shareholder's death, the executor or administrator of the estate consents to the election on behalf of the deceased shareholder. If the stock goes into the estate (rather than directly to another beneficiary), the executor or administrator also consents to the election on behalf of the estate.

Example 1-12: Allocating pass-through when a shareholder dies.

Jane and Jeff each own 50% of the shares of JJ Corp, an S corporation. Jeff dies on June 30 and his shares are transferred to his estate. If the books were closed at the end of June 30, JJ 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. The income is JJ's only pass-through item.

Jeff's death is a complete termination of his interest. If the specific accounting election is not made, pass-through to Jeff's final Form 1040 is based on the income for the entire year as follows:

Jane (50% of shares × 365/365 of year)	$ 15,000
Jeff (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 of Jeff's estate must consent to the election on behalf of both Jeff and the estate.) The pass-through will result in the following allocation to the shareholders:

	1/1–6/30	7/1–12/31	Total
Jane (50%)	$ (10,000)	$ 25,000	$ 15,000
Jeff (50% × $20,000)	(10,000)	—	(10,000)
Estate (50% × $50,000)	—	25,000	25,000
Totals	$ (20,000)	$ 50,000	$ 30,000

Making Elections to Use Specific Accounting When Shares Are Transferred from the Estate to Beneficiaries

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, may be made when shares are transferred from the estate to the beneficiary or beneficiaries.

Example 1-13: Electing to use specific accounting when shares are transferred from the estate to beneficiaries.

Assume the same facts as in Example 1-12. On March 31 of the following year, the estate transfers the stock to Jeff's beneficiary, Jerry. Because the estate has disposed of its entire interest in JJ, the corporation can make the election to use specific accounting. If the specific accounting election is made, pass-through to the estate's fiduciary return is based on the income or loss through March 31. Both Jerry and the executor or administrator of Jeff's estate must consent to the election.

Example 1-14: Electing to use specific accounting when transfer from estate to beneficiary is a qualifying disposition of stock.

Assume the same facts as Example 1-13, except that Jeff left 75% of his stock to Jerry and 25% of his stock to Jill. On March 31, the estate distributes the shares inherited by Jerry, and on October 31, it distributes Jill's stock to her. When the shares are distributed to Jerry, the estate has disposed of 37.5% (50% $\times$ 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. All shareholders (Jane, Jill, 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 Jill because the estate will have disposed of its entire interest in the 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.

Passing through Income to Decedent Shareholder When Corporation Uses a Fiscal Year

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. Best practices indicate that the decedent's share of the income for the S corporation's fiscal year in which the shareholder dies is included in his or her final return.

Example 1-15: Pass-through to decedent shareholder when corporation uses a fiscal year.

Phil and John each own 50% of the shares of Popco, an S corporation, that uses a fiscal year ending October 31. Phil dies on December 1, 2010. The corporation passes through to Phil income of $20,000 for the tax year ending October 31, 2010 and $25,000 for the tax year ending October 31, 2011. How much income is reported on Phil's final Form 1040 for the year ending December 31, 2010?

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 Phil had disposed of his shares other than by death, he would report $20,000 income from the S corporation on his 2010 Form 1040 and $25,000 on his 2011 Form 1040. However, since Phil's final return is filed for the year ending December 31, 2010, it appears that both the $20,000 and the $25,000 would appear on that return, even though Popco does not pass through the $25,000 until October 31, 2011—the end of its tax year that includes the date of Phil's death.

Note that it may be necessary to file an amended final return for Phil 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 corporation's fiscal year.

Passing Through Life Insurance Proceeds

Life insurance proceeds are generally tax-exempt income if paid to an S corporation upon the death of the insured. The proceeds are normally allocated to the shareholders on a per-share, per-day basis and increase each affected shareholder's stock basis. A shareholder's death, however, is a total disposition of the shareholder's interest in the S corporation, so the corporation can make the specific accounting election and allocate pass-through items based on the actual transaction dates.

ESTABLISHING OWNERSHIP ON THE DAY 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. Allocations to the acquiring shareholder begin on the day following the date the stock is acquired.

Example 1-16: Determining stock ownership on the day shares are transferred.

Bill's shares are transferred to Norman on June 30. Bill is considered to own the shares through June 30. The transferee, Norman, is considered to own the shares on July 1.

PASS-THROUGH WHEN S ELECTION TERMINATES—TIMING

Pass-through to shareholders is affected when the S election terminates on a date other than the corporation's year-end. Generally, corporate items of income, loss, deduction, and credit for the entire tax year are allocated prorata between the S and C corporation short years based on the number of days in each short year. However, a corporation can elect, with the consent of all shareholders, to allocate items between the S and C short years based on a specific accounting from the company's actual books and records for the period the S corporation election is in effect. Actual books and records must be used if a sale or exchange of 50% or more of the corporation's stock occurs during the termination year or if a Section 338 election is made in connection with a purchase of 80% or more of the S corporation's stock.

Example 1-17: Allocating pass-through when S election terminates.

Norman and Norma each own 50% of the stock of Nan, Inc., a calendar year S corporation. On July 1, the corporation revokes its S election. If no allocation election is made, items of income, loss, deduction, and credit are allocated prorata between the S and C corporation short years based on the number of days in each year. If the corporation so elects, items are allocated between the S and C short years using specific accounting from the actual books and records during each short period. If Norman had sold all of his shares to Norma on July 1, the date the termination became effective, the corporation 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.

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 the shareholders on a per-share, per-day basis using the number of days in the S short year.

Timing of Pass-through When the S Election Terminates during a Fiscal Year

When the S election terminates, the shareholder reports pass-through items on his personal tax return for the year that includes the last day of the C corporation short tax year. The S termination year includes both the S and C short years.

Example 1-18: Pass-through to shareholders when a fiscal year S corporation terminates its S election.

Sky Corp. is an S corporation with a fiscal year ending July 31. Dale, the sole shareholder, reports on a calendar year. On December 1, 2010, the S corporation election is terminated. On that date the only pass-

through item is ordinary income of $15,000. For the remainder of the fiscal year, the corporation recognized ordinary income of $50,000, so net income for the full year is $65,000. How is income allocated to each short year, and in which calendar year will Dale be taxed on the income?

The S termination year is split into an S corporation short year ending November 30, 2010, and a C corporation short year ending July 31, 2010. The S corporation income tax return is not due until the return for the full tax year would be due. Since the normal year-end is July 31, the return is due October 15, 2010, not considering extensions.

The best results for Dale are accomplished by making the election, so Dale will report $15,000 in taxable income from the S corporation. If the election is not made, the year's $65,000 income is allocated based on the number of days in each short year. In that case, income of $21,726 (122/365 × $65,000) would pass through to Dale and $43,274 (243/365 × $65,000) would be allocated to the C corporation year.

An important exception to these rules applies if 50% or more of the corporation's stock is sold or exchanged in the termination year. In that event, the prorata method cannot be used, and the specific accounting method is required rather than elective.

The election to use the specific accounting allocation method is attached to the corporation's return for the C short year. Therefore, the election does not have to be made until the tax return for the total year is filed. In other words, the shareholders conceivably can remain undecided about whether to use the prorata or specific accounting method up to the filing date of the return. The due date for filing the return for the S short year is the same as for the C short year.

This example also poses this question: Is income properly reportable by the shareholder in the year the S election terminates or in the year the S corporation's normal year ends? If the answer is the former, Dale will report the income in 2010; otherwise, he will report it in 2011.

A shareholder includes the pass-through in his taxable income for the year in which the S corporation's termination year ends. Since the term "S corporation year" includes both the S and C short years, the pass-through occurs in 2011 in this case. The termination of the S election does not accelerate income (or loss) recognition.

The post-termination transition period rules apply upon the termination of the corporation's S election.

SELF-STUDY QUIZ

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

6. Frank and Cecil own an equal interest in Dante Corporation, a calendar year S corporation. On October 1st of the current year, Frank sells his entire interest in the S corporation to Louie. The S corporation reported ordinary income of $100,000 for the entire year. However, for the period January 1st through September 30th, Dante incurred a taxable loss of ($10,000). Using the specific accounting election under IRC §1377(a)(2), compute the allocation of income or loss to Louie for the calendar year.

   a. $0.

   b. $12,500.

   c. $50,000.

   d. $55,000.

7. Which of the following statements is most accurate regarding what happens when a stockholder disposes of an entire interest in an S corporation?

   a. The S corporation can choose to allocate pass-through items based on the actual transaction dates.

   b. If a shareholder elects to dispose of his or her entire interest, shareholders affected by the stock disposition are not required to give their consent.

   c. Once the election to dispose of an entire interest in an S corporation is made, the S election is automatically terminated.

8. If _____ of the stock is sold or exchanged during the S termination year, the specific accounting method is required.

   a. 50% or more.

   b. 80% or more.

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.)**

6. Frank and Cecil own an equal interest in Dante Corporation, a calendar year S corporation. On October 1st of the current year, Frank sells his entire interest in the S corporation to Louie. The S corporation reported ordinary income of $100,000 for the entire year. However, for the period January 1st through September 30th, Dante incurred a taxable loss of ($10,000). Using the specific accounting election under IRC §1377(a)(2), compute the allocation of income or loss to Louie for the calendar year. **(Page 15)**

   a. $0. [This answer is incorrect. Louie will receive an allocation of income for the portion of the year he owned stock in the S corporation.]

   b. $12,500. [This answer is incorrect. If the per-share per-day allocation were made, then this would be Louie's income allocation, but the question asks for the specific accounting election to be used in computing allocations.]

   c. $50,000. [This answer is incorrect. Louie owns 50% of the stock after September 30. Since the S corporation reports a loss of ($10,000) for the period January 1 through September 30, the total income for the period after September 30 cannot be $100,000.]

   d. $55,000. [This answer is correct. Louie owns 50% of the stock after September 30. Since the S corporation reports a loss of ($10,000) for the period January 1 through September 30 and the total income for the year equals $100,000, the S corporation earned $110,000 of taxable income for the period after September 30. Louie's income allocation is 50% of $110,000 = $55,000.]

7. Which of the following statements is most accurate regarding what happens when a stockholder disposes of an entire interest in an S corporation? **(Page 14)**

   a. The S corporation can choose to allocate pass-through items based on the actual transaction dates. [This answer is correct. If a shareholder's entire interest in an S corporation is disposed of, the corporation can elect to allocate pass-through items based on the actual transactions that occurred before and after the stock disposition took place per IRC Sec. 1377(a)(2); Reg. 1.1377-1(b). This election is referred to as the "election to apply specific accounting rules in connection with the termination of a shareholder's entire interest."]

   b. If a shareholder elects to dispose of his or her entire interest, shareholders affected by the stock disposition are not required to give their consent. [This answer is incorrect. According to IRC Sec. 1377(a)(2); Reg. 1.1377-1(b)(5), Shareholders affected by the stock disposition must consent to the specific accounting election. The shareholders affected by the stock disposition include all shareholders who disposed of shares and all shareholders acquiring shares during the tax year.]

   c. Once the election to dispose of an entire interest in an S corporation is made, the S election is automatically terminated. [This answer is incorrect. 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 to apply specific accounting rules in connection with the termination of a shareholder's entire interest is not made, the pass-through to shareholders is a per-share, per-day allocation of the S corporation's annual pass-through amount per IRC Sec. 1377(a)(2); Reg. 1.1377-1.]

8. If _____ of the stock is sold or exchanged during the S termination year, the specific accounting method is required. **(Page 23)**

   a. 50% or more. [This answer is correct. The specific accounting method is not elective for transactions where 50% or more of the stock is sold or exchanged during a termination year per IRC Sec. 1362(e)(6).]

   b. 80% or more. [This answer is incorrect. The threshold for stock sales during the year requiring the specific accounting method to be used is something other than 80% as indicated in IRC Sec. 1362(e)(3).]

ADJUSTMENT TO BASIS BY PASS-THROUGH ITEMS

Each shareholder adjusts basis in stock by the pass-through items. Although losses and deductions are passed through to the shareholders, each shareholder's ability to deduct the losses and deductions may be limited because of basis, the passive activity loss rules, or the at-risk rules.

The basis reduction for nonseparately and separately stated items of loss and deduction occurs even if the loss or deduction is disallowed or deferred under a provision such as the passive activity rules or the at-risk rules.

Example 1-19: Passing through losses that are limited at the shareholder level.

Fredco, Inc., an S corporation, passes through a nonseparately stated loss of $50,000 to Fred, its sole shareholder. Before considering the loss, Fred's basis in the stock is $35,000, and his basis in a note receivable from the corporation is $20,000. He shows other losses on his personal tax return, so he cannot currently deduct the loss from Fredco. Nevertheless, the pass-through loss reduces his stock basis to zero and his debt basis to $5,000.

Pass-through items of income, loss, or deduction affect the basis of each share by the shareholder's portion of pass-through items allocable to each share. This "separate basis" approach is similar to the basis of a shareholder in a regular C corporation. While this approach does not alter the allocation rules discussed earlier in this lesson, it does mean, for example, that an S corporation shareholder who acquired stock at different times and for different amounts does not spread his stock basis evenly over all the shares, but instead may have a different basis per-share in different blocks of stock.

PASS-THROUGH AND DISTRIBUTIONS ARE NOT SUBJECT TO SELF-EMPLOYMENT TAX

Pass-through income and distributions from an S corporation are not subject to self-employment (SE) 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 rendered by an officer-shareholder is wages, not SE income.

INTEREST EXPENSE PAID BY AN S CORPORATION OR ITS SHAREHOLDERS

The following paragraphs summarize various rules relating to interest that may be paid by an S corporation or its shareholders.

Interest Paid by the S Corporation

The pass-through treatment of interest expense paid by the corporation is generally determined by reference to the use of the debt proceeds. Interest paid by the corporation can be passed through as a component of nonseparately stated income, as a component of rental income or loss, as investment interest expense, or as other interest, depending on how the loan proceeds are used by the corporation. For example, interest paid on loans used in the operations of the business reduces ordinary income from operations and is a component of nonseparately stated income or loss. Interest paid on loans for rental property is considered when determining the separately stated item of rental income or loss. Interest expense on a loan for land held for investment is investment interest expense, a separately stated item.

A special rule applies to interest and other expenses paid to an S corporation shareholder if the expense is paid after the end of the corporation's tax year. These expenses cannot be deducted by the corporation until they are includable in the shareholder's income. That is, the corporation is on the cash basis for these expenses.

If a shareholder makes a loan to an S corporation for use in a passive activity, Reg. 1.469-7 allows the shareholder to recharacterize some or all of the interest income as passive (rather than portfolio) income. The shareholder can

then deduct all or part of the interest expense passed through to him, even though the interest expense is part of a loss that would otherwise not be deductible in the current year. This is the *self-charged interest* rule. This rule also applies to a loan from an S corporation to a shareholder if the shareholder uses some or all of the loan proceeds in a passive activity.

Interest Incurred by Shareholder to Purchase Stock or Inject Capital into an S Corporation

An individual who purchases S corporation stock may incur interest expense on debt used to acquire the stock. Such interest is deductible as a business expense if the shareholder materially participates in the operations of the corporation, and the corporation owns business assets only. In that case, the interest expense is reported on Schedule E of the shareholder's Form 1040. If the corporation owns assets other than those used in trade or business activities, the interest expense must be allocated between business expense and other (such as rental or portfolio) expense. The debt and related interest are allocated among the assets of the entity using any reasonable method. If the shareholder does not materially participate, the interest expense attributable to trade or business activities is reported as a passive activity loss with the same character as the pass-through income or loss from the corporation. Thus, the interest expense decreases passive activity income or increases passive activity loss on the shareholder's personal return.

Trade or Business Deduction for Interest Paid by Shareholder

An S shareholder may be allowed a trade or business deduction for personally paid interest. In *Rosser*, the Tax Court allowed a deduction for interest that an S shareholder personally paid on debt he previously incurred to purchase, renovate, and operate two nursing homes. After transferring the nursing homes to his two wholly owned S corporations, the shareholder remained personally responsible for repaying the debt. The IRS argued that the interest was investment interest or that the interest was that of the S corporation rather than the shareholder. The Tax Court disagreed, holding that the interest was trade or business interest because the taxpayer-shareholder had purchased the nursing homes to provide self-employment income for himself and his former spouse.

While this case is probably not sufficiently strong to establish a planning opportunity, it represents a fallback where debt that should have been inside the S corporation is carried by the shareholder.

DETERMINE ACTIVE OR PASSIVE NATURE OF PASS-THROUGH FOR PASSIVE ACTIVITY LOSS PURPOSES

The stockholder's share of the S corporation's nonseparately stated income is active if the stockholder materially participates in the operations of the business. It is generally passive activity income if the shareholder does not materially participate. If the corporation is engaged in more than one activity, schedules must be attached to each shareholder's Schedule K-1 that reflect his share of income and loss attributable to each activity. Rental income or loss passes through as a separately stated item and is generally passive. Under IRC Sec. 469(i), up to $25,000 of losses from rental real estate may be allowed if the shareholder actively participates in the rental activity.

Interest and other portfolio income earned by an S corporation pass through as portfolio income, whether or not the shareholder materially participates in the S corporation's activities, or whether the interest income was used for business purposes. Other separately stated items may be either active or passive, depending on the type of income and the taxpayer's participation in the activity.

Example 1-20: Determining deductibility of passive losses.

Derek owns stock in two S corporations. He is the sole shareholder of Sunny Corp., and he owns half the shares of Dew Corp. He works full-time at Sunny and draws an annual salary of $75,000. He does not participate in Dew's operations. The two corporations are engaged in different business activities conducted at different locations.

Sunny reports a loss of $25,000, after considering $1,000 of interest income from investing working capital for a short time. Dew reports a loss of $40,000. Neither corporation receives any rental income.

Derek does not have any other income items in arriving at adjusted gross income (AGI) on his income tax return. He believes his income will be computed as follows:

Salary	$ 75,000
Sunny Corp. pass-through items:	
Interest income	1,000
Ordinary loss	(26,000)
Dew Corp. loss	(20,000)
Total income	$ 30,000

He asks his practitioner if his assumptions are correct and, if not, can he do anything to decrease his taxes. Can Derek offset the S corporation losses from Sunny and Dew against his salary?

Derek materially participates in Sunny's operations. Therefore, the ordinary loss from Sunny is active and can offset Derek's salary. He does not materially participate in Dew's operations, so the ordinary loss from Dew is passive and can only offset income from other passive activities.

Derek's AGI is computed as follows:

Salary	$ 75,000
Interest income	1,000
Sunny Corp. ordinary loss	(26,000)
Dew Corp. loss	—
AGI	$ 50,000

The Dew loss carries over until there is other passive income to apply against it or until Derek disposes of his entire interest in that corporation.

In future years, Derek might want to increase his involvement in Dew so he materially participates in it as well as in Sunny. If he can participate on a regular, continuous, and substantial basis, the losses could offset other active income and portfolio income.

INCREASE PASSIVE ACTIVITY LOSS DEDUCTIONS WITH SELF-CHARGED INTEREST

Generally portfolio income cannot be used to offset passive activity losses. But a special rule is provided for *self-charged* interest. Under this rule, an S corporation shareholder subject to the passive activity loss rules who makes a loan to the corporation can offset the interest income received from that loan with some or all of the interest expense passed through by the S corporation. (A similar rule applies to loans from the S corporation to the shareholder.)

Under the regulations, an S corporation shareholder can recharacterize all or part of the interest income from the S corporation as passive activity income if the following three conditions are present:

a. The S corporation has a deduction for *self-charged interest*. Self-charged interest is interest charged by (1) a person who during the corporation's tax year had a direct interest in the corporation (i.e., was a shareholder) or (2) a person who during the tax year had an indirect ownership interest in the corporation. (The taxpayer has an indirect interest in an entity if the interest is held through one or more S corporations or partnerships].)

b. The shareholder has interest income from the S corporation in the shareholder's tax year in which the corporation's tax year ends.

c. The shareholder's share of the self-charged interest includes a passive activity deduction.

The amount of interest income that can be characterized as passive income is limited to an "applicable percentage." The applicable percentage is determined by a fraction, the numerator of which is the shareholder's share of

the corporation's self-charged interest deductions that are passive activity deductions. The denominator is the greater of (a) the taxpayer's share of the corporation's total self-charged interest deduction (that is, the self-charged interest deduction determined regardless of whether the deduction is passive or nonpassive), or (b) the amount of the shareholder's income for the tax year from interest charged to the corporation. This can be expressed by the following formula:

$$\frac{\text{shareholder's share of the corporation's passive activity self-charged interest deductions}}{\text{shareholder's share of the corporation's total self-charged interest deduction}} \times \text{interest received from the S corporation} = \text{interest recharacterized as passive income}$$

or, if greater, the alternative denominator is:

shareholder's interest income from the corporation

The self-charged interest rule is illustrated in the following examples.

Example 1-21: Computing recharacterized self-charged interest on shareholder loans to a corporation.

Neil owns 50% of the stock of Blue, Inc., an S corporation. On January 1 of the current year, he loaned the corporation $100,000. The loan bears interest at 10%, payable on December 31. Neil relies on Sam, the other shareholder, for management of the corporation and does not participate in the corporate operations (which do not include any rental activities). Blue experiences a $25,000 loss during the year and passes through $12,500 to Neil. On December 31, the corporation pays Neil $10,000 of interest.

For the year, Neil shows the following income and losses:

Wages		$ 90,000
Interest income:		
From Blue	10,000	
Other	4,000	
Total interest income		14,000
Blue pass-through:		
Loss, before considering interest on loan	(7,500)	
Interest on Neil's loan	(5,000)	
Total pass-through loss		(12,500)
Total income		$ 91,500

Can Neil deduct any of his passive loss from Blue?

Neil is receiving $10,000 in interest income from Blue. He is also receiving pass-through of $5,000 interest expense—his share of the $10,000 interest expense the corporation paid on its indebtedness to him. He is allowed to deduct all or part of the interest expense passed through to him, even though the interest expense is part of a passive loss that would otherwise be nondeductible in the current year.

Neil can recharacterize all or part of the interest income from Blue as passive activity income because the three conditions described earlier are present.

The amount of interest income that can be characterized as passive income is limited to an "applicable percentage," described earlier. The applicable percentage is calculated as follows:

$$\frac{\$5,000}{\$10,000} \times \$10,000 = \$5,000$$

Neil's applicable percentage is 50%: his share of the passive activity self-charged interest deduction ($5,000) over the corporation's entire self-charged interest expense ($10,000). The practitioner applies the percentage (50%) to the interest Neil received from Blue ($10,000), to determine that $5,000 of the interest income from Blue is reclassified as passive activity income. Therefore, the entire $5,000 of interest expense passed through to Neil as a passive loss can be offset against nonpassive (that is, active or portfolio) income.

Sam is not under the self-charged interest rules because all of his interest expense from Blue is nonpassive and he did not receive interest income from loans he made to Blue.

The favorable effects of the self-charged interest rule are illustrated in Example 1-22.

Example 1-22: Illustrating the benefits of the self-charged interest rule.

Assume the same facts as in Example 1-21. Without the self-charged interest rule, none of Neil's loss from Blue would be deductible because of the passive activity rules. Using those rules, the entire $5,000 interest expense from Blue can be offset against nonpassive income. Neil's adjusted gross income (AGI), assuming the self-charged interest rules do and do not apply, is as follows:

	Self-charged Rules Apply		Self-charged Rules Do Not Apply	
Wages		$ 90,000		$ 90,000
Interest income:				
From Blue	10,000		10,000	
Other	4,000		4,000	
Net interest income		14,000		14,000
Blue loss	(12,500)		(12,500)	
Add-back amount not deductible because of passive activity rules	7,500		12,500	
Deductible portion of Blue loss		(5,000)		—
Adjusted gross income		$ 99,000		$ 104,000

Neil's interest income remains reportable on his Form 1040, Schedule B. However, $5,000 of the interest income from Blue is treated as passive income on Form 8582 (Passive Activity Loss Limitations). This allows $5,000 of the S corporation's passive loss to carry to Schedule E, where it is deductible.

Example 1-23: Applying self-charged interest rules to sole shareholder.

Assume Neil, in Example 1-22, is the sole shareholder of Blue. All the interest income from Blue, Inc. now would be characterized as passive income under the self-charged interest rule and $10,000 of the passive loss from Blue would be deductible.

Example 1-24: Allocating interest among shareholders and activities.

Neil (in Example 1-21) is a 50% shareholder who lent the corporation $100,000. Assume now that Neil made no such loan. Instead, the corporation loaned $100,000 to him. He invests the entire $100,000 in a passive activity. The loan bears interest at 10%, and on December 31 he paid the corporation $10,000 of interest expense. The $10,000 of S corporation interest income is passed through equally ($5,000) to the two shareholders.

Since all the money borrowed from the corporation was invested in a passive activity, Neil will treat his entire $5,000 share of the pass-through interest income as passive activity income. If he invested a portion of the $100,000 loan proceeds in a passive activity, then only a portion of his pass-through interest income would be

recharacterized as passive activity income. If Neil invested none of the $100,000 loan proceeds in a passive activity (e.g., spent the $100,000 on personal items), none of his pass-through interest income would be recharacterized as passive activity income.

Making the Election Not to Apply the Self-charged Interest Rules

The S corporation can elect not to apply the self-charged interest rules by attaching to its return a statement that includes the name, address, and taxpayer identification number of the S corporation and a declaration that an election is being made under Reg. 1.469-7(g). Once made, the election is effective for that year and all subsequent years unless revoked, which requires IRS consent.

Example 1-25: Electing not to apply the self-charged interest rules.

Neil (in Example 1-21) lent the corporation $100,000 at 10% interest, and $5,000 of the corporation's interest expense was passed through to him. However, also assume he receives plenty of passive income from an unrelated partnership investment, but needs portfolio income to deduct otherwise unusable investment interest expense. Here, it would be beneficial for the corporation to elect not to apply the self-charged interest rules.

Self-charged Rules Apply to Interest Only

As illustrated in Example 1-22, the self-charged interest rules are favorable to taxpayers because they allow an S shareholder to recharacterize self-charged interest income as passive (rather than portfolio) and offset it (within limits) against passive losses. The self-charged interest rules apply to interest only and not to other self-charged income and deduction situations.

SELF-STUDY QUIZ

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

9. For purposes of the passive activity loss rules, which of the following passes through from an S corporation as portfolio income?

    a. Rental income.

    b. Interest income.

    c. Loss attributable to an activity.

10. The amount of interest income that can be designated as passive income is limited to which of the following?

    a. Maximum section 179 deduction.

    b. Applicable percentage.

11. If an S corporation conducts multiple activities, the results of each activity must be attached to which of the following?

    a. Schedule K, Form 1120S.

    b. Schedule K-1.

    c. Schedule E.

12. Which of the following statements regarding Section 179 deduction limitations is most accurate?

    a. Shareholders and corporations are required to produce positive taxable income from active businesses prior to the Section 179 expense deduction.

    b. Suspended Code deductions generally are included in the net income calculation for purposes of the Section 179 deduction.

    c. Any unused taxable income, as a result of the taxable income limitation, cannot be carried forward to a succeeding tax year.

    d. A shareholder cannot include wages from an S corporation in the aggregate amount of their income.

13. When a shareholder deducts all or a portion of the interest expense passed through to him or her even though the interest is a part of a loss that would be otherwise nondeductible in the current year, is considered which of the following?

    a. Qualifying disposition rule.

    b. Tax benefit rule.

    c. Self-charged interest rule.

    d. Partnership rule.

14. How can an S corporation elect **not** to apply the self-charged interest rules?

    a. By attaching a statement to a timely filed original or amended tax return (Form 1120S) for the year the disposition of shares occurred.

    b. By attaching to its return a statement that includes the name, address, and taxpayer identification number of the S corporation and a declaration that an election is being made under Reg. 1.469-7(g).

    c. By attaching a statement to a timely filed original or amended income tax return (Form 1120S) for the year the disposition, release, or issuance of shares took place.

    d. 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 occurred.

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. For purposes of the passive activity loss rules, which of the following passes through from an S corporation as portfolio income? **(Page 28)**

    a. Rental income. [This answer is incorrect. According to IRC Sec. 469(c)(2), rental income passes through as a separately stated item and is generally passive.]

    b. Interest income. [This answer is correct. Interest and other portfolio income earned by an S corporation pass through as portfolio income, whether or not the shareholder materially participates in the S corporation's activities, or whether the interest income was used for business purposes, per IRC Sec. 469(e)(1)(A): Temp. Reg. 1.469-2T(c)(3).]

    c. Loss attributable to an activity. [This answer is incorrect. According to IRC Sec. 469(c)(2), loss passes through as a separately stated item and is generally passive.]

10. The amount of interest income that can be designated as passive income is limited to which of the following? **(Page 29)**

    a. Maximum section 179 deduction. [This answer is incorrect. The Section 179 deduction is a separately stated item and does not limit the amount of interest income that can be designated as passive income.]

    b. Applicable percentage. [This answer is correct. The amount of interest income that can be characterized as passive income is limited to an "applicable percentage." The applicable percentage is determined by a fraction, the numerator of which is the shareholder's share of the corporation's self-charged interest deductions that are passive activity deductions. The denominator is the greater of the shareholder's interest income from the corporation or the shareholder's share of the corporation's total self-charged interest deduction.]

11. If an S corporation conducts multiple activities, the results of each activity must be attached to which of the following? **(Page 38)**

    a. Schedule K, Form 1120S. [This answer is incorrect. Pass-through amounts are entered on Schedule K of Form 1120S.]

    b. Schedule K-1. [This answer is correct. If the S corporation conducts more than one activity, the results of each activity must be reported separately to all shareholders on Schedule K-1.]

    c. Schedule E. [This answer is incorrect. An individual who purchases S corporation stock may incur interest expense on debt used to acquire the stock. Such interest is deductible as a business expense if the shareholder materially participates in the operations of the corporation, and the corporation owns business assets only. In that case, the interest expense is reported on Schedule E of the shareholder's Form 1040.]

12. Which of the following statements regarding Section 179 deduction limitations is most accurate? **(Page 39)**

    a. Shareholders and corporations are required to produce positive taxable income from active businesses prior to the Section 179 expense deduction. [This answer is correct. The aggregate amount of any Section 179 property deducted in any tax year cannot exceed taxable income derived from all actively conducted trades or businesses. This limitation applies at both the S corporation and shareholder levels. Therefore, both the corporation and the shareholders must reflect positive taxable income from active businesses before the Section 179 expense can be deducted.]

    b. Suspended Code deductions generally are included in the net income calculation for purposes of the Section 179 deduction. [This answer is incorrect. According to Reg. 1.179-2(c)(1) and (c)(3), deductions

suspended under any section of the Code are not included in the net income calculation for purposes of the Section 179 deduction.]

c. Any unused taxable income, as a result of the taxable income limitation, cannot be carried forward to a succeeding tax year. [This answer is incorrect. Any amount not used because of the taxable income limitation may be carried to a succeeding tax year and added to the Section 179 expense deductible in such year. Any Section 179 deduction limited by taxable income is carried forward indefinitely to be claimed as the taxpayer generates sufficient trade or business income.]

d. A shareholder cannot include wages from an S corporation in the aggregate amount of their income. [This answer is incorrect. According to Reg. 1.179-2(c)(6)(iv), the shareholder's wages from the S corporation *and other employers* are included in the aggregate amount of the shareholder's income. The shareholder's taxable income derived from the active conduct of a trade or business is computed without regard to (a) the Section 179 deduction, (b) any deduction for one-half of self-employment tax, (c) any NOL carryback or carryforward, and (d) deductions suspended under any section of the Code.]

13. When a shareholder deducts all or a portion of the interest expense passed through to him or her even though the interest is a part of a loss that would be otherwise nondeductible in the current year, is considered which of the following? **(Page 27)**

a. Qualifying disposition rule. [This answer is incorrect. According to Reg. 1.1368-1(g)(2), *a*n S corporation can choose to use specific accounting when a qualifying disposition occurs. Under the qualifying disposition rules, if 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, the corporation can choose to treat the tax year as if it consists of two separate years.]

b. Tax benefit rule. [This answer is incorrect. Under IRC Sec. 111; Reg. 1.111(a), a taxpayer's gross income consists of recoveries of mounts deducted in any prior tax year to the extent the amounts reduced the tax in the prior year. This is known as the tax benefit rule.]

c. Self-charged interest rule. [This answer is correct. If a shareholder makes a loan to an S corporation for use in a passive activity, Reg. 1.469-7 allows the shareholder to recharacterize some or all of the interest income as passive (rather than portfolio) income. The shareholder can then deduct all or part of the interest expense passed through to him, even though the interest expense is part of a loss that would otherwise not be deductible in the current year. This is the self-charged interest rule.]

d. Partnership rule. [This answer is incorrect. Under the partnership rule, a partner can deduct losses only to the extent of the partner's basis per IRC Sec. 704(d).]

14. How can an S corporation elect **not** to apply the self-charged interest rules? **(Page 32)**

a. By attaching a statement to a timely filed original or amended tax return (Form 1120S) for the year the disposition of shares occurred. [This answer is incorrect. The election to apply specific accounting rules in connection with the termination of a shareholder's entire interest is made by attaching a statement to a timely filed original or amended tax return (Form 1120S) for the year the disposition of shares occurred per Reg. 1.1377-1(b)(5).]

b. By attaching to its return a statement that includes the name, address, and taxpayer identification number of the S corporation and a declaration that an election is being made under Reg. 1.469-7(g). [This answer is correct. The S corporation can elect not to apply the self-charged interest rules by attaching to its return a statement that includes the name, address, and taxpayer identification number of the S corporation and a declaration that an election is being made under Reg. 1.469-7(g). Once made, the election is effective for that year and all subsequent years unless revoked, which requires IRS consent.]

c. By attaching a statement to a timely filed original or amended income tax return (Form 1120S) for the year the disposition, release, or issuance of shares took place. [This answer is incorrect. 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.]

d. 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 occurred. [This answer is incorrect. 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.]

REPORT MULTIPLE ACTIVITIES

If the S corporation conducts more than one activity, the results of 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.

THE SECTION 179 EXPENSE DEDUCTION

For tax years beginning in 2010, the Section 179 deduction is limited to $250,000 of qualified equipment placed in service during the year. The expense deduction is reduced (for 2010) by the cost of Section 179 property placed in service during the year in excess of $800,000. The Section 179 deduction limitation of $250,000 (for 2010) is imposed at both the S corporation and the shareholder levels. Thus, the S corporation can pass through a total of $250,000 (for 2010) of Section 179 deduction, regardless of the number of shareholders, and each shareholder is limited to a maximum Section 179 deduction of $250,000 (for 2010) from all sources. The Section 179 deduction is a separately stated item (i.e., it is not part of the "ordinary" income or loss shown on page 1 of the Form 1120S that passes through to the shareholders).

Example 1-26: Maximizing the Section 179 deduction.

PQR Corp., an S corporation, purchases $300,000 of equipment during 2010. The company's stock is owned equally by individuals Pat, Quincy, and Ryan. On his individual income tax return, Pat knows he will receive a Section 179 deduction of $250,000 from STU Corp., another S corporation. Quincy has other business losses and does not need additional deductions. Ryan has significant income from other business sources, but no other source can provide him with a Section 179 deduction. How much of the equipment cost should be expensed to provide the shareholders with the best tax results?

If PQR elects to use the Section 179 deduction, the maximum deduction during the year that can be passed through to shareholders is $250,000 in total. If PQR takes the full deduction, it will be allocated equally among the shareholders, or $83,333 each. Here, Pat will also be limited to an individual deduction of $250,000 in total, and the $83,333 passed through from PQR will be wasted; the unused deduction does not carry over and any unused deduction still reduces stock basis. PQR must reduce the basis of the machinery by the full $250,000 even though Pat cannot use the deduction. Quincy does not need the deduction because of his income situation; thus, his share of the Section 179 pass-through would be carried over under the taxable income limitation of IRC Sec. 179(b). (See the following discussion.) Ryan could use the deduction, but he could only deduct his proportionate share, $83,333, and the basis of the machinery would be reduced by $250,000, causing reductions in the corporation's depreciation expense in subsequent years.

In this case, the best course of action is for the corporation not to elect use of the Section 179 deduction and, instead, to use the full basis of the assets for depreciation purposes.

Variation: Assume PQR had incurred a net operating loss (NOL) (computed without regard to any Section 179 property). Since the aggregate amount of any Section 179 property deducted in any tax year cannot exceed taxable income derived from the active conduct of trades or businesses, no Section 179 expense could pass through to the shareholders. However, any Section 179 deduction claimed but not used because of the taxable income limitation may be carried to a succeeding tax year and added to the corporation's Section 179 expense in such year.

Applying the Section 179 Excess Property Limitation

The $250,000 (for 2010) Section 179 deduction limitation is reduced dollar for dollar by the cost of Section 179 property placed in service during the year in excess of $800,000 (so-called excess Section 179 property). For example, if the taxpayer places $962,000 of Section 179 property in service during 2010, the excess Section 179 amount is $162,000 ($962,000 − $800,000), and the taxpayer is eligible for an $88,000 ($250,000 − $162,000) Section 179 deduction.

The regulations state that Section 179 additions by the S corporation are not attributed to the shareholder in computing the shareholder's excess Section 179 property amount. This means that the shareholder's prorata

share of equipment placed in service by the corporation during the year is ignored when computing the shareholder's excess Section 179 property amount. (See the following example.)

Example 1-27: Applying the excess Section 179 property limit.

During 2010, Rolly, Inc., a calendar-year S corporation, purchases and places in service $550,000 of Section 179 property and elects to expense $250,000 of the cost of that property. Rolly properly passed through to Ray (a 60% shareholder) $150,000 of Section 179 expense. In applying the $250,000 annual limitation in 2010, Ray will include the $150,000 of Section 179 expense allocated from Rolly. Thus, Ray is eligible to deduct up to $100,000 ($250,000 − $150,000) of additional Section 179 expense from other sources on his individual return. (See Example 1-26.)

Ray also operates a sole proprietorship that placed in service $800,000 of Section 179 property during the year. In determining the amount of any excess Section 179 property he placed in service during the year for purposes of the $800,000 property-placed-in-service limitation, Ray does not include any of the Section 179 property placed in service by Rolly. Thus, Ray is not affected by the excess Section 179 property limitation and he is allowed a combined total Section 179 deduction of $250,000 for the year. He can expense up to $100,000 of the cost of the equipment purchased by the proprietorship.

Section 179 Deduction Is Limited by Taxable Income

The aggregate amount of any Section 179 property deducted in any tax year cannot exceed taxable income derived from all actively conducted trades or businesses. This limitation applies at both the S corporation and shareholder levels. Therefore, both the corporation and the shareholders must reflect positive taxable income from active businesses before the Section 179 expense can be deducted. However, any amount not used because of the taxable income limitation may be carried to a succeeding tax year and added to the Section 179 expense deductible in such year. Any Section 179 deduction limited by taxable income is carried forward indefinitely to be claimed as the taxpayer generates sufficient trade or business income. However, the allowable Section 179 deduction may not exceed the annual dollar limitation for any given tax year.

S Corporation Taxable Income. An S corporation's taxable income for this purpose is made up of the corporation's items of income, loss, and deduction (but not credits) arising from active trades or businesses. Furthermore, the following items are *not* included in the net income calculation for purposes of the Section 179 deduction:

- The Section 179 deduction.
- Deductions suspended under any section of the Code.
- Tax-exempt income.
- The deduction for compensation paid to the S corporation's shareholders.

Shareholder Taxable Income. For purposes of the Section 179 deduction, an S shareholder aggregates the taxable income (or loss) from all the trades or businesses actively conducted by the shareholder. Also, the shareholder's wages from the S corporation *and other employers* are included in the aggregate amount of the shareholder's income. The shareholder's taxable income derived from the active conduct of a trade or business is computed without regard to (a) the Section 179 deduction, (b) any deduction for one-half of self-employment tax, (c) any NOL carryback or carryforward, and (d) deductions suspended under any section of the Code.

Example 1-28: Applying the Section 179 deduction taxable income limitation at the corporate and shareholder level.

Tubes, Inc., an S corporation, passes through $30,000 of nonseparately stated income to Ted, its sole shareholder. Ted received no salary from the corporation. The corporation placed property qualifying for the Section 179 deduction of $100,000 in service during the year. The corporation can elect expensing up to $100,000, but it can only pass through $30,000, the amount of its business income before considering the Section 179 deduction. The elected amount would decrease the basis of the corporation's Section 179

property, and the elected amount in excess of $30,000 would be carried forward at the corporate level. Tubes, however, elects to claim and pass through only $30,000 of Section 179 deduction. Ted reports the $30,000 deduction on his Form 1040.

Variation 1: Assume now that the corporation paid Ted $80,000 in salary during the year and his only other income is the $30,000 passed through from the S corporation. The wages paid to the shareholder are added to the corporation's operating income for purposes of the Section 179 income limitation, so the corporation's taxable income is considered to be $110,000 ($30,000 + $80,000). Tubes elects to claim a Section 179 deduction of $100,000 and passes it through to Ted.

Variation 2: Assume the same facts as in Variation 1. Ted can consider the pass-through income and wages as income from a trade or business, so Ted's taxable income for purposes of the Section 179 deduction is $110,000 ($30,000 + $80,000). He claims a Section 179 deduction of $100,000 on his personal return.

Maximizing the Section 179 Deduction When S Corporation Income Limit Applies

An S corporation's taxable income for purposes of the Section 179 taxable income limit is computed without regard to certain income and deductions, including the deduction for Section 179 property. Because the amount of the Section 179 deduction affects the remaining depreciation calculation, an interaction exists among the Section 179 expense, the depreciation expense, and the determination of net taxable income (when the 2010 taxable income for these purposes is $250,000 or less). When only a portion of the Section 179 deduction is allowable because of the taxable income limitation, a simultaneous equation is required to optimize the S corporation's deductions.

When the taxable income limit prevents claiming the full $250,000 deduction (and the midquarter convention does not apply), the following formulas can be used for five-year and seven-year MACRS assets to calculate the maximum Section 179 deduction:

$$\text{Five-year assets} = \frac{\text{Taxable income} - (.20 \times \text{asset basis})}{.80}$$

$$\text{Seven-year assets} = \frac{\text{Taxable income} - (.1429 \times \text{asset basis})}{.8571}$$

The formulas should be used only when the dollar amount of assets placed in service exceeds the S corporation's taxable income. If the dollar amount of assets placed in service is less than taxable income (as adjusted, but before considering the Section 179 deduction and depreciation deduction), the S corporation can deduct the cost of the assets that were placed in service.

These formulas apply when the S corporation has qualifying additions of only one class of property. If 150% declining balance depreciation is elected, those rates are used.

Example 1-29: Claiming the optimal Section 179 deduction for five-year assets.

XYZ, Inc., an S corporation, shows net taxable income of $10,000 before determining the Section 179 deduction and depreciation on assets placed in service during the year. XYZ paid salaries of $40,000 to its shareholder-employees. Such salaries are not considered when determining net taxable income for purposes of the Section 179 taxable income limit. Therefore, the S corporation's taxable income before considering the Section 179 deduction and the regular depreciation deduction on new assets is $50,000 ($10,000 + $40,000). XYZ purchased a new five-year MACRS asset for $75,000 during the year and elects to forego bonus depreciation. The optimal Section 179 amount of $43,750 is computed as follows:

$$\text{Five-year assets} = \frac{\$50{,}000 - (.20 \times \$75{,}000)}{.80}$$

The optimal Section 179 deduction ($43,750) is proved as follows:

Net taxable income before Section 179 and depreciation deduction	$ 50,000
Less:	
Section 179 amount	(43,750)
Regular depreciation [($75,000 − $43,750) × 20%]	(6,250)
Net taxable income	$ -0-

When depreciation on the property exceeds taxable income before depreciation, there is no breakeven point for claiming depreciation and Section 179 expense. Instead, some or all of the Section 179 deduction claimed will be disallowed due to the taxable income limitation.

Increasing Stock Basis by Unused Section 179 Deduction

An S corporation shareholder who disposes of S corporation stock can increase stock basis immediately before the disposition by the amount of any unused Section 179 deduction carryover attributable to the stock. After the stock basis adjustment, the unused Section 179 carryover deduction cannot be used by either the shareholder who disposes of the stock or the shareholder who acquires the stock.

Example 1-30: Increasing basis by Section 179 deduction upon disposition of stock.

JJ, Inc., an S corporation, passes through $100,000 of the Section 179 deduction to Jack. Two years later, Jack has $32,000 of unused Section 179 deduction. He sells all of his JJ stock. Ted's stock basis increases by $32,000 immediately before the stock disposition.

Shareholder Taxable Income Limit Does Not Include Income as Passive Investor

The Section 179 deduction is limited to the taxable income derived from the active conduct of any trade or business. As with the $250,000 (for 2010) limitation, the taxable income limitation applies at both the S corporation and the shareholder levels. The regulations under IRC Sec. 179 clarify that a "mere passive investor" in an S corporation is not entitled to include his prorata share of income from the corporation in computing the shareholder-level taxable income limit. The regulations do not rely on the Section 469 passive activity rules to determine whether the taxpayer "actively conducts" the business. Instead, a shareholder "generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business. . . . A mere passive investor in a trade or business does not actively conduct the trade or business."

Example 1-31: Income as passive investor is not included in shareholder's Section 179 taxable income limit.

Assume Ryan in Example 1-26 "meaningfully participates in the management or operations" of PQR, but is only a passive investor in ABC Corp., an unrelated S corporation. If his share of pass-through income from PQR is $75,000, and his share of pass-through income from ABC is $25,000, his aggregate taxable income limitation from the conduct of any trade or business is only $75,000, the amount of pass-through income from PQR.

If Ryan cannot deduct the full amount of the Section 179 deduction passed through from PQR because of the shareholder-level taxable income limitation, his stock basis is still reduced by the full amount of the deduction allocated (passed through) to him. However, the disallowed amount is carried forward indefinitely until he generates sufficient business income to deduct it. In addition, if he disposes of his PQR stock and there is a Section 179 deduction carryover attributable to the Section 179 deduction passed through from the S corporation, the regulations permit him to increase stock basis immediately before the disposition, for computing gain or loss, by the amount of the unused carryover. For further discussion, see Example 1-30.

Excluding S Corporations from Controlled Group to Avoid Apportionment of the Section 179 Limitations

The $250,000 dollar limitation and the $800,000 placed-in-service (for tax years beginning in 2010) limitations must be apportioned among the members of a controlled group of corporations. Furthermore, the controlled group is treated as one taxpayer for purposes of the taxable income limitation. In addition, property purchased from another group member does not qualify as Section 179 property.

For Section 179 purposes, a controlled group is defined by reference to IRC Sec. 1563(a), but uses a more than 50% (instead of at least 80%) stock ownership test. However, an S corporation is excluded from the definition of a member of a controlled group of corporations. Because of this exclusion, it is appropriate to treat an S corporation as an excluded corporation that is not required to apportion the Section 179 limitation. Proposed regulations, however, would change this rule as discussed later in this lesson.

Example 1-32: Avoiding allocation of Section 179 limitations by excluding S corporation from controlled group for 2010.

Molly owns all the shares of Caps, Inc., a C corporation, and Salt, Inc., an S corporation. Both corporations use calendar tax years. During 2010, each corporation purchases $250,000 of equipment that qualifies for the Section 179 deduction. Salt is subject to the built-in gains tax because it operated as a C corporation that elected S status five years ago. Nevertheless, Salt is excluded from the definition of a member of a controlled group of corporations. Thus, Caps and Salt can each claim a $250,000 Section 179 deduction for the year.

Variation: Assume that Salt was not subject to the built-in gains tax because it had never operated as a C corporation. Once again, Salt is excluded from the definition of a member of a controlled group. Thus, Caps and Salt can each claim a $250,000 Section 179 deduction for the year.

Proposed Regulations. Proposed regulations would provide that an S corporation is a member of a controlled group if the controlled group rules for qualification and stock ownership are met. Thus, if the proposed regulations become final, apportionment of the Section 179 deduction will be required if the S corporation is a member of a controlled group, using the 50% stock ownership test. The proposed regulations are scheduled to become effective for tax years beginning on or after the date they are published as final regulations in the Federal Register.

Example 1-33: Treating S corporations as members of a controlled group after proposed regulations become final.

Jack owns all of the stock of three S corporations, ABC Corp., DEF Corp., and GHI Corp. ABC, DEF, and GHI are members of a brother sister controlled group. Assume the proposed regulations have become final. The Section 179 dollar limitation, placed-in-service limitation, and taxable income limitation must be apportioned among the members of the group. Also, property purchased from another group member is not considered to be Section 179 property.

Passing through the Section 179 Deduction to Estates and Trusts

Estates and trusts are not eligible for the Section 179 deduction. Thus, if an estate or trust holds S corporation shares, and the S corporation passes through a Section 179 deduction, the estate or trust cannot take any of the deduction allocated to it. Normally, the S corporation is required to reduce its basis in the property for the Section 179 deduction claimed at the corporation level. However, the regulations provide that the S corporation's (or partnership's) basis in 179 property is not reduced for the portion of the Section 179 deduction that is passed through to the trust or estate.

Evidently, the corporation's depreciation expense on the disallowed Section 179 deduction amount is included in the nonseparately stated income shown on page one of Form 1120S and is allocated pro rata to all shareholders, rather than just the estate or trust. This treatment appears to be required because the S corporation pass-through rules of IRC Sec. 1377 do not provide for any allocation method other than per-share, per-day. If certain stock transactions take place (such as a shareholder disposing of all of his or her stock), the corporation can elect to treat the tax year as if it were two tax years. Even if such an election is made, however, allocations to shareholders are made on a per-share, per-day basis within each deemed short tax year, as discussed earlier in this lesson.

Higher Expensing Limits for Qualified Disaster, Enterprise Zone or Qualified Renewal Property

The Section 179 deduction limit is increased for qualified disaster assistance property. For 2010, the Section 179 deduction limit is increased by the lesser of (a) $100,000 or (b) the cost of qualified Section 179 disaster assistance property placed in service during the tax year. The property-placed-in-service threshold is increased by the lesser of (a) $600,000 or (b) the cost of qualified Section 179 disaster assistance property.

Enterprise Zone or Qualified Renewal Property. For Section 179 property that is also part of an enterprise zone business under IRC Sec. 1397C or qualified renewal property under IRC Sec. 1400J(b), the Section 179 limits are increased by the lesser of $35,000 (for 2010) or the cost of the qualified renewal property. In addition, only 50% of the cost of qualified property is taken into account in computing the assets subject to the $800,000 (for 2010) excess property limitation.

Amending or Revoking the Section 179 Deduction

Taxpayers can amend or revoke the Section 179 expense election or specifications within the election for property acquired before 2011 by filing an amended return within the statute of limitations for the year in question.

A taxpayer can make the following changes regarding the Section 179 election subject to the deduction and income limitations:

- Additional assets can be expensed under IRC Sec. 179 that had previously been capitalized;
- One specific asset can be substituted for another asset of the same type;
- The amount that is being expensed for a specific item can be increased or decreased; or
- The election to expense an asset can be totally revoked.

Once a deduction is revoked, the Section 179 deduction on that property cannot be reinstated; that is, the revocation itself is irrevocable.

Avoiding Potential Section 179 Trap for 2010 Fiscal Year S Corporations

Assets acquired and placed in service during the fiscal year beginning in 2010 and ending in 2011 qualify for a $250,000 Section 179 deduction. This deduction will be reflected on the 2010 Form 1120S and passed through to the calendar-year shareholders who will claim the deduction on their 2011 Form 1040. The shareholder's 2011 return will be subject to the Section 179 deduction limits for 2011, which will be $25,000 unless Congress extends the increased limits.

Example 1-34: Section 179 trap for majority shareholder in fiscal-year S corporation.

Elaine owns all the shares of ABC, Inc., an S corporation that uses an October 31 tax year-end. For the tax year beginning November 1, 2010, ABC claims a $250,000 Section 179 deduction. Elaine takes the expense into account on her 2011 Form 1040 because this tax year includes the ABC tax year ending on October 31, 2011. (The 2011 Section 179 deduction limit is $25,000.) Elaine can deduct only $25,000 of the $250,000 amount passed through in 2011 by ABC. Elaine loses $225,000 ($250,000 – $25,000) of the deduction because there is no carryover provision for this excess. The $225,000 is wasted—it can neither be deducted nor carried over.

Avoiding or Triggering the Depreciation Midquarter Convention with Section 179 Deduction

Depreciable assets other than real property generally are subject to a half-year convention when calculating tax depreciation. (Real property is subject to a midmonth convention.) Thus, regardless of the actual acquisition date, property subject to the half-year convention is assumed to have been acquired at the tax year's midpoint. This method provides half a year's depreciation deduction in the year of acquisition and the year of disposition. No depreciation is allowed for property that is acquired and disposed of in the same tax year.

A midquarter convention (with property assumed to be placed in service at the midpoint of the quarter in which it is acquired) applies if more than 40% of depreciable property placed in service during the year is done so in the last three months of the tax year. Real property and property for which a Section 179 deduction has been elected are excluded when testing for the midquarter convention.

Many times, S corporations want to avoid the midquarter convention since property acquired after the midpoint of the tax year is entitled to less depreciation in the first year than under the half-year convention. One way to do this

is by timing asset purchases so that at least 60% of the assets purchased during the year are placed in service during the first three quarters of the year.

The cost of property expensed under IRC Sec. 179 is excluded when applying the 40% rule for the midquarter convention test. Because the S corporation can choose which assets to expense for Section 179 purposes, the Section 179 deduction can be used to avoid or trigger the midquarter convention. For example, to avoid the midquarter convention, the S corporation can claim a Section 179 deduction on assets purchased in the fourth quarter to reduce fourth quarter purchases to or below the 40% threshold.

Unlike the Section 179 deduction, bonus depreciation is claimed after determining whether more than 40% of the basis of the property has been placed in service in the last quarter of the year. While bonus depreciation is available regardless of when an asset is placed in service during the year, the basis of these assets before the bonus depreciation deduction determines whether the S corporation is subject to the mid-quarter convention for computing regular depreciation on current-year additions.

DEDUCTING 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, the IRS often asserts that a controlling shareholder-employee cannot deduct the expenses in any event because they relate to corporate business rather than to duties as an employee.

Example 1-35: Losing deductions for corporate expenses paid by shareholder.

Mark is the sole shareholder of MRK, Inc., an S corporation. He personally paid expenses incurred in the corporation's business. MRK and Mark had agreed that the corporation would not reimburse expenses or pay salaries to him until the business started making a profit. Mark did not request reimbursement of the expenses. He deducted the expenses as ordinary and necessary trade or business expenses on Schedule C of his Form 1040.

Upon audit, the IRS disallowed the deductions. Mark 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 Mark's basis in his stock. Thus, the increase in basis could support a larger pass-through loss deduction, if losses would otherwise be limited by basis.

Example 1-36: Preserving corporate deduction for expenses paid by shareholder.

The deduction for the expenses in the Example 1-35 did not have to be lost. The corporation could have deducted the expenses if it had reimbursed Mark for them or had treated the payments as loans from Mark to the corporation. Alternatively, the corporation could have paid the expenses directly. If it did not have sufficient funds, Mark could have loaned the money to the corporation, and the expenses could have been paid and deducted at the corporate level. (All indebtedness between an S corporation and a shareholder should be documented with a written note and bear a fair market interest rate.)

SELF-STUDY QUIZ

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

15. A specific formula is used when an S corporation's taxable income limit prevents claiming the full Section 179 deduction. When should an S corporation use this formula?

    a. When the dollar amount of assets placed in service exceeds the S corporation's taxable income.

    b. When the dollar amount of assets placed in service is less than taxable income.

16. The Section 179 deduction is limited to which of the following?

    a. A corporation's tax basis in contributed property.

    b. Taxable income resulting from the active conduct of any trade or 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. A specific formula is used when an S corporation's taxable income limit prevents claiming the full Section 179 deduction. When should an S corporation use this formula? **(Page 40)**

    a. When the dollar amount of assets placed in service exceeds the S corporation's taxable income. [This answer is correct. When the taxable income limit prevents claiming the full $250,000 deduction (and the midquarter convention does not apply), specific formulas can be used for five-year and seven-year MACRS assets to calculate the maximum Section 179 deduction. The formulas should be used only when the dollar amount of assets placed in service exceeds the S corporation's taxable income.]

    b. When the dollar amount of assets placed in service is less than taxable income. [This answer is incorrect. If the dollar amount of assets placed in service is less than taxable income, the S corporation can deduct the cost of the assets that were placed in service.]

16. The Section 179 deduction is limited to which of the following? **(Page 41)**

    a. A corporation's tax basis in contributed property. [This answer is incorrect. The amount passed through due to the contribution of 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 contributed property.]

    b. Taxable income resulting from the active conduct of any trade or business. [This answer is correct. The Section 179 deduction is limited to the taxable income derived from the active conduct of any trade or business. As with the $250,000 (for 2010) limitation, the taxable income limitation applies at both the S corporation and the shareholder levels.]

DECREASING OVERALL TAX WITHIN A FAMILY BY PAYING REASONABLE SALARIES

Establishing that Compensation Is Reasonable

For compensation to be deductible, it must be reasonable for the personal services actually rendered. The Code specifically empowers the IRS to reallocate an S corporation's income in family income-splitting situations. IRC Sec. 1366(e) states that 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 whether or not they own shares in the corporation. Under these rules, 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. Therefore, inadequate salary, rent, or interest could result in reallocations by the IRS.

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 five factors:

a. the character and financial condition of the corporation;

b. the role the shareholder plays in the corporation, including the employee's position, hours worked, and duties performed;

c. 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;

d. how the compensation compares with similarly situated employees of other companies; and

e. whether a hypothetical, independent investor would conclude that there is an adequate return on investment after considering the shareholder's compensation.

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

a. the employee's qualifications;

b. the size and complexity of the business;

c. a comparison of salaries paid to sales and net income;

d. general economic conditions;

e. comparison of salaries to shareholder distributions and retained earnings;

f. compensation paid in prior years;

g. the corporation's dividend history;

h. whether the employee and employer dealt at arm's length; and

i. 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.

Example 1-37: Reducing overall tax within a family by paying reasonable salaries.

Paul is president of Paulco, an S corporation, and owns 52% of its stock. His two adult children, Susan and Ronald, each own 24% of the stock. Paul receives an annual salary of $125,000, and the corporation has a stable net income of $5,000. At the beginning of the next tax year and for the next few years, Paul wants to set aside funds to help each child buy a house. He asks his tax practitioner if there is any way to have the children taxed on those amounts. The practitioner suggests that Paul's salary be decreased to $75,000 so nonseparately stated income will increase and the amount taxed at the children's lower rates will be greater.

If Paul's salary is decreased, Paulco's income will increase and more taxable income will be allocated to the children. If Paul's salary is reduced to $75,000, the corporation's nonseparately stated income will be $55,000. The income will be allocated to the shareholders as follows:

Paul (52%)	$28,600
Susan (24%)	13,200
Ronald (24%)	13,200
Total	55,000

The strategy is to have the salaries of the higher-bracket family members as low as possible if the objective is to split income among family members to take advantage of lower tax brackets.

Salaries paid to shareholders must be reasonable. However, since the determination of "reasonable" is subjective, wages can be set at a justifiable amount that produces a desired result, such as income shifting among family members.

It is important to recognize that the IRS can target S corporations that are not paying any officer's salaries, or are possibly paying insufficient salaries. It can do so by looking at the deduction claimed for salaries paid to the officers on the front page of Form 1120S, as well as looking at the balance sheet to determine if there is cash on hand. If the officers render services and if the S corporation can pay salaries to the officers (there is cash on hand), not paying salaries probably is unjustifiable.

Conversely, paying the smallest reasonable salary (if this is the client's objective) can be a justifiable goal. However, to accomplish this objective, documentation supporting the amount paid should be prepared and kept with the corporation's permanent records. For example, in this case, the corporate minutes could reflect Paul's decreased involvement in the daily activities of the company, increased duties and responsibilities assumed by other employees, and/or reduced cash available for current expenses, as reasons for lowering his salary.

Avoiding Payroll Taxes and Social Security Benefit Reduction

Aside from income splitting, an S corporation shareholder may want the S corporation to pay less wages than what might otherwise be considered reasonable for at least two reasons:

a. *Avoidance of FICA and Other Payroll Taxes.* S corporation pass-through and distributions are not subject to self-employment tax.

b. *Social Security Benefits.* The receipt of social security benefits for retired persons who have not reached the full benefit retirement age can be affected by wages received.

As discussed throughout this section, however, compensation to S shareholder/employees must be reasonable.

Avoiding Recharacterization of Distributions as Wages

Distributions to a shareholder are not subject to SE tax. However, distributions to an actively employed shareholder can be considered wages subject to payroll taxes if the distributions are actually disguised wages. Several court

cases have held that distributions to service-providing shareholders who received no salaries can be recharacterized as salaries. These cases form a continuing and consistent pattern of government victories on this issue.

Having distributions reclassified as wages can be expensive. The corporation must pay the FICA and federal unemployment taxes (FUTA), and may be required to pay withholding on the wages. (The withholding is abated if the shareholder pays the proper income tax.) The corporation could be subject to the IRC Sec. 6651(a)(1) failure to file penalty, the IRC Sec. 6656(b)(1) failure to deposit penalty, and the IRC Sec. 6662(c) negligence penalty. Also, a social security recipient's benefits may be reduced because of the reclassified wages if the recipient has not attained the full benefit retirement age and his or her earned income (including the wages) is above a threshold amount. (Full benefit retirement age is gradually increasing from age 65 in 2002 to age 67 in 2027.)

If distributions are actually disguised compensation to shareholders, the IRS can reclassify the distributions as wages.

Example 1-38: IRS can reclassify disguised distributions as wages.

Assume now that Paul, in Example 1-37, is the sole shareholder in Paulco, an S corporation. Paul has sufficient basis so distributions to him are nontaxable. Throughout the current year, Paul performed services for Paulco but drew no salary. Instead, he arranged for the corporation to make distributions of $40,000, the amount he would have otherwise received as reasonable compensation for the services performed, based on industry trends, geographic location, and the size of the company.

IRC Sec. 3401(a)(1), which deals with income tax withholding, defines wages as all remuneration for service performed by an employee for his employer. In Paulco's case, the distributions paid to Paul were in lieu of reasonable compensation for services. Accordingly, the IRS could determine that the $40,000 constitutes wages (rather than distributions) includible in Paul's ordinary income. Furthermore, Paul and the corporation would be subject to payroll taxes and potential penalties.

Shareholder May Want to Maximize Wages

Circumstances may occur when a shareholder wants to maximize wages. In a C corporation, increased wages can be paid to avoid distributing dividends that are subject to double tax. An S corporation can likewise increase wages to reduce income that would otherwise be subject to double tax.

Example 1-39: Avoiding built-in gains tax by paying reasonable compensation.

ABC, Inc., an S corporation, recognizes built-in gains for the year of $50,000. The company projects that its taxable income for that year will be $60,000. The amount taxable under the built-in gain rules is limited to the corporation's taxable income for the year, computed as if the corporation were a C corporation. Consequently, if the shareholders' wages are increased by $60,000 before the end of the year, the corporation will have no taxable income and will not be subject to the built-in gains tax for that year. (However, any built-in gain not recognized because of the taxable income limitation carries over during the 10-year recognition period.) This same technique could also be applied to avoid the tax on passive income.

However, if wages paid exceed a reasonable amount, the excess may be recharacterized as a nondeductible dividend distribution to the employee/shareholder. Such recharacterization can defeat the tax objective for paying a larger salary. Continuing with Example 1-39, recharacterizing part of the salary expense as a nondeductible distribution could subject the corporation to current year liability for the built-in gains tax (at a flat 35% rate). Therefore, it is important for the employee and the practitioner to document in writing the specific reasons why the salary is reasonable.

A related issue that has resulted in significant litigation concerns stock transfers between family members as income-shifting devices. Courts have applied an "economic reality" rationale to determine whether an actual transfer occurred or if the parents remained beneficial owners. If the children enjoy the economic benefits of ownership, such as voting rights and the right to dispose of their shares, the transfer will be valid and the children will own the shares.

Shareholder-officer Is Not Treated as an Independent Contractor

Compensation for services rendered by an officer-shareholder is wages, not self-employment income.

Example 1-40: Compensation paid to shareholder-officer is not self-employment income.

Assume that the corporation in Example 1-37 pays Paul no salary during the year. Instead, Paul and Paulco enter into an agreement whereby Paul will perform services for the corporation as an independent contractor. At the end of the year, Paulco issues a 1099-MISC to Paul showing $125,000 of "management fees" paid to him. Paul reports the $125,000 on his Schedule C.

The payments to Paul are compensation for services by a shareholder-officer and are wages. Thus, the payments cannot be claimed as self-employment income.

Example 1-41: Substance over form applies to an employment contract.

Assume that in Example 1-40, Paul had executed a formal employment contract specifying no salary was to be paid to him during the year. Would this formality change the results?

No! This was precisely the situation in *Radtke*, in which an attorney tried to use the formalities of an employment contract (calling for a base salary of zero) to avoid employment taxes. His scheme failed in the District Court and on appeal to the 7th Circuit Court of Appeals. Distributions to the shareholder were considered to be wages subject to payroll taxes. A similar scheme failed in *Dunn and Clark, P.A.*

Distributions to Corporate Officers

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 1-42: Classifying payments to corporate officers.

Linda is a practicing attorney who also serves as secretary-treasurer of Ellco, Inc., an S corporation in which she is a minority shareholder. Linda is employed full-time by a law firm throughout the current year. In her role as secretary-treasurer of Ellco, Linda attends to legal and financial matters but is not involved in the day-to-day affairs of the business. Linda was paid no compensation for her services, but she received a $5,000 distribution from Ellco, Inc.

If the $5,000 payment to Linda was actually compensation for services, it is considered to be wages subject to payroll taxes and withholding.

Disguising Compensation 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. The IRS can adjust income to reflect reasonable compensation for services rendered or capital furnished to the corporation.) The corporation should 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 a valid and enforceable obligation to pay a fixed or determinable sum of money.

Example 1-43: Differentiating between compensation and loans to shareholders.

Paul owns all the stock of Paulco, 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 Paul 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. Is Paulco vulnerable to an IRS argument that the loan payments are actually disguised wages subject to payroll taxes?

Yes. Under similar facts, the 6th Circuit affirmed the Tax Court and ruled that "loan" payments to a majority shareholder, who was the driving force behind the corporation's business, were wages.

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.

Noncash Compensation

While the preceding discussion has focused on cash compensation, the determination of whether compensation is reasonable involves more than just an analysis of the amount of cash paid to each employee. Although the IRS usually places more emphasis on cash payments, in certain cases the amount of other compensation (such as fringe benefits and retirement plan contributions) also receives 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.

Receiving Cash by Renting Home Office Space to an S Corporation

Renting a portion of a shareholder's home to the S corporation (either for office space or storage) gets corporate cash to the shareholder without subjecting it to payroll tax. Entering into a valid lease (with a FMV rental payment) may be better than taking cash distributions (which are also free from payroll tax) because the IRS tends to scrutinize cash distributions to determine whether they are disguised compensation (subject to payroll tax).

The rental income must be reported on the shareholder's Form 1040, and because individuals cannot claim any deduction for a home office space that is leased to their employer, no deduction is allowed for the home office. However, a fully documented valid lease at FMV for a good business reason (e.g., providing office space for the corporation) should provide a legitimate means to take cash out of the corporation as rental income (not subject to payroll tax), rather than as a distribution (subject to IRS scrutiny) or compensation (subject to payroll tax).

Example 1-44: Renting home office space to an S corporation.

Brooke and her daughter, Linda, age 31, own all the stock of BLC Inc., an S corporation. To shift some corporate income to Linda, BLC enters into a lease with her for both an office and a storage area in her home. These spaces are used by the S corporation for its business activities and by Linda to perform her duties as an employee. Based on a local property management firm's analysis, Brooke and Linda determine that a reasonable rent for this space is $12,000 per year. Thus, BLC will pay $12,000 of deductible rent to Linda, who will report $12,000 of rental income on her individual tax return. Because she is BLC's employee, she cannot claim any deductions for the rental activity. Still, as rental income, the payments are not subject to SE tax or payroll taxes.

THE BENEFICIAL OWNER OF S CORPORATION STOCK

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. For example, a minor child is considered the owner of any stock held by a custodian under the Uniform Gifts to Minors Acts

(UGMA). 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.

Effect of Beneficial Ownership 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 that he was a shareholder because (a) he agreed to buy 25% of the stock (but made no payments), (b) he received a compensation package comparable to that of other shareholder-employees, (c) the firm's name was changed to include his name, and (d) he was shown as a shareholder on the corporation's Form 1120S.

Shares Held by Spouse as Community Property

Reg. 1.1366-1(d) provides that a husband and wife who hold S corporation stock that is community property receive the pass-through in accordance with the community property rules.

Example 1-45: Passing through S corporation items to married shareholders in a community property state.

Anita owns stock of ABC Corp., an S corporation, in her own name. She and her husband, Bill, live in a community property state and the stock is community property. The only pass-through item for the current year is $50,000 of nonseparately stated income from operations. Under the regulations, the corporation passes through $25,000 to Anita and $25,000 to Bill.

Restricted Stock

A person who holds S corporation stock that is subject to restrictions (e.g., limiting the stock's sale or transfer) might not be considered the owner of the stock for pass-through purposes.

AVOID THE S SHAREHOLDERS' ESTIMATED TAX UNDERPAYMENT PENALTIES

Under IRC Sec. 1366(a)(1), 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, the penalty for underpayment of an individual's estimated tax under IRC Sec. 6654 can be avoided if any one of several situations apply.

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.

OTHER PASS-THROUGH MATTERS

Passing through Charitable Contributions

Charitable contribution deductions are not limited at the corporate level. Rather, they pass through as a separately stated item, and deduction limitations, if any, are determined at the individual shareholder level. An S corporation's charitable contributions are passed through to shareholders in the year paid, regardless of whether the corporation uses the cash or accrual method of accounting.

Maximizing Tax Benefit of Charitable Contributions Made by S Corporation

The following strategies can be used to maximize the tax benefit of charitable contributions made by an S corporation:

- Donate appreciated long-term securities rather than cash to avoid tax on the unrealized gain while the shareholders get a charitable deduction for the security's full FMV. This provides a better tax result than selling the securities, reporting the gain, and contributing the cash.

- Hold short-term capital gain property until the long-term holding period is met to generate a deduction equal to FMV, thereby increasing the amount of the contribution deduction. The amount passed through due to the contribution of 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 contributed property.

- Contribute appreciated property to charity to avoid the built-in gains tax. This corporate-level tax applies when an asset on hand at the date the S election became effective is disposed of, but only if the transaction results in recognized income or gain. A charitable contribution of appreciated property does not result in recognized gain. Therefore, charitable contributions of property that appreciated before the S election became effective are not subject to the built-in gains tax.

- Sell depreciated property (i.e., property that has an adjusted basis in excess of its FMV), pass-through the loss, and contribute the sales proceeds to charity. If depreciated property is contributed to charity, the deduction is limited to FMV and the donor corporation is not allowed to deduct or pass-through a loss for the difference between the property's basis and FMV.

Excluding Cancellation of Debt Income from Pass-through Items

Special rules apply to debt discharge income of bankrupt or insolvent taxpayers. Under IRC Sec. 108, 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.

COD income not includable in an S shareholder's gross income because the corporation is insolvent or bankrupt does not pass through to the shareholders. Thus, S shareholders do not increase their basis for the excluded COD income.

Passing through Income under the Tax Benefit Rule

Generally, a taxpayer's gross income includes recoveries of amounts deducted in any prior tax year to the extent the amounts reduced the tax in the prior year. This is commonly known as the *tax benefit rule*.

Example 1-46: Applying the tax benefit rule.

Jaycorp, an S corporation, deducts $10,000 of accrued interest expense in Year 1. In Year 2, it is determined that the interest will never be paid, and the previously deducted $10,000 is included in the corporation's income in Year 2.

The Tax Court has ruled that the shareholders of an S corporation must include the recovered deduction in income, even though the deductions were taken when the corporation was a C corporation.

Example 1-47: Passing through income under the tax benefit rule.

Assume the same facts as in Example 1-46, except Jaycorp was a C corporation until it elected S status at the beginning of Year 2. According to the Tax Court, the $10,000 of income passes through to Jaycorp's share-

holders in Year 2 and is included in their income. In *Frederick*, the shareholders argued they should not have to report such income because doing so would cause the recovery of the deduction to be taxed to a person other than the one who took the deduction. The Tax Court disagreed and stated that conversion from C status to S status does not create a new taxpayer. Further, the IRS would be "severely prejudiced" if a C corporation shareholder could avoid recovering income simply by having the corporation elect S status.

Reporting Nonbusiness Bad Debts

Under the general rule, a deduction is allowed for a debt that becomes worthless during the tax year. However, IRC Sec. 166(d) provides that, for a taxpayer other than a corporation, a worthless nonbusiness bad debt is deductible as a short-term capital loss, rather than as an ordinary deduction from business income. (A nonbusiness bad debt is debt that is not created or acquired in connection with the taxpayer's trade or business.)

The IRS has ruled that an S corporation reports the amount of a worthless nonbusiness bad debt as a short-term capital loss, which is a separately stated item on Schedules K and K-1. The IRS reached this conclusion because an S corporation's income is computed (with certain exceptions) as if the corporation were an individual.

Passing Through Current Year S Items when Stock Becomes Worthless

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 original shareholders of certain smaller corporations 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.

Example 1-48: Passing through S items to worthless stock.

Ernest owns 25% of the stock of Verne, Inc., an S corporation in which he materially participates. Ernest 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 to Ernest a $15,000 loss from business activities. Ernest's $20,000 stock basis is first reduced by the $15,000 pass-through loss. He deducts the loss on his Form 1040, Schedule E. Also, he recognizes a $5,000 long-term capital loss for his remaining adjusted tax basis in the stock.

Dealing with Bankruptcy Issues

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 items of income, loss, deduction, and credit pass through to shareholders or the bankruptcy estate.

Avoiding Self-employment Tax on Pass-through to 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 in turn reports the pass-through items to its shareholders on the appropriate lines of Form 1120S, Schedule K-1.

S corporation pass-through income and distributions are not subject to self-employment tax.

Example 1-49: Avoiding self-employment tax on income passed through by a partnership to an S corporation.

Bob Boles is the sole shareholder in BB, Inc., an S corporation. BB conducts a manufacturing business that shows net business income for the year of $40,000. BB also owns an interest in a partnership and receives a K-1 from the partnership showing nonseparately stated income of $25,000. The K-1 indicates that the $25,000 is net income from self-employment.

The income and expense items for the manufacturing business and the nonseparately stated income from the partnership are combined into one net amount on page 1 of Form 1120S, which therefore will reflect a net ordinary income amount of $65,000 ($40,000 + $25,000). The activities must be reported to Bob separately because he may not materially participate in all of the activities.

Since pass-through income from an S corporation is not subject to self-employment tax, the $25,000 of self-employment income passed through from the partnership is not shown as self-employment income on Bob's personal income tax return. Rather, it is evidently included in the $35,000 of nonseparately stated income from the S corporation that Bob reports on his Form 1040, Schedule E. If Bob's Form 1040 includes a Schedule SE on which the self-employment tax is calculated, none of the $65,000 passed through by the S corporation is reported on that form.

Basis Limitations on Losses Passed through by a Partnership to an S Corporation. Losses passed through by a partnership to an S corporation may be limited by the corporation's basis in the partnership, as well as the shareholder's interest in the S corporation.

Example 1-50: Losses passed through by a partnership to an S corporation may be limited at partnership and S corporation levels.

Sandal, Inc., an S corporation, owns an interest in Pallet Company, a partnership. The corporation's basis in the partnership is $10,000, and the partnership passes through a $25,000 loss to the S corporation. Both the S corporation and Marty, its sole shareholder, 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 Marty?

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. 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, the S corporation evidently deducts $10,000 of the loss and passes through that amount to Marty. The remaining $15,000 loss is carried over by the S corporation partner and passed through to Marty as the S corporation acquires basis in its partnership interest in Pallet. Marty 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 Marty because of a lack of basis carries over at the shareholder level to be deducted by him as he acquires basis.

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 statements regarding compensation to shareholder is most accurate?

    a. If payments made to shareholders represent compensation for services provided to a corporation, those payments are usually considered wages.

    b. When compensation is paid to a shareholder by an S corporation, the compensation is considered reasonable based on the specific accounting method.

    c. Compensation such as retirement plan contributions and fringe benefits are scrutinized more by the IRS than cash compensation.

18. Which of the following statements regarding beneficial owner of S corporation stock is **least** accurate?

    a. If a registered owner of S corporation stock is not the individual that controls the stock, the beneficial owner is considered the shareholder.

    b. Pass through items are allocated to beneficial shareholders only if shares have been disseminated to that person or entity.

    c. A partnership will be considered the shareholder and the corporation will not qualify for S status if the partnership is the beneficial owner of the stock.

19. Which of the following statements regarding avoiding recharacterization of distribution as wages is most accurate?

    a. Most distributions to a shareholder are subject to SE tax.

    b. Social Security benefits of the shareholder generally are increased when wages are reclassified.

    c. Reclassifying distributions as wages can be costly.

    d. Even if the shareholder pays the appropriate income tax, the withholding is still due to the Treasury Department from the corporation.

20. Stonehill, Inc, an S corporation, wants to maximize tax benefits of charitable contributions made by the S corporation. Which of the following strategies would allow the S corporation shareholders to obtain a better tax result than if the S corporation contributes cash?

    a. The S corporation can contribute appreciated, long-term securities.

    b. The S corporation can donate depreciated property to charity.

    c. The S corporation can increase the amount of the contribution deduction by contributing short-term capital gain property to the charity.

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 statements regarding compensation to shareholder is most accurate? **(Page 50)**

    a. If payments made to shareholders represent compensation for services provided to a corporation, those payments are usually considered wages. [This answer is correct. Often, an S corporation will loan funds to shareholders. However, if these payments are not bona fide loans, but instead represent compensation for services rendered to the corporation, the payments may be reclassified as wages. The corporation should 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 a valid and enforceable obligation to pay a fixed or determinable sum of money.]

    b. When compensation is paid to a shareholder by an S corporation, the compensation is considered reasonable based on the specific accounting method. [This answer is incorrect. According to the IRS, taxpayers generally will not succeed when compensation paid by an S corporation is extremely low in exchange for extensive services. It is impossible to make a broad statement as to what amount of compensation is logical because reasonableness must be determined based on the surrounding facts and circumstances.]

    c. Compensation such as retirement plan contributions and fringe benefits are scrutinized more by the IRS than cash compensation. [This answer is incorrect. The determination of if compensation is reasonable entails more than just an analysis of the amount of cash paid to each employee. Although the IRS usually places more emphasis on cash payments, in certain cases the amount of other compensation (such as fringe benefits and retirement plan contributions) also receives IRS scrutiny when determining reasonable compensation, especially when the noncash compensation represents a substantial benefit to the employee per the IRS.]

18. Which of the following statements regarding beneficial owner of S corporation stock is **least** accurate? **(Page 52)**

    a. If a registered owner of S corporation stock is not the individual that controls the stock, the beneficial owner is considered the shareholder. [This answer is incorrect. 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) according to Reg. 1.1361-1(e)(1). Thus, the person for whom S corporation stock is held by a nominee, guardian, custodian, or agent is considered the shareholder.]

    b. Pass through items are allocated to beneficial shareholders only if shares have been disseminated to that person or entity. [This answer is correct. Pass-through items are allocated to beneficial shareholders, even if no shares actually have been issued to that individual or entity. In one tax case, 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 that he was a shareholder because (a) he agreed to buy 25% of the stock (but made no payments), (b) he received a compensation package comparable to that of other shareholder-employees, (c) the firm's name was changed to include his name, and (d) he was shown as a shareholder on the corporation's Form 1120S.]

    c. A partnership will be considered the shareholder and the corporation will not qualify for S status if the partnership is the beneficial owner of the stock. [This answer is incorrect. According to Reg. 1.1361-1(e)(1), 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.]

19. Which of the following statements regarding avoiding recharacterization of distribution as wages is most accurate? **(Page 48)**

    a. Most distributions to a shareholder are subject to SE tax. [This answer is incorrect. Distributions to a shareholder are not subject to SE tax. There is a risk that distributions to an actively employed shareholder can be considered wages subject to payroll taxes if the distributions are actually disguised wages, according to Rev. Rul. 74-44.]

    b. Social Security benefits of the shareholder generally are increased when wages are reclassified. [This answer is incorrect. Social Security recipient's benefits may be reduced because of the reclassified wages if the recipient has not attained the full benefit retirement age and his or her earned income (including the wages) is above a threshold amount per IRS regulations.]

    c. Reclassifying distributions as wages can be costly. [This answer is correct. Having distributions reclassified as wages can be expensive. The corporation must pay the FICA and federal unemployment taxes (FUTA), and may be required to pay withholding on the wages according to IRC Sec. 3403; Reg. 31.3402(g)-1(a)(2)(ii).]

    d. Even if the shareholder pays the appropriate income tax, the withholding is still due to the Treasury Department from the corporation. [This answer is incorrect. According to IRS rules, the withholding is abated if the shareholder pays the proper income tax.]

20. Stonehill, Inc, an S corporation, wants to maximize tax benefits of charitable contributions made by the S corporation. Which of the following strategies would allow the S corporation shareholders to obtain a better tax result than if the S corporation contributes cash? **(Page 53)**

    a. The S corporation can contribute appreciated, long-term securities. [This answer is correct. Donating appreciated long-term securities rather than cash to avoid tax on the unrealized gain while the shareholders get a charitable deduction for the security's full FMV is one strategy used to maximize tax benefits of charitable contributions made by S corporation. This strategy provides a better tax result than selling the securities, reporting the gain, and contributing the cash.]

    b. The S corporation can donate depreciated property to charity. [This answer is incorrect. If the S corporation contributes depreciated property to charity, the deduction is limited to FMV and the donor corporation is not allowed to deduct or pass-through a loss for the difference between the property's basis and FMV per Reg. 1.170A-1(c). It would be more advantageous to the shareholders for the S corporation to sell the depreciated property, pass through the loss and donate the proceeds to charity.]

    c. The S corporation can increase the amount of the contribution deduction by contributing short-term capital gain property to the charity. [This answer is incorrect. If the S corporation had held the property until the long-term capital gain holding period was met, a deduction equal to the FMV would be available to shareholders in accordance with IRC Sec. 170(c)(1)(A).]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TSCTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following would most likely be treated as a nonseparately stated item included in the computation of ordinary income or loss?

   a. Charitable contributions.

   b. Section 179 deduction.

   c. Real estate taxes on corporate office building.

   d. Intangible drilling costs.

2. ELI Corp. is an S corporation that reports on a calendar year. The corporation's shares are owned 50% by Ernest and 50% by Larry. For the four months ending April 30, the company showed a $60,000 loss; but, during the next three months of the year, it had net income of $30,000. During the final five months, ELI had net income of $20,000, resulting in a net loss of $10,000 for the year. The loss is the only pass-through item for the year. How is the loss allocated to the shareholders under the per-share, per-day method?

   a. It is reported on Schedule K-1 and each shareholder receives $5,000 which is passed through on a separate Schedule K.

   b. It is reported on Schedule K of Form 1120S and each shareholder receives $5,000 which is passed through on a separate K-1.

   c. It is reported on Schedule K-1 of Form 1040 and each shareholder receives $2,500 which is passed through on a separate K-1.

   d. It is reported on Schedule K of Form 1040 and each shareholder receives $2,500 which is passed through on a separate Schedule K.

3. When a shareholder dies, the decedent's interest in the S corporation completely terminates. Which of the following scenarios describes the proper execution of the election to apply specific accounting rules?

   a. The CPA for the Dun-Rite S Corp timely files the Form 1120S for the year the disposition of shares occurs. No statement of facts is attached.

   b. The CPA for the All-Night S Corp is aware that some shareholders in the S Corp acquired their shares during the year. The CPA obtains consent of shareholders who held shares for the entire year and timely files Form 1120S.

   c. The CPA for the Good Day S Corp obtains consent of shareholders acquiring or disposing of shares during the tax year in which the death of the shareholder occurred. A statement of facts is attached to a timely filed Form 1120S.

   d. The CPA for the Black Rock S Corp obtains consent of shareholders acquiring or disposing of shares during the tax year in which the shareholder death occurred. A statement of facts is attached to a timely filed Form 1120S along with all the consent forms from the shareholders.

4. Thompson and McLain each own 50% of the shares of Shady Glen Corp, a calendar-year S corporation. Thompson sells 50% of his shares to Louis on Jun 30. On November 30, McLain sells all of his shares to Louis. If the books were closed as of June 30, Shady Glen would pass through an operating loss of $20,000. For the next five months (through November 30) Shady Glen earns $40,000, and it earns $10,000 of net income in December, resulting in $30,000 of ordinary income for the entire year. Which of the following is Shady Glen's **only** pass-through item?

   a. $10,000 net income in December.

   b. $20,000 operating loss through June.

   c. $30,000 ordinary income for the year.

   d. $40,000 earnings through November.

5. A shareholder who disposes of his or her stock cannot decide the tax consequences of the disposition or of distributions received prior to the disposition until the end of the corporation's tax year under which of the following methods?

   a. Cash.

   b. Specific accounting.

   c. Per-share, per-day.

   d. Accrual.

6. Joan and John each own 50% of the shares of JJ Corp, an S corporation. John dies on June 30 and his shares are transferred to his estate. If the books were closed at the end of June 30, JJ 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. The income is JJ's only pass-through item. On March 31 of the following year, the estate transfers the stock to John's beneficiary, Jesse. Because the estate has disposed of its entire interest in JJ, the corporation can make the election to use specific accounting. If the specific accounting election is made, pass-through to the estate's fiduciary return is based on the income or loss through March 31. Who should consent to the election?

   a. Jesse.

   b. Jesse and the executor.

   c. Executor.

   d. Joan and the executor.

7. The following scenarios occur during the S termination year for Count Me Out S Corporation. In which of the following would the specific accounting method be required?

   a. Frederick sold 50% of his Count Me Out stock.

   b. Frederick sold 25% of his Count Me Out stock.

   c. Frederick transferred 20% of his Count Me Out stock to a trust.

   d. Frederick transferred 15% of his Count Me Out stock.

8. Aaron owns stock in two S corporations. He is the sole shareholder of Mountain Corp., and he owns half the shares of Dew Corp. He works full-time at Mountain and draws an annual salary of $75,000. He does not participate in Dew's operations. The two corporations are engaged in different business activities conducted at different locations.

   Mountain reports a loss of $25,000, after considering $1,000 of interest income from investing working capital for a short time. Dew reports a loss of $40,000. Neither corporation receives any rental income.

   Aaron does not have any other income items in arriving at adjusted gross income (AGI) on his income tax return. He believes his income will be computed as follows:

Salary	$ 75,000
Mountain Corp. pass-through items:	
Interest income	$ 1,000
Ordinary loss	(26,000)
Dew Corp. loss	(20,000)
Total income	$30,000

   He asks his practitioner if his assumptions are correct and, if not, can he do anything to decrease his taxes. Can Aaron offset the S corporation losses from Mountain and Dew against his salary?

   a. Yes.

   b. No.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

9. During 2009, Jackson places $962,000 of Section 179 property in service. The excess Section 179 amount is $162,000. How much Section 179 deduction is Jackson eligible for?

   a. $88,000.

   b. $162,000.

   c. $250,000.

   d. $800,000.

10. Tools, Inc., an S corporation, passes through $30,000 of nonseparately stated income to Tim, its sole shareholder. Tim received no salary from the corporation. The corporation placed property qualifying for the Section 179 deduction of $100,000 in service during the year. The corporation can elect expensing up to $100,000, but it can only pass through $30,000, the amount of its business income before considering the Section 179 deduction. The elected amount would decrease the basis of the corporation's Section 179 property, and the elected amount in excess of $30,000 would be carried forward at the corporate level. Tools, however, elects to claim and pass through only $30,000 of Section 179 deduction. How much will Tim report on his Form 1040?

    a. $30,000.

    b. $70,000.

    c. $100,000.

    d. $250,000.

11. Which of the following statements regarding pass-through and distributions is most accurate?

    a. Pass-through income generally is treated as net earnings from self-employment (SE) for the purpose of making retirement plan contributions.

    b. Self-employment income from other sources can be reduced by pass-through losses.

    c. Payment for services provided by an officer- shareholder is considered SE income.

    d. Pass-through income and distributions from an S corporation cannot be subject to SE tax.

12. How do you determine the pass-through treatment of interest expense paid by the corporation?

    a. Using a mathematical equation.

    b. Referring to the use of the debt proceeds.

    c. Using the per-share, per-day method.

    d. Do not select this answer choice.

13. Interest paid by a corporation can be passed through as all of the following **except**:

    a. Rental income or loss components.

    b. Nonseparately stated income components.

    c. Investment interest expense.

    d. Section 179 deduction.

14. Which of the following schedules should a partnership issue if an S corporation owns an interest in it?

    a. Schedule B.

    b. Schedule E.

    c. Schedule K.

    d. Schedule K-1.

15. Which of the following statements regarding the midquarter convention with Section 179 deduction is most accurate?

    a. More than 50% of depreciable property placed in service during the year is placed in the last three months of the tax year for the midquarter convention to apply.

    b. One way for a S corporation to avoid the midquarter convention is to time any assets purchased so that at least 60% of the purchased assets during the year are place in service during the first three quarters of the year.

    c. The cost of property expensed under IRC Sec. 179 is eliminated when applying the community property rules for the midquarter convention test.

    d. The Section 179 deduction is claimed after it is determined that more than 40% of the basis of the property has been place in service in the final quarter of the year.

16. Unreimbursed business expenses paid by a shareholder/employee on behalf of an S corporation are considered employee business expenses subject to which of the following?

    a. 2%-of-AGI floor.

    b. Work opportunity tax credit.

    c. Passive activity rules.

    d. Midquarter convention.

17. How does an S corporation report a nonbusiness bad debt?

    a. As a long term capital loss.

    b. As an ordinary deduction from business income.

    c. As a short term capital loss.

    d. As a casualty loss.

18. When an S corporation shareholder rents a portion of their home to the S corporation for purposes of providing storage facilities to the S Corp, where is rental income reported?

    a. Shareholder's Form 1040.

    b. Shareholder's Form 1120S, Schedule K-1.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

19. There are situations that may occur when a shareholder wants to maximize wages. Increased wages for an S corporation can be paid to avoid which of the following?

    a. Distributing taxable income subject to built-in gains tax.

    b. Recharacterization rules.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

20. Generally, a shareholder of S corporation stock that becomes worthless can claim a loss as a deduction during the year in which it becomes worthless. This type of loss is generally considered which of the following?

    a. Capital loss.

    b. Ordinary loss.

    c. Passive activity loss.

    d. Pass-through loss.

Lesson 2: Basis and Losses

INTRODUCTION

Basis in S corporation stock and debt is important from a tax planning standpoint for three reasons. Basis (a) limits the amount of corporate loss that can be deducted by shareholders, (b) determines the gain or loss upon disposition of the stock or upon repayment of the debt, and (c) governs the amount of distributions that can be received from an S corporation free of tax.

According to a recent GAO report, properly calculating and tracking basis is one of the biggest challenges facing shareholders, and is one of the largest issues for IRS examiners. Typically, this is not a one-time problem. In a sample of S corporations that reported losses in 2003 and filed returns each year from 2001 through 2006, 61% took losses in four or more of the six years (GAO-10-195, December 2009).

Most of the tax planning relating to shareholder basis in stock or debt revolves around the timing of contributions to capital and timing of loans to the corporation to maximize the stockholder's ability to deduct losses.

Completion of this lesson will enable you to:

- Identify stockholder basis planning strategies and basis rules.
- Recognize tax planning strategies to deduct losses to the extent of basis, carry over loss items that exceed basis, structure loans to provide shareholders with debt basis and time the deductibility of losses using capital contributions or loans from shareholders.
- Identify the unique tax planning strategies for debt basis and losses allowed under the IRS rules for S corporations.

STRATEGIES RELATING TO STOCKHOLDER BASIS

Increasing Basis to Deduct Pass-through Losses and Deductions

In a year that losses decrease stock and debt basis to zero, the losses can be deducted in that year only if the shareholder increases stock or debt basis. (Basis must be increased before the end of the corporation's tax year.) To increase stock basis, the shareholder can:

- Contribute additional capital to the corporation.
- Purchase additional shares from the corporation or, if there were other shareholders, from one or more of the other shareholders.

To increase debt basis, the shareholder can:

- Lend money to the corporation. If necessary, the shareholder can personally borrow the money then lend it to the corporation.
- Make payments on debt made to the corporation by a third party lender that the shareholder had previously guaranteed. Or, the shareholder can have the third-party lender substitute the shareholder's note for the note from the corporation.

Timing Deductibility of Losses

The deductibility of losses can be timed to provide the maximum benefit from the deduction. Assuming the shareholder can increase basis through capital contributions or by making loans to the corporation, the year the loss deduction is claimed can be manipulated by determining the proper period for basis to be increased.

Obtaining Valid Basis in Debt

A loan must run directly from the shareholder to the corporation if the shareholder is to have debt basis in the loan. If the funds are not available, the shareholder can borrow from a (preferably unrelated) third-party lender, then

personally lend the funds to the corporation. Guaranteeing a loan from a third party lender to the corporation does not provide the shareholder with debt basis unless the shareholder actually makes a payment to the lender under the guarantee. Planning techniques to get around the hard and fast rule that loans must run directly from the shareholder are, for the most part, unsuccessful.

Making Corporate Payments on Debt, Rather than Making Distributions

Shareholder gain on corporate distributions to the shareholder can be avoided if the corporation makes payments on debt to the shareholder, rather than making distributions. The transaction should be clearly documented in the minutes and other corporate records as a loan repayment to avoid an IRS argument that the payment was a distribution instead of debt reduction.

Avoiding or Reducing Gain on Repayment of Reduced Basis Debt

Gain results when a shareholder's loan to the corporation is repaid, if the note's basis has been reduced by pass-through losses. One tax planning strategy to avoid the tax on the gain is to offset the capital gain with capital losses on the shareholder's tax return. Timing of the note payments can also be an effective tax planning tool. For instance, the note payments might be delayed until a year when there are capital losses to offset the gain. Another planning technique would be to have the corporation make distributions, rather than loan payments, to the shareholder. This is not always a practical solution, however, because distributions may be taxable also.

Reducing Shareholder/Employee's Salary to Decrease Loss

Under some circumstances, reducing a shareholder/employee's salary to decrease a pass-through loss can be an effective tax planning strategy. Reduction of salary can also result in FICA and other payroll tax savings. Other factors, however, such as contributions to corporate retirement plans, should be considered before reducing salaries.

ILLUSTRATING AND SUMMARIZING THE BASIS RULES

Determining Original Basis

A shareholder's initial basis in shares of S corporation stock depends on how the shares are acquired. If the shares were purchased, for example, basis equals the initial cost.

Making Annual Adjustments to Basis

Stock basis is adjusted when a shareholder buys or sells stock in the corporation or contributes capital to the corporation. Also, each shareholder's basis is adjusted each year by pass-through items of income, loss, and deduction, and by distributions to the shareholder. Adjustments are generally made to stock basis in the following order:

a. increased by pass-through income and gain items;

b. decreased by distributions (other than distributions of dividends); and

c. decreased for pass-through items of loss or deduction.

Basis adjustments are normally made at the end of the corporation's taxable year.

Basis Is Determined Immediately before Stock Disposition. A shareholder can have basis against which to deduct losses, even if the shareholder disposes of the shares during the year. While basis normally is determined as of the close of the corporation's tax year, when a shareholder disposes of stock, basis in that stock is determined immediately before the stock disposition takes place.

If a shareholder holds no stock in the corporation at the end of the year, basis in debt is determined immediately before the stock disposition takes place.

Basis Cannot Be Negative Amount

Basis cannot be reduced below zero.

Allocating Basis Adjustments to Each Share

Pass-through items of income, loss, or deduction affect the basis of each share by the shareholder's portion of pass-through items allocable to each share.

Limiting Deductible Losses to Basis

Losses and deductions passed through by an S corporation can be deducted by the shareholder only to the extent of the shareholder's basis in stock and debt of the S corporation. Before the loss items are applied, stock basis is increased by all nonseparately and separately stated income items passed through to the shareholder and reduced by distributions during the year.

At-risk and Passive Activity Loss Limitations. An S shareholder's deduction of pass-through losses may also be limited by the at-risk rules and the passive activity loss rules.

Pass-through Losses Can Reduce Debt Basis

Once a shareholder's basis in S corporation stock has been reduced to zero, pass-through losses and deductions can be deducted to the extent the shareholder has debt basis (i.e., basis in direct loans to the S corporation) in debt that is outstanding at the end of the corporation's tax year.

Losses Reduce Basis Even If Shareholder Receives No Tax Benefit

The basis reduction for nonseparately and separately stated items of loss and deduction occurs whether or not the shareholder can deduct the loss on the shareholder's current year personal return [and whether or not the shareholder can obtain a refund from carrying the loss back to prior years' returns under IRC Sec. 172(b)].

Carrying Losses over to Future Years

A shareholder who cannot deduct a loss in the current year because of a lack of basis does not necessarily lose the benefit of the loss. The loss can be carried forward indefinitely by that shareholder, to be used when stock or debt basis is increased; such as, when (a) the corporation has profits, (b) the shareholder contributes capital, or (c) the shareholder makes loans to the corporation. The carryover loss is personal to the shareholder who owned the stock when the loss occurred. Consequently, the shareholder generally loses the ability to deduct carryover losses when (a) the S election is terminated; (b) the shareholder disposes of all of his or her stock to someone other than a spouse or former spouse incident to a divorce; or (c) the shareholder dies.

Obtaining Basis Requires an Economic Outlay

Stock basis is acquired only if the shareholder experiences an actual economic outlay. Furthermore, to obtain debt basis, the shareholder must incur a true economic outlay, and the debt must be owed by the corporation directly to the shareholder. The shareholder's personal guarantee of the corporation's obligations to third parties does not create basis.

Increasing Basis to Deduct Losses

An S corporation's pass-through losses can be deducted only to the extent the shareholder has stock and debt basis at the end of the corporation's tax year. Thus, if the shareholder has insufficient basis to cover the S corporation's projected loss, the shareholder must increase his or her basis by the end of the corporation's tax year in order for the loss to be currently deductible.

Increasing Previously Reduced Debt Basis by Corporate Income

When debt basis has been previously reduced because of losses occurring in years after 1982, S corporation income (net of losses and nondividend distributions) will increase the debt basis, up to the outstanding balance at

the beginning of the year, before it increases stock basis (i.e., corporate net income restores debt basis to the extent it has been reduced by post-1982 losses). Debt basis reductions that occurred before 1983 cannot be restored.

Distributions Do Not Reduce Debt Basis

Nondividend distributions [i.e., those not considered to be distributions of accumulated earnings and profits (AE&P)] reduce stock basis but do not reduce debt basis.

Accumulated Adjustments Account. If the corporation has AE&P, the taxability of distributions is determined by reference to the accumulated adjustments account (AAA) and stock basis.

Repaying Reduced-basis Loan Is Taxable

Repayment of shareholder loans reduces the shareholder's basis in such loans. However, when basis in a shareholder's loan has been used to support a loss deduction, repayment of the loan is a taxable event to the extent full repayment exceeds the shareholder's basis in the debt, or to the extent partial repayments exceed a prorata portion of the basis in the debt. This income is capital gain if the debt was evidenced by a written note or ordinary income if there is no written note, as would be the case with an open account receivable.

Domestic Production Activities Deduction Does Not Affect Basis

Information necessary to calculate the Section 199 domestic production activities deduction is passed through to the S corporation's shareholders. The deduction does not affect a shareholder's stock basis.

Increasing Basis with QSub Debt

Debt issued by a qualified Subchapter S subsidiary (QSub) to a shareholder of a parent S corporation is treated as debt of the parent for purposes of determining the shareholder debt basis. While, the IRS is allowed to issue rules for determining the order in which losses pass through when debt of both the parent and subsidiary are held by the parent S corporation shareholders the regulations do not address this (and at the time this book went to press, the IRS had issued no such rules). To the extent a shareholder of the parent S corporation is subject to the at-risk rules of IRC Sec. 465, the QSub's pass-through losses may be nondeductible and carried over to future years.

Example 2-1: Shareholder loan to QSub increases the shareholder's debt basis.

Marge owns all the stock of ABC, Inc., an S corporation. ABC, in turn, owns all the stock of Sub, Inc., a QSub. In a previous year, Marge loaned $50,000 directly to ABC. During the current year, Marge loans $25,000 directly to Sub. As a result, she increases her debt basis in ABC to $75,000. If ABC passes through losses in excess of her stock basis, it is clear that she can deduct the losses to the extent of her combined debt basis, but, as explained in the previous paragraph, it is not clear exactly the order in which she reduces her debt basis.

Using the Post-termination Transition Period

Generally, unused losses caused by lack of basis are not available after the S corporation election terminates. However, a special relief provision allows those losses to be deducted by the shareholder under certain conditions for a limited time during the post-termination transition period (PTTP). The PTTP is generally the one-year period after the S election terminates.

ORIGINAL BASIS IN S CORPORATION STOCK

A shareholder's initial basis in shares of S corporation stock depends on how the shares are acquired. The most common methods of acquisition follow:

a. *Outright Purchase.* The basis is the initial cost of the shares.

b. *As a Party to the Capitalization of the Corporation.* The basis of the stock has the same basis as the property contributed, plus gain recognized on the transfer.

c. *By Gift.* The basis in the hands of the donee is usually the same as the basis in the hands of the donor. Certain exceptions exist if gift tax is paid on the transfer, or if the donor's basis is greater than the fair market value and the stock later is sold at a loss. For example, under Reg. 1.1366-2(a)(6), basis of S stock received by gift is limited to the stock's fair market value at the date of gift for purposes of determining the deductibility of losses. Another exception applies if the donor has passive loss carryovers related to the transferred stock.

d. *By Inheritance.* In years in which the estate tax is in effect, the basis is the fair market value on the date of death, or alternate valuation date if so elected. Under IRC Sec. 1367(b)(4)(B), the stepped-up basis in the inherited S corporation stock is reduced to the extent the stock's value is attributable to "income in respect of a decedent" (IRD).

e. *By Holding the Stock on the Date a C Corporation Elects S Status.* The basis in stock upon electing S status will equal the shareholder's original basis in the stock, adjusted for certain transactions that occurred before electing S status. For example, original stock basis may be adjusted for C corporation distributions that exceeded earnings and profits, stock dividends, reorganizations, and partial liquidations.

f. *Stock Received for Services.* Basis in stock received in exchange for services is measured by the stock's FMV, rather than by the value of the services.

Obtaining Stock Basis Requires Economic Outlay

The shareholder must experience an actual economic outlay to acquire basis. This means that, before basis can be increased, "there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense". Giving only a note to the corporation or subscribing for more stock without making payment does not increase basis.

Example 2-2: Economic outlay is required to acquire basis.

Keith is the sole shareholder in KC, Inc., an S corporation. His stock basis at the beginning of the year was $25,000. No distributions were made to him during the year. During the year, Keith executed an unsecured demand promissory note stating that he owed KC, Inc. $100,000. He gave the note to the corporation. No payments were actually made on the note. At the end of the year, the only pass-through item is a $67,000 nonseparately stated loss from business operations.

The note does not provide Keith with stock basis against which the loss can be deducted, because there was no actual economic outlay. If Keith had made payments on the note, he would have basis to the extent of the payments.

Variation: Assume now that KC issued stock to Keith in exchange for his note receivable. The issuance of stock does not alter the fact that Keith has made no economic outlay and has no basis in the stock until and unless he makes payments on the note.

ANNUAL ADJUSTMENTS TO BASIS

Adjusting Stock Basis

The first step in calculating stock basis is to determine the shareholder's original basis. Thereafter, stock basis is adjusted when a shareholder buys or sells stock in the corporation or contributes capital to the corporation. Also, each shareholder's basis is adjusted each year by various items of corporate income, loss, and deduction, and by distributions to the shareholder in accordance with the following rules.

a. Stock basis is increased by the stockholder's share of:

(1) nonseparately stated income;

(2) separately stated items of income (including tax-exempt income);

(3) the excess of the shareholder's deduction for depletion over the allocable basis in the property subject to depletion (this does not apply to oil and gas depletion that is determined at the shareholder level); and

(4) the addition to an asset's basis when recapture of general business credits causes such an addition under IRC Sec. 50(a)(1).

b. Stock basis is decreased by nondividend distributions that are not includable in the shareholder's income, i.e., distributions other than distributions of AE&P.

c. Finally, stock basis is decreased by the stockholder's share of:

(1) nonseparately stated loss;

(2) separately stated items of deduction or loss;

(3) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account;

(4) the shareholder's deduction for depletion on any oil and gas property to the extent such deduction does not exceed the shareholder's proportionate share of the corporation's basis in the property; and

(5) the reduction in an asset's basis when general business credits cause such a reduction under IRC Sec. 50(c)(1).

Nonseparately Stated Income. Nonseparately stated income increases basis and is the corporation's ordinary income from trade or business activities that appears as the "bottom line" amount on Form 1120S, Page 1. It is called "taxable income" by the Code.

Separately Stated Items of Income. Separately stated items of income increase basis and are pass-through items that might affect the shareholder's tax liability in a different way than ordinary income. Examples of these items are portfolio income, capital gains, rental income, and tax-exempt income. (See Example 2-3.)

Recapture of General Business Credits—Asset Basis Adjustments. Adjustments to an asset's basis because of claiming the general business credit or recapture of the general business credit cause a corresponding increase or decrease in the shareholder's stock basis. Under IRC Sec. 38(b), the general business credit includes the investment tax credit (which is made up of the rehabilitation and energy credits), the work opportunity credit, alcohol fuels credit, incremental research credit, low-income housing credit, disabled access credit, and the employer social security credit.

Recapture of General Business Credits—Tax Paid at the S Corporation Level. Business credit recapture is paid at the corporate level if the credit was originally claimed by the corporation prior to electing S status (i.e., while the corporation was a C corporation). The recapture tax paid by the S corporation is a nondeductible, noncapitalizable expense that reduces basis. However, the business credit recapture tax paid by the S corporation does not reduce AAA because the recapture is a federal tax attributable to a C corporation year and AAA is not reduced by such items. Business credit recapture paid at the corporate level also reduces the corporation's AE&P.

Determining the Effect of LIFO Recapture on Basis. LIFO recapture paid by the S corporation does not reduce basis or AAA. (The AAA is generally adjusted by the same items that affect basis, but is not reduced by federal taxes attributable to a C corporation year.) The S corporation's LIFO recapture payments, however, do reduce accumulated earnings and profits (AE&P).

Nondividend Distributions. Nondividend distributions are distributions that are not considered to be from accumulated earnings and profits (AE&P). Such distributions are those that are considered to be a nontaxable return of basis, or that are distributions of AAA or PTI (to the extent of stock basis).

Nonseparately Stated Loss. Nonseparately stated loss reduces basis and is the corporation's ordinary trade or business loss that appears as the "bottom line" amount on Form 1120S, Page 1.

Separately Stated Items of Deduction or Loss. Separately stated items of loss or deduction reduce basis and are pass-through items that could affect the shareholder's tax liability differently than ordinary trade or business losses. (See Example 2-3.) They include capital losses, charitable contributions, the Section 179 deduction for expensing assets, and expenses related to tax-exempt income.

Any Expense of the Corporation Not Deductible in Computing Its Taxable Income and Not Properly Chargeable to a Capital Account. These items that reduce basis include nondeductible expenses such as the nondeductible portion of meals and entertainment expense; penalties and fines; income taxes attributable to the corporation's operations as a C corporation; expenditures that are not deductible because of a credit (such as the disabled access credit); nondeductible, noncapitalizable life insurance premiums—see Example 2-3; losses on sales or exchanges between related parties; expenses and interest relating to tax-exempt income; and illegal payments, bribes, and kickbacks. Expenditures that must be capitalized at the corporate level are not included in this category.

Increasing Basis Only for Reported Income Items

No increase in basis is allowed for pass-through items that must be included in the shareholder's taxable income unless the amounts are included in gross income on the shareholder's income tax return. This rule prevents a taxpayer from omitting an income item from the personal tax return and then increasing basis for that item after the limitations period for reporting the income has expired.

Adjusting Basis at End of Year

Basis adjustments are normally made at the end of the corporation's taxable year. Basis first is increased by pass-through income items, then decreased by nontaxable distributions, and, finally, decreased by pass-through items of loss and deduction. (See Example 2-3.) The order is important because it causes the tax effects of distributions to be determined by reference to basis at the end of the corporation's year. Also, this order dictates that a shareholder's stock basis in a fiscal year S corporation is determined at the end of the corporation's tax year, rather than the shareholder's tax year.

If a shareholder disposes of stock during the corporation's tax year, adjustments to the basis of such shares of stock are effective immediately before the disposition. If the corporation elects under IRC Sec. 1377(a)(2) to use specific accounting upon the complete disposition of a shareholder's interest, or elects under Reg. 1.1368-1(g)(2) to use specific accounting when certain stock is disposed of, issued, or redeemed, the basis adjustment rules apply as if the tax year consisted of separate tax years, with the first year ending on the date of the disposition.

Basis Cannot Be Negative Amount

Basis cannot be reduced below zero. When S corporation stock is disposed of, gain or loss is determined by reference to a basis amount that is either zero or a positive number.

Adjusting Stock and Debt Basis for Nonseparately Stated and Separately Stated Items

Basis is adjusted annually by nonseparately stated and separately stated items. These adjustments are illustrated in the following example.

Example 2-3: Adjusting stock and debt basis for nonseparately stated and separately stated items.

New Leaf is a calendar year S corporation. At the beginning of the current tax year, Paul, the sole shareholder, has stock basis of $29,000, and debt basis of $45,000. Paul's debt basis has not been reduced by post-1982 pass-through losses. The corporation shows the following items for the year:

Ordinary income from business activity (nonseparately stated income)	$ 50,000
Tax-exempt interest income	7,000
Interest (portfolio) income	6,000
Nondeductible portion of meals expense	1,750

Life insurance premiums	2,200
Investment interest expense	3,300
Charitable contributions	2,000
Section 179 deduction	750

The life insurance premiums are for a term policy owned by the corporation. The policy pays in the event of Paul's death, and the corporation is the beneficiary. The life insurance policy has no cash surrender value, and the premiums are nondeductible.

The corporation made distributions of $55,000 to Paul during the year.

Nonseparately and separately stated items of income, including tax-exempt income, increase basis. Next, nontaxable distributions reduce basis. Finally, basis is reduced by items of loss, deduction, and nondeductible expenditures.

Paul's basis is computed as follows:

	Stock Basis	Debt Basis
Balances, beginning of year	$ 29,000	$ 45,000
Income and gain items:		
Nonseparately stated income	50,000	
Tax-exempt income	7,000	
Interest income	6,000	
Balances, before distributions and loss items	92,000	45,000
Distributions	(55,000)	—
Balances, before loss and deduction items	37,000	45,000
Loss and deduction items:		
Nondeductible portion of meals expense	(1,750)	
Life insurance premiums	(2,200)	
Investment interest expense	(3,300)	
Charitable contributions	(2,000)	
Section 179 deduction	(750)	
Balances, end of year	$ 27,000	$ 45,000

Debt basis remains the same because the corporation did not experience losses that reduced stock basis to zero. Also, distributions reduce stock basis but have no effect on debt basis.

All of the pass-through items necessary to determine the shareholder's basis can be found on Schedule K-1 of the Form 1120S. Some basis adjustments (such as capital contributions, loans to the corporation, or the purchase of stock from another shareholder) are not reflected on the Schedule K-1.

Tax-exempt income and nondeductible expenses are shown on Schedule K-1. These items generally do not appear on the taxpayer's Form 1040, but they are necessary to compute basis.

Calculation of the accumulated adjustments account (AAA), using the same items as in Example 2-3, is not in this course.

Applying Basis Adjustments in the Proper Order

Under IRC Sec. 1367(a), adjustments are made to stock basis in the following order: (a) increases for income items and the excess of the deductions for depletion, (b) decreases for distributions, and finally (c) decreases for items of loss or deduction. The regulations provide that items of loss and deduction reduce basis first by nondeductible, noncapital expenses and certain oil and gas depletion deductions, then by items of loss or deduction.

Electing to Reduce Basis by Loss or Deduction Items before Nondeductible Expenses. The shareholder may elect to reduce basis by items of loss or deduction before reducing basis by nondeductible, noncapital expenses and certain oil and gas depletion deductions. The election is made by attaching a statement to a timely filed original

or amended return stating that the shareholder agrees to carry over to the succeeding tax year the nondeductible, noncapital expenses (and certain oil and gas depletion deductions) that are in excess of stock and debt basis. The election is permanent and cannot be changed without the IRS's permission.

Example 2-4: Electing to reduce basis by loss or deduction items before nondeductible expenses.

Paul is the sole shareholder in a calendar year S corporation. Paul's basis at the beginning of the year was $14,000. At the end of the year, the corporation passes through a $14,000 nonseparately stated loss and $3,500 of nondeductible meals and entertainment expenses. No distributions were made to Paul during the year.

If no election is made, the $3,500 nondeductible amount reduces basis first, so Paul can deduct only $10,500 ($14,000 − $3,500) of the $14,000 nonseparately stated loss. The remaining $3,500 loss ($14,000 − $10,500) will carry over to be deducted in a future year when Paul has basis.

If Paul does not make the election to reduce basis by items of loss and deduction before nondeductible expenses, the results are:

	Nondeductible Expenses	Nonseparately Stated Loss	Total
Pass-through	$ 3,500	$ 14,000	$ 17,500
Used in current year	(3,500)	(10,500)	(14,000)
Carryover to following year	$ -0-	$ 3,500	$ 3,500

If Paul so elects, he can reduce basis by items of loss or deduction before reducing basis for nondeductible capital expenses and certain oil and gas depletion deductions. If the election is made, Paul can deduct $14,000 of the nonseparately stated loss in the current year. The $3,500 of nondeductible meals and entertainment expenses will carry over to succeeding years until there is sufficient basis to absorb them. In future years, Paul will continue to reduce basis by other carryover and current items of loss and deduction before reducing basis by carryover and current nondeductible, noncapital expenses and certain oil and gas depletion deductions.

If the election is made, the results are:

	Nonseparately Stated Loss	Nondeductible Expenses	Total
Pass-through	$ 14,000	$ 3,500	$ 17,500
Used in current year	(14,000)	—	(14,000)
Carryover to following year	$ -0-	$ 3,500	$ 3,500

Nondeductible, Noncapitalizable Expenses May Not Carry Over to Future Years

Statutory language seems to indicate that nondeductible, noncapitalizable expenses (discussed earlier) do not carry over to future years if basis is reduced to zero in the current year. Under IRC Sec. 1366(d)(2)(A), any "loss or deduction" that is disallowed due to lack of basis carries over to the succeeding taxable year. The items that decrease basis and are therefore subject to potential carryover are listed in IRC Sec. 1367(a)(2)(A)–(E). However, only IRC Sec.1367(a)(2)(B) and (C) use the terms "loss" or "deduction" when describing separately stated and nonseparately stated items. In contrast, IRC Sec. 1367(a)(2)(D) describes a nondeductible, noncapitalizable item as an "expense." Therefore, the wording of the Code seems to mean that nondeductible, noncapitalizable items are not subject to the carryover provisions because they are items of "expense," rather than items of "loss or deduction." However, if the shareholder makes the election to reduce basis by losses or deductions before nondeductible expenses, the shareholder must agree to carry the nondeductible items over to succeeding years.

Example 2-5: Omitting nondeductible expenses from the loss carryover rules.

Pat's basis at the beginning of the year in Pin, Inc., an S corporation in which he materially participates, is $13,000. At the end of the year, the corporation passes through a $14,000 nonseparately stated loss and $15,500 of nondeductible meals and entertainment expenses. (These are a variation of the facts found in Example 2-4.) Pat does not make the election to reduce basis by items of loss and deduction before nondeductible expenses.

The $15,500 nondeductible amount reduces the $13,000 of basis to zero. Pat can claim no S corporation deductions on his Form 1040, because all of his basis has been offset by the nondeductible expenses. Under strict interpretation of the Code, the remaining $2,500 ($15,500 – $13,000) of nondeductible expenses does not carry over and disappears. Pat cannot deduct any of the $14,000 nonseparately stated loss, but it carries over to be deducted in a later year when Pat has basis, as follows:

	Nondeductible Expenses	Nonseparately Stated Loss	Total
Pass-through	$ 15,500	$ 14,000	$ 29,500
Used in current year	(13,000)	—	(13,000)
Carryover to following year	$ -0-	$ 14,000	$ 14,000

The preceding table does not crossfoot because strict interpretation of the Code indicates that nondeductible expenses in excess of basis do not carry over to the following year. Under this interpretation of the Code, the amount of nondeductible expenses that does not reduce basis ($2,500) disappears in the current year.

Variation: Assume now that Pat makes the election to reduce basis by losses before nondeductible expenses (see Example 2-4). Here, the shareholder must agree to carry over the nondeductible, noncapitalizable items. Pat can, however, deduct $13,000 of the $14,000 nonseparately stated loss in the current year. The remaining $1,000 of nonseparately stated loss carries over to the following year and can be deducted in that year before considering the nondeductible expenses (including the carryover of nondeductible expenses), if Pat has sufficient basis.

The results of making the election are:

	Nonseparately Stated Loss	Nondeductible Expenses	Total
Pass-through	$ 14,000	$ 15,500	$ 29,500
Used in current year	(13,000)	—	(13,000)
Carryover to following year	$ 1,000	$ 15,500	$ 16,500

To summarize, if Pat does not make the election to reduce basis by losses before nondeductible expenses, he cannot deduct a loss in the current year, but the excess of nondeductible expenses over basis evidently disappears and does not carry over to the following year.

If Pat makes the election, he can deduct $13,000 of the nonseparately stated loss in the current year. He carries over the $1,000 of nonseparately stated loss in excess of basis, as well as the $15,500 of nondeductible expenses. In future years, he reduces basis by losses (including carryover losses) before nondeductible expenses.

Deciding Whether to Elect to Reduce Basis by Loss Items Before Nondeductible Expenses

The election to reduce basis by losses before nondeductible expenses allows basis to be reduced first by deductible items, rather than reducing basis first by nondeductible items that provide no tax benefit to the client. The election is valuable and should be considered when the corporation passes through loss and deduction items that in the aggregate exceed the shareholder's basis, if the pass-through items include nondeductible expenses,

such as the nondeductible portion of meals and entertainment expense. Under these circumstances, the planner will normally recommend that the election be made so the shareholder will receive as much current tax benefit as possible from the deductible pass-through items. Even though nondeductible expenses must be carried over, they reduce basis in future years only to the extent that basis exceeds current and carryover losses (i.e., nondeductible expenses remain at the bottom of the list of items that reduce basis, thus allowing deductible losses to be considered first).

Once the election is made, it is permanent, so practitioners may not know whether the election will provide the best overall results in the long run because predicting future losses and nondeductible expenses is difficult, if not impossible. Nevertheless, when the corporation passes through both deductible and nondeductible items that in total exceed the shareholder's basis, the election will normally be beneficial. Under those conditions, reducing basis by deductible items first provides the client with the largest current deduction. (See Examples 2-4 and 2-5.)

AAA Is Reduced by Nondeductible Expenses Regardless of Basis Treatment

AAA is always reduced by the current year's items of loss and deduction, including nondeductible expenditures, regardless of whether the shareholder elects to reduce basis by items of loss or deduction before reducing basis by nondeductible expenses under Reg. 1.1367-1(g).

Electing to Reduce Basis by Loss Items First to At-risk and AMT Rules

The election to reduce basis by loss or deduction items before nondeductible expenses is provided in Reg. 1.1367-1(g). The regulation does not state that the election applies only for regular tax calculations. Therefore, the election would appear to apply for at-risk, and AMT computation purposes also.

Allocating Basis Adjustments to Each Share

Pass-through items of income, loss, or deduction affect the basis of each share by the shareholder's portion of pass-through items allocable to each share. When a shareholder has a different basis in different blocks of stock, pass-through items are generally allocated prorata to all shares, rather than more to the shares with the larger basis.

Example 2-6: Allocating pass-through items to individual shares of stock.

Lynn's Place, Inc., an S corporation, passes through a $9,000 operating loss to Lynn, its sole shareholder. Lynn owns 300 shares of stock. She bought 100 shares (Block 1) six years ago for $100 each. She bought an additional 100 shares (Block 2) four years ago for $200 each, and 100 shares (Block 3) two years ago for $300 each. The corporation has distributed its income each year, so the basis in Lynn's shares remains the same as the purchase price. The $9,000 loss reduces the basis of each share by $30. Thus, at the end of the current year, the shares in Block 1 have basis of $70 each, the shares in Block 2 have a basis of $170 each, and the shares in Block 3 have a basis of $270 each.

If the loss or deduction attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining basis of all other shares of stock owned by the shareholder in proportion to the remaining basis of each of those shares.

Example 2-7: Applying losses to individual shares of stock.

Assume the same facts as in Example 2-6, except the corporation passes through an operating loss of $45,000. The loss reduces the basis of each of the 300 shares by $150, which brings the basis of the shares in Block 1 below zero. The negative amount is then allocated to the shares in Block 2 and Block 3 in proportion to the remaining basis in those shares, as shown in the following calculation:

	Block 1		Block 2		Block 3		
	Per Share	Total	Per Share	Total	Per Share	Total	Total Basis
Beginning basis	$ 100.00	$ 10,000	$ 200.00	$ 20,000	$ 300.00	$ 30,000	$ 60,000
Allocation of loss	(150.00)	(15,000)	(150.00)	(15,000)	(150.00)	(15,000)	(45,000)
Preliminary basis	(50.00)	(5,000)	50.00	5,000	150.00	15,000	15,000
Allocate negative basis in proportion to basis in remaining shares	50.00	5,000	(12.50)	(1,250)	(37.50)	(3,750)	—
Ending basis	$ -0-	$ -0-	$ 37.50	$ 3,750	$ 112.50	$ 11,250	$ 15,000

Calculating Basis Is Shareholder Responsibility

It is the shareholder's responsibility, rather than the corporation's, to determine the proper stock or debt basis. The details necessary to determine a shareholder's basis are not always readily available to the corporation; for example, when a shareholder purchases stock from another shareholder, the purchase (and resulting cost basis) usually occurs without the knowledge or participation of the corporation. On the other hand, the accumulated adjustment account (AAA), previously taxed income (PTI), and accumulated earnings and profits (AE&P) balances are calculated at the corporate level. Normally, however, the practitioner representing the corporation will track the shareholders' bases since most S corporations are relatively small, closely held entities.

Accumulated Adjustments Account

If the corporation has AE&P, the taxability of distributions is determined by reference to the accumulated adjustments account (AAA) and stock basis.

SELF-STUDY QUIZ

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

21. What can a shareholder do to increase his or her stock basis?

    a. Loan money to the corporation.

    b. Buy additional shares from the corporation.

    c. Make payments on debt made to the corporation by a third party lender that the shareholder had previously confirmed.

    d. Allow the third-party lender to replace the shareholder's note for the note from the corporation.

22. If a shareholder cannot deduct a loss in the current year because of a lack of basis it does not mean he or she will automatically lose the benefit of the loss. The loss can be carried forward indefinitely by that shareholder, to be used when stock or debt basis is increased in which of the following situations?

    a. Death of a shareholder.

    b. Termination of the S election.

    c. Corporation receives loans from the shareholder.

    d. All of the shareholders make a stock disposition to someone other than a spouse incident to a divorce.

23. Which of the following increases basis and is considered the corporation's ordinary income from trade or business?

    a. Separately stated income.

    b. Nonseparately stated income.

    c. Nonseparately stated loss.

24. Shareholders are permitted to elect to reduce basis by loss items before nondeductible expenses. Which of the following statements regarding this election is most accurate?

    a. Once the election is made, the practitioner cannot change it.

    b. Reducing basis by nondeductible expenses provides the taxpayer with the largest current deduction.

    c. Nondeductible expenses must be carried over; however, they do not reduce basis in future years.

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. What can a shareholder do to increase his or her stock basis? **(Page 65)**

    a. Loan money to the corporation. [This answer is incorrect. A shareholder lends money to a corporation to increase debt basis. If needed, the shareholder can personally borrow the money then lend it to the corporation.]

    b. Buy additional shares from the corporation. [This answer is correct. A shareholder can purchase additional shares from the corporation to increase his or her stock basis. According to IRC Sec. 1366(d)(1), a shareholder can also purchase additional shares from other shareholders if there are additional shareholders.]

    c. Make payments on debt made to the corporation by a third party lender that the shareholder had previously confirmed. [This answer is incorrect. According to IRC Sec. 1366(d)(1), Making payments on debt made to the corporation by a third party lender that the shareholder had previously guaranteed, increases the debt basis.]

    d. Allow the third-party lender to replace the shareholder's note for the note from the corporation. [This answer is incorrect. If a shareholder allows the third-party lender to substitute the shareholder's note for the note from the corporation, the debt basis will increase.]

22. If a shareholder cannot deduct a loss in the current year because of a lack of basis it does not mean he or she will automatically lose the benefit of the loss. The loss can be carried forward indefinitely by that shareholder, to be used when stock or debt basis is increased in which of the following situations? **(Page 67)**

    a. Death of a shareholder. [This answer is incorrect. According to Reg. 1.1366-2(a)(5), if a shareholder dies, he or she generally will lose the ability to deduct carryover losses.]

    b. Termination of the S election. [This answer is incorrect. If the S election is terminated, the shareholder generally will lose the ability to deduct carryover losses per Reg. 1.1366-2(a)(5).]

    c. Corporation receives loans from the shareholder. [This answer is correct. According to IRC Sec. 1366(d)(2), a loss can be carried forward indefinitely by the shareholder to be used when stock or debt basis is increased when the shareholder makes loans to the corporations. The shareholder can also carry forward the loss indefinitely when the shareholder contributes capital and when the corporation has profits.]

    d. All of the shareholders make a stock disposition to someone other than a spouse incident to a divorce. [This answer is incorrect. According to per Reg. 1.1366-2(a)(5), if the shareholder disposes of all of his or her stock to someone other than a spouse or former spouse incident to a divorce, the shareholder generally will lose the ability to deduct carryover losses.]

23. Which of the following increases basis and is considered the corporation's ordinary income from trade or business? **(Page 70)**

    a. Separately stated income. [This answer is incorrect. Separately stated items of income increase basis and are pass-through items that might affect the shareholder's tax liability in a different way than ordinary income. Examples of these items are portfolio income, capital gains, rental income, and tax-exempt income.]

    b. Nonseparately stated income. [This answer is correct. Nonseparately stated income increases basis and is the corporation's ordinary income from trade or business activities that appears as the "bottom line" amount on Form 1120S, Page 1. It is called "taxable income" by the Code.]

c. Nonseparately stated loss. [This answer is incorrect. Nonseparately stated loss reduces basis and is the corporation's ordinary trade or business loss that appears as the "bottom line" amount on Form 1120S, Page 1.]

24. Shareholders are permitted to elect to reduce basis by loss items before nondeductible expenses. Which of the following statements regarding this election is most accurate? **(Page 75)**

a. Once the election is made, the practitioner cannot change it. [This answer is correct. According the IRS regulations, once the election is made, it is permanent, so practitioners may not know whether the election will provide the best overall results in the long run because predicting future losses and nondeductible expenses is difficult, if not impossible.]

b. Reducing basis by nondeductible expenses provides the taxpayer with the largest current deduction. [This answer is incorrect. The greatest tax benefit to the client is to reduce basis by deductible expenses.]

c. Nondeductible expenses must be carried over; however, they do not reduce basis in future years. [This answer is incorrect. Even though nondeductible expenses must be carried over, they reduce basis in future years only to the extent that basis exceeds current and carryover losses (i.e., nondeductible expenses remain at the bottom of the list of items that reduce basis, thus allowing deductible losses to be considered first).]

BASIS IN DEBT CALCULATION

Loaning Money to an S Corporation Provides Debt Basis

Direct shareholder loans to an S corporation can be a very important tax planning tool. Unlike a partner, an S corporation shareholder does not increase basis by a ratable share of corporate indebtedness to third parties. This is because a shareholder generally is not liable for the corporation's obligations.

To obtain basis, the shareholder must incur a true economic outlay, and the debt must be owed by the corporation to the shareholder. The shareholder's personal guarantee of the corporation's obligations to third parties does not create basis. Furthermore, debt basis does not result solely from the issuance of the shareholder's personal note to the corporation.

Pass-through Losses Can Reduce Debt Basis

Once a shareholder's basis in S corporation stock has been reduced to zero, pass-through losses and deductions still can be deducted to the extent the shareholder has debt basis (i.e., basis in direct loans from the shareholder to the S corporation).

Basis Reduction Applies to Each Debt Outstanding at Year End. If the shareholder holds more than one debt at the end of the corporation's year, the basis reduction applies to each debt in the same proportion that the basis of each debt bears to the aggregate bases of all debt.

No Basis Reduction If Debt Is Not Outstanding at Year End. Debt basis is not reduced by pass-through losses or deductions if the debt has been satisfied, disposed of, or forgiven during the corporation's tax year. (Even though debt basis cannot be decreased if the loan was fully repaid during the year, it can be increased by the corporation's income under certain conditions.)

Increasing Previously Reduced Debt Basis by Corporate Income

When debt basis has been reduced by pass-through losses in a year after 1982, pass-through items of income or gain generally increase debt basis. However, the items of income, gain, loss, and deduction must first be netted, along with the nondividend distributions. (Nondividend distributions are distributions other than those made from accumulated earnings and profits.) If the result is a positive amount (income and gain amounts exceed losses, deductions, and nondividend distributions), there is a net increase and debt basis is increased by the net increase to the extent debt basis has been reduced by post-1982 losses. Debt basis is increased only up to the outstanding balance on the note at the beginning of the year. After the net increase has been applied against debt basis, any remaining net increase is used to increase stock basis.

Example 2-8: Increasing previously reduced debt basis by corporate income.

Green, Inc. is an S corporation that incorporated and simultaneously elected S status 11 years ago. At the beginning of the current tax year, Paul, the sole shareholder, has no stock basis and a debt basis of $33,000. (The note to Paul has a face value of $50,000, and his debt basis has been reduced $17,000 by losses in excess of stock basis.) Paul's Schedule K-1 shows the following items:

Nonseparately stated income	$ 41,500
Long-term capital gain	4,500
Section 1231 loss on sale of business asset	(6,000)
Nondividend distributions	(18,000)

What are Paul's stock basis and debt basis at the end of the current year?

The practitioner must first determine whether there was a net increase during the year by netting the items of income, gain, loss, and deduction, and nondividend distributions. The net increase in this case is $22,000 ($41,500 + $4,500 − $6,000 − $18,000). Thus, Paul's debt basis is increased by $17,000, the amount it has been reduced by post-1982 losses. The remaining $5,000 of net increase is used to increase stock basis. His stock and debt basis are determined as follows:

	Stock Basis	Debt Basis
Balances, beginning of year	$ —	$ 33,000
Net increase	5,000	17,000
Balances, end of year	$ 5,000	$ 50,000

Paul includes the $41,500 nonseparately stated income and $4,500 long-term capital gain in his gross income and deducts the $6,000 Section 1231 loss on his Form 1040. All $18,000 of the distribution is nontaxable.

Capital Contributions Do Not Cause "Net Increase." Debt basis that has previously been reduced by pass-through losses is reinstated by the current year's "net increase." The net increase is the amount that the current year's pass-through income and gains exceed losses, deductions, and nondividend distributions. Capital contributions by the shareholder to the corporation are not included as items of income used in calculating the net increase.

Adjusting Stock and Debt Basis When Net Amount Is Negative

If the netting of items of income, gain, loss, deduction, and nondividend distributions results in a negative number, debt basis is not increased by pass-through items of income and gain. Rather, stock basis is increased by income and gain items and reduced by nondividend distributions. Stock basis is then reduced by loss and deduction items. Once the loss and deduction items have reduced stock basis to zero, they reduce debt basis (but not below zero). The loss and deduction items are deductible on the shareholder's personal return to the extent they have reduced either stock or debt basis (and to the extent they are otherwise deductible).

Example 2-9: Adjusting stock and debt basis when net amount is negative.

Assume the same facts as in Example 2-8, except the distributions totaled $48,000 instead of $18,000. The netting process would result in a negative amount of $8,000, and Paul's stock and debt basis would be calculated as follows:

	Stock Basis	Debt Basis
Balances, beginning of year	$ —	$ 33,000
Income and gain items:		
Nonseparately stated income	41,500	
Capital gain	4,500	
Balances, before distributions and loss items	46,000	33,000
Distributions, to extent of stock basis	(46,000)	—
Balances, before loss and deduction items	—	33,000
Section 1231 loss		(6,000)
Balances, end of year	$ -0-	$ 27,000

The distribution is nontaxable to the extent of stock basis ($46,000) and the remainder ($2,000) is taxable to Paul as long-term capital gain. Paul includes the $41,500 nonseparately stated income and $4,500 long-term capital gain in his gross income and deducts the $6,000 Section 1231 loss on his Form 1040.

Distributions Do Not Reduce Debt Basis

Nondividend distributions (those not considered to be distributions of AE&P) reduce stock basis, but do not reduce debt basis.

Example 2-10: Distributions do not reduce debt basis.

Steve owns all of the shares of Canyon, Inc., an S corporation that incorporated and simultaneously became an S corporation 11 years ago. At the beginning of the current tax year, his stock basis is $10,000 and his debt basis is $50,000. The debt basis has not previously been reduced by pass-through losses. Canyon distributes $23,000 to Steve on July 1. At year-end, Steve's Schedule K-1 shows nonseparately stated income of $2,000. His stock and debt basis are determined as follows:

	Stock Basis	Debt Basis
Balances, beginning of year	$ 10,000	$ 50,000
Nonseparately stated income	2,000	—
Balances, before distributions	12,000	50,000
Distributions, to extent of stock basis	(12,000)	—
Balances, end of year	$ -0-	$ 50,000

Distributions do not reduce debt basis. Distributions from an S corporation that does not have AE&P are nontaxable to the extent of stock basis and are capital gain to the extent they exceed stock basis. Thus, the distributions to Steve are $12,000 nontaxable and $11,000 capital gain. The capital gain is long-term because Steve held the shares more than 12 months.

Making Corporate Payments on Debt, Rather than Making Distributions

Shareholder gain on corporate distributions to the shareholder can be avoided if the corporation makes payments on debt to the shareholder, rather than making distributions.

Example 2-11: Avoiding shareholder gain by making corporate payments on debt.

Assume the same facts as in Example 2-10. The $11,000 of long-term capital gain would be avoided if the corporation had made a $23,000 payment on the debt, rather than making a distribution to Steve. The loan payment would reduce his debt basis from $50,000 to $27,000, and his stock basis at the end of the year would be $12,000. The transaction should be clearly documented in the minutes and other corporate records as a loan repayment to avoid an IRS argument that the $23,000 payment was a distribution instead of debt reduction.

LOSSES TO THE EXTENT OF BASIS—DEDUCTING

Losses and deductions passed through by an S corporation can be deducted by the shareholder only to the extent of the shareholder's basis in stock and debt of the S corporation. The ability to offset other income is an important benefit for S Corporation shareholders. According to a recent GAO report, shareholders receiving pass-through losses in 2001 used those losses to offset 16.6% of their other income. Furthermore, 42% of the shareholders used pass-through losses to offset other income.

Deducting Losses to the Extent of Basis

An S corporation shareholder reports corporate income or loss on the personal income tax return for the year in which the corporate year ends. Losses or deductions passed through to the shareholder first reduce stock basis. After stock basis has been reduced to zero, remaining loss amounts are applied against debt basis. Debt basis is not reduced by pass-through losses or deductions if the debt has been satisfied, disposed of, or forgiven during the corporation's tax year. A "net increase" first restores debt basis to the extent debt basis has been reduced by losses or deductions in tax years beginning after 1982. A "net increase" is, generally, the amount by which the sum of pass-through income and gains exceed the sum of pass-through loss, deductions, and distributions.

Example 2-12: Adjusting stock and debt basis annually.

Buds, Inc. was formed on January 1, 2007, and reports on a calendar year. At formation, Paul contributed $50,000 in exchange for 100% of Buds, Inc.'s stock and also loaned $45,000 to the corporation. The corporation's nonseparately stated (taxable) income or loss for each year is as follows:

Year	Income (Loss)
2007	$ (63,000)
2008	42,000
2009	119,000

The corporation had no other income or expense items. No loan payments were made to Paul and Paul did not contribute additional capital to the corporation. Buds distributed $100,000 to Paul in 2009. Is Paul's basis adequate to permit full deduction of corporate losses? Paul's basis is as follows:

Year	Explanation	Stock Basis	Debt Basis
2007	Beginning balances	$ 50,000	$ 45,000
	Loss—reduce stock basis	(50,000)	
	Loss—reduce debt basis		(13,000)
	Ending balances	—	32,000
2008	Income—increase debt basis		13,000
	Income—increase stock basis	29,000	
	Ending balances	29,000	45,000
2009	Income—increase stock basis	119,000	—
	Distributions—decrease stock basis	(100,000)	
	Ending balances	$ 48,000	$ 45,000

Paul has stock basis of $48,000 (after taking into account distributions to Paul of $100,000 during the year) and debt basis of $45,000 at the end of 2009. Each loss was fully deductible in the year it occurred because Paul had sufficient basis in stock and debt to cover the loss.

Distributions do not reduce debt basis. Although not a factor in this example, pass-through income increases debt basis only to the extent that debt basis has been reduced for tax years beginning after 1982.

Planning to Obtain Additional Basis

In a year losses decrease stock and debt basis to zero, the losses can be deducted in that year only if the shareholder increases basis. (Basis must be increased before the end of the corporation's tax year.)

Example 2-13: Planning to obtain additional basis.

Assume the same facts as in Example 2-12. Also assume that, in 2010, Buds, Inc. shows a net loss of $125,000. Paul's stock basis and debt basis are zero at the end of the year, as follows:

	Stock Basis	Debt Basis
Balances, beginning of year	$ 48,000	$ 45,000
Loss—reduce stock basis	(48,000)	
Loss—reduce debt basis		(45,000)
Balances, end of year	$ -0-	$ -0-

Unless his basis is increased, Paul will have a nondeductible loss of $32,000, computed as follows:

Loss		$ (125,000)
Basis:		
Stock basis	48,000	
Debt basis	45,000	
Total basis		93,000
Nondeductible (suspended) loss		$ (32,000)

Paul would have to obtain additional basis of $32,000 before the end of the corporation's tax year to deduct the entire loss in 2010.

Paul could establish additional stock basis by:

1. Contributing cash to the corporation. If necessary, Paul could personally borrow the money from an unrelated lender and contribute the proceeds to the corporation. Paul, rather than the corporation, should make the loan payments.

2. Contributing property to the corporation in exchange for stock. Paul's stock basis is increased by his adjusted basis in the property. If Paul recognizes gain on the transaction, the gain also increases stock basis.

3. Purchasing additional shares. Paul could purchase the shares from the corporation or, if there were other shareholders, from one or more of the other shareholders.

Paul could increase his debt basis by:

1. Lending money to the corporation. If necessary, Paul could personally borrow the money from an unrelated lender and use the proceeds to make the payments. Paul, rather than the corporation, should make the loan payments to the lender.

2. Paying all or part of corporate debt that Paul has guaranteed. Banks and other lenders may require that the shareholders guarantee loans that are made to the corporation. If Paul makes payments on such guaranteed loans, those payments increase his debt basis. If necessary, Paul could personally borrow the money from an unrelated lender and use the proceeds to make the payments. Note that merely guaranteeing a loan does not give the shareholder debt basis.

3. Having the lender substitute Paul's note for a note from the corporation to a third-party lender. If the lender substitutes Paul's note for that of the corporation and releases the corporation from liability to repay the debt, Paul obtains debt basis because the corporation then becomes indebted to the shareholder under the doctrine of subrogation.

4. Advancing the corporation funds as open account debt. Open account debt owed to the shareholder provides debt basis. Within limits, open account advances and repayments can be netted and treated as one indebtedness. However, under regulations, open account debt is treated as if it were evidenced by a written note when the balance of open account debt equals or exceeds $25,000 at the end of the corporation's tax year.

If Paul's basis is not increased by the end of 2010, the $32,000 loss will carry forward and become deductible in a year in which all or part of the basis is restored. Basis restoration occurs when the shareholder acquires additional stock or debt basis, or when corporate income increases basis.

Increasing Basis Is Not Always Best Course of Action

A loss that is not deductible because of basis limitations carries over indefinitely (as long as the S corporation election remains in effect). Even so, the taxpayer will want to use losses as soon as possible to take advantage of the tax savings. Basis increases occurring before the end of the S corporation's taxable year can be used to deduct current and prior losses. Practitioners should be aware, however, that making capital contributions or loans to increase basis so that losses can be deducted is not always the optimal course of action. This is especially true if there is a risk that the corporation may become insolvent. For example, if the taxpayer makes a contribution to capital of $10,000 and cannot recover that amount because of the corporation's insolvency, the taxpayer has actually lost the $10,000, net of the tax savings from claiming the tax deduction. Before the taxpayer parts with cash, or makes a binding obligation to repay a loan, both the tax and nontax factors should be assessed carefully.

Claiming a Business or Nonbusiness Bad Debt Loss at the Shareholder Level

Shareholders who increase basis by making loans to the S corporation can take a bad debt loss if the loan becomes uncollectible. Shareholders can deduct two types of bad debt losses: business and nonbusiness (IRC Sec. 166). Business bad debts result in ordinary losses; nonbusiness bad debts result in short-term capital losses. The shareholder can claim a business bad debt loss when the loss from a worthless debt is incurred in the shareholder's trade or business. A shareholder may establish that a loan to another business (such as the

shareholder's S corporation) is a business loan if it was made to protect the taxpayer's status as an employee, source of income, business relationship, or business reputation.

In the 10th Circuit allowed a shareholder/employee's business bad debt deduction for amounts loaned to the corporation. The deduction was allowed because the taxpayer's predominant motives for making the loans were that he (a) wanted to remain employed, earn a salary, and remain useful to society; (b) spent a large portion of his time working for the corporation; (c) intended to draw a salary in the future; and (d) took a sizable risk when he guaranteed loans far in excess of the value of his investment (indicating there was another motive besides investment). Although the taxpayer's loans were much larger than the salary anticipated in the near future, the court ruled his business motives outweighed his investment motives.

In contrast, the 7th Circuit ruled that a taxpayer's advances to a controlled corporation did not result in business bad debts. The taxpayer received no compensation from the corporation and was not considered to be in the business of loaning money, nor was he in the business of selling corporations he owned. Thus, when a taxpayer's predominant motivation for making loans is to protect his investment as a shareholder, nonbusiness bad debt status generally applies.

The 9th Circuit held that a shareholder/employee's business bad debt deduction for loans he made to his corporation as an employee was a miscellaneous itemized deduction subject to the 2% floor and not an adjustment to gross income as the employee had contended. The court relied on IRC Sec. 62(a)(1) that provides that trade or business expenses do not include those connected with services as an employee. The performance of personal services as an employee does not constitute carrying on a trade or business.

Credits Are Not Limited by Basis

The shareholder can deduct pass-through credits without regard to basis. However, other rules outside of Subchapter S may limit credits, for example, to a percentage of the shareholder's tax liability (in the case of the general business credit), or to the extent the shareholder-level at-risk rules or passive activity loss rules apply to the activity generating the credit.

ALLOCATING AND CARRYING OVER OF LOSS ITEMS THAT EXCEED BASIS

Carrying over Unused Losses

A shareholder who cannot deduct a loss in the current year because of a lack of basis does not necessarily lose the benefit of the loss. The loss can be carried forward indefinitely, to be used when stock or debt basis is increased; such as, when (a) the corporation has profits, (b) the shareholder contributes capital, or (c) the shareholder makes loans to the corporation. The carryover loss is personal to the shareholder who owned the stock when the loss occurred. Consequently, the shareholder loses the ability to deduct carryover losses when one of the following occurs:

a. the S corporation election is terminated;

b. the shareholder disposes of *all* of his or her stock to someone other than a spouse or former spouse incident to a divorce; or

c. the shareholder dies.

Through astute tax planning, the deductibility of losses can be timed to provide the maximum benefit from the deduction. Assuming the shareholder can increase basis through capital contributions or by making loans to the corporation, the year the loss deduction is claimed can be manipulated by determining the proper period for basis to be increased.

Allocating Pass-through Loss Items that Exceed Basis

If a shareholder's portion of pass-through losses and deductions are more than basis, the various deductible losses and deductions are allocated proportionately. This process is illustrated in the following example.

Example 2-14: Allocating pass-through items in excess of basis.

Paul is the sole shareholder in Branch, Inc., a calendar year S corporation. At the end of the corporation's current tax year, Paul's stock basis before considering losses and deductions is $14,000, and he has not loaned money to the corporation. The only pass-through items of Branch are the following:

Nonseparately stated loss	$ 15,000
Charitable contributions	3,500
Total	$ 18,500

Paul can deduct a total of $14,000 in losses and deductions for the year. He can deduct $11,351 of the nonseparately stated loss ($14,000 basis × $15,000 ÷ $18,500) and $2,649 of the charitable contributions ($14,000 basis × $3,500 ÷ $18,500).

Paul's carryover loss to the following year is computed as follows:

	Nonseparately Stated Loss	Charitable Contributions	Total
Pass through	$ 15,000	$ 3,500	$ 18,500
Used in current year	(11,351)	(2,649)	(14,000)
Carryover to following year	$ 3,649	$ 851	$ 4,500

Paul's basis in stock is zero, calculated as follows:

Stock basis, beginning of year	$ 14,000
Nonseparately stated loss	(11,351)
Charitable contributions	(2,649)
Stock basis, end of year	$ -0-

Applying Current Year's Income against Loss Carryovers

Under IRC Sec. 1366(d)(2), the carryover losses and deductions that are nondeductible because of basis limitations are treated as if the corporation incurred them in the following year with respect to the affected shareholder.

When loss and deduction items exceed basis and there are carryover loss and deduction items, Reg. 1.1366-2(a) provides that the allocation is made after adding carryover items to the current items.

Example 2-15: Applying current year's income against loss carryovers.

Continuing with the facts in Example 2-14, assume that at the end of 2009 Paul has a nonseparately stated loss carryover of $3,649 and charitable contribution carryover of $851. He has no stock or debt basis. For 2010, Paul's Inc. passes through nonseparately stated income of $3,000, capital loss of $2,000, and charitable contributions of $1,500 to Paul. He does not increase his basis through capital contributions or loans to the corporation. The corporation made no distributions during the year.

The combined carryover and current year loss and deduction items are as follows:

	Carryover from 2009	2010	Total
Nonseparately stated loss	$ (3,649)	$ —	$ (3,649)
Capital loss	—	(2,000)	(2,000)
Charitable contributions	(851)	(1,500)	(2,351)
Totals	$ (4,500)	$ (3,500)	$ (8,000)

Paul's stock basis at the end of the year is zero, calculated as follows:

Basis, beginning of year		$ —
Nonseparately stated income		3,000
Basis, before distributions and loss items		3,000
Distributions		—
Basis, before loss and deduction items		3,000
Loss and deduction items:		
Nonseparately stated loss	$ (3,649)	
Capital loss	(2,000)	
Charitable contributions	(2,351)	
Total loss and deduction items	$ (8,000)	
Deductible amount (limited to basis)		$ 3,000
Basis, end of year		$ -0-

Paul has $8,000 of loss and deduction items, but has only $3,000 of basis against which to deduct them. The $3,000 of deductible losses and deductions is allocated as follows:

Nonseparately stated loss reported on Paul's Form 1040, Schedule E:

$$\frac{\$3,649}{\$8,000} \times \$3,000 = \$1,368$$

Capital loss reported on Paul's Form 1040, Schedule D:

$$\frac{\$2,000}{\$8,000} \times \$3,000 = \$750$$

Charitable contributions reported on Paul's Form 1040, Schedule A:

$$\frac{\$2,351}{\$8,000} \times \$3,000 = \$882$$

Paul's loss carryover to the following year is:

Nonseparately stated loss ($3,649 − $1,368)	$ 2,281
Capital loss ($2,000 − $750)	1,250
Charitable contributions ($2,351 − $882)	1,469
Total	$ 5,000

Loss Does Not Carry over to New Shareholder Other Than Spouse or Former Spouse

S corporation loss carryovers are attributed "to that shareholder" and are lost when the shareholder disposes of his entire interest in the S corporation to someone other than a spouse or former spouse incident to a divorce. (See Examples 2-16 through 2-21.)

Transfer of Suspended S Corporation Losses to Spouse or Former Spouse

Transfers to a spouse or former spouse incident to a divorce are generally tax-free under IRC Sec. 1041(a). When a tax-free Section 1041(a) transfer of S stock occurs, any disallowed losses or deductions are carried over to the spouse or former spouse. The losses or deductions are treated as incurred by the corporation in the succeeding tax year with respect to the transferee spouse or former spouse.

Example 2-16: Carryover loss can be transferred to spouse or former spouse.

Betty owns 100 shares of BB Corp., an S corporation that reports on a calendar year. On December 31, 2010, she transfers all her shares to her ex-husband, Bob, as part of the divorce settlement. Immediately before the

transfer, her stock basis is zero and the corporation has passed through to her $25,000 in losses that she cannot deduct because of lack of basis.

Losses related to the stock are treated as if they were the losses of the spouse who received the stock. Thus, Bob can deduct the losses when he acquires basis because the corporation has passed through income or he has made capital contributions or loans to the corporation.

Variation: Assume now that Betty transferred her shares to Bob during 2011 while they were still married. The results would be the same because transfers between spouses qualify for the loss carryover rule, even if no divorce is involved.

In Example 2-16, all of the shares were transferred to a spouse or former spouse at the end of the year. However, if only a portion of the shares is transferred or if the shares are transferred during a tax year and suspended losses are carrying forward, the regulations present a complex set of rules.

The regulations provide that the amount of any loss or deduction relating to the stock transferred is determined by prorating the suspended losses for the year of the transfer between the transferor and transferee spouses (or former spouses) based on the stock ownership at the beginning of the following tax year.

Example 2-17: Deducting losses when a portion of the shareholder's shares is transferred to spouse or ex-spouse.

Brenda owns all 100 shares of Esscorp, a calendar year S corporation. For the 2009 tax year, Esscorp has $10,000 in losses which Brenda cannot deduct because she has no stock or debt basis. The losses carry over to the following tax year. Halfway through the 2010 tax year, Brenda transfers 50 shares to Fred, her former spouse. On the date of the transfer, each shareholder obtains basis by contributing $20,000 to the corporation. Both shareholders materially participate in the corporation's activities.

For the 2010 tax year, Esscorp has $8,000 in losses. Brenda's pass-through percentage for the year is 75% (100% of the stock for half the year and 50% of the stock for half the year). The corporation passes through a loss of $6,000 ($8,000 × 75%) to her. Under the regulations, she can deduct losses of $16,000, made up of the entire $10,000 carryover loss from the preceding year and the loss passed through to her in the current year, $6,000.

Fred's pass-through percentage is 25% (50% of the stock for 50% of the year), so the corporation passes through a loss of $2,000 ($8,000 × 25%) to him and he can deduct that amount.

Variation: If Brenda cannot deduct all of the losses because she lacks basis in 2010, the losses are prorated between Brenda and Fred based on their stock ownership at the beginning of 2010.

Assume now that neither Brenda nor Fred made contributions to the corporation in 2010. Here, the shareholders each own 50 shares of stock on January 1, 2011. Also at that date, there is a suspended loss of $10,000 from 2009 and a suspended loss of $8,000 from 2010. The $10,000 loss from 2009 is allocated depending on the ratio of stock ownership at the beginning of the year following the year in which the stock transfer takes place. Thus, at the beginning of 2011, $5,000 of the $10,000 loss is attributed to Brenda and $5,000 to Fred. The 2010 loss is allocated based on the stock percentages for 2010, so the $8,000 loss is attributed $6,000 (75%) to Brenda and $2,000 (25%) to Fred. The shareholders' carryover losses to 2011 are shown in the following table.

	Brenda	Fred	Total
2009 Loss	$ 5,000	$ 5,000	$ 10,000
2010 Loss	6,000	2,000	8,000
Carryover Losses	$ 11,000	$ 7,000	$ 18,000

Under some circumstances, the transferor may have enough basis to deduct only a portion of the pass-through losses for the year in which the transfer takes place. In that event, the loss limitation must be allocated

among the transferor's share of each loss or deduction, including disallowed losses and deductions carried over from the prior year. [See Example 2-18, which was adapted from Reg. 1.1366-2(a)(5)(iii), Example 2.]

Example 2-18: Deducting losses when stock is transferred to a spouse or ex-spouse and a portion of transferor's losses is deductible.

Assume the same facts as Example 2-17, except that during the 2010 tax year, Brenda acquires $1,000 of stock basis (rather than $20,000) and Fred has no basis in his stock. For the 2010 tax year, Brenda claims a $1,000 loss deduction, which must be allocated between the suspended losses. The allocation is based on the $16,000 of disallowed losses, made up of the 2009 $10,000 loss and Brenda's 2010 pass-through loss of $6,000. The $1,000 deduction, then, represents $625 of the disallowed 2009 loss ($1,000 × $10,000/$16,000) and $375 of the 2010 loss ($1,000 × $6,000/$16,000). The disallowed 2009 loss is reduced to $9,375, as follows:

2009 loss	$ 10,000
Loss deducted	(625)
Remaining loss	$ 9,375

The $9,375 remaining suspended loss is allocated to the shareholders based on their shareholdings at the beginning of 2011 (50-50). Their carryover losses to that year are $10,313 for Brenda and $6,687 for Fred, as shown in the following table.

	Brenda	Fred	Total
2010 loss	$ 6,000	$ 2,000	$ 8,000
Deductible portion	(375)	—	(375)
Suspended 2010 loss	5,625	2,000	7,625
Suspended 2009 loss (rounded)	4,688	4,687	9,375
Carryover Losses	$ 10,313	$ 6,687	$ 17,000

Effect of Partial Disposition of Stock on Carryover Loss

A shareholder who disposes of a portion of his stock does not forfeit a prorata portion of the carryover loss. Loss carryovers are attributed "to that shareholder" rather than to individual shares. Therefore, the disposition of a portion of a shareholder's interest in an S corporation does not reduce the shareholder's carryover loss.

Example 2-19: Planning to offset debt basis against losses when stock is sold during the year.

James is unmarried. He owns 100 shares of Acme, Inc., an S corporation that reports on a calendar year. James sells all his shares for $30,000 to Joan on December 31, 2010. Immediately before the sale, James's stock basis is zero and the corporation has passed through to him $25,000 in losses that he cannot deduct because of lack of basis. The $30,000 sales price does not increase James's stock basis and he reports that amount as capital gain on his Form 1040, Schedule D. Since James disposed of all his stock, the $25,000 loss expires and neither James nor Joan can deduct it in the current or future years. Debt basis is determined as of the last day stock is owned. Thus, if James loaned the corporation $25,000 before December 31, 2010, he would have debt basis and could deduct the loss on his 2010 personal return. (However, before making such a loan, he would want to assure himself that the corporation would repay it.)

Example 2-20: Retaining a portion of stock to utilize carryover losses.

Assume the same facts as in Example 2-19, except that James sells 99 shares, instead of 100. James still has $25,000 of loss carryover, and he can deduct the entire $25,000 loss carryover if his stock or debt basis increases by $25,000.

Example 2-21: Loss does not transfer to nonspouse shareholder who receives stock by gift.

Tom owns 100 shares of Tom's Tools, an S corporation that reports on a calendar year. On December 31, Tom makes a gift to his daughter, Toni, and transfers all his shares to her. Immediately before the transfer, Tom's

stock basis is zero and the corporation has passed through to him $25,000 in losses that he cannot deduct because of lack of basis. Tom's basis in the stock carries over to Toni and she has zero basis in the shares. Neither Tom nor Toni can carry over the $25,000 loss.

MAXIMIZING DEDUCTIBILITY OF LOSSES BY STRUCTURING LOANS TO PROVIDE SHAREHOLDER WITH DEBT BASIS

Experiencing Economic Outlay to Obtain Basis

As discussed throughout this section, a shareholder has basis in debt only if the loan is made by the shareholder directly to the S corporation. If the funds are not available, the shareholder can borrow from a (preferably unrelated) third-party lender, then personally lend the funds to the corporation. However, the shareholder must experience an actual economic outlay to acquire basis. This means that, before basis can be increased, "there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense." Giving only a note to the corporation or subscribing for additional shares of stock without making payment does not increase basis.

Example 2-22: Giving note to corporation does not result in debt basis unless there is economic outlay.

Chuck is the sole shareholder in Drill, Inc., an S corporation. His stock basis at the beginning of the year was $25,000. No distributions were made to him during the year. During the year, Chuck executed an unsecured demand promissory note stating that he owed Drill, Inc. $100,000. He then transferred the note to the corporation. No payments were actually made on the note. At the end of the year, the only pass-through item is a $67,000 nonseparately stated loss from business operations.

The note does not provide Chuck with stock basis against which the loss can be deducted, because there was no actual economic outlay. If Chuck would have made payments on the note, he would have basis to the extent of the payments.

Economic Substance Doctrine. For a taxpayer to experience an actual economic outlay, the transaction must have economic substance. The courts have used this economic substance doctrine inconsistently over the years to deny tax benefits when the transaction generating these tax benefits lacked economic substance. Effective for transactions entered into after March 30, 2010, the Code clarifies the manner in which the economic substance doctrine should be applied by the courts and imposes a 20% penalty on understatements attributable to a transaction lacking economic substance. Under these provisions, a transaction has economic substance only if (a) the transaction changes in a meaningful way (other than income tax effects) the taxpayer's economic position, and (b) the taxpayer has a substantial purpose (other than income tax effects) for entering into the transaction.

Maximizing Deductibility of Losses by Structuring Loans to Provide Shareholder with Debt Basis

Guaranteeing Loans from Third Party to Corporation. An S corporation shareholder has debt basis only if the indebtedness results from a loan directly from the shareholder to the corporation. A loan to the S corporation from a third party (e.g., a bank) does not provide debt basis, even if the shareholder acts as guarantor, co-maker, or surety. This is true even if the third-party debt is secured with the shareholder's individually owned property. In other words, if the shareholder guarantees a loan to the corporation from a third-party lender, the shareholder will not have debt basis in that loan. However, if the shareholder has to make payment on the loan because of the guarantee, the shareholder has debt basis to the extent of the payment. The shareholder's payment creates a debt between the corporation and the shareholder/guarantor under the doctrine of subrogation.

Example 2-23: Guaranteeing loan from third party does not provide debt basis.

Will Nelson is the sole shareholder of Willco, a calendar year S corporation. Will capitalized Willco on January 1 with $20,000 in exchange for stock. Willco then borrowed $200,000 from the First National Bank, which required that Will personally guarantee the loan. Will anticipates that the corporation will generate a $50,000 loss in the first year. After these transactions have occurred, Will consults a tax practitioner to determine the

deductibility of the loss. Will materially participates in the operations of the corporation and does not want to make additional cash contributions to the corporation. Can a loan from a third-party lender to an S corporation be structured to provide basis for a shareholder?

Given these facts, Will is limited to a $20,000 loss deduction, which is the amount of his stock basis. If Will had borrowed the funds personally and had contributed the $200,000 to the corporation, he clearly would have sufficient basis to deduct the loss. Other planning techniques to obtain debt basis are discussed in the following paragraphs.

Some taxpayers have argued that a loan guarantee provides debt basis. That is, the loan was effectively a loan to the shareholder followed by a capital contribution to the corporation by the shareholder. The taxpayer has lost all but one of these cases. For example, see *Estate of Daniel Leavitt*, where the Tax Court and the 4th Circuit rejected the taxpayer's argument that a bank loan to the corporation guaranteed by the shareholder should generate debt basis because the bank would not have made the loan without his guarantee. Similarly, the 11th Circuit disallowed shareholder debt basis for personal guarantees made by individual real estate developers in connection with bank loans to their S corporations. Also, the 7th Circuit upheld the Tax Court and ruled that the shareholder did not have debt basis for a participation interest in a loan between a bank and the taxpayer's S corporation when the taxpayer would not be responsible for the debt unless and until the S corporation failed to pay. The 7th Circuit held that, using the doctrine of substance over form, the shareholder did not have a participation interest at all, but rather had guaranteed the loan.

The preceding paragraphs cite a few of the many guaranteed loan cases that have been decided in favor of the IRS. The lone shareholder victory was in *Selfe v. U.S*., but the factors in this case severely limit its application. (The corporation was thinly capitalized, and the debts were originally loans to shareholders that were converted to corporate-level debt when the company incorporated.)

The negligence and substantial underpayment penalties of IRC Sec. 6662 have been assessed against the shareholder in some cases.

Obtaining Debt Basis By Making Loans to the S Corporation

There are numerous cases where a shareholder attempted to claim debt basis for a loan that was not a direct loan to the corporation from the shareholder. The shareholder almost always loses this argument, even if the loan is from another entity entirely or predominately owned by the shareholder, such as a brother-sister corporation, a partnership, an estate, or a trust. The debt must be owed by the corporation directly to the shareholder.

In *Kerzner*, the Tax Court stated that "transactions involving a brief, circular flow of funds (beginning and ending with the original lender) designed solely to generate bases in an S corporation have no economic substance and therefore do not evidence the required economic outlay."

Example 2-24: Making circular loans among shareholders and multiple S corporations in attempt to generate debt basis.

Jack and Janet Smith each own 50% of two S corporations, SC1 and SC2.

On December 24, the following transactions took place: (1) SC2 issued the Smiths a check for $80,000, (2) the Smiths issued a check to SC1 for $80,000, and (3) the check was deposited in SC1's bank account. The check from SC2 was deposited in the Smith's bank account on December 26.

For each of the following four years, SC2 loaned funds to the Smiths, the Smiths loaned funds to SC1, and SC1 paid rent to SC2. All of the loans from SC2 were deposited in the Smiths' personal checking account, and all of the loans to SC1 were made from that account. The loans were evidenced by notes that were drafted near the end of the year and within a short time of each other. Each note included the total outstanding loan balance and, consequently, superseded the prior year's note. No payments of principal or interest were actually made on any of the notes.

The Tax Court has ruled under similar facts that the loans to SC1 did not create debt basis against which pass-through losses could be deducted. Even though made directly from the shareholders to SC1, the loans

lacked economic substance, and the taxpayers experienced no actual economic outlay. According to the Tax Court, the loans were circular transfers of funds that traveled from SC2 to SC1, then back to SC2 through the purported rent payments. Factors that led to this conclusion included the facts that (1) both SC1 and SC2 were completely controlled by the taxpayers, (2) interest was never reported as an expense of SC1 or income to the taxpayers, and (3) it was unlikely that SC1 would require the taxpayers to repay the loans.

In *Bergman*, the 8th Circuit (reversing the district court) ruled that the shareholders did not have debt basis in a loan to their wholly-owned S corporation, even though they remitted a check directly to the corporation. A series of check exchanges between the shareholder and three S corporations they controlled resulted in the shareholders lending the S corporation funds they had borrowed from the other S corporations. The court stated that the entire transaction prevented the shareholder from suffering any actual loss, and the exchange of checks resulted in no actual economic outlay that left the shareholders poorer in a material sense. Therefore, according to the court, the shareholders did not have basis in the debt.

In *Culnen*, however, the Tax Court and 3rd Circuit allowed a taxpayer who had made loans from one controlled corporation to his S corporation to treat the controlled corporation loans as if they were personal loans to him, followed by personal loans to the S corporation. The shareholder was allowed to increase debt basis for the loans, and was allowed to deduct the entire loss against that debt basis. Thus, the shareholder had debt basis in the loans to the S corporation even though the funds were disbursed by the controlled corporation. The Tax Court also reached a similar result in *Yates*. In those cases, the shareholders and corporations had excellent records that were consistent with the position that the loans could be traced back to the shareholders. Nevertheless, these appear to be the only cases to allow this type of two-step deemed approach to shareholder economic outlay and seem contrary to the decisions in *Bergman* and other cases.

All financial transactions between (a) the related entities and (b) the entities and the shareholders should be carefully documented in the minutes to ensure that the transactions have a legitimate business purpose other than to provide basis against which losses can be deducted. Notes and other documents, such as leases, should be properly executed. Principal and interest should be paid in accordance with the terms of the notes, and the interest income and expense should be properly reported for tax purposes. Properly making the loans directly from the shareholder to the S corporation will unquestionably provide the shareholder with debt basis. However, the *Culnen* and *Yates* decisions may represent a last resort when the shareholder has not been properly advised and has made loans, either directly or indirectly, from one controlled entity to a controlled S corporation.

Lending Borrowed Funds to the S Corporation. The shareholder does not have debt basis even if the note shows both the corporation and the shareholder as co-borrowers. The shareholder obtains debt basis only if the indebtedness is owed by the corporation directly to the shareholder.

Example 2-25: Obtaining debt basis when shareholder lends borrowed funds to the S corporation.

Will Nelson is the sole shareholder of Willco, a calendar year S corporation. Willco borrowed $200,000 from the First National Bank, which required that Will personally guarantee the loan. (These are the same facts as in Example 2-23.) An S shareholder does not obtain debt basis from a guaranteed loan. However, Will may obtain debt basis if the bank will issue a note in Will's name and substitute it for the corporation's note. If the bank agrees to the substitution, debt basis will be established in the amount of the substituted note. Will's personal note must be accepted in full satisfaction of the corporation's note, and the corporation must be released from its obligation to repay the debt. The substitution of the shareholder's note for the corporation's note causes the corporation to be obligated to the shareholder for the amount of the note under the doctrine of subrogation, and the shareholder acquires basis in the debt. Also, in *Gilday* and *Miller*, the Tax Court allowed the taxpayers to obtain debt basis when the bank substituted their personal notes for the corporation's note.

In a 1989 Tax Court case, however, the Tax Court ruled and the 4th Circuit affirmed that the shareholder did not have debt basis when the shareholder's note was substituted for the corporation's note. (The Tax Court noted that the corporation was insolvent when the substitution occurred.) Since the shareholder experienced no economic outlay, basis did not increase. This decision seems to be contrary to Rev. Rul. 75-144 and other precedent, but until regulations or additional cases clarify the treatment of substituted notes, the practitioner may suggest as an alternative that the client obtain a new loan, as covered in the following discussion.

Perhaps the best alternative is for Will to borrow the money from the bank. The bank should disburse the funds to Will, who will deposit them in his account, then loan the funds to the corporation. The corporation uses the funds to pay off its original note to the bank. The IRS has ruled that this transaction gives the shareholder debt basis if:

1. the shareholder is personally liable for the bank loan to the shareholder;

2. the corporation is not a guarantor or co-maker on the loan to the shareholder; and

3. the interest rate on the bank's loan to the shareholder is at the bank's current rate.

If all these conditions are met, the shareholder has debt basis, even if the shareholder's bank loan is secured by the shareholder's stock in the corporation. (As discussed in Example 2-26, collateral owned by the corporation may be used as collateral for the loan if the transaction is properly structured.) To be safe, payments on the note to the shareholder should be made by the corporation, and the shareholder should in turn make the payments to the lending institution. In other words, the corporation should not make payments directly to the lending institution if the shareholder is claiming basis in the loan.

To summarize, Will cannot receive any debt basis for the third-party loan that he has guaranteed unless he actually makes payment on the guarantee. If the lender is willing to substitute Will's personal note for that of the corporation, he should receive debt basis in the amount of the substituted note.

Obtaining Debt Basis by Pledging Collateral Owned by the Corporation

An S corporation shareholder may be able to borrow funds from a third party lender using collateral owned by the corporation and obtain debt basis if the funds are then loaned to the corporation. This technique is illustrated in the following example.

Example 2-26: Obtaining debt basis by pledging collateral owned by the corporation.

Will Nelson is the sole shareholder of Willco, a calendar year S corporation. Willco needs to borrow $200,000, but the First National Bank will make the loan only if Will personally guarantees the loan. (These facts are a variation of those in Examples 2-23 and 2-25.) Will's practitioner advises him that if the loan is to Wilco and he guarantees it, he cannot use the loan basis to deduct losses. Will consequently asks the bank to loan him the money directly so that he can loan the funds to Wilco. But, the bankers do not want to make the loan to him because they believe the loan will not be secured adequately unless Wilco is comaker of the note.

The tax planner suggests this approach: The bank loans Will the money, and he immediately loans it to Willco in exchange for a note. Will pledges the note from Willco as security on his bank loan. Also, Willco gives Will a security interest in its assets as the corporation buys them. Will in turn pledges the security interest in the assets as collateral on his bank loan. In that way, the bank is in the same position as if it had loaned the money to the corporation, with Will guaranteeing the loan.

Structuring Debt to Ensure that Loans Are Not Recharacterized as Equity

Under IRC Sec. 385 and related case law, the IRS has the power to recharacterize corporate debt if it is actually disguised equity. Thus, if the corporation classifies a transfer of funds from a shareholder as a loan, the IRS may argue that the debt is actually equity (i.e., a capital contribution). Accordingly, S corporation debt that resembles equity can be potentially troublesome because of the IRC Sec. 1361(b)(1)(D) limitation that prevents an S corporation from having more than one class of stock. Also, if the loan is recharacterized, the S corporation will not be allowed to deduct interest payments to the shareholder.

SELF-STUDY QUIZ

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

25. Sallie, an S corporation shareholder is deducting losses to the extent of basis. Where should Sallie report her corporate income or loss?

    a. On her Schedule K-1 of Form 1120S.

    b. On her personal tax return at the corporate year end.

    c. On her Schedule E, of Form 1140.

    d. On her Schedule D at the corporate year end.

26. A shareholder can increase debt basis by performing all of the following **except**:

    a. Buying additional shares.

    b. Loaning money to a corporation.

    c. Moving the corporation funds forward as open account debt.

    d. Paying a partial amount of the debt that has been guaranteed.

27. A net increase is generally the amount by which the sum of pass-through income and gains exceed which of the following?

    a. The shareholder's basis in debt.

    b. Current and carryover losses.

    c. A prorate portion of the basis in debt.

    d. Sum of pass-through deductions, distributions, and loss.

28. A shareholder who is unable to deduct a loss in the current year due to a lack of basis can carry the loss forward indefinitely. This loss can be used when stock or debt basis is increased. Which of the following is **not** considered an example of this?

    a. The corporation makes payments on debt to the shareholder.

    b. The corporation receives loans from the shareholder.

    c. The corporation has profits.

    d. The shareholder contributes capital.

29. Which of the following statements regarding how to maximize deductibility of losses by structuring loans to provide shareholders with debt basis is most accurate?

    a. A shareholder can receive debt basis from a loan made to the corporation by a third-party.

    b. A shareholder will have debt basis to the extent of the payment if the shareholder is required to make payment on the loan due to a guarantee.

    c. Instead of making a payment on an obligation of the S corporation in which the shareholder is the guarantor of the obligation, the shareholder may give a note to the corporation to receive debt basis.

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.)**

25. Sallie, an S corporation shareholder is deducting losses to the extent of basis. Where should Sallie report her corporate income or loss? **(Page 82)**

    a. On her Schedule K-1 of Form 1120S. [This answer is incorrect. Tax-exempt income and nondeductible expenses are shown on Schedule K-1.]

    b. On her personal tax return at the corporate year end. [This answer is correct. An S corporation shareholder reports corporate income or loss on the personal income tax return for the year in which the corporate year ends. Losses or deductions passed through to the shareholder first reduce stock basis.]

    c. On her Schedule E, of Form 1140. [This answer is incorrect. Nonseparately stated loss is reported on From 1040, Schedule E.]

    d. On her Schedule D at the corporate year end. [This answer is incorrect. Capitol loss is reported on this schedule.]

26. A shareholder can increase debt basis by performing all of the following **except**: **(Page 83)**

    a. Buying additional shares. [This answer is correct. According to the IRS, purchasing additional shares establishes additional stock, not an increase in debt basis.]

    b. Loaning money to a corporation. [This answer is incorrect. Lending money to a corporation is one way to increase debt basis according to the IRS.]

    c. Moving the corporation funds forward as open account debt. [This answer is incorrect. Advancing the corporation funds as open account debt is an example of how a shareholder can increase debt basis per the IRS. Open account debt owed to the shareholder provides debt basis.]

    d. Paying a partial amount of the debt that has been guaranteed. [This answer is incorrect. Paying all or part of corporate debt that is guaranteed is an example of how a shareholder can increase debt basis per the IRS.]

27. A net increase is generally the amount by which the sum of pass-through income and gains exceed which of the following? **(Page 82)**

    a. The shareholder's basis in debt. [This answer is incorrect. When basis in a shareholder's loan has been used to support a loss deduction, repayment of the loan is a taxable event to the extent full repayment exceeds the shareholder's basis in the debt, or to the extent partial repayments exceed a prorata portion of the basis in the debt.]

    b. Current and carryover losses. [This answer is incorrect. According to the IRS, even though nondeductible expenses must be carried over, they reduce basis in future years only to the extent that basis exceeds current and carryover losses (i.e., nondeductible expenses remain at the bottom of the list of items that reduce basis, thus allowing deductible losses to be considered first).]

    c. A prorate portion of the basis in debt. [This answer is incorrect. Repayment of shareholder loans reduces the shareholder's basis in such loans. However, when basis in a shareholder's loan has been used to support a loss deduction, repayment of the loan is a taxable event to the extent full repayment exceeds the shareholder's basis in the debt, or to the extent partial repayments exceed a prorata portion of the basis in the debt per Rev. Ruls. 64-162 and 68-537).]

d. Sum of pass-through deductions, distributions, and loss. [This answer is correct. According to IRC Sec. 1367(b)(2)(B); Reg. 1.1367-2(c)(1), a net increase first restores debt basis to the extent debt basis has been reduced by losses or deductions in tax years beginning after 1982. A net increase is, generally, the amount by which the sum of pass-through income and gains exceed the sum of pass-through loss, deductions, and distributions.]

28. A shareholder who is unable to deduct a loss in the current year due to a lack of basis can carry the loss forward indefinitely. This loss can be used when stock or debt basis is increased. Which of the following is **not** considered an example of this? **(Page 85)**

a. The corporation makes payments on debt to the shareholder. [This answer is correct. Shareholder gain on corporate distributions to the shareholder can be avoided if the corporation makes when the corporation makes payments on debt to the shareholder. Thus, according to IRC Sec. 1366(d)(2), this is not an example of using a loss when stock or basis is increased.]

b. The corporation receives loans from the shareholder. [This answer is incorrect. According to IRC Sec. 1366(d)(2), this is an example of using a loss debt basis is increased.]

c. The corporation has profits. [This answer is incorrect. According to IRC Sec. 1366(d)(2), this is an example of using a loss when stock basis is increased.]

d. The shareholder contributes capital. [This answer is incorrect. According to IRC Sec. 1366(d)(2), this is an example of using a loss when stock basis is increased.]

29. Which of the following statements regarding how to maximize deductibility of losses by structuring loans to provide shareholders with debt basis is most accurate? **(Page 90)**

a. A shareholder can receive debt basis from a loan made to the corporation by a third-party. [This answer is incorrect. According to Rev. Rul. 70-50, a shareholder does not have debt basis from a loan made to the corporation by a third-party lender, even if the shareholder acts as guarantor, co-maker, or. This is true even if the third-party debt is secured with the shareholder's individually owned real property.]

b. A shareholder will have debt basis to the extent of the payment if the shareholder is required to make payment on the loan due to a guarantee. [This answer is correct. if the shareholder has to make payment on the loan because of the guarantee, the shareholder has debt basis to the extent of the payment. The shareholder's payment creates a debt between the corporation and the shareholder/guarantor under the doctrine of subrogation per Rev. Rul. 71-288.]

c. Instead of making a payment on an obligation of the S corporation in which the shareholder is the guarantor of the obligation, the shareholder may give a note to the corporation to receive debt basis. [This answer is incorrect. According to Rev. Rul. 81-187, to acquire debt basis, the shareholder must experience an actual economic outlay. Giving only a note to the corporation, or subscribing for additional shares of stock without making payment, does not increase basis.]

TIMING DEDUCTIBILITY OF LOSS USING CAPITAL CONTRIBUTIONS OR LOANS FROM SHAREHOLDER

Determining Whether Stock or Debt Basis Should Be Increased

Many factors must be considered when deciding whether the shareholder should increase stock or debt basis when the corporation passes through losses in excess of the shareholder's basis. As discussed in this lesson, the planner should perform "what if" calculations to assist the shareholder in making this decision. Under some circumstances, making capital contributions or loans to increase basis is not the best course of action. This is especially true if the corporation may become insolvent.

Using Capital Contributions or Loans from Shareholder to Time Deductibility of Losses

An S corporation shareholder has some ability to choose the year in which the loss is deductible by timing when loans or capital contributions are made or repaid, as illustrated in the following example.

Example 2-27: Timing deductibility of losses by use of capital contributions or loans from shareholder.

Anna is the sole shareholder in Clipcorp, a calendar year S corporation that has had a valid S corporation election in effect for all years it has existed. She also operates an unincorporated company and materially participates in the operations of both businesses. On January 1 of the current year Anna has no stock basis, but she has full basis in a $20,000 loan to the corporation. In December, the tax practitioner determines that the corporation will incur a loss of approximately $25,000 for the year. The practitioner also determines that Clipcorp should break even in the following year. The unincorporated business will generate about $25,000 of taxable income this year, but is expected to collect some large receivables next year, making net income approximately $100,000. If Clipcorp's loss is deducted in the following year, Anna's overall tax for the two years will be less than if it is deducted in the current year. Can Anna defer recognition of the loss deduction until next year?

As it stands, Anna is able to deduct $20,000 of the loss in the current year because she has $20,000 of debt basis. The remaining $5,000 loss will be carried over and deducted when additional basis is obtained. If debt basis is reduced by having Clipcorp repay the $20,000 debt to Anna before the end of the corporation's current tax year, Anna can avoid recognition of the loss in the current year. By restoring basis in the subsequent year, Anna effectively can defer $20,000 of the loss from the current year to the next year, creating a substantial tax savings. If Clipcorp does not have the cash to repay Anna's loan, she may be able to arrange a short-term bank loan to Clipcorp, which she would guarantee.

Example 2-28: Determining whether shareholder should increase stock basis or debt basis to deduct losses and apply against distributions.

Assume the same facts as in Example 2-27, except that Anna owns 25% of the stock of Clipcorp, and her prorata share of the current year pass-through loss is $25,000. Anna's overall tax will be less if the pass-through loss from Clipcorp is deducted in the current year. Also, assume that Anna has stock basis of zero at the beginning of the current year and has not loaned money to the corporation in the current or prior years. Finally, assume that Clipcorp distributes $25,000 to Anna during the year.

Unless Anna increases her basis in the current year, the entire $25,000 pass-through loss will be suspended and carried over to the following year. While it is preferable for Anna to provide additional basis in the current year in order to currently deduct the loss, the question now posed is whether Anna should increase stock basis or debt basis by $25,000.

If Anna increases *stock* basis (i.e., makes a $25,000 capital contribution), all of the distribution is nontaxable, but none of the $25,000 loss is deductible, as shown in the following calculation:

	Stock Basis	Debt Basis
Balances, beginning of year	$ —	$ —
Capital contribution	25,000	—
Distributions	(25,000)	—
Balances, before loss items	—	—
Loss and deduction items (to extent of basis)	—	—
Balances, end of year	$ -0-	$ -0-

The $25,000 capital contribution increases stock basis, which is then reduced by the $25,000 distribution. The distribution is nontaxable, but it has reduced stock basis to zero, so none of the $25,000 loss is deductible in the current year. The loss carries over to be deducted in the following year when the corporation passes through income to Anna.

If Anna increases *debt* basis (i.e., loans the corporation $25,000), all of the distribution would be taxable because there would be no stock basis against which to offset the distributions. (Distributions cannot reduce debt basis.) All of the $25,000 loss would be deductible against debt basis, as follows:

	Stock Basis	Debt Basis
Balances, beginning of year	$ —	$ —
Loan to corporation	—	25,000
Distributions (to extent of stock basis)	—	—
Balances, before loss items	—	25,000
Loss and deduction items	—	(25,000)
Balances, end of year	$ -0-	$ -0-

Here, Anna will report the $25,000 distribution as long-term capital gain and will deduct the $25,000 loss on her Form 1040 for the current year.

The result is that Anna has no net taxable income from Clipcorp, regardless of whether she contributes $25,000 of stock basis or $25,000 of debt basis. However, the lowest overall taxable income results from Anna increasing stock basis because the distribution is not currently taxable, and the $25,000 loss that is not deductible in the current year will carry over to subsequent years to be deducted when the corporation has income.

To receive the distribution tax free and deduct the loss in the current year, Anna would have to either (1) contribute $50,000 to capital (i.e., increase stock basis), or (2) contribute $25,000 to capital and loan the corporation $25,000. (If she loaned the corporation $50,000 and made no capital contribution, the distribution would be taxable because distributions do not reduce debt basis.)

Example 2-29: Considering the self-charged interest rules.

Assume the same facts as in Example 2-28. If Anna prefers to loan money to the corporation but does not materially participate in the activities of Clipcorp, she will need to consider the impact of the self-charged interest rules. Since she is only a 25% owner, only 25% of the interest income she receives from the corporation will be recharacterized from portfolio income to passive activity income.

Using Year-end Loans to Accelerate Loss Deductions

After stock basis has been reduced to zero, an S shareholder may deduct losses to the extent of debt basis. Loans to the corporation near year-end can provide basis that allows the shareholder to deduct pass-through losses.

Example 2-30: Using year-end loans to accelerate loss deductions.

George is the sole shareholder of Essco, an S corporation that incurred a $5,000 loss in its first year (Year 1), entirely eliminating his basis in his stock.

As the end of Year 2 approaches, George estimates that Essco will incur a $20,000 loss, which he will have to defer because of insufficient basis. On December 31, George makes a last-minute $20,000 loan to Essco to provide debt basis. This year-end loan allows full use of the second-year loss.

Example 2-31: Accelerating loss deductions by making year-end loans can increase the shareholder's overall income if loan is repaid.

Assume the same facts as in Example 2-30. Early in Year 3, George has Essco repay the loan. At the end of Year 3, the practitioner determines that Essco incurred a loss of $10,000, which becomes a carryforward at the shareholder level due to insufficient basis. Furthermore, George recognizes $20,000 of gain because his basis in the repaid note is zero.

In Year 4, Essco passes through income of $30,000, thus providing basis to George to allow use of his $10,000 carryover loss. At the end of Year 4, George has reported cumulative net pass-through income of $15,000 and has $20,000 of basis in his stock. The following table summarizes these calculations:

	Stock Basis	Debt Basis	Shareholder Income (Loss)	Shareholder Carryover Loss
Year 1				
Stock investment	$ 5,000			
Loss of $5,000	(5,000)		$ (5,000)	
Year 2				
Loan before year-end		$ 20,000		
Loss of $20,000		(20,000)	(20,000)	
Year 3				
Loan repaid: Gain			20,000	
Loss of $10,000				$ (10,000)
Year 4				
Income of $30,000	20,000		20,000	10,000
Summary	$ 20,000	$ -0-	$ 15,000	$ -0-

How would George's position compare if he had not loaned money to the corporation during this four-year period?

	Stock Basis	Debt Basis	Shareholder Income (Loss)	Shareholder Carryover Loss
Year 1				
Stock investment	$ 5,000			
Loss of $5,000	(5,000)		$ (5,000)	
Year 2				
Loss of $20,000				$ (20,000)
Year 3				
Loss of $10,000				(10,000)
Year 4				
Income of $30,000				30,000
Summary	$ -0-	$ -0-	$ (5,000)	$ -0-

The losses in Years 2 and 3 carry forward, awaiting additional basis created by the $30,000 pass-through income in Year 4. At the end of the four years, George has reported an overall tax loss of $5,000 in his personal return, contrasted with the overall $15,000 income result noted above in the first illustration where the loan was made to Essco and repaid in the subsequent year. In recognition of the fact that George reported additional cumulative income with the loan technique, he has a corresponding increase in stock basis ($20,000 basis versus zero basis where no loan was made). In summary, the loan technique can be advantageous in accelerating use of a loss, but it eliminates the availability of the loss for future offset of profits or income from the S corporation.

If the shareholder anticipates that income will be realized from the S corporation in the near term, it may be advisable to have the corporation repay the loan in a year when the corporation has net income. Debt basis is increased by any "net increase," which is the amount that pass-through income and gains exceed losses, deductions, and nondividend distributions. Nondividend distributions are distributions other than those made from AE&P.) Debt basis is increased only up to the amount of the outstanding balance of the debt on the first day of the corporation's tax year. This increase in debt basis will reduce or eliminate gain on the loan repayment.

Timing the Repayment of the Loan

An important consideration in lending money to an S corporation is timing the repayment of the loan to avoid reporting income because of the repayment of the reduced-basis debt. Reg. 1.1367-2(c) states that reduced-basis debt is restored by the current year "net increase" (up to the outstanding balance of the debt on the first day of the corporation's tax year) before stock basis is increased. ("Net increase" is, generally, the amount by which the sum of pass-through income and gain items exceed the sum of pass-through loss and deduction items and distributions.) Furthermore, if a debt is repaid in whole or in part during the tax year, restoration of debt basis is effective immediately before the first payment on the debt is made.

Example 2-32: Using current year's pass-through income to avoid gain on repayment of note.

Assume the same facts as in Example 2-27. If Clipcorp repaid the loan at any time during the following year, the repayment would not cause Anna to recognize income because under the regulations, the $100,000 of pass-through income in that year would first restore the debt basis to $25,000, then increase stock basis by $75,000.

Maximizing Deductibility of Losses by Timing of Loans to the Corporation When the Corporation and Shareholder Have Different Tax Years

When the shareholder cannot deduct losses because of insufficient basis, she has some flexibility as to the timing of the loss deduction. Capital contributions or loans to the corporation made before the end of the corporation's fiscal year allow losses to be deducted in the current year. While recognizing losses as early as possible is the usual strategy, there can be circumstances (such as rate differences or the anticipated recognition of extraordinary income or gain) that make the loss deduction more valuable in the following year. If that is the case, the taxpayer can defer the loss deduction by not increasing basis until the following corporate tax year.

Example 2-33: Timing loans to maximize deduction of losses when corporation and shareholder have different tax years.

Mary Artson is the sole shareholder of Artco, an S corporation. Mary reports on the calendar year basis, and Artco previously established a business purpose for using a fiscal year ending September 30. Mary materially participates in the corporation's operations. On October 1, 2009, Mary had $50,000 in stock basis and no debt basis. For the year ended September 30, 2010, Artco reported a loss of $75,000. Mary loaned the corporation $30,000 on October 15, 2010. How can the timing of shareholder loans to a fiscal year S corporation enhance the tax benefits of pass-through losses?

Mary includes her share of income or loss on her personal tax return for the year in which the S corporation year ends. The deductible loss is limited to her basis in stock and the basis in direct loans to the corporation, determined at the end of the corporate tax year.

Since Mary loaned Artco the funds after the end of the corporate tax year, her basis for purposes of deducting the loss remains at $50,000 for her tax year ending December 31, 2010. The unused portion of the loss ($25,000) carries over and can be deducted in future years, to the extent there is basis at the end of each fiscal year.

To summarize, Mary can deduct only $50,000 of Artco's $75,000 loss. The deductibility of a loss from an S corporation is determined by reference to the shareholder's basis as of the corporation's year-end, not the shareholder's year-end. A calendar year shareholder therefore must establish sufficient basis as of the corporation's fiscal year-end to be entitled to deduct the pass-through loss in that year. Additional basis obtained between the fiscal year-end of the S corporation and the year-end of the shareholder has no effect until the next fiscal year-end of the S corporation.

Variation: If Mary had made the loan to Artco on or before September 30, 2010 (the corporate tax year-end), she could have deducted the total amount of the loss on her 2010 return.

The shareholder has some flexibility in determining the year in which the loss will be deductible. If contributions to capital or loans are made in the corporation's current year, the loss will be deductible, to the extent of basis, in the current year. If the taxpayer does not increase basis in the corporation's current year, the loss will carry over and will be deductible in a later year when there is sufficient basis to absorb it. That basis may arise from future income and gains, stock purchases, contributions to capital, or loans.

Gain on Repayment of Reduced-basis Loan

Repayment Gain Does Not Increase Basis. Gain on the repayment of reduced-basis debt does not increase debt basis for purposes of using S corporation losses in the hands of that shareholder.

AVOIDING GAIN AT THE SHAREHOLDER LEVEL WHEN REDUCED-BASIS LOAN IS REPAID

Repayment of shareholder loans reduces the shareholder's basis in such loans. However, when basis in a shareholder's loan has been used to support a loss deduction, repayment of the loan is a taxable event to the extent full repayment exceeds the shareholder's basis in the debt, or to the extent partial repayments exceed a prorata portion of the basis in the debt

Loan repayments are reported to the shareholder on Schedule K-1.

Avoiding Shareholder Gain When Reduced-basis Loan Is Repaid

Pre-1983 reductions in debt basis always result in gain when the loan is partially or fully repaid. This is inevitable because corporate income increases debt basis only to the extent debt basis was reduced by losses or deductions in tax years beginning after 1982.

The character of the gain depends on whether the debt is evidenced by a written note. If there is no note, as with an open account receivable, the gain is ordinary income. If the indebtedness is evidenced by a written instrument, the repayment is treated as a sale or exchange of a capital asset. Thus, the gain is long-term capital gain if the debt instrument has been held for more than 12 months, and short-term capital gain otherwise.

Example 2-34: Recognizing gain on repayment of reduced-basis note.

Paul is the sole shareholder of Newton, Inc., a calendar year S corporation that has had a valid S corporation election in effect for all years it has existed. Five years ago, Paul loaned Newton $60,000. The loan was documented properly, and pays fair market interest. A pass-through loss in the following year reduced the basis of the loan by $15,000, bringing Paul's debt basis to $45,000.

At the beginning of the current year, Paul has stock basis of $29,000 and debt basis of $45,000.

Newton's only pass-through items for the year are a nonseparately stated trade or business income of $12,500. The corporation made distributions of $14,000 during the year. (Therefore, there is no "net increase" for the year and debt basis is not increased by the current year's income items.)

The corporation has paid the interest annually. This year, Paul decides he would like to have Newton pay him the face amount of the note, $60,000, and tells his tax planner that he wants Newton to make a principal payment of at least $45,000. (The payments can be made from funds the corporation has on hand.) How can the tax effects of the loan repayment be minimized?

Paul must recognize gain if he receives payments on the note. Receipt of the face amount would result in gain of $15,000 ($60,000 payment − $45,000 basis).

The tax planner then discusses the effects of a partial repayment. Paul assumed that a repayment equal to his basis in the note, $45,000, would have no adverse tax effects. In fact, the IRS position is that partial repayment of a shareholder loan that has been used as a basis for loss deductions represents income to the shareholder. Such income, computed on a prorata basis, is $11,250, determined as follows:

$$\frac{\$60,000 \text{ (Face Amount)} - \$45,000 \text{ (Basis)}}{\$60,000 \text{ (Face Amount)}} \times \$45,000 \text{ (Repayment)} = \$11,250$$

Paul's gain on the note is a long-term capital gain because Paul held the note for more than 12 months. Thus, the repayment is made up of a long-term capital gain of $11,250 and a nontaxable return of basis of $33,750.

The note's outstanding balance and Paul's basis in the note at year-end are computed as follows:

	Face Value	Basis
Balances, beginning of year	$ 60,000	$ 45,000
Loan repayment	(45,000)	(33,750)
Balances, end of year	$ 15,000	$ 11,250

Example 2-35: Making a partial payment in following year.

Assume the same facts as in Example 2-34, except that the corporation makes a payment of $7,500 in the following year. The income from the repayment is $1,875, calculated as follows:

$$\frac{\$15,000 \text{ (Face Amount)} - \$11,250 \text{ (Basis)}}{\$15,000 \text{ (Face Amount)}} \times \$7,500 \text{ (Repayment)} = \$1,875$$

The repayment is made up of a long-term capital gain of $1,875 and a nontaxable return of basis of $5,625.

The note's face value and Paul's basis in the note at year-end are computed as follows:

	Face Value	Basis
Balances, beginning of year	$ 15,000	$ 11,250
Loan repayment	(7,500)	(5,625)
Balances, end of year	$ 7,500	$ 5,625

Tax Planning Strategies to Avoid Gain on Repayment of Reduced-basis Note

One tax planning strategy to avoid the tax on the gain from repayment of a reduced-basis note is to offset the capital gain with capital losses. Disposition of personal or corporate assets that would generate capital losses, or capital loss carryovers from previous years, can be used to offset the capital gain generated by repayment of the shareholder note. Timing of the note payments can also be an effective tax planning tool. For instance, the

practitioner may recommend the note payments be delayed until a year when there are capital losses to offset the gain.

If the purpose of the loan repayment is for the shareholder (Paul in Example 2-35) to receive funds from the corporation, other means might be used. For instance, if the gain could not be offset by losses, the practitioner might recommend that no loan payments be made, and a distribution be made instead. But that is not always practical because distributions may be taxable also.

Another tax planning strategy that can mitigate the gain generated from repayment of a reduced-basis loan involves the investment interest expense deduction limitations in the shareholder's return. Capital gain arising from a debt repayment may be treated as investment income to the shareholder, thereby enhancing the deductibility of investment interest. Conversely, had the shareholder received a distribution (rather than a loan repayment), the character of capital gain recognized on the distribution may be passive, active, or portfolio income depending on the taxpayer's participation in the operations of the business and the nature of the corporation's activities.

Paul may want to consider making a debt for stock swap to eliminate the debt and thereby remove the threat of gain on repayment. However, certain requirements and formalities must be met to implement the swap.

Reporting Gain on Repayment of Reduced-basis Loan when the Corporation Uses a Fiscal Year

When is gain on repayment of a reduced-basis loan reported by the shareholder when the corporation repays the loan after the close of its fiscal year but before the end of the calendar year?

Example 2-36: Reporting gain on repayment of reduced-basis loan when the corporation uses a fiscal year.

Paul is the sole shareholder of Newton, Inc., an S corporation. Five years ago, Paul loaned Newton $60,000. A pass-through loss the following year reduced the basis of the loan by $15,000, bringing Paul's debt basis to $45,000.

At the beginning of the current year, Paul has stock basis of $29,000 and debt basis of $45,000. (These are basically the same facts as in Example 2-34.

Assume now that Newton uses a fiscal year ending November 30. During December 2010, the corporation repays $45,000 of Paul's $60,000 note, resulting in a gain of $11,250 as shown in Example 2-34. Under Reg. 1.1367-2(d)(1), adjustments to debt basis are made immediately prior to repayment of the debt. Thus, it appears that gain on the repayment is determined when the loan repayment is made, and Paul evidently reports the $11,500 gain on his return for the calendar year ending December 31, 2010, when the payment was received, rather than the year when the corporate year ends, 2011.

Paul may not know what the gain on the note will be until the corporate year ends. Debt basis that has been reduced by losses after 1982 can be increased by income passed through to the shareholder, even if the loan has been repaid during the year. The debt basis is increased when there is a "net increase" for the year; that is, the corporation's pass-through income and gains exceed losses, deductions, and nondividend distributions. The amount of the net increase (or even whether there will be a net increase) may not be known at the end of Paul's tax year. Thus, in that situation, Paul would have to estimate the gain and report it on his 2010 Form 1040 and amend the return, if necessary, after the corporation's operating results for the year ending November 30, 2011, are determined.

DETERMINING BASIS IN THE YEAR STOCK IS SOLD OR DEBT REPAID

Basis Is Determined Immediately before Stock Disposition

A shareholder can have basis against which to deduct losses, even if the shareholder disposes of the shares during the year. While basis normally is determined as of the close of the corporation's tax year, when a shareholder disposes of stock, basis in that stock is determined immediately before the stock disposition takes place.

If a shareholder holds no stock in the corporation at the end of the year, basis in debt is determined immediately before the stock disposition takes place. (See Example 2-40.)

Computing Debt Basis When Reduced-basis Debt Is Repaid during the Year

Income Increases Basis of Reduced-basis Debt That Is Repaid during the Year. Reduced-basis debt is restored by the current year "net increase" (up to the outstanding balance of the debt on the first day of the corporation's tax year) before stock basis is increased. "Net increase" is, generally, the amount by which the sum of pass-through income and gain items exceed the sum of pass-through loss and deduction items and distributions.

Furthermore, if a debt is repaid in whole or in part during the tax year, restoration of debt basis is effective immediately before the first payment on the debt is made.

Losses Do Not Reduce Basis of Debt That Is Repaid during the Year. Debt basis is not reduced by pass-through losses or deductions if the debt has been satisfied (i.e., repaid), disposed of, or forgiven during the corporation's tax year. (See Example 2-38.)

Computing Stock and Debt Basis When the S Corporation Has Losses and Stock Is Sold during the Year

Normally, the adjusted basis of the shareholder's stock is determined as of the close of the corporate tax year. But the adjusted basis of stock that is sold or otherwise disposed of during the year is determined immediately before the sale or other disposition. The same premise applies to the basis of debt owed to the shareholder. Debt basis usually is determined as of the close of the corporate tax year; but, if the shareholder is not a shareholder as of the close of the tax year, debt basis is determined as of the last day that stock was owned. Consequently, the basis can be used to deduct ordinary losses on the taxpayer's income tax return, rather than being used as a factor in the calculation of gain from the disposition of stock or notes.

Example 2-37: Computing basis when the S corporation has losses and stock is sold.

William, who has been the sole shareholder of Esscorp for several years, materially participates in Esscorp's operations. His stock basis at the beginning of the corporation's calendar tax year was zero. There were no loans payable to William at that time, and he has a suspended pass-through loss (due to lack of basis) of $15,000 from prior years.

During 2010, the following transactions occurred:

January 2	William made a capital contribution of $10,000.
January 15	William loaned the corporation $32,500.
July 1	William sold all of his stock in Esscorp for $39,000.

On July 15, 2011, Esscorp pays William the principal amount of the note, $32,500.

The corporation elected under IRC Sec. 1377(a)(2), with the consent of the shareholders, to allocate income or loss based on specific accounting using the corporation's actual books and records as of the date of the stock disposition. William's share of the loss is $17,000.

Can William use his basis in stock and loans to deduct ordinary losses in the year of complete termination of his interest? What amount can William deduct as suspended pass-through losses and as current pass-through losses on his income tax return? What is his gain on the stock sale and on the note repayment?

First, William's basis in stock and debt must be computed. William's stock and debt basis as of the date of the stock sale is calculated as follows:

	Stock	Debt
Basis, beginning of year	$ —	$ —
Capital contribution	10,000	—
Loan to corporation		32,500
Basis, before adjustment for income or loss	10,000	32,500
Loss carryover	(10,000)	(5,000)
Basis, before adjustment for current loss	—	27,500
Current loss	—	(17,000)
Basis, date of stock sale	$ -0-	$ 10,500

William has sufficient basis to deduct all $32,000 of the losses ($15,000 carryover loss plus the $17,000 loss from the current year). He will report a long-term capital gain of $39,000 from the stock sale because he held the stock for more than 12 months. The following year he will recognize gain of $22,000 ($32,500 note balance less $10,500 basis) from the note repayment. The gain is long-term capital gain because the indebtedness is evidenced by a written note and William held the note for more than 12 months. It would be ordinary income if there was no debt instrument. (See Example 2-38 for an illustration of how to compute basis in stock and debt when stock is sold and debt is repaid during the same year.)

Computing Stock and Debt Basis When Stock Is Sold and Debt Is Repaid during the Year

Under Reg. 1.1367-(2)(d), debt basis is not reduced by pass-through losses or deductions if the debt has been satisfied (i.e., repaid), disposed of, or forgiven during the corporation's tax year.

Example 2-38: Computing stock and debt basis when debt is repaid during the year.

Assume the same facts as in Example 2-37, except that Esscorp pays William the $32,500 principal amount of the note on June 15, 2010, 15 days before he sells his stock.

Debt basis is not reduced by pass-through losses or deductions if the debt has been satisfied, disposed of, or forgiven during the corporation's tax year. Thus, debt basis would not be reduced, and William's stock and debt basis is calculated as follows:

	Stock	Debt
Basis, beginning of year	$ —	$ —
Capital contribution	10,000	—
Loan to corporation		32,500
Basis, before adjustment for income or loss	10,000	32,500
Loss carryover	(10,000)	—
Basis, date of stock sale	$ -0-	$ 32,500

Since the loan was fully paid off before the end of the tax year, debt basis is not reduced by the losses. William can deduct the portion of the loss that reduced stock basis, $10,000. The remaining $5,000 carryover loss and $17,000 current loss can never be deductible by William because he no longer holds Esscorp stock. However, his basis in the debt before repayment is $32,500, so he recognized no gain or loss on the note repayment. As in Example 2-37, he recognizes $39,000 of long-term capital gain from the stock sale.

As illustrated in this example, debt basis is not reduced if the debt has been satisfied, disposed of, or forgiven during the corporation's tax year. If the election to use specific accounting is made, the end of the tax year for purpose of determining debt basis is the date the shareholder sells all of his stock. If the election to use specific accounting is not made, the end of the corporation's regular tax year is evidently used to determine whether debt to the shareholder has been satisfied, disposed of, or forgiven during the tax year.

Using Current Year's Income to Increase Basis in Debt That Is Repaid during the Year

Reduced-basis debt held on the first day of the corporation's tax year is restored by the current year's "net increase" (up to the outstanding balance of the debt on the first day of the corporation's tax year) before stock basis

is increased, effective immediately before the repayment. ["Net increase" is, generally, the amount by which the sum of pass-through income and gain items exceed the sum of pass-through loss and deduction items (including nondeductible, noncapitalizable expenditures) and distributions.]

Example 2-39: Increasing debt basis by pass-through income when debt is repaid during the year.

Paul is the sole shareholder of Newton, Inc., a calendar year S corporation. Two years ago, Paul loaned Newton $60,000. The following year, a pass-through loss reduced the basis of the loan by $15,000, bringing Paul's debt basis to $45,000. On January 1 of the current year, Paul's stock basis is zero and his debt basis is $45,000. On July 1 of the current year, the corporation pays him $60,000 in full satisfaction of the note. At year-end, the corporation passes through $65,000 of nonseparately stated income, and no distributions are made to Paul during the year. Is Paul's basis in the note increased at year-end, even though the loan was paid off? (This is a variation of the facts in Example 2-34.)

The $65,000 net increase is first applied to increase Paul's debt basis to the extent it was reduced by post-1982 losses. The remaining $50,000 ($65,000 − $15,000) of net increase is applied to increase Paul's stock basis. His stock and debt basis is determined as follows:

	Stock Basis	Debt Basis
Balances, beginning of year	$ —	$ 45,000
Nonseparately stated income	50,000	15,000
Balances, before loan repayments	50,000	60,000
Loan repayments	—	(60,000)
Balances, end of year	$ 50,000	$ -0-

The pass-through income increases Paul's debt basis, so there is no gain on the repayment of the note.

As illustrated in this example, pass-through income increases basis of reduced-basis debt. Losses, however, do not reduce debt basis if the loan has been repaid during the year. (See Example 2-38.)

Adjusting Debt Basis When Shareholder Terminates Ownership in the S Corporation

If the shareholder does not own any stock in the corporation at the end of the corporation's tax year, adjustments to stock and debt basis are effective immediately before the shareholder's interest in the corporation is terminated.

Example 2-40: Adjusting debt basis when shareholder does not own S shares at the end of the tax year.

Assume the same facts as in Example 2-39, except Paul sells all of his shares to another shareholder during the year. Are Paul's stock and debt basis increased even though he does not own shares at the end of the year?

Yes, they are. Stock and debt basis adjustments are effective immediately before the shareholder's interest in the corporation is terminated. Thus, the basis adjustments illustrated in Example 2-39 will apply even though Paul disposed of all his shares during the year. At the end of the year (before considering the stock sale) he will show $50,000 of stock basis and debt basis of zero. Any amount over $50,000 that he receives from the sale of the stock will be capital gain.

As illustrated in this example, pass-through income increases basis of reduced-basis debt. Losses also reduce debt basis, even if the shareholder disposes of all of his shares. Debt basis is reduced by losses, unless the loan has been repaid, disposed of, or forgiven during the corporation's tax year. (See Examples 2-38 and 2-39.)

Gain or Loss on Sale of S Corporation Stock Does Not Affect Stock and Debt Basis

Stock and debt basis are adjusted annually by the items of income, loss, deduction, and credit. These adjustment items do not include gain or loss on the sale of the stock.

Example 2-41: Gain on sale of S corporation stock does not affect stock basis.

William is the sole shareholder in Esscorp. He has no stock basis and no outstanding loans to the corporation on January 1, the beginning of the corporation's tax year. At that date, William has $25,000 in suspended losses that he has been unable to deduct due to lack of basis. On July 1, William sells his shares for $39,000. At the end of the year, the corporation passes through to William a loss of $15,000, bringing his aggregate suspended losses to $40,000.

Gain on the sale of S corporation stock does not increase stock or debt basis. Therefore, William must recognize the $39,000 gain on the sale of his shares, but, because he has no basis, he cannot deduct any portion of the $40,000 of suspended losses. In fact, the loss expires upon the sale of his stock, and is never deductible.

Gain on Repayment of Reduced-basis Debt Does Not Increase Basis

An S corporation shareholder can recognize taxable gain when the corporation repays all or part of a debt to the shareholder after the debt has been reduced by pass-through losses. This gain on the repayment of reduced-basis debt does not increase debt basis for purposes of using S corporation losses in the hands of that shareholder.

Applying the At-risk and Passive Activity Loss Limitations

Stock and debt basis is not increased by gain on the sale of S corporation stock or repayment of reduced-basis debt. However, gain from a stock disposition does increase the amount that can be deducted for at-risk purposes. Also, suspended passive losses can generally be deducted upon disposition of a passive activity.

CALCULATING DEBT BASIS WHEN SHAREHOLDER HOLDS MULTIPLE NOTES

Increasing Debt Basis by Pass-through Items of Income when Shareholder Holds Multiple Notes from the Corporation

If the shareholder holds more than one note from the corporation, and if one of the notes has been partially or fully repaid in the current year, an ordering rule applies to increases in debt basis. First, debt basis of the note that was repaid during the year is increased by the "net increase" to the extent necessary to offset any gain that would otherwise be realized on the repayment. Next, remaining income restores basis of the other outstanding notes in proportion to the amount that the basis of each outstanding debt has been reduced. "Net increase" is, generally, the amount by which the sum of pass-through income and gains exceed the sum of pass-through loss and deductions and distributions.

Example 2-42: Increasing debt basis when shareholder holds multiple notes.

Nola owns all the stock of NL, Inc., an S corporation. During prior years, she made three loans of $60,000 each to the corporation. At the beginning of the current year, she has no stock basis, and Note 1's basis has been reduced by $15,000 of losses, Note 2 by $15,000, and Note 3 by $10,000. Nola receives $60,000 in full payment of Note 1 during the current year. At year-end, the corporation passes through $35,000 of nonseparately stated income, and no distributions were made to Nola during the year. Nola's basis in debt at the end of the year is determined as follows:

	Note 1	Note 2	Note 3	Total
Balances, beginning of year	$ 45,000	$ 45,000	$ 50,000	$ 140,000
Nonseparately stated income	15,000	12,000	8,000	35,000
Balances, before debt repayment	60,000	57,000	58,000	175,000
Debt repayment	(60,000)	—	—	(60,000)
Balances, end of year	$ -0-	$ 57,000	$ 58,000	$ 115,000

The $35,000 income first applies to increase the basis of Note 1 by $15,000 because that note was repaid during the year. Thus, Nola recognizes no gain on the repayment of that note. The remaining $20,000 ($35,000 − $15,000) of income restores basis of each outstanding indebtedness in proportion to the amount that the basis of each outstanding debt has been reduced. Thus, Note 2's basis is increased by $12,000 ($15,000 ÷ $25,000 × $20,000) and Note 3's basis is increased by $8,000 ($10,000 ÷ $25,000 × $20,000).

Reporting Gain on the Repayment of a Note When New Loan Is Made during the Year

The Tax Court and the 5th Circuit Court of Appeals have ruled that the shareholder experiences gain on the repayment of a reduced-basis indebtedness, even if a new loan is made by the end of the corporation's tax year. Each loan is looked at separately.

Example 2-43: Reporting gain on the repayment of a note when a new loan is made during the year.

An S corporation owes its sole shareholder, Paul, $60,000. Paul has a basis of $45,000 in the indebtedness because of pass-through losses in previous years. On July 1 of the current year, the corporation pays Paul $60,000 in satisfaction of the note (Note 1). On December 15 of the same year, Paul loans the corporation $60,000 in exchange for a note (Note 2) from the corporation. (Assume that debt basis was not adjusted for pass-through items for the year because there were no losses and no net increase.) Does Paul still experience a $15,000 gain from the repayment of Note 1 or is gain determined by comparing the combined note payable balances at the beginning and end of the year? In the latter case, there will be no gain because of the note repayment in the current year. (There was $60,000 payable to Paul at both the beginning and end of the year.)

Each loan is looked at separately. Thus, Paul has a $15,000 gain from repayment of Note 1 and has basis of $60,000 in Note 2. Even though the issuance of Note 2 does not prevent the gain recognition on the repayment of Note 1, it does give Paul $60,000 of debt basis.

To avoid this result, Paul could execute Note 2 and loan the company the additional $60,000 before the $60,000 repayment. It should then be possible for the company to designate the subsequent $60,000 repayment as payment in full of Note 2 rather than payment of the reduced-basis Note 1. The IRS may closely scrutinize the notes and payments to ensure that they reflect the economic reality of the transactions. Paul should have good business reasons for executing a new note. For example, Paul could follow this approach if the company is engaged in a seasonal business (such as farming or tourism) when the need for and availability of cash can be predicted through past experience.

Making Adjustments to Debt Basis When There Are Multiple Notes Payable to the Shareholder

Loss and deduction items reduce debt basis after they have reduced stock basis to zero. If the shareholder holds more than one debt at the end of the corporation's year, the basis reduction applies to each debt in the same proportion as the basis of each debt bears to the aggregate bases of all debt.

Example 2-44: Making adjustments to debt basis when there are multiple notes payable to the shareholder.

Green, Inc. incorporated and elected S status 11 years ago. At the beginning of the current year, Paul had stock basis of $25,000 and debt basis of $50,000, made up of Note 1 with a face value and basis of $30,000 and Note 2 with a face value and basis of $20,000. No new loans, loan repayments, or distributions were made during the year. At year-end, Paul's Schedule K-1 shows the following pass-through items:

Nonseparately stated loss	$ (41,000)
Long-term capital gain	5,000
Section 1231 loss on sale of business asset	(6,000)

Paul's stock basis is adjusted as shown in the following calculation:

Stock basis, beginning of year	$ 25,000
Pass-through gain	5,000
Subtotal	30,000
Pass-through losses and deductions:	

Nonseparately stated loss	$ (41,000)	
Section 1231 loss	(6,000)	
Total losses and deductions	$ (47,000)	
Limited to remaining stock basis		(30,000)
Stock basis, end of year		$ -0-

Debt basis is then adjusted as follows:

Debt basis, beginning of year		$ 50,000
Pass-through losses and deductions:		
Losses and deductions	(47,000)	
Applied against stock basis	30,000	
Remaining losses and deductions		(17,000)
Debt basis, end of year		$ 33,000

The $17,000 debt basis reduction is allocated to Loans 1 and 2 in proportion to their respective bases, as shown in the following calculation:

	Loan 1	Loan 2	Totals
Debt basis, beginning of year	$ 30,000	$ 20,000	$ 50,000
Losses and deductions	(10,200)	(6,800)	(17,000)
Debt basis, end of year	$ 19,800	$ 13,200	$ 33,000

Example 2-45: Making adjustments to debt basis when the shareholder holds multiple debts and a debt is repaid during the year.

Assume the same facts as in Example 2-44, except Paul holds three notes at the beginning of the corporation's tax year: Loan 1 has a basis of $30,000, Loan 2 has a basis of $12,000, and Loan 3 has a basis of $8,000. Paul also lends the corporation an additional $8,000 during the year (Loan 4). Loan 3 is repaid during the year. The basis of Loan 3 is not reduced by the corporation's loss or deduction items because it was repaid during the year. The $17,000 debt basis reduction is allocated to Loans 1, 2, and 4 in proportion to their respective bases as shown in the following calculation:

	Loan 1	Loan 2	Loan 3	Loan 4	Totals
Debt basis, beginning of year	$ 30,000	$ 12,000	$ 8,000	$ —	$ 50,000
Debt incurred during year	—	—	—	8,000	8,000
Debt repaid during year	—	—	(8,000)	—	(8,000)
Debt basis, before applying losses and deductions	30,000	12,000	—	8,000	50,000
Losses and deductions	(10,200)	(4,080)	—	(2,720)	(17,000)
Debt basis, end of year	$ 19,800	$ 7,920	$ -0-	$ 5,280	$ 33,000

Handling Loans Payable to and Receivable from a Shareholder

An S corporation shareholder evidently has debt basis in a loan payable by the corporation to the shareholder, even if the shareholder also owes funds to the corporation.

Example 2-46: How loans payable to and receivable from the shareholder affect debt basis.

Marsha owns all the shares of MM, Inc., an S corporation. Marsha has stock basis of zero at the beginning of the current year. During the previous year, MM loaned Marsha $75,000, and she has made no payments on

the note. In October of the current year, the practitioner projects that MM will pass through a nonseparately stated loss of $70,000. Can Marsha loan the corporation $70,000 by the end of the year and deduct the loss against that debt basis even though she owes $75,000 to the corporation?

Evidently, Marsha can loan the corporation $70,000 and use that amount as debt basis against which to deduct the loss. In *Cornelius*, the Tax Court and the 5th Circuit ruled that loans payable to the shareholder are looked at separately when determining gain on repayment of reduced-basis debt. Reg. 1.1367-2 also requires notes to be treated separately rather than aggregated. Furthermore, there is no requirement that shareholder notes payable and receivable be offset when determining debt basis. Thus, the note payable to Marsha increases her debt basis, and the note receivable from Marsha has no effect on basis. Each note should be separately documented and carry specific repayment terms and interest rates so that the notes are, in fact, separate transactions.

The loan to the shareholder and the loan from the shareholder back to the corporation should not be simultaneous. The IRS might attempt to collapse simultaneous loans and treat them as a single transaction. The loans are more likely to be accepted by the IRS as separate transactions if there is some time between them.

Applying Debt Basis Against Open Account Debt and Shareholder Advances

Open account debt is made up of shareholder advances that are not evidenced by a written instrument and repayments on those advances.

Effective for shareholder advances to the S corporation on or after October 20, 2008, open account loans to an S corporation by any shareholder are treated as separate written notes at the beginning of the year following the year in which the ending balance exceeds $25,000. The $25,000 threshold amount applies to each shareholder separately.

Example 2-47: Applying the $25,000 open account debt threshold amount to each shareholder.

ABC, Inc. is an S corporation. Art and Bill have each owned 50% of ABC's stock for nine years. As of the beginning of the corporation's calendar tax year, Art's and Bill's stock bases are both zero, and there are no outstanding loans due to the shareholders. On June 1, 2010, Art advances ABC $16,000, which is not evidenced by a written instrument. On August 1, Bill advances ABC $22,000, which is not evidenced by a written instrument. Both the $16,000 advance and the $22,000 advance are open account debt and remain outstanding at those amounts during the year.

At December 31, Art's $16,000 and Bill's $22,000 of open account debt carry over as open account debt to the following year.

As long as the balance of a shareholder's open account debt is $25,000 or less at the *beginning* of the year, advances and repayments are netted during the year, and the increase or decrease in the balance is measured by the difference in the open account balances at the beginning and end of the year.

Example 2-48: Determining debt basis by using open account debt balances at beginning and end of the tax year.

Assume the same facts as in Example 2-47, except that ABC passes through an $8,000 loss to each shareholder on December 31, 2010. The loss reduces Art's $16,000 basis in the open account debt to $8,000.

On April 1, 2011, ABC repays Art $4,000 of the open account indebtedness. On September 1, Art advances ABC an additional $1,000, which is not evidenced by a written instrument. (The corporation has no "net increase" for the year, so there is no adjustment to debt basis.)

The $4,000 April repayment and Art's $1,000 September advance are netted to result in a net repayment of $3,000 for the taxable year on Art's $16,000 open account debt. Art realizes $1,500 of ordinary income on the $3,000 net repayment calculated at the close of the tax year. (Evidently, the balance at the beginning of the

year is considered to be the face amount of the loan for purposes of the calculation.) The gain is calculated as follows:

$$\frac{\$16{,}000 \text{ (Face Amount)} - \$8{,}000 \text{ (Basis)}}{\$16{,}000 \text{ (Face Amount)}} \times \$3{,}000 \text{ (Repayment)} = 1{,}500$$

The net repayment of $3,000 on Art's $16,000 open account debt leaves him with an open account debt at the end of the year of $13,000 ($16,000 − $3,000), which will carry forward as open account debt to the following year.

The regulations allow a shareholder's open account debt to be increased by the shareholder's advances to the corporation and decreased by the corporation's repayments during the year, so long as the balance at the beginning of the year does not exceed $25,000. This netting process allows the shareholder to increase debt basis during the year, and therefore avoid gain on reduced-basis open account debt.

Example 2-49: Making advances to avoid gain on repayment of open account debt.

Assume the same facts as in Example 2-48, except that Art made additional advances of $3,000 during the year. The open account balance is $16,000 at the beginning of the year and $16,000 ($16,000 − $4,000 + $1,000 + $3,000) at the end of the year. There is no net reduction in the open account debt during the year, and Art does not have recognized gain because there is no loan repayment.

Treating Debt as If It Were Evidenced by a Written Instrument

The character of the open account debt changes if the balance of a specific shareholder's open account debt, net of advances and repayments, is more than $25,000 at the close of the S corporation's tax year. In that event, beginning with the next tax year, the principal amount of the open account debt is no longer considered to be open account debt. Rather, it is treated as if it were indebtedness evidenced by a separate written instrument for purposes of the debt basis rules.

Once a debt is treated as being evidenced by a written instrument, netting of advances and repayments on that loan is no longer allowable. Repayments on the loan reduce the loan's face value and the shareholder's debt basis in the loan. Additional advances are considered to be new loans. If these advances are not evidenced by written instruments, they are additions to open account debt, and will be considered when determining whether the shareholder's $25,000 threshold has been reached.

Example 2-50: Treating open account debt as evidenced by a note when shareholder's open account debt exceeds $25,000.

Alan is the sole shareholder in XYZ, Inc., an S corporation. The corporation owes Alan open account debt of $13,000 on January 1, 2010. Previous pass-through losses have reduced his debt basis to zero. XYZ repays $5,000 of the open account debt on February 1, and on March 1, Alan advances XYZ $20,000, which is not evidenced by a written instrument. The corporation has no "net increase" for the year, so there is no adjustment to debt basis.

The advances and repayments are netted during the year to result in an open account balance of $28,000 ($13,000 + $20,000 − $5,000) at the end of the year. The debt's ending balance is more than its beginning balance, so Alan recognizes no gain on the $5,000 repayment.

Because Alan's year-end open account debt exceeds $25,000, the $28,000 indebtedness is treated in the same manner as indebtedness evidenced by a separate written instrument for debt basis purposes, beginning with the following tax year, 2011. During that year, Alan advances XYZ $20,000, which is not evidenced by a written instrument. The $20,000 cannot increase the $28,000 of debt considered to be evidenced by a written note. The corporation now has open account debt of $20,000 and debt of $28,000 considered to be evidenced by a written note.

Treating All Debts Separately for Basis Adjustment Purposes

Each loan owed to a shareholder is treated separately for purposes of the debt basis rules. This means that the basis of (a) each loan deemed to be evidenced by a written instrument, (b) other notes payable to the shareholder, and (c) any open account debt not evidenced by a written instrument will be subject to the rule that proportionately reduces the debt basis of each loan when losses are passed through. Likewise, each loan's debt basis is proportionately reinstated when the reduced debt basis reinstatement rules apply.

Determining $25,000 Threshold upon Disposition of Open Account Debt

If all or part of a shareholder's open account debt is disposed of before the end of the S corporation's tax year, the adjustments to the stockholder's debt basis are made immediately before the disposition of the debt.

Determining $25,000 Threshold When Shareholder Disposes of Stock during the Year

If a shareholder with open account debt is no longer a shareholder at the end of the S corporation's tax year, the adjustments to the stockholder's debt basis must be made immediately before the shareholder's interest in the S corporation is terminated.

How to Treat Open Account Debt Outstanding on October 19, 2008

Before October 20, 2008, prior Reg. 1.1367-2(a) provided that open account debt not evidenced by separate written notes was treated as one indebtedness, meaning that shareholder open account loans made late in the year could be netted with repayments on shareholder open account loans made earlier in the year, thus preventing the recognition of income as a result of the debt repayment. If a shareholder has open account debt outstanding before October 20, 2008, the rules under the prior final regulations apply to any repayments on that open account debt. Thus, that debt will not be subject to the $25,000 threshold. However, additional advances cannot be made to that "old" debt because all shareholder advances made after October 19, 2008, are considered to be new open account debt.

Below-market Interest

The open account debt rules under Reg. 1.1367-2 do not affect the below-market interest rules of IRC Sec. 7872. Thus, interest must be paid or imputed on below-market interest loans (regardless of whether evidenced by a written instrument) once the balance in the loan exceeds the *de minimis* amount of $10,000.

REDUCING BASIS BY LOSSES THAT PROVIDE THE SHAREHOLDER WITH NO TAX BENEFIT

The basis reduction for nonseparately and separately stated items of loss and deduction occurs whether or not the shareholder can deduct the loss on the shareholder's current year personal return [and whether or not the shareholder can obtain a refund from carrying the loss back to prior years' returns under IRC Sec. 172(b)].

Example 2-51: Reducing basis by pass-through losses even though the shareholder receives no benefit.

Wink, Inc., an S corporation, passes through a nonseparately stated loss of $50,000 to Ned, its sole shareholder. Before considering the loss, Ned's basis in the stock is $35,000, and his basis in a note receivable from the corporation is $20,000. He shows other losses on his personal tax return, so he cannot currently deduct the loss from Wink. Nevertheless, the pass-through loss reduces his stock basis to zero and his debt basis to $5,000.

ADJUSTMENT OF BASIS BY LIFE INSURANCE PREMIUMS AND BENEFITS

An S corporation may be the owner of a life insurance policy covering a shareholder or key employee. If the corporation is directly or indirectly a beneficiary of the policy, the cost of premiums paid is not deductible. Likewise,

if the corporation receives insurance proceeds from the policy because of the insured person's death, the proceeds generally are not taxable.

Life insurance premiums (on policies of which the corporation is the beneficiary) are nondeductible expenditures that reduce stock basis. However, if the policy has a cash surrender value (CSV), it seems that the CSV is properly capitalizable. Therefore, stock basis is evidently reduced by life insurance premiums to the extent attributable to the "pure" life insurance coverage. The portion attributable to an increase in CSV is a capital expenditure and, therefore, not a reduction in basis.

Because basis is increased by tax-exempt income, the proceeds of a life insurance policy increase the shareholders' stock bases.

Example 2-52: Adjusting basis for life insurance proceeds.

Laura and Lana each own 50% of the shares of LL, Inc., a cash basis, calendar year S corporation. LL is the owner and beneficiary of a life insurance policy on Laura's life. Laura dies on January 15 and her stock passes immediately to her estate. The corporation receives $100,000 in life insurance proceeds on February 1. If no election relating to pass-through is made, the life insurance proceeds are allocated to the shareholders on a per-share, per-day basis using the number of days in the entire tax year. (Laura died in a nonleap-year.) The $100,000 of life insurance proceeds is tax-exempt and is allocated to shareholders as follows:

	Shareholder Income
Laura (50% of stock × 15/365 of year)	$ 2,055
Laura's estate (50% of stock × 350/365 of year)	47,945
Lana (50% of stock × 365/365 of year)	50,000
Total	$ 100,000

Each shareholder's basis is increased by these amounts. The tax exempt income is reported on Schedules K and K-1.

Variation: If a shareholder's entire interest in an S corporation is disposed of, the corporation can make the specific accounting election to allocate pass-through items based on the actual transactions that occurred before and after the stock disposition took place. Assume now that LL makes this election. Under the election, the year is considered to consist of two short years. The first short year is considered to end at the close of business on January 15, the day all of Laura's shares are transferred to her estate. The second short year ends on December 31. No tax-exempt income was received during the first short year. Laura (through her representative) and Laura's estate must consent to the election. Lana held her shares for the entire year and is not required to consent. The following table shows how the $100,000 of tax-exempt income is allocated to shareholders if the election to use specific accounting is made.

	1/1–1/15	1/16–12/31	Total
Laura	$ —	$ —	$ —
Laura's estate (50%)	—	50,000	50,000
Lana (50%)	—	50,000	50,000
Total	$ -0-	$ 100,000	$ 100,000

Life insurance proceeds do not increase the AAA because tax-exempt income does not increase AAA. Thus, distribution of the insurance proceeds can result in taxable income to the shareholders if the corporation has AE&P.

Alternative Minimum Tax

The AMT adjustments and preferences listed in IRC Secs. 56 and 57 do not include life insurance proceeds. Thus, S corporation shareholders are not subject to AMT on life insurance proceeds. (S corporations are not subject to AMT at the corporate level.)

MAKING ADJUSTMENTS TO BASIS OF INHERITED S STOCK BECAUSE OF INCOME IN RESPECT OF A DECEDENT

"Income in respect of a decedent" (IRD) generally consists of items of gross income a decedent was entitled to at the time of death that, because of the decedent's method of accounting, were not included in the final individual return. IRD is included in a decedent's assets on the estate tax return and, when received, is includable in the income of the person or entity acquiring the right to receive it (i.e., the beneficiary). Some of the more common items that may be IRD include interest and dividend income from the S corporation's investments and income from installment sales made by the S corporation. Furthermore, a cash method professional practice will always have IRD in the form of its accounts receivable, as these represent an asset to the decedent and are also income under the cash method of accounting when subsequently collected.

A person acquiring stock in an S corporation from a decedent treats as IRD his prorata share of income items that would have been IRD if the items had been acquired directly from the decedent. To mitigate the fact that the income has been included in the decedent's estate and is taxable to the beneficiary as well, the beneficiary deducts the federal estate tax attributable to the IRD as a miscellaneous itemized deduction, not subject to the 2% of AGI limitation.

The stepped-up basis in the stock of an S corporation acquired from a decedent is reduced to the extent the value of the stock is attributable to items consisting of IRD. The accumulated adjustments account (AAA) is also reduced by the IRD items.

APPLICATION OF SPECIAL RULES FOR BANKRUPT AND INSOLVENT TAXPAYERS

Determining the Effect of Cancellation of Debt Income on Basis

Special rules apply to cancellation of debt (COD) income of bankrupt or insolvent taxpayers (IRC Sec. 108). 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.

For S corporations, these special mandatory relief provisions of IRC Sec. 108 apply at the corporate level. For example, insolvency must be determined at the corporate level.

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.

Assessing the Effects of Filing a Bankruptcy Petition

The effect on the S corporation of filing a bankruptcy petition depends on whether the petition was filed by the corporation or a shareholder.

Effect of S Corporation's Bankruptcy. 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. The 1st Circuit also ruled in *Mourad* that when the S corporation declares bankruptcy, it continues to pass through items of income, loss, deduction, and credit to the shareholders, rather than to the bankruptcy trust.

Effect of Shareholder's Bankruptcy. In *Williams*, a case of first impression, the Tax Court considered what effect the filing of a bankruptcy petition by an individual S shareholder had on the allocation of the S corporation's pass-though. The court stated that, under IRC Sec. 1398(f)(1), the transfer of stock from the debtor-shareholder to the bankruptcy estate is not a disposition that triggers tax consequences. The bankruptcy estate is treated as the

debtor-shareholder with respect to that stock. Thus, the bankruptcy estate is treated as if it had owned the stock for the full year and is entitled to all the pass-through allocable to the shares of stock held by in the bankruptcy estate on the last day of the corporation's tax year. When the shareholder files for bankruptcy before the last day of the S corporation's tax year end, the pass-through for that year flows through in its entirety to the bankruptcy estate and no part of the pass-through is allocated to the debtor-shareholder.

Example 2-53: Allocating pass-through income and loss after shareholder declares bankruptcy.

Steve is the sole shareholder of Sayco, a calendar-year S corporation. On December 3, of the current year, Steve files a petition for bankruptcy. For Sayco's tax year ended December 31, the corporation reports an ordinary loss from operations of $200,000 and a Section 1231 gain of $10,000. The full $200,000 loss and the full $10,000 gain flow through to the bankruptcy estate. Steve is not entitled to report any portion of the loss or the gain on his personal return for the current year.

S Corporation Income May Pass Through to Bankrupt Shareholder under Certain Circumstances. In *DeVault* (a Small Tax Case Division case that holds no value as precedent and decided after the *Williams* case), the court held that the S corporation debtor-shareholder who declared bankruptcy was fully taxable on his allocable share of the S corporation's pass-through income for all the years at issue. The court reached this conclusion after finding that the shareholder had never validly abandoned his interest in his S corporation. In addition, the bankruptcy court did not administer the petitioner's shareholder interest as part of the bankruptcy estate. (In *Williams*, on the other hand, the S corporation stock was validly transferred to the bankruptcy estate and administered by it.)

Preventing Bankruptcy Trustee from Recovering Refund Due to Pass-through Losses

Losses generally are not deducted at the S corporation level. Rather, losses pass 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.

Revoking the S Election Prior to Bankruptcy May Not Be Effective

A bankruptcy trustee may be able to "avoid" a revocation filed shortly before a bankruptcy petition is filed. The 9th Circuit has held that a corporation's prebankruptcy revocation of its S election was a "transfer" that was avoidable by the bankruptcy trustee. The 9th Circuit bankruptcy panel concluded that the corporation's prebankruptcy "right" to make or revoke an S election was "property" or "an interest of the debtor in property" under the Bankruptcy Code. Furthermore, a prepetition revocation of S status was a "transfer" that could be avoided by the trustee under Bankruptcy Code Sec. 548(a). Once a revocation is avoided it is treated as if it had never been made, and the trustee is free to act as he sees fit.

Example 2-54: Bankruptcy trustee may have power to avoid S revocation.

Owen Corp. is a calendar-year S corporation 100% owned by Ima. The losses that Owen has experienced over the last several years have passed through to Ima. She has deducted these pass-through losses to the extent of her stock basis. During the current year, she realizes the corporation will continue to incur losses and will not be able to pay its debts as they come due. She decides to have the corporation file a bankruptcy petition, but she realizes the bankruptcy trustee will liquidate the corporation and the gains realized on the sales of the corporation's assets will flow through to her if the corporation maintains its S status.

To prevent this, she files a revocation of the corporation's S election two weeks before it files for bankruptcy. Under these circumstances, the bankruptcy trustee may be able to avoid the revocation of S status and have the corporation continue to be treated as an S corporation. Ima would be liable for the tax resulting from the pass-through gains on the liquidation of the corporation.

Reduction of Tax Attributes

While bankrupt and insolvent taxpayers exclude debt discharge income from gross income, the price for this relief is reduction of tax attributes. This reduction of attributes means that some or all of the excluded debt discharge income will eventually become taxable (e.g., when an asset with reduced basis is sold) and therefore is really just a timing difference. Some of the attributes subject to reduction are NOL carryovers, general business credit carryovers, minimum tax credit carryovers, capital loss carryovers, and asset bases.

Bankrupt and insolvent S corporations can fully exclude debt discharge income from gross income, even though the excluded income may exceed the amount applied to reduce the corporation's tax attributes [IRC Sec. 108(a)(1) and (b)(1)]. Debt discharge income in excess of the corporation's tax attributes simply goes away. Thus, bankrupt corporations can exclude the full amount of debt discharge income from gross income, and insolvent corporations can exclude debt discharge income to the full extent of their insolvency.

Other Bankruptcy Issues

Business Credit Recapture. Changes in ownership of stock can trigger business credit recapture. However, a special provision governing the tax consequences of bankruptcy provides that a transfer of an asset from the bankrupt individual to the bankruptcy estate is not treated as a disposition giving rise to adverse tax consequences.

ELECTION TO DISTRIBUTE DEEMED DIVIDENDS TO MAXIMIZE LOSS DEDUCTIONS WHEN C CORPORATION ELECTS S STATUS

When a C corporation converts to S status, the shareholder's stock basis in the C corporation becomes the beginning stock basis in the S corporation. This basis applies when limiting the deductibility of S corporation losses.

Example 2-55: Maximizing loss deductions when C corporation elects S status.

Adam owns 100% of the stock in BCD Corp., a calendar year C corporation. Adam originally contributed $5,000 in exchange for his stock, and no adjustments have been made to his stock basis. On January 1, BCD elected S status. At that date, BCD shows an accumulated earnings and profits (AE&P) balance of $125,000. At the end of the first S year, the corporation sustained an ordinary loss of $75,000.

Adam's deductible loss is limited to his stock basis of $5,000. The $70,000 of loss in excess of his basis must be carried forward to the following year.

In addition, the loss reduces the S corporation's accumulated adjustments account (AAA) to negative $75,000. The AE&P balance remains at $125,000. Since AAA is less than zero, any subsequent distribution would come out of AE&P as a taxable dividend under the ordering rules, even if Adam were to increase his basis through additional capital contributions or direct loans to the S corporation.

DEDUCTION OF AT-RISK AND PASSIVE ACTIVITY LOSSES

Interaction of Basis, At-risk, and Passive Activity Loss Limitations

The at-risk rules apply only to individuals and closely held C corporations, meaning that the limits are imposed at the shareholder level in the case of an S corporation. Losses passed through to S shareholders are limited by the various loss limitation provisions in the following order:

a. basis limitations,

b. the at-risk rules, and

c. the passive activity loss rules.

The interaction of the three pass-through limitation rules is illustrated in Examples 2-56 and 2-57.

Example 2-56: Calculating deductible losses under the basis, at-risk, and passive activity loss limitation rules.

Pat invests cash of $10,000 in exchange for 15% of the stock of a new S corporation that raises cattle. (The $10,000 is made up of $6,000 from his personal savings and $4,000 that he borrowed from Ryan, a 25% shareholder in the company.) Pat, who does not materially participate in the company's operations, is allocated an $11,000 pass-through loss at the end of the first year. He does not receive passive income from any other source.

Pat's basis limitation restricts his deductible loss to $10,000. The at-risk rules then limit his deductible loss to $6,000 (the amount not borrowed from a person who has an interest in the company). The passive activity loss rules reduce his deductible loss to zero. Thus, his entire $11,000 first year loss will be suspended and carried over in the following order:

1. $1,000 under the basis limitation rules,

2. $4,000 under the at-risk rules, and

3. $6,000 under the passive activity loss rules.

Increasing At-risk Basis by Gain from Stock Disposition

Stock dispositions often allow use of previously restricted losses. Gain from the disposition of stock increases at-risk basis, allowing the shareholder to use all or part of losses that have been deferred under the at-risk rules. (See Example 2-57.) Similarly, a taxable disposition of stock in a passive activity allows use of any passive activity losses from the activity that may have been previously suspended because of insufficient passive activity income. However, gain on the sale of S corporation stock does not affect stock or debt basis. Thus, losses suspended because of a lack of basis expire and are not deductible when stock with no basis is sold.

Example 2-57: Effect of stock sales on the basis, at-risk, and passive activity loss limitation rules.

The facts are the same as in Example 2-56. Assume also that the corporation uses a calendar tax year, and Pat sells all of his stock to an unrelated person for $20,000 on January 1 of the following year. The first year pass-through loss reduced his stock basis to zero, so Pat will recognize a $20,000 gain from the sale. The gain does not increase stock basis, so Pat cannot deduct the $1,000 loss suspended under the basis limitation rules. Gain on the sale of stock does, however, increase at-risk basis and allows Pat to deduct the $4,000 loss suspended under the at-risk rules. Furthermore, the $6,000 loss suspended under the passive activity loss rules can be deducted because Pat disposed of his entire interest in the passive activity.

Deducting S Corporation Losses That Are Restricted by At-risk Limitations

A shareholder may claim deductions from an activity only to the extent of the aggregate amount for which the taxpayer is at risk at the close of the S corporation's (not the shareholder's) tax year. Since the measuring date is the last day of the year, changes in the amount at risk during the S corporation's tax year do not adversely affect the shareholder. A shareholder of an S corporation is at risk for money and the adjusted basis of property contributed to the corporation.

Loans to S Corporation May Provide At-risk Basis. An S corporation shareholder has at-risk basis to the extent of amounts loaned directly to the S corporation (assuming the shareholder's source of the funds was not a prohibited source, such as nonrecourse borrowing). A shareholder does not receive an increase in his at-risk amount for his share of corporate-level liabilities. And, as with the rules applying to stock basis, an S shareholder does not receive an increase in at-risk amount for corporate-level debt that is personally guaranteed.

IRC Sec. 465(b)(2) holds that a taxpayer is considered at risk with respect to borrowed amounts only if the taxpayer is personally liable for repayment (i.e., a recourse obligation) or in the case of a nonrecourse obligation, if the

taxpayer has pledged property, other than property used in the activity, as security for the borrowed amount. In the case of nonrecourse borrowings secured by pledged property, the at-risk amount is limited to the net fair market value of the taxpayer's interest in the pledged property. The S corporation stock is considered to be "property used in the activity," meaning that a shareholder is not considered at risk for amounts contributed or loaned to an S corporation when the amounts were obtained by nonrecourse borrowings secured by the corporation's stock.

A special exception allows at-risk investment for nonrecourse loans secured by real property used in the activity of holding real property. To meet this "qualified nonrecourse financing" exception, no person can be personally liable for repayment, and the debt generally must be (a) borrowed by the taxpayer with respect to the activity of holding real property; (b) secured by real property used in the activity; and (c) borrowed from a commercial lender.

Amounts borrowed, whether recourse or nonrecourse, are not considered to be at risk if the amounts are borrowed from any person who has an interest in the activity, or is related to a person having such an interest in the activity. However, a person who has an interest only as a creditor with respect to the activity is not a prohibited party.

Amounts Borrowed from Party Who Has an Interest in the Activity. For amounts borrowed after May 3, 2004, loans from persons involved in the activity will not provide at-risk basis if the lender is involved in any activity engaged in by the taxpayer (a) in carrying on a trade or business or (b) for the production of income.

Example 2-58: Applying the at-risk rules to stock and debt basis.

Carol and several of her business associates formed Sheepco, a calendar year S corporation, on January 1, 2010, to operate a retail store selling wool products. She contributed $60,000 of her own funds to Sheepco in exchange for her portion of the stock. She also borrowed $100,000 from her parents and loaned the funds to the corporation (in return for a written corporate note bearing a market rate of interest). At the same time, Carol's father purchased 10% of the stock.

For the calendar year 2010, Sheepco allocated a loss of $100,000 to Carol. Her use of the $100,000 loss ordinarily would result in the following basis adjustments (Carol's share of the annual loss first reduces stock basis and then reduces debt basis):

	Stock Basis	Debt Basis	Total Basis
Original investment	$ 60,000	$ 100,000	$ 160,000
Less: pass-through loss	(60,000)	(40,000)	(100,000)
Remaining basis	$ -0-	$ 60,000	$ 60,000

Thus, Carol has basis under the normal S corporation rules for both her stock investment and her loan to Sheepco. However, for at-risk purposes, she is not considered to have basis in the amount she loaned to the corporation because the funds she invested were borrowed from a person who has an interest in the activity.

Her father's stock ownership in the S corporation is considered to make Carol not "at risk" with respect to the funds she borrowed from him. This same result would occur if Carol had borrowed from any other shareholder in the corporation, or from a person related to someone (other than Carol) who has an interest in the activity.

Without application of the at-risk rules, Carol would have used the $100,000 loss in its entirety by first applying $60,000 of the loss to reduce stock basis, and then applying the remaining portion of the loss to reduce the debt basis from $100,000 to $60,000. However, since Carol is not considered at risk with respect to her loan to Sheepco, she encounters a limit under IRC Sec. 465 at the shareholder level. The loan does not constitute debt basis, and Carol cannot deduct $40,000 of the loss in 2010. The unused loss carries over to the following year.

Amounts Borrowed from Related Party With No Interest in the Activity. The rule restricting at-risk basis for amounts borrowed from a person with an interest in the activity does not prevent at-risk basis for amounts borrowed from a member of the shareholder's family who holds no stock in the S corporation.

Example 2-59: Claiming at-risk basis for certain loans from a related party.

Assume the same facts as in Example 2-58. Carol's loans to Sheepco with funds borrowed from her father would be considered to be "at risk" if her father were not a shareholder. Accordingly, a redemption of her father's shares might be an appropriate remedy if Carol is faced with continuing restrictions on the deductibility of future losses.

Amounts Borrowed before May 4, 2004, from Party Who Has an Interest in the Activity. For amounts borrowed prior to May 4, 2004, the restriction against borrowing from others involved in the business applies only to the following five types of activities:

a. holding, producing, or distributing motion picture films or video tapes;

b. leasing of any Section 1245 property;

c. farming, as defined in IRC Sec. 464(e);

d. exploring for, or exploiting, oil and gas resources; and

e. exploring for, or exploiting, geothermal deposits.

Example 2-60: Pre-May 4, 2004, loan from party who has an interest in the activity.

Assume the same facts as in Example 2-58, except that Carol borrowed the funds from her father on April 1, 2004. Sheepco does not conduct one of the five activities listed in paragraph above. Thus, the loan from Carol's father is not subject to the at-risk rules and she can deduct losses passed through by the S corporation without regard to the at-risk limitations.

Carrying over Losses Limited by At-risk Rules

Any loss not allowed under the at-risk limits for a particular tax year is treated as a deduction allocable to the activity in the first succeeding tax year. The practical effect of this rule is to allow an unlimited carryover for losses and deductions that were not currently used because of the at-risk limits. The carryforward of suspended at-risk losses is indefinite.

Comparing At-risk Basis with Stock and Debt Basis

It is important to recognize that the amount at risk may be different than basis under the general S corporation basis computations of IRC Sec. 1367. Examples of such differences include loans from other investors in the activity, loans from a person related to a person (other than the taxpayer) having an interest in the activity, loans secured by property transferred to the S corporation, and nonrecourse loans secured by the corporate stock. When an at-risk limitation is encountered, the practitioner will need to monitor any carryover losses subject to the at-risk rules, as well as the normal stock basis rules.

Using Form 6198 to Report At-risk Information

Form 6198 (At-Risk Limitations) is used to report the profit or loss from an at-risk activity, the amount at risk, and the deductible loss from at-risk activities. The form is filed at the shareholder level by S shareholders who incurred a loss in an at-risk activity and whose investment contains nonrecourse financing, guarantees, stop-loss agreements, or loans from another party to the transaction (i.e., another shareholder).

Prorating the At-risk Limit

At-risk basis is allocated to losses and deductions on a prorata basis. The instructions to Form 6198 also take this prorata approach. It appears the IRS will not follow the ordering rule originally provided in Prop. Reg. 1.465-38(a).

Carrying At-risk Losses into the Post-termination Transition Period

Losses of an S corporation suspended under the at-risk rules of IRC Sec. 465 are carried forward to the S corporation's post-termination transition period (PTTP). The losses can be deducted at the end of the PTTP to the extent stock basis and at-risk basis increase by capital contributions during the PTTP.

Example 2-61: Carrying at-risk loss over to the post-termination transition period.

Norman owns 30% of the stock in a calendar-year S corporation. Norman has a $9,000 suspended at-risk loss carryforward. Shareholders owning more than 50% of the corporation's stock file a revocation of the corporation's S election, effective January 1, 2010, and the one-year PTTP begins on that date. The corporation makes no distributions during the PTTP. If Norman contributes at least $9,000 to capital during 2010, he can deduct the $9,000 at-risk loss carried into that year. Norman must increase stock basis—an increase in debt basis during the PTTP will not increase his amount at-risk.

DETERMINE THE EFFECT OF CREDITS ON STOCK BASIS

General business credits themselves do not affect stock basis or the accumulated adjustments account (AAA) [i.e., IRC Sec. 1367(a)(2)(B) only requires reduction in stock basis for items of loss and deduction]. However, if a credit or credit recapture causes an adjustment to the basis of an asset, that adjustment also increases or reduces stock basis.

An S shareholder can claim pass-through credits without regard to basis. However, other rules outside of Subchapter S may limit the credit, such as:

a. the shareholder's tax liability,

b. the passive activity loss rules, or

c. income from the activity (in the case of the Section 41 research credit).

Example 2-62: Determining the effect of credits on stock basis.

Julie, a single taxpayer, owns all the shares of Gem, Inc., an S corporation. She materially participates in Gem's operations. Gem's Schedules K and K-1 report $10,000 of nonseparately stated loss from business activities and $80,000 of qualified rehabilitation expenditures used to remodel a pre-1936 building used in Gem's business. The expenditures qualify Julie for a rehabilitation credit of $8,000, and the building's basis must be reduced by that amount. Julie's stock basis at the beginning of the year is $18,000, and she has no debt basis. The corporation's beginning AAA balance is $19,000. The corporation made no distributions to her during the year.

Julie has income from other sources, and the income tax shown on her Form 1040 (before the credit) is $12,000.

Julie can claim the $8,000 credit, even though she has no stock basis at the end of the year. Julie's stock basis and Gem's AAA at the end of the year are calculated as follows:

	Stock Basis	AAA
Balances, beginning of year	$ 18,000	$ 19,000
Nonseparately stated loss	(10,000)	(10,000)
Reduction in basis of asset due to rehabilitation credit	(8,000)	(8,000)
Balances, end of year	$ -0-	$ 1,000

Decreasing Basis When Credits Cause Reduction in Operating Expenses

Certain credits cause operating expenses to be decreased under IRC Sec. 50(c)(5). When this reduction occurs, stock basis and the AAA are not decreased by the credit itself, but they are decreased by the nondeductible portion of the expenses, which are passed through on Schedule K-1.

Example 2-63: Decreasing basis when credits cause reduction in operating expenses.

Val, a single taxpayer, owns all the shares of Vee, Inc., an S corporation. She materially participates in Vee's operations. During the year, Vee takes $15,000 of employer social security credit for employee tips under IRC Sec. 45B. The corporation's net income, before considering the credit, is $20,000, but payroll tax expense must be reduced by the amount of the credit, $15,000. Thus, the nonseparately stated income for the year is $35,000 ($20,000 + $15,000), and the $15,000 credit passes through on Val's Schedule K-1. (Reporting business credits is discussed in more depth in Chapter 28 of *PPC's 1120S Deskbook*.) Val's stock basis at the beginning of the year is $20,000 and Vee's AAA is $25,000. Vee made no distributions to her during the year.

Val's stock basis and Vee's AAA at the end of the year are calculated as follows:

	Stock Basis	AAA
Balances, beginning of year	$ 20,000	$ 25,000
Nonseparately stated income	35,000	35,000
Nondeductible expenses	(15,000)	(15,000)
Balances, end of year	$ 40,000	$ 45,000

BASIS FOR AMT PURPOSES MAY DIFFER FROM REGULAR TAX BASIS

An S corporation is not subject to the alternative minimum tax (AMT). However, the corporation may pass through items that the shareholder must use in determining the individual AMT. For example, depreciation may be computed under the modified accelerated cost recovery system (MACRS) for regular tax purposes, but it must be computed under the alternative depreciation system (ADS) when calculating the AMT. The S corporation reports these differences on Form 1120S, Schedule K-1.

Pass-through items of income, gain, deduction, or loss affect basis for both regular tax and AMT purposes, while adjustments and preferences passed through to the shareholder affect the calculation of basis for AMT purposes only.

The difference between regular tax and AMT on the shareholder's personal tax return can cause basis in S corporation stock to differ for regular tax and AMT purposes.

Example 2-64: Calculating basis for regular tax and AMT purposes.

On January 1, Marie bought all of the shares of MM, Inc., an S corporation, for $30,000. She 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 Marie 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 Marie 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 of gain for AMT purposes. Her Form 6251 (Alternative Minimum Tax—Individuals) would show a $500 negative amount on the "Adjusted gain or loss" line.

This example underscores the importance of maintaining separate basis records for regular tax and AMT purposes.

DEDUCT LOSSES DURING THE POST-TERMINATION TRANSITION PERIOD

Defining the Post-termination Transition Period

Generally, unused losses caused by lack of basis are not available after the S corporation election terminates. However, a special relief provision allows those losses to be deducted by the shareholder under certain conditions for one year (or more) during the post-termination transition period (PTTP). Also, the corporation can make nontaxable cash distributions to the extent of the accumulated adjustments account (AAA), limited to the amount of stock basis. The PTTP is:

a. the period beginning on the day after the last day of the corporation's last S corporate year and ending on the later of:

   (1) one year after such last day, or

   (2) the due date, including extensions, of that year's tax return;

b. the 120-day period after a determination that the S election terminated for a previous year; or

c. the 120-day period beginning on the date of any determination under an IRS audit occurring after the termination of the S election, if an S corporation item of income, loss, or deduction is adjusted.

Per IRC Sec. 1377(b)(2), *determination* means (a) a court decision that becomes final, (b) a closing agreement, or (c) an agreement between the corporation and the IRS that the corporation failed to qualify as an S corporation. While the date that a court decision becomes "final" has not been clarified by the IRS, it presumably is the date after which the decision can no longer be modified or appealed.

The PTTP applies when the S election terminates, regardless of whether the termination occurs voluntarily because the corporation revokes its S election or involuntarily (e.g., an ineligible shareholder acquires stock in the corporation).

Measurement of the post-termination transition period is illustrated in the following examples.

Example 2-65: Measuring the post-termination transition period by the due date of the tax return.

A calendar year S corporation involuntarily terminates its S election on April 10, 2010. The final S corporation tax return (Form 1120S) is due on March 15, 2011, but can be extended for six months to September 15. Assuming the corporation extends the due date of the return, the PTTP will begin on April 10, 2010, and end on September 15, 2011 (even if the return is filed prior to September 15).

Example 2-66: Measuring the post-termination transition period by the expiration of one year after the S election terminates.

A calendar year S corporation voluntarily terminates its S election on November 10, 2010. The final S corporation tax return (Form 1120S) is due on March 15, 2011, but can be extended for six months to September 15. The PTTP will begin on November 10, 2010, and end on November 9, 2011.

Example 2-67: Measuring the post-termination transition period when the corporation is audited.

Joe is the sole shareholder in Jaycorp, an S corporation. The corporation voluntarily revokes its S election on December 31, 2008, when the AAA balance is $25,000 and Joe's stock basis is $32,000. Joe withdraws

$25,000 in cash from the corporation on March 15, 2009. Since the withdrawal is made during the PTTP, it is a distribution of AAA and reduces the AAA to zero and his stock basis to $7,000.

On February 1, 2010, the IRS begins an audit of Jaycorp's prior returns. The auditor finds that the S corporation's depreciation deduction was overstated by $5,000. On March 18, 2010, Joe signs a closing agreement showing an assessment of additional tax on a prior Form 1040 because of the error on Jaycorp's return. Joe's stock basis and the accumulated adjustments account (AAA) will increase by the additional income, $5,000, and Joe can withdraw the AAA in cash tax-free if the withdrawal is made by July 15, 2010 (i.e., the end of the 120-day PTTP that begins on March 18, 2010).

Treating Losses as Incurred on Last Day of Post-Termination Transition Period

Losses that have not been used when the S election terminates are treated as incurred on the last day of the PTTP. Thus, the shareholder can increase stock basis by making additional contributions to capital during the PTTP, and losses can be deducted against this additional basis. However, losses suspended on the date the S election ends can only be deducted to the extent of stock basis. Increasing debt basis during that period does not allow the deduction of losses. Losses that have not been deducted by the end of the PTTP are lost forever.

Example 2-68: Deducting losses during the post-termination transition period.

Jonathan is the sole shareholder of a calendar year S corporation. On February 5, 2010, he sells 75% of his stock to a partnership, causing the immediate termination of the corporation's S election. On December 31, 2009, Jonathan had a $5,000 suspended pass-through loss attributable to his stock. The corporation incurred an additional $3,000 loss from January 1 through February 4 resulting in a suspended pass-through loss of $8,000 on the date S status terminated. The PTTP rules give Jonathan until March 15, 2011 (the due date of the final S corporation return) to inject $8,000 of additional capital to deduct the $8,000 suspended pass-through loss. If the due date of the corporate tax return is extended, Jonathan will have until the extended due date to contribute the additional capital.

Timing Loss Deductions by Taking Advantage of the Post-termination Transition Period

Loss carryforwards are available for a limited period of time after the S corporation election terminates (i.e., during the PTTP). During that period, a shareholder can restore stock basis and deduct losses against that basis. The losses cannot be applied against debt basis during the PTTP. Therefore, if the S election has terminated, instead of making loans to the corporation, the shareholder will have to contribute capital or acquire more stock. Losses are treated as if they were incurred on the last day of the period, which in most cases is one year after the termination occurs. Losses not used at the end of the period do not carry forward into a C corporation year and are lost forever.

Example 2-69: Timing loss deductions by using the post-termination transition period.

On December 1, the tax practitioner projects that Waltco, a calendar year S corporation, will have a loss of approximately $25,000 for the current year. Walt, the sole shareholder, materially participates in the operations of the corporation. Before considering the expected loss, he has $2,000 in stock basis. On January 1 of the next year, Walt is going to sell a portion of his stock to a nonqualified shareholder. Consequently, the S corporation election will terminate as of December 31, the day before the disqualifying event takes place. Walt believes the corporation at some point will become profitable again, and he wants to make a loan to the corporation to provide working capital. He feels that his personal income will be greater in the following year, and that the loss may be more valuable to him then.

Walt can take the loss in either year, depending on when his basis increases. He can increase his stock or debt basis before December 31 and deduct the loss in the current year. If he waits until the termination is effective, he can increase stock basis during the subsequent year and deduct the loss in the following year [i.e., at the end of the post-termination transition period (PTTP)].

Methods of Increasing Stock Basis during the PTTP

A shareholder may increase stock basis during the PTTP by making capital contributions to the corporation or purchasing stock in the corporation. Also, stock basis is increased if the shareholder is allocated additional pass-through income from the S corporation due to an IRS audit.

At-risk Losses

Losses of an S corporation suspended under the at-risk rules of IRC Sec. 465 are carried forward to the S corporation's PTTP. The losses can be deducted at the end of the PTTP to the extent stock basis and at-risk basis increase by capital contributions during the PTTP.

SELF-STUDY QUIZ

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

30. Shareholder advances that are not evidenced by a written instrument and repayments on those advances make up open account debt. Prior to October 20, 2008, Reg. 1.1367-2(a) provided that open account debt not evidenced by separate written notes was treated as which of the following?

    a. A deduction allocable to the activity in the first succeeding tax year.

    b. One indebtedness.

    c. A sale or exchange.

    d. Investment income.

31. Which of the following statements is most accurate regarding how basis is determined in the year stock is sold or debt repaid?

    a. Generally, basis in stock is determined prior to the stock disposition.

    b. Basis in debt is always determined as of the close of the corporation's tax year if the shareholder holds no stock in the corporation at the end of the year.

    c. Reduced-basis debt is reinstated by the current year loss and deduction prior to the stock basis increase.

    d. Debt basis can still be reduced by pass-through losses even if the debt has been repaid.

32. The IRS states that partial repayment of a shareholder loan that has been used as a basis for loss deductions represents income to the shareholder. Which of the following formulas determines such income?

    a. The repayment amount multiplied by a fraction. The numerator of which is the face amount and the denominator is the face amount less the basis.

    b. The repayment amount multiplied by a fraction.

    c. The repayment amount multiplied by a fraction. The numerator of which is the face amount, minus the basis and the denominator is the face amount.

    d. The payment, minus the basis.

33. Which of the following occurs when a shareholder holds multiple notes from the corporation and the notes have been fully or partly repaid in the current year?

    a. The at-risk rules are imposed.

    b. Debt basis is increased by the ordering rule.

34. I.N.K., Inc., an S corporation, passes through a nonseparately stated loss of $100,000 to Fred, its sole shareholder. Before considering the loss, Fred's basis in the stock is $70,000, and his basis in a note receivable from the corporation is $40,000. He shows other losses on his personal tax return, so he cannot currently deduct the loss from I.N.K.. Fred's stock basis is reduced to zero. What is his debt basis?

    a. $10,000.

    b. $40,000.

    c. $100,000.

35. When S corporation stock is inherited, IRD is included in which of the following?

    a. A decedent's nondeductible expenses.

    b. A decedent's assets on the estate tax return.

36. With regard to a bankrupt S Corporation, losses generally are deducted at which of the following levels?

    a. Shareholder.

    b. S corporation.

37. Which of the following examples regarding how to deduct S corporation losses that are restricted by at-risk limitations is most accurate?

    a. Sharon shareholder can claim deductions from activities.

    b. Shelby shareholder can receive an increase in her at-risk amount for her corporate-level liabilities shares.

    c. If Tiffany taxpayer is personally liable for repayment, the Internal Revenue Code states that she is not considered at risk in respect to borrowed amounts.

    d. According to the Internal revenue Code, S shareholder Sherry is not considered at risk for money and the adjusted basis of property contributed to a corporation.

38. In addition to restricting S corporation losses by at-risk limitations; how do the at-risk rules affect the stock and debt basis?

    a. The at-risk basis will be the same as the stock or debt basis.

    b. The at-risk basis may be different than basis under the general S corporation computations but only if there are loans from other investors in the activity.

    c. The amount at risk may be different than basis under the general S corp computations due to several types of loans.

39. Which of the following statements regarding the difference between the basis for regular taxes and the basis for alternative minimum tax (AMT) purposes is most accurate?

    a. Most S corporations are subject to the AMT.

    b. There is no difference between the S Corp stock basis for AMT purposes and regular tax purposes.

    c. Preferences and adjustments passed through to the shareholder affect the calculation of basis for AMT purposes only while pass-through items of income, gain, deduction, or loss affect basis for both regular tax and AMT purposes.

40. When does the post-termination transition period (PTTP) apply?

    a. When the corporation's S election terminates.

    b. Stock basis and the AAA are reduced by the nondeductible portion of the expenses.

    c. When a shareholder's loan to the corporation is repaid.

    d. When a shareholder buys or sells stock in the 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.)**

30. Shareholder advances that are not evidenced by a written instrument and repayments on those advances make up open account debt. Prior to October 20, 2008, Reg. 1.1367-2(a) provided that open account debt not evidenced by separate written notes was treated as which of the following? **(Page 111)**

    a. A deduction allocable to the activity in the first succeeding tax year. [This answer is incorrect. Any loss not allowed under the at-risk limits for a particular tax year is treated as a deduction allocable to the activity in the first succeeding tax year per IRC Sec. 465(a)(2). The practical effect of this rule is to allow an unlimited carryover for losses and deductions that were not currently used because of the at-risk limits.]

    b. One indebtedness. [This answer is correct. Open account debt is made up of shareholder advances that are not evidenced by a written instrument and repayments on those advances. Prior to October 20, 2008, Reg. 1.1367-2(a) provided that open account debt not evidenced by separate written notes was treated as one indebtedness.]

    c. A sale or exchange. [This answer is incorrect. The character of the gain depends on whether the debt is evidenced by a written note. If there is no note, as with an open account receivable, the gain is ordinary income. If the indebtedness is evidenced by a written instrument, the repayment is treated as a sale or exchange of a capital asset per Rev. Rul. 64-162.Thus, the gain is long-term capital gain if the debt instrument has been held for more than 12 months, and short-term capital gain otherwise.]

    d. Investment income. [This answer is incorrect. This is a tax planning strategy that can mitigate the gain generated from repayment of a reduced-basis loan involves the investment interest expense deduction limitations in the shareholder's return. Capital gain arising from a debt repayment may be treated as investment income to the shareholder, thereby enhancing the deductibility of investment interest.]

31. Which of the following statements is most accurate regarding how basis is determined in the year stock is sold or debt repaid? **(Page 104)**

    a. Generally, basis in stock is determined prior to the stock disposition. [This answer is correct. According to Reg. 1.1367-1(d)(1), a shareholder can have basis against which to deduct losses, even if the shareholder disposes of the shares during the year. While basis normally is determined as of the close of the corporation's tax year, when a shareholder disposes of stock, basis in that stock is determined immediately before the stock disposition takes place.]

    b. Basis in debt is always determined as of the close of the corporation's tax year if the shareholder holds no stock in the corporation at the end of the year. [This answer is incorrect. If a shareholder holds no stock in the corporation at the end of the year, basis in debt is determined immediately before the stock disposition takes place per Reg. 1.1367-2(d).]

    c. Reduced-basis debt is reinstated by the current year loss and deduction prior to the stock basis increase. [This answer is incorrect. According to Reg. 1.1367-2(c), reduced-basis debt is restored by the current year "net increase" (up to the outstanding balance of the debt on the first day of the corporation's tax year) before stock basis is increased.]

    d. Debt basis can still be reduced by pass-through losses even if the debt has been repaid. [This answer is incorrect. Debt basis is not reduced by pass-through losses or deductions if the debt has been satisfied (i.e., repaid), disposed of, or forgiven during the corporation's tax year per Reg. 1.1367-2(d).]

32. The IRS states that partial repayment of a shareholder loan that has been used as a basis for loss deductions represents income to the shareholder. Which of the following formulas determines such income? **(Page 102)**

    a. The repayment amount multiplied by a fraction. [This answer is incorrect. The numerator of which is the face amount and the denominator is the face amount less the basis. [This answer is incorrect. This is not the correct formula for computing the income according to the IRS Rules.]

    b. The repayment amount multiplied by a fraction. [This answer is incorrect. The numerator of which is the face amount and the denominator is also the face amount. According to IRS Rulings, the income cannot be computed by dividing the face amount by the face amount, and multiplying it by the repayment.]

    c. The repayment amount multiplied by a fraction. The numerator of which is the face amount, minus the basis and the denominator is the face amount. [This answer is correct. This is the correct calculation for determining the income to the shareholder.]

    d. The payment, minus the basis. [This answer is incorrect. The basis subtracted from the payment equals the gain.]

33. Which of the following occurs when a shareholder holds multiple notes from the corporation and the notes have been fully or partly repaid in the current year? **(Page 108)**

    a. The at-risk rules are imposed. [This answer is incorrect. According to Temp. Reg. 1.469-2T(d)(6), the at-risk rules apply only to individuals and closely held C corporations, meaning that the limits are imposed at the shareholder level in the case of an S corporation.]

    b. Debt basis is increased by the ordering rule. [This answer is correct. If the shareholder holds more than one note from the corporation, and if one of the notes has been partially or fully repaid in the current year, an ordering rule applies to increases in debt basis per Reg. 1.1367-2(c)(2).]

34. I.N.K., Inc., an S corporation, passes through a nonseparately stated loss of $100,000 to Fred, its sole shareholder. Before considering the loss, Fred's basis in the stock is $70,000, and his basis in a note receivable from the corporation is $40,000. He shows other losses on his personal tax return, so he cannot currently deduct the loss from I.N.K.. Fred's stock basis is reduced to zero. What is his debt basis? **(Page 113)**

    a. $10,000. [This answer is correct. Since Fred's stock basis is reduced to zero, his debt basis is $10,000.]

    b. $40,000. [This answer is incorrect. This is Fred's basis in the note from the corporation.]

    c. $100,000. [This answer is incorrect. This is Fred's nonseparately stated loss.]

35. When S corporation stock is inherited, IRD is included in which of the following? **(Page 115)**

    a. A decedent's nondeductible expenses. [This answer is incorrect. IRD is not included in a decedent's nondeductible expenses. Any expense of a corporation not deductible in calculating its taxable income and not properly chargeable to a capital account are items that reduce basis and include nondeductible expenses per Reg. 1.1367-1(c)(2).]

    b. A decedent's assets on the estate tax return. [This answer is correct. "Income in respect of a decedent" (IRD) generally consists of items of gross income a decedent was entitled to at the time of death that, because of the decedent's method of accounting, were not included in the final individual return per Reg. 1.691(a)-1(b). IRD is included in a decedent's assets on the estate tax return and, when received, is includable in the income of the person or entity acquiring the right to receive it (i.e., the beneficiary).]

36. With regard to a bankrupt S Corporation, losses generally are deducted at which of the following levels? **(Page 116)**

    a. Shareholder. [This answer is correct. According to the IRS, losses pass 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.]

    b. S corporation. [This answer is incorrect. According to the IRS, losses generally are not deducted at the S corporation level.]

37. Which of the following examples regarding how to deduct S corporation losses that are restricted by at-risk limitations is most accurate? **(Page 118)**

    a. Sharon shareholder can claim deductions from activities. [This answer is correct. A shareholder may claim deductions from an activity only to the extent of the aggregate amount for which the taxpayer is at risk at the close of the S corporation's (not the shareholder's) tax year per IRC Sec. 465; Prop. Reg. 1.465-1(a).]

    b. Shelby shareholder can receive an increase in her at-risk amount for her corporate-level liabilities shares. [This answer is incorrect. Shelby cannot receive an increase in her at-risk amount for her share of corporate-level liabilities. And, as with the rules applying to stock basis, Shelby does not receive an increase in at-risk amount for corporate-level debt that is personally guaranteed per Prop. Reg. 1.465-6(d).]

    c. If Tiffany taxpayer is personally liable for repayment, the Internal Revenue Code states that she is not considered at risk in respect to borrowed amounts. [This answer is incorrect. IRC Sec. 465(b)(2) holds that a taxpayer is considered at risk with respect to borrowed amounts only if the taxpayer is personally liable for repayment (i.e., a recourse obligation) or in the case of a nonrecourse obligation, if the taxpayer has pledged property, other than property used in the activity, as security for the borrowed amount. In the case of nonrecourse borrowings secured by pledged property, the at-risk amount is limited to the net fair market value of the taxpayer's interest in the pledged property.]

    d. According to the Internal revenue Code, S shareholder Sherry is not considered at risk for money and the adjusted basis of property contributed to a corporation. [This answer is incorrect. A shareholder of an S corporation is at risk for money and the adjusted basis of property contributed to the corporation per the Internal Revenue Code.]

38. In addition to restricting S corporation losses by at-risk limitations; how do the at-risk rules affect the stock and debt basis? **(Page 120)**

    a. The at-risk basis will be the same as the stock or debt basis. [This answer is incorrect. The at-risk basis may be different than basis under the general S corporation basis computations of IRC Sec. 1367.]

    b. The at-risk basis may be different than basis under the general S corporation computations but only if there are loans from other investors in the activity. [This answer is incorrect. There are other transactions that will cause a difference in the at-risk basis and stock and debt basis.]

    c. The amount at risk may be different than basis under the general S corporation computations due to several types of loans. [This answer is correct. Loans from other investors in the activity, and it may be necessary for the practitioner to monitor any carryover losses subject to the at-risk rules as well as the normal stock basis rules.]

39. Which of the following statements regarding the difference between the basis for regular taxes and the basis for alternative minimum tax (AMT) purposes is most accurate? **(Page 122)**

    a. Most S corporations are subject to the AMT. [This answer is incorrect. Although a corporation may pass through items that the shareholder must use in determining the individual AMT, S corporations are not subject to the AMT per IRC Sec. 56(g)(6).]

    b. There is no difference between the S Corp stock basis for AMT purposes and regular tax purposes. [This answer is incorrect. According to IRC Sec. 56(g)(6), The difference between regular tax and AMT on the shareholder's personal tax return can cause basis in S corporation stock to differ for regular tax purposes.]

    c. Preferences and adjustments passed through to the shareholder affect the calculation of basis for AMT purposes only while pass-through items of income, gain, deduction, or loss affect basis for both regular tax and AMT purposes. [This answer is correct. According to the Internal Revenue Code, pass-through items of income, gain, deduction, or loss affect basis for both regular tax and AMT purposes, while adjustments and preferences passed through to the shareholder affect the calculation of basis for AMT purposes only.]

40. When does the post-termination transition period (PTTP) apply? **(Page 123)**

    a. When the corporation's S election terminates. [This answer is correct. According the Code, the PTTP applies when the S election terminates, regardless of whether the termination occurs voluntarily because the corporation revokes its S election or involuntarily (e.g., an ineligible shareholder acquires stock in the corporation).]

    b. Stock basis and the AAA are reduced by the nondeductible portion of the expenses. [This answer is incorrect. Certain credits cause operating expenses to be decreased under IRC Sec. 50(c)(5). When this reduction occurs, stock basis and the AAA are not decreased by the credit itself, but they are decreased by the nondeductible portion of the expenses, which are passed through on Schedule K-1. This does not occur as a result of PTTP.]

    c. When a shareholder's loan to the corporation is repaid. [This answer is incorrect. According to the IRS, gain results when a shareholder's loan to the corporation is repaid and does not occur as a result of PTTP.]

    d. When a shareholder buys or sells stock in the corporation. [This answer is incorrect. Stock basis is adjusted when a shareholder buys or sells stock in the corporation or contributes capital to the corporation per the IRS.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TSCTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. There are many tax planning strategies relating to shareholder basis. Which of the following is one of those strategies?

    a. The corporation can make debt payments to the shareholder.

    b. The corporation can make distributions to the shareholder.

    c. The shareholder can guarantee a loan to the corporation from a third party.

    d. The corporation can make loan payments on a reduced basis loan made by the shareholder.

22. When a shareholder buys or sells stock in a corporation or contributes capital to the corporation stock basis is adjusted. Each shareholder's basis is adjusted each year by pass-through items of income, loss, and deduction, and by distributions to the shareholder. Adjustments made to stock basis generally are made in a specific order. Which of the following is the correct order?

    a. Decreased by distributions, increased by pass-through income and gains items, and decreased for pass-through items of loss or deduction.

    b. Increased by pass-through income and gains items, decreased for pass-through items of loss or deduction, and decreased by distributions.

    c. Decreased for pass-through items of loss or deduction, decreased by distributions, and Increased by pass-through income and gains items.

    d. Increased by pass-through income and gains items, decreased by distributions, and decreased for pass-through items of loss or deduction.

23. What is the first step in calculating stock basis?

    a. Calculate the AMT.

    b. Calculate the nonseparately stated income.

    c. Calculate the original basis in stock.

    d. Do not select this answer choice.

24. When should stock basis be adjusted?

    a. Annually when adjusting items are determined.

    b. Only when a stock disposition occurs.

    c. Whenever the shareholder lends money to the corporation.

    d. After stock basis has been reduced to zero.

25. Generally, when are stock basis adjustments normally made?

    a. End of the corporation's tax year.

    b. Beginning of the current tax year.

    c. End of each fiscal year.

    d. Beginning and end of the tax year.

26. A shareholder can deduct pass-through credits without regard to which of the following?

    a. Basis.

    b. Loss limitation.

    c. At-risk loss limitation.

    d. Do not select this answer choice.

27. S corporation loss carryovers are lost when a shareholder disposes all of his or her entire interest in the S corporation to an individual other than which of the following?

    a. Child.

    b. Spouse or former spouse.

    c. Parent.

    d. Grandparent.

28. Who is responsible for determining the appropriate debt basis or stock?

    a. Shareholder.

    b. Corporation.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

29. Which of the following statements regarding lending money to an S corporation to provide debt basis is most accurate?

    a. Generally, shareholders are responsible for the corporation's commitments.

    b. A shareholder must gain a true economic expense and the debt must be owed by the corporation to the shareholder for the shareholder to attain basis.

    c. A shareholder can create basis by making a personal guarantee of the corporation's commitments third parties.

    d. Generally, basis results exclusively from the issuance of the shareholder's note to the corporation.

30. What happens when the netting of items of income, loss, gain, deduction and nondividend distributions results in a negative number?

    a. Gain items are reduced by nondividend distributions.

    b. Stock basis is increased by income.

    c. Pass-through items of gain and income does not increase debt basis.

    d. Debt basis is decreased to zero.

31. Nondividend distributions—

    a. Decrease stock basis.

    b. Decrease debt basis.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

32. Deductions and losses that are passed through by an S corporation can be deducted by the shareholder to the extent of which of the following?

    a. Shareholder's basis in debt and stock of the S corporation.

    b. The shareholder has debt basis.

    c. Full repayment exceeds the shareholder's basis in the debt.

    d. Partial repayments exceed a prorata portion of the basis in the debt.

33. What does Reg. 1.1367-2(c) say regarding reduced-basis debt?

    a. That nondeductible expenses in excess of basis do not carry over to the following year.

    b. That items of loss and deduction reduce basis first by nondeductible, noncapital expenses and certain oil and gas depletion deductions, then by items of loss or deduction.

    c. That the basis of inherited S corporation stock is reduced by "the portion of the value of the stock which is attributable to items constituting income in respect of the decedent."

    d. That it is restored by the current-year "net increase" before stock basis is increased.

34. Green is a shareholder in Spring, an S corp. The tax year for Green is different than the tax year for the S corp. Green has received a pass through loss from Spring and has insufficient basis to deduct the loss. Which of the following transactions will allow Green to deduct the loss in the following tax year?

    a. Green makes a stock purchase prior to the end of Spring's fiscal year.

    b. Green makes a loan to Spring prior to the end of Spring's fiscal year.

    c. Spring passes through income to Green prior to the end of Green's tax year.

    d. Spring passes through losses to Green prior to the end of Green's tax year.

35. What is net increase?

    a. The amount of distributions that can be received from an S corporation free of tax.

    b. The amount by which the sum of pass-through income and gain items exceed the sum of pass-through loss and deduction items.

    c. The amount that pass-through income and gains exceed losses, deductions, and nondividend distributions.

    d. The amount that can be deducted for at-risk purposes.

36. When are adjustments to stock and debt basis effective when a shareholder does not own stock in a corporation at the corporation's tax year end?

    a. Immediately before the shareholder's interest in the corporation is terminated.

    b. Immediately before the disposition of the debt.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

37. When a repayment of reduced-basis debt occurs, when does an S corporation shareholder recognize taxable gain?

    a. When all or part of the basis has been restored.

    b. When all or part of a shareholder's open account debt is disposed of.

    c. When all or part of the corporation's debt is repaid to the shareholder once the debt has been decreased by pass-through losses.

    d. When all or part of losses have been deferred under the at-risk rules.

38. Whenever a loan is owed to a shareholder, that loan is treated separately for purposes of which of the following?

    a. At-risk rules.

    b. Debt basis rules.

    c. Passive activity rules.

    d. Basis limitation rules.

39. S shareholder Sharon needs to report her profit/loss from at-risk activity. Which form should be used, who should complete it, and who should file it?

    a. Form 1040; Sharon; Sharon.

    b. Form 6198; S corporation; Sharon.

    c. Form 1120S; S corporation; S corporation.

    d. Form 6198; Sharon; Sharon.

40. Wiggins Inc., a calendar year S corporation, voluntarily terminates its S election on November 10, 2009. The final S corporation tax return (Form 1120S) is due on March 15, 2010, but can be extended for six months to September 15. The PTTP will begin and end on which of the following?

    a. March 15, 2009; March 15, 2010.

    b. March 15, 2009; November 9, 2010.

    c. November 10, 2009; November 9, 2010.

    d. March 15, 2010; November 9, 2010.

GLOSSARY

Accumulated adjustments account (AAA): The AAA is the first tier used to determine the tax treatment of distributions when the corporation has AE&P. The AAA is used to track the undistributed net income that has been subject to tax at the shareholder level. The AAA balance generally can be distributed to the shareholder without causing additional shareholder-level tax.

Accumulated earnings and profits (AEP): An S corporation only has AE&P if it was previously a C corporation or acquires another corporation that has AE&P.

Active participation: The shareholder must own at least 10% of the value of all interests in the activity at all times during the tax year, and also must "actively" participate in the operations of the rental property in both the year the loss is incurred and the year that recognition is sought, if different. Active participation is a less stringent standard than material participation and does not require regular, continuous, and substantial involvement in the operations. Rather, the shareholder must participate in a significant way, such as by making management decisions or arranging for others to provide services.

At-risk: A shareholder of an S corporation is at risk for money and the adjusted basis of property contributed to the corporation.

At-risk activity: The at-risk rules currently apply to any activity engaged in by the taxpayer in carrying on a trade or business or for the production of income.

At-risk limitation: An S corporation shareholder faces restrictions on the use of pass-through losses and deductions from both the passive activity loss rules and the basis limitation rule. The third barrier facing the S shareholder is the at-risk limitations of IRC Sec. 465.

Basis limitations: With basis limitations, losses that are currently limited may be carried over indefinitely until at-risk amounts are generated in future years.

Built-in gains: To discourage C corporations from electing S status to avoid double taxation upon liquidation, certain S corporations are subject to a tax on "built-in gains."

Built-in gains tax: The built-in gains tax generally applies to C corporations that make an S corporation election, and can be assessed during the ten-year period beginning with the first day of the first tax year for which the S election is effective. The built-in gains tax is imposed at the highest corporate rate (presently 35%), and is triggered by the disposition of an asset that was on hand at the time the S election became effective, if on that date the asset had a FMV in excess of its basis.

Disposition: 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.

Distributions: 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.

Excess net passive income tax: 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

Material participation: There are seven material participation such as: 1)The taxpayer participates in an activity for more than 500 hours during the tax year. 2)The taxpayer's participation in the activity for the current year constitutes substantially all the participation of all individuals in the activity, including nonowners.

Nonpassive income: Nonpassive income includes: 1) income from a trade or business in which the taxpayer materially participates; 2) salaries and wages, and; 3) portfolio income (generally interest, dividends, and gains from sale of investment property.

Passive activity: Any rental activity, or a trade or business in which the taxpayer does not materially participate.

Passive activity credit: Passive activity losses are limited at the shareholder (rather than the S corporation) level. IRC Sec. 469 also limits, at the shareholder level, the use of credits arising from passive activities. Credits arising from passive activities may offset the shareholder's current tax only to the extent the taxpayer's tax is attributable to net passive income for the year.

Passive activity loss: For purposes of the Section 469 passive activity loss rules, income or loss from a rental activity conducted by the S corporation generally is passive, regardless of whether the shareholder materially participates and regardless of whether the rented property is real or personal property.

Per-share per-day rules: 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.

Portfolio income: Generally interest, dividends, and gains from sale of investment property.

S corporation: To continue S corporation status, the corporation and its shareholders must meet a number of basic requirements. Under IRC Sec. 1361, only a "small business corporation" can operate as an S corporation.

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."

Section 179 deduction: Under IRC Sec. 179(d)(8), the corporation passes through a maximum Section 179 deduction of $250,000 (in 2010) regardless of the number of shareholders, and each shareholder is limited to the same maximum deduction from all sources.

Self-charged interest: Self-charged interest is interest on a loan by a shareholder to an S corporation if the corporation passes through a passive activity loss.

Self-rented property: Self-rented property" and affects taxpayers who rent property to a trade or business in which they materially participate.

Shareholder basis: A shareholder's stock basis is determined at the end of each of the corporation's tax years. Stock basis increases when the shareholder buys new shares or contributes capital and when income is passed through by the corporation. It decreases when the shareholder disposes of shares, when losses or deductions are passed through, and when nontaxable distributions are received.

Short tax 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

Significant participation activity: A significant participation activity is one in which (a) the taxpayer cannot be treated as materially participating under any of the other six tests, and (b) the taxpayer participates in the activity for more than 100 but fewer than 500 hours.

Specific accounting election: 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."

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COMPANION TO PPC'S TAX PLANNING GUIDE—S CORPORATIONS

COURSE 2

REORGANIZATIONS, RECAPITALIZATIONS, AND QUALIFIED SUBCHAPTER S SUBSIDIARIES (TSCTG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to *PPC's Tax Planning Guide—S Corporations*. Lesson1 classifies the different types of reorganizations, explains how an S corporation can use reorganization for their advantage in a tax-free reorganization, and explains the rules for determining gains, losses and basis for S corporations in a reorganization and what happens when S status is terminated in reorganization. Lesson 2 details the different types of reorganizations—Type A through F—and the advantages and disadvantages of each. Lesson 3 covers various aspects of qualified subchapter S subsidiaries including planning, eligibility, liquidation, operation, and termination.

PUBLICATION/REVISION DATE: May 2010

RECOMMENDED FOR: Users of *PPC's Tax Planning Guide – S Corporations*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

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FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **May 31, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Understanding Reorganizations and the Applicable Tests Related to S Corporations

Completion of this lesson will enable you to:

- Identify the different types of reorganizations and the choices for an S Corporation to minimize taxes associated with reorganization.
- Apply the required tests to qualify for tax-free reorganizations.
- Recognize the rules for determining gains, losses and basis in an S corporation reorganization and how business credits can be recaptured.
- Identify the effects of the S status termination or when S status is retained when reorganization occurs, as well as the reporting requirements of reorganization.

Lesson 2—Attributes and Advantages of Differing Types of Reorganizations

Completion of this lesson will enable you to:

- Determine how built-in gains and boot affect a Type A merger in a reorganization.
- Identify the advantages and risk factors of a Type B, C, D, E and F reorganization for an S corporation.

Lesson 3—Understanding Various Aspects of Qualified Subchapter S Subsidiaries

Completion of this lesson will enable you to:

- Identify various aspects of qualified subchapter S subsidiaries such as uses, eligibility, status, liquidation, operation, and termination.

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Lesson 1: Understanding Reorganizations and the Applicable Tests Related to S Corporations

INTRODUCTION

Introducing Reorganizations and Recapitalizations

Tax-free Transactions. The reorganization provisions of the Internal Revenue Code, primarily located in IRC Secs. 354, 355, and 368, allow a variety of tax-free transactions in the form of combinations, divisions, and recapitalizations.

The tax-free treatment of these types of transactions is based on the theory that the corporation has essentially continued its old business within the corporate structure, without distributing boot or assets to the shareholders, despite the various implementing sales and exchanges. Stated another way, the tax-free reorganization provisions of the Code are intended to recognize that in some cases there simply has not been a sufficient change in the economic circumstances of the corporation and its shareholders to justify the imposition of an income tax.

The Code's definitions are concerned with the form of the transaction rather than its substance. Accordingly, form plays an important role in achieving the desired tax result. This does not mean the economic consequences of a transaction can or should be ignored. Tests such as "business purpose," "continuity of shareholder interest," "continuity of business enterprise," and the "step-transaction" doctrine can be applied to disqualify what otherwise seemingly qualifies, under the technical requirements of the Code, as a tax-free reorganization.

If the transaction meets the requirements for a tax-free reorganization, the property, stock, and securities passing between corporations involved in the transaction and the stock and securities passing to shareholders of the corporations can be received without recognition of gain or loss. The price to be paid for tax-free (tax-deferred) treatment of reorganization exchanges is in the basis carryover and adjustment rules.

Tax-free versus Taxable Transactions. A tax-free reorganization is only one way to acquire the assets or stock of another corporation. A major difference between a tax-free and taxable transaction is that stock of the acquiring corporation is the principal if not sole consideration that can be conveyed in a tax-free reorganization.

Introducing Qualified Subchapter S Subsidiaries (QSubs)

A qualified Subchapter S subsidiary (QSub) is a subsidiary corporation 100% owned by an S corporation that has made a valid QSub election for that subsidiary. In addition to being 100% owned by an S corporation, a QSub must be a domestic corporation that otherwise meets the basic requirements to be an S corporation.

A QSub is technically neither a C corporation nor an S corporation. Instead, a QSub is not treated as a separate corporation for federal tax purposes (although it is still treated as a separate corporation for other purposes). A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the different types of reorganizations and the choices for an S Corporation to minimize taxes associated with reorganization.
- Apply the required tests to qualify for tax-free reorganizations.
- Recognize the rules for determining gains, losses and basis in an S corporation reorganization and how business credits can be recaptured.
- Identify the effects of the S status termination or when S status is retained when reorganization occurs, as well as the reporting requirements of reorganization.

S CORPORATIONS AND THE REORGANIZATION STATUTES

While S corporations are often viewed as being taxed in a manner similar to partnerships, the Code specifically applies C corporation tax concepts to the S corporation. The provisions of Subchapter C of the Code (governing corporate formations, reorganizations, redemptions, and liquidations, among other areas) are specifically applied to an S corporation and its shareholders, except to the extent inconsistent with other provisions in Subchapter S.

An S corporation may participate as a corporate entity in a corporate reorganization. This leads to a substantive advantage of S corporations over partnerships: S corporations and their shareholders have the ability to accomplish stock exchanges, corporate divisions, mergers, and the many other forms of transactions known as "tax-free reorganizations," whereas Subchapter K of the Code provides no such opportunity for partnerships.

S corporations are permitted to own up to 100% of the stock in a C corporation. However, an S corporation faces loss of its S status if any of its stock is owned by another corporation. Obviously, as part of many plans of reorganization, this situation will temporarily occur as newly formed corporations are being spun-off, exchanged, etc. The IRS has ruled that momentary control of a subsidiary or party to a merger as part of a liquidating or reorganizing transaction does not cause the termination of S status.

REORGANIZATION DEFINITIONS AND REQUIREMENTS

Tax-free Treatment

The various reorganizations are described in IRC Sec. 368. However, this section is definitional only; other portions of the Code provide the nonrecognition treatment for the parties to the reorganization.

In general, no gain or loss is recognized upon the exchange of corporate stock or securities, solely for stock or securities in the same or another corporation, pursuant to a plan of reorganization. Exceptions exist if corporate securities (for example, debt instruments) are used and the principal amount received does not match the principal amount surrendered, or if any of the stock, securities, or property received are attributable to accrued interest on corporate securities.

Recognizing Types of Reorganizations That Qualify for Tax-free Treatment

IRC Sec. 368 defines several different types of reorganizations and prescribes the form each type must take to qualify for tax-free treatment. These types of transactions can be divided into broad groups:

a. *Acquisitive Reorganizations.* Mergers/consolidations and stock exchanges leading to the acquisition or combination of corporations.

b. *Divisive Reorganizations.* Spin-offs, split-offs, and split-ups designed to divest a corporate business.

c. *Recapitalizations.* Reissuance of stock or securities within the same corporation.

d. *Title 11 Cases.* Transfers in Title 11 cases (bankruptcy and insolvency cases).

Recognizing Additional Requirements Imposed by the Courts and the IRS

Additional requirements for tax-free treatment have been added by the courts and the IRS as they have ruled on the tax consequences of reorganization transactions.

Additional Discussion

The statutory definitions for tax-free reorganizations are described below:

Acquisitive reorganizations (Types A, B, C, and D)

Divisive reorganizations (Type D)

Recapitalizations (Types E and F)

Transfers in Title 11 Cases (Type G)

Requesting an IRS Ruling

Corporations considering a reorganization transaction may want to obtain a ruling from the IRS that the proposed transaction qualifies as tax-free under IRC Secs. 351 and 368. While a ruling is not technically binding on the IRS, it does provide significant assurance that the transaction will be treated as a tax-free reorganization if it is actually completed in the form proposed. A ruling is a written statement, prepared by the IRS National Office at a taxpayer's request, interpreting and applying the tax laws to a specific set of facts.

The IRS has undertaken a new program that allows taxpayers to request rulings on one or more issues pertaining to a particular reorganization transaction rather than the entire transaction (Rev. Procs. 2009-25 and 2010-3). The revenue procedures allow taxpayers to make such requests if the issue:

a. is solely under the jurisdiction of the Associate Chief Counsel (Corporate).

b. is a significant issue [as defined in Rev. Proc. 2010-3, Sec. 3.01(38)], and

c. involves tax consequences or characterization of a transaction (or part of a transaction) that occurs in the context of a Section 355 distribution.

Under this program, taxpayers may request a ruling on part of a transaction rather than the larger transaction, or on a particular legal issue under a Code section or regulation. Thus, a ruling may be requested on one aspect of a transaction such as the continuation of business enterprise or continuity of interest requirements.

PLANNING REORGANIZATIONS—TYPE A, B, C, AND ACQUISITIVE D REORGANIZATIONS

Type A—Statutory Mergers and Consolidations

In a merger, one corporation dissolves into an existing corporation. In a consolidation, the corporations both dissolve into a newly formed third corporation.

Type A mergers can also take the form of a forward triangular merger or a reverse triangular merger. In a forward triangular merger, the target corporation is absorbed into a subsidiary of the parent corporation. The subsidiary then exchanges stock of the parent for the target's stock held by the shareholders of the target. In a reverse triangular merger, the subsidiary is absorbed by the target. The target then exchanges stock of the parent for the target's stock.

Tax Planning with Type A Reorganization. Tax planning opportunities with Type A reorganizations are discussed below:

1. Electing or retaining S status incidental to a Type A reorganization
2. Using a Type A merger to avoid built-in gains tax
3. Determining if boot received in a Type A merger has the effect of dividend

Type B—Stock-for-Stock Exchanges

Stock-for-stock exchanges occur when one corporation acquires 80% or more of the stock of another corporation in exchange solely for the voting stock of the acquiring corporation.

Type C—Stock-for-Asset Exchanges

Stock-for-asset exchanges occur when one corporation acquires substantially all the assets of another corporation in exchange for voting stock of the acquiring corporation, either exclusively or together with an assumption of liabilities of the acquired corporation. To a minor extent, cash or other property may also be distributed by the acquiring corporation (if, when combined with liabilities assumed, the cash or other property does not exceed 20% of the value of the assets acquired).

Acquisitive Type D Reorganization

Overview. An acquisitive Type D reorganization occurs with the transfer of assets to a controlled subsidiary in connection with a distribution of the stock and securities of the subsidiary to the transferor's shareholders. For purposes of an acquisitive Type D reorganization, control is defined as ownership of at least 50% (by vote and value) of the stock of the subsidiary.

Defining Control. In an acquisitive Type D reorganization, IRC Sec. 354 applies to the distribution of the controlled subsidiary's stock. Thus, control (50%) is determined under IRC Sec. 304(c) via IRC Sec. 368(a)(2)(H)(i).

Planning Uses. Acquisitive Type D reorganizations can be used to merge parents and subsidiaries. For example, an acquisitive Type D reorganization occurs when the parent has transferred substantially all its assets and must then be liquidated.

Meeting the Requirements for a D Reorganization Even Though No Stock Is Distributed

To qualify as a Type D reorganization, a corporation must transfer all or part of its assets to another corporation and, immediately after the transfer, the transferor corporation or one or more of its shareholders must be in control of the transferee corporation.

Normally, stock or securities of the transferee must be distributed under the reorganization plan. However, a transaction that otherwise meets the requirements of a Type D reorganization will be treated as satisfying the requirements of IRC Secs. 368(a)(1)(D) and 354(b)(1)(B) even though there is no actual issuance of stock or securities of the transferee corporation, provided the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions.

Example 3-1: D Reorganization in which no stock is distributed.

Andy owns all the stock of Target and Survivor. The Target stock has a fair market value of $100,000. Target sells all of its assets to Survivor in exchange for $100,000 cash and immediately liquidates. Because there is complete shareholder identity and proportionality of ownership in Target and Survivor, the requirements of IRC Secs. 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied even though no Survivor stock is issued. Survivor will be deemed to issue a nominal share of Survivor stock to Target in addition to the $100,000 of cash actually exchanged for the Target assets, and Target will be deemed to distribute all such consideration to Andy. The transaction qualifies as a reorganization described in IRC Sec. 368(a)(1)(D).

Preliminary Tax Planning Considerations for Acquisitive Reorganizations

In a taxable purchase and sale transaction, the seller often prefers a stock sale because it allows capital gain and installment sales treatment, while the buyer often prefers an asset purchase because it allows a fresh basis for depreciation purposes. However, in a tax-free acquisitive reorganization transaction, this primary consideration does not apply.

Initial Considerations. The initial planning consideration in a tax-free acquisitive reorganization is deciding whether to acquire the assets or stock of the target corporation. Considerations that apply in determining whether to acquire stock or assets in a reorganization include the following:

a. Does potential liability exist for unknown claims against the target? If so, acquisition of the target's assets may be the preferred approach.

b. Is the approval of a creditor or regulatory authority required prior to the transfer of the assets or stock?

c. Is it necessary or desirable to enable key personnel of the target to retain an equity interest in the target?

d. Does the acquiring S corporation want to acquire only one trade or business operated by the target? If so, acquisition of the assets that comprise that trade or business may be the simplest approach.

e. Does the target have loss and/or credit carryforwards? If so, it may be desirable to purchase stock and maintain the target as a separate entity, if such carryforwards can be used by the target.

Additional Considerations for Acquiring S Corporations. Two additional considerations apply to an S corporation (but not to a regular C corporation) that is the acquiring entity in a tax-free acquisitive reorganization.

Tax on Excess Net Passive Income or Termination of S Status May Be Triggered by Target's AE&P. Does the target have positive (or negative) accumulated earnings and profits (AE&P) since an acquisition of the target's assets will cause the S corporation to succeed to the target's AE&P? Positive AE&P can lead to liability for the corporate-level tax on excess net passive income and termination of the S election after three years. The target's negative AE&P will offset the parent's positive AE&P. Thus, if the target's negative AE&P equals or exceeds the parent's positive AE&P balance, the threat of taxation on excess net passive income and possible termination of the S election after three years will be eliminated.

Built-in Gains Tax on Target's Appreciated Assets. Does the target have appreciated assets? The disposition of such assets within a 10-year period will subject the acquiring S corporation to the built-in gains tax to the extent fair market value exceeds basis as of the date of the reorganization. However, if the target is an S corporation, the 10-year recognition period is reduced by the portion of the recognition period applicable to the target that expired prior to the reorganization.

Deciding Whether to Use a Type A or Type C Reorganization

Type A statutory mergers or consolidations and Type C reorganizations both involve the acquisition of the target's assets. Factors that favor use of a Type A reorganization include the following:

a. In a Type A reorganization, compliance is required only with applicable state law. This makes it less likely that the reorganization will be retroactively disqualified from tax-free status.

b. In a Type A reorganization, the assets pass by operation of law. This can simplify consummation of the transaction and reduce expenses for preparing and recording documents of conveyance.

Factors that favor use of a Type C reorganization include the following:

a. In a Type A reorganization, all state laws relating to the merger or consolidation must be complied with. Depending on their complexity, compliance with the various state laws can be costly and time consuming.

b. In a Type C reorganization, only those liabilities specifically assumed become the responsibility of the acquiring corporation. The acquiring corporation is generally not liable for unknown or contingent liabilities.

Maintaining a Subsidiary of the S Corporation

Overview. Several types of reorganizations (including Type B reorganizations and other reorganizations involving a subsidiary of the S corporation) require the parent S corporation to be in "control" of the subsidiary.

In addition, it may be desirable for the target to remain a subsidiary of the acquiring S corporation after the reorganization.

Defining Control. "Control" is defined as ownership of stock possessing at least 80% of the combined voting power of all outstanding voting stock and at least 80% of the shares of each class of nonvoting stock.

PLANNING TYPE D DIVISIVE REORGANIZATIONS

Divisive Type D Reorganizations

Overview. A divisive Type D reorganization has the same scenario as the acquisitive Type D discussed above, except only part of the parent's assets are transferred. Whether or not the parent is liquidated, the reorganization has divided the corporation into two or more corporations.

A divisive Type D reorganization can take the form of a *spin-off* (distribution of stock of a controlled corporation to the shareholders of the controlling corporation), a *split-off* (same as a spin-off, except the shareholders of the controlling corporation surrender stock in exchange for the stock of the controlled corporation), or a *split-up* (distribution of the stock of two or more controlled corporations as part of the complete liquidation of the controlling corporation).

Defining Control. For purposes of a divisive Type D reorganization, control is defined as ownership of at least 80% (by vote and value) of the subsidiary. In a divisive Type D reorganization, IRC Sec. 355 applies to the distribution of the controlled subsidiary's stock. Thus, control (80%) is determined under the general rule provided in IRC Sec. 368(c).

Examples—Spin-off, Split-off, and Split-up. In the following examples of Type D divisive reorganizations, assume that Corp. X operates a trucking business and a hazardous waste disposal business. Because of insurance concerns, the board of directors decides to operate the two businesses separately.

Example 3-2: Understanding a spin-off.

In a spin-off, Corp. Y is formed and the hazardous waste disposal business is transferred to it in exchange for all of its stock. Corp. X then transfers the Y stock prorata to its shareholders.

Example 3-3: Understanding a split-off.

In a split-off, Corp. Y is formed and the hazardous waste disposal business is transferred to it in exchange for all of its stock. Corp. X then transfers the Y stock on a prorata or nonprorata basis to some or all of its shareholders in exchange for part or all of their X stock.

Example 3-4: Understanding a split-up.

In a split-up, Corp. Y is formed and the hazardous waste disposal business is transferred to it in exchange for all of its stock. In addition, Z is formed and the trucking business is transferred to it in exchange for all of its stock. The Y and Z stock is distributed to the Corp. X shareholders on either a prorata or nonprorata basis, and X is liquidated.

Tax Planning with Type D Reorganizations. Tax planning opportunities with divisive Type D reorganizations are discussed below:

1. Splitting an existing corporation into two entities to achieve an ownership objective as well as to qualify for fiscal year reporting by one of those entities
2. Determining if boot received in a divisive Type D reorganization has the effect of a dividend
3. Facilitating the development of natural resource property, avoiding double taxation, and minimizing liability for built-in gains tax

Deciding Which Form of Divisive Reorganization to Use

The same basic requirements apply whether a divisive Type D reorganization is structured as a spin-off, split-off, or split-up. However, when deciding what form of corporate division to undertake, two considerations may be relevant.

Purpose of the Division. First, the purpose of the division should be considered.

Example 3-5: Considering the purpose of a divisive reorganization.

Disputes, Inc., is an S corporation that has 12 shareholders who currently disagree on the corporation's management. The shareholders also recognize the need to inject a substantial amount of capital in the near future to maintain the competitive advantages that several of the corporation's business units currently enjoy. The shareholders are contemplating a divisive reorganization to resolve the shareholder disputes and facilitate the corporation's financing needs.

Although a corporate division can be used to resolve shareholder discord, a spin-off should not be used in this situation because it will result in prorata ownership of the distributing and new corporations by the existing shareholders. In contrast, a split-off does not require a prorata distribution of stock and thus can result in one shareholder owning most or all of the controlling (original) S corporation and the other shareholder(s) owning most or all of the newly formed company.

Taxation of Boot. Second, the taxation of boot should be considered. While only stock of the controlling S corporation can be distributed tax free, other property (boot) can be distributed without jeopardizing the tax-free treatment of the stock distribution.

When Stock Is Not Surrendered. When the shareholder does not surrender stock held in the controlling (original) S corporation (a spin-off), the distribution of the boot is normally taxed under IRC Sec. 301. Since IRC Sec. 1368 applies to S corporation distributions otherwise governed by IRC Sec. 301(c), it appears that the normal S corporation distribution rules govern the taxation of the boot.

When Stock Is Surrendered. When the shareholder surrenders stock held in the controlling (original) S corporation (a split-off or split-up), gain realized in the exchange is recognized to the extent of the boot received. The boot is treated as the receipt of a taxable dividend to the extent of the recipient shareholder's prorata share of the controlling corporation's undistributed earnings and profits. Since the boot distribution is taxed under IRC Sec. 356(a) and not under IRC Sec. 301, it is uncertain whether IRC Sec. 356(a) applies, or whether the Section 1368 S corporation distribution rules apply:

a. If the controlling S corporation has no accumulated earnings and profits (AE&P), the result to the recipient shareholder would be the same.

b. If the controlling S corporation has AE&P, the result to the recipient shareholder under IRC Secs. 356(a)(2) and 1368 may differ, depending on the amount, if any, of the controlling corporation's accumulated adjustments account (AAA).

Applying the Anti-Morris Trust Rules

A corporation that owns 80% or more of the stock of a subsidiary corporation generally may distribute the stock of the controlled corporation to its (the distributing corporation's) shareholders without having to recognize gain on the distribution. This nonrecognition-of-gain rule applies when the distribution is made under a divisive Type D reorganization plan. It also applies when the distribution is not part of a reorganization plan. To curtail perceived abuse of this rule, IRC Sec. 355(e) requires the distributing corporation to recognize gain on certain distributions of stock of a controlled corporation.

The distributing corporation must recognize gain under IRC Sec. 355(e) if pursuant to a plan, one or more unrelated shareholders directly or indirectly acquire 50% or more of the value or voting power of either the distributing or the controlled corporation in the distribution. The distribution and acquisition of 50% or more of the value or voting power do not have to occur at the same time. A plan is presumed to exist, and IRC Sec. 355(e) is presumed to apply to the distribution if the unrelated shareholders acquire the requisite 50% or more interest at any time within two years before or after the distribution. The gain recognition presumption can be overcome by showing that the distribution and the acquisition of 50% or more of the value or voting power are not pursuant to a plan or series of related transactions.

The determination of whether a distribution and an acquisition are part of a plan is based on all the facts and circumstances. Two nonexclusive lists of facts and circumstances apply in assessing whether an acquisition and a distribution are part of a plan. One list of factors tends to demonstrate that a distribution and an acquisition are part of a plan. The other list tends to demonstrate that a distribution and an acquisition are not part of a plan. However, a distribution and an acquisition are not considered to be part of a plan if they are described in one of several safe harbors.

The following examples illustrate the Section 355(e) rules:

Example 3-6: Acquisition of a 50% or more interest in the distributing corporation.

Esco is a calendar year S corporation that owns all the stock of Subco. Esco is owned by five individuals. In September of the current year, Esco distributes all of Subco's stock to the five Esco shareholders. Esco's basis in the Subco stock is $100,000, and the stock is worth $500,000 when it is distributed. In November, Esco merges into Ceeco in a Type A reorganization. In the merger, each Esco shareholder exchanges his Esco stock and receives 8% (determined immediately after the merger) of the stock of Ceeco. The five Esco shareholders receive 40% of the value and voting power of Ceeco and are treated as retaining a 40% interest in Esco, and the original Ceeco shareholders are treated as receiving the remaining 60% of Esco. Thus, the Ceeco shareholders have acquired a 50% or more interest in Esco.

If Esco can prove that the distribution and the merger are independent transactions, Esco will not recognize gain on the distribution of Subco stock. If the distribution and the merger are pursuant to a reorganization plan, Esco will have to recognize $400,000 ($500,000 − $100,000) of gain on the distribution. If Esco must recognize the gain, it passes through to the five original Esco shareholders under the normal S corporation pass-through and stock basis adjustment rules. [The Committee Reports to TRA '97 (Act Sec. 1012) state that the gain is recognized immediately before the distribution. They also state that Congress did not intend to place any limitation on the pass-through and stock basis adjustment rules of IRC Sec. 1367.]

Example 3-7: Acquisition of less than a 50% interest in the distributing corporation.

Assume the same facts as in Example 3-6, except the five original Esco shareholders each receive 11% (determined immediately after the merger) of the stock of Ceeco. The five Esco shareholders receive 55% of the value and voting power of Ceeco and are treated as retaining a 55% interest in Esco, and the original Ceeco shareholders are treated as receiving the remaining 45% of Esco. Thus, the Ceeco shareholders have acquired only a 45% interest in Esco. IRC Sec. 355(e) does not apply and Esco will not have to recognize gain under IRC Sec. 355(e).

Example 3-8: No change in interest owned.

Assume the same facts as in Example 3-6, except the original five Esco shareholders also own 100% of the stock of Ceeco. The five shareholders own 100% of both Esco and Ceeco both before and after the merger, thus no unrelated shareholders have acquired a 50% or more interest in either Ceeco or Esco. IRC Sec. 355(e) does not apply, so Esco will not have to recognize gain on the distribution of Subco stock.

RECAPITALIZATIONS—TYPES E AND F

Type E—Recapitalization of a Single Corporation

Recapitalizations involve the issuance of either new stock or new debt in exchange for former stock or debt of the same corporation. For C corporations, this also includes the issuance of preferred stock for common stock. Because of the single-class-of-stock requirement, recapitalization opportunities are more limited for S corporations, although they are available.

Type F—Changes in Identity, Form, or Place of Organization

This includes mere changes in the identity, form, or place of organization of a corporation.

TRANSFERS IN TITLE 11 (BANKRUPTCY OR INSOLVENCY) CASES—TYPE G

A Type G reorganization occurs in a Title 11 or similar case (a federal bankruptcy case, or a receivership or foreclosure action in state or federal court). The corporation must transfer all or part of its assets to an acquiring corporation, and the transfer must be pursuant to a plan of reorganization approved by the court. Transfers to a corporation in bankruptcy, as well as transfers from a corporation in bankruptcy, can qualify. The rules discussed later in this course concerning the carryover of tax attributes generally apply. However, the Section 382 limitation on the amount of income that can be offset by loss carryovers applies to certain Type G reorganizations.

Regulations provide guidance regarding when and to what extent creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of shareholder interest (COSI—see later in lesson) is preserved in a reorganization.

The regulations provide that, in certain circumstances, stock received by creditors may count for COSI purposes in bankruptcy and insolvency cases. The regulations provide that the value of a proprietary interest in the target corporation represented by a senior claim is determined by multiplying the fair market value of the creditor's claim by a fraction. The numerator of the fraction is the aggregate fair market value of the proprietary interests in the issuing corporation received in exchange for the senior claims, and the denominator is the aggregate sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in exchange for such claims. In contrast, the value of the proprietary interest in the target corporation represented by a junior claim is the fair market value of the junior claim.

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 is correct regarding S corporations?

   a. S corporations have the same advantages as partnerships in relation to transactions for "tax-free reorganizations."

   b. During a reorganization, if an S corporation is not 100% owed by a C corporation, the corporations will lose their S status.

   c. The tax concepts of a C corporation are applied to an S corporation during a reorganization.

2. Big Time Corporation is starting to reorganize due to a spin-off of the original corporation. The corporation is not going to reissue any stock to stockholders and the spin-off is going to be its own corporation. What type of reorganization is Big Time's reorganization classified as by IRC Sec. 368?

   a. Recapitalization.

   b. Title 11 Cases.

   c. Acquisitive Reorganization.

   d. Divisive Reorganization.

3. Lehman Corporation is the parent corporation of Davis Corporation. Due to business waning, Lehman has decided to merge the Davis Corporation back into the parent and provide Davis Corporation stockholders with a 1 for 1 exchange of their Davis stock for Lehman stock. What type of reorganization would this be categorized as?

   a. Type A.

   b. Type B.

   c. Type C.

   d. Type D.

4. Which of the following would be an example of a divisive Type D reorganization split-up?

   a. The stockholders of the controlling corporation relinquish stock in exchange for stock of the controlled corporation.

   b. Voting stock is exchanged for substantially all the assets of another corporation, along with an assumption of the liabilities of the acquired company.

   c. All stock of a controlled corporation is distributed to the shareholders of the controlling corporation.

   d. The stock of two or more controlled corporations is distributed as part of the complete liquidation of the controlling corporation.

5. When a corporation is trying to decide on a reorganization plan, many factors should be considered. One of those factors is the taxation of boot. Which of the following is correct regarding boot in a reorganization plan?

   a. S corporations have special rules concerning the taxation of boot when a stockholder does not surrender stock in the controlling S corporation.

   b. A shareholder must recognize a gain to the extent of boot received when the reorganization is a split-off or a split-up of an S corporation.

   c. If any boot is distributed when the stock is distributed in the reorganization, the distribution can no longer be tax-free.

   d. It does not have an effect on the taxability of the boot if a controlling S corporation has accumulated earnings and profits in a reorganization.

6. Hartman Industries, an S corporation, has decided that they are going to have to declare bankruptcy and reorganize the business. Hartman's parent company, Barrow Enterprises, will be acquiring Hartman after the reorganization. Which of the following is correct about Hartman and the reorganization?

   a. Any stock given to creditors by Hartman does not count for continuity of shareholder interest purposes for the bankruptcy.

   b. If a creditor has a junior claim against Hartman, the value is represented in the bankruptcy the same as a senior claim.

   c. Hartman must transfer all of its assets to Barrow after the reorganization is completed.

   d. In senior credit claims against Hartman, the value is determined by multiplying the fair market value of the claim by a fraction.

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 is correct regarding S corporations? **(Page 148)**

   a. S corporations have the same advantages as partnerships in relation to transactions for "tax-free reorganizations." [This answer is incorrect. S corporations have substantial advantages over partnerships when it comes to transactions known as "tax-free reorganizations." S corporations and their shareholders have the ability to accomplish stock exchanges, corporate divisions, mergers and the many other forms of transactions known as "tax-free organizations," whereas Subchapter K of the Code provides no such opportunity for partnerships.]

   b. During a reorganization, if an S corporation is not 100% owed by a C corporation, the corporations will lose their S status. [This answer is incorrect. S corporations are permitted to own up to 100% of the stock in a C corporation. However, an S corporation faces loss of its S status if any of its stock is owned by another corporation. But, as part of many plans of reorganization, this situation will temporarily occur as newly formed corporations are being spun-off, exchanged, etc., so the IRS has ruled that momentary control of a subsidiary or party to a merger as part of a liquidating or reorganizing transaction does not cause the termination of S status.]

   c. The tax concepts of a C corporation are applied to an S corporation during a reorganization. [This answer is correct. While S corporations are often viewed as being taxed in a manner similar to partnerships, the Code specifically applies C corporation tax concepts to the S corporation when governing corporation formations, reorganizations, redemptions and liquidations as stated in IRC Sec. 1371(a).]

2. Big Time Corporation is starting to reorganize due to a spin-off of the original corporation. The corporation is not going to reissue any stock to stockholders and the spin-off is going to be its own corporation. What type of reorganization is Big Time's reorganization classified as by IRC Sec. 368? **(Page 148)**

   a. Recapitalization. [This answer is incorrect. According to the definitions included in IRC Sec. 368, a recapitalization includes the reissuance of stock or securities. Since Big Time is not going to reissue any stock associated with the reorganization, it is not categorized as a recapitalization.]

   b. Title 11 Cases. [This answer is incorrect. Title 11 cases are reorganizations due to bankruptcy or insolvency cases. This is not the situation for Big Time Corporation.]

   c. Acquisitive Reorganization. [This answer is incorrect. Per IRC Sec. 368, an acquisitive reorganization occurs when there are mergers/consolidations and stock exchanges due to an acquisition or combination of corporations. Big Time did not acquire or merger with any other corporation.]

   d. Divisive Reorganization. [This answer is correct. According to IRC Sec. 368, a divisive reorganization includes spin-offs, split-offs and split-ups designed to divest a corporation business. Since Big Time is reorganizing due to a spin-off, it would be classified as a divisive reorganization.]

3. Lehman Corporation is the parent corporation of Davis Corporation. Due to business waning, Lehman has decided to merge the Davis Corporation back into the parent and provide Davis Corporation stockholders with a 1 for 1 exchange of their Davis stock for Lehman stock. What type of reorganization would this be categorized as? **(Page 149)**

   a. Type A. [This answer is correct. Type A reorganizations are statutory mergers and consolidations. This would be classified as a reverse triangular merger under a Type A reorganization since the subsidiary is absorbed by the parent organization and then the parent exchanges the stock of the parent for the absorbed corporation's stock.]

   b. Type B. [This answer is incorrect. A Type B reorganization is a stock-for-stock exchange. It occurs when one corporation acquires 80% or more of the stock of another corporation, in exchange solely for the voting stock of the acquiring corporation as defined in IRC Sec. 368(a)(1)(B) and (C).]

   c. Type C. [This answer is incorrect. A stock-for-asset exchange is a Type C reorganization. This occurs when one corporation acquires substantially all the assets of another corporation in exchange for the voting stock of the acquiring corporation, either exclusively or together with an assumption of liabilities of the acquired corporation.]

   d. Type D. [This answer is incorrect. An acquisitive Type D reorganization occurs with the transfer of assets to a controlled subsidiary in connection with a distribution of the stock and securities of the subsidiary to the transferor's shareholders, as described in IRC Sec. 368(a)(1)(D).]

4. Which of the following would be an example of a divisive Type D reorganization split-up? **(Page 152)**

   a. The stockholders of the controlling corporation relinquish stock in exchange for stock of the controlled corporation. [This answer is incorrect. This is identified as a split-off for a divisive Type D reorganization as defined in the IRS Code.]

   b. Voting stock is exchanged for substantially all the assets of another corporation, along with an assumption of the liabilities of the acquired company. [This answer is incorrect. This would be classified as a Type C stock-for-asset exchange, not a Type D reorganization.]

   c. All stock of a controlled corporation is distributed to the shareholders of the controlling corporation. [This answer is incorrect. This is the definition of a spin-off for a divisive Type D reorganization as classified in the IRS Code.]

   d. The stock of two or more controlled corporations is distributed as part of the complete liquidation of the controlling corporation. [This answer is correct. The definition of a split-up for a divisive Type D reorganization is when one corporation completely liquidates the stock of two or more controlled corporations and the controlled corporations are completely liquidated at the end of the reorganization as stated in the IRS Code.]

5. When a corporation is trying to decide on a reorganization plan, many factors should be considered. One of those factors is the taxation of boot. Which of the following is correct regarding boot in a reorganization plan? **(Page 153)**

   a. S corporations have special rules concerning the taxation of boot when a stockholder does not surrender stock in the controlling S corporation. [This answer is incorrect. When the shareholder does not surrender stock held in the controlling (original) S corporation (a spin-off), the distribution of the boot is normally taxed under IRC Sec. 301. Since IRC Sec. 1368 applies to S corporation distributions otherwise governed by IRC Sec. 301(c), it appears that the normal S corporation distribution rules govern the taxation of the boot.]

   b. A shareholder must recognize a gain to the extent of boot received when the reorganization is a split-off or a split-up of an S corporation. [This answer is correct. According to IRC Sec. 356(a)(2), when the shareholder surrenders stock held in the controlling S corporation (a split-off or split-up), gain realized in the exchange is recognized to the extent of the boot received.]

c. If any boot is distributed when the stock is distributed in the reorganization, the distribution can no longer be tax-free. [This answer is incorrect. According to IRC Sec. 355(a)(4)(A) and 368(a)(1)(B), boot can be distributed without jeopardizing the tax-free treatment of the stock distribution.]

d. It does not have an effect on the taxability of the boot if a controlling S corporation has accumulated earnings and profits in a reorganization. [This answer is incorrect. If the controlling S corporation has AE&P, the result to the recipient shareholder under IRC Sec. 356(a)(2) and 1368 may differ, depending on the amount, if any of the controlling corporation's accumulated adjustment account. So tax treatment would be different based on the AE&P of the corporation.]

6. Hartman Industries, an S corporation, has decided that they are going to have to declare bankruptcy and reorganize the business. Hartman's parent company, Barrow Enterprises, will be acquiring Hartman after the reorganization. Which of the following is correct about Hartman and the reorganization? **(Page 155)**

a. Any stock given to creditors by Hartman does not count for continuity of shareholder interest purposes for the bankruptcy. [This answer is incorrect. Final regulations issued by the IRS provide that, in certain circumstances, stock received by creditors may count for continuity of shareholder interest (COSI) purposes in bankruptcy and insolvency cases.]

b. If a creditor has a junior claim against Hartman, the value is represented in the bankruptcy the same as a senior claim. [This answer is incorrect. For creditors, the value of the proprietary interest in the target corporation represented by the junior claim is the fair market value of the junior claim. This is different than the value of a senior claim in the bankruptcy.]

c. Hartman must transfer all of its assets to Barrow after the reorganization is completed. [This answer is incorrect. Hartman Industries must transfer all or part of its assets to Barrow Enterprises. The transfer must be pursuant to a plan of reorganization and approved by the bankruptcy court as stated in IRC Sec. 368(a)(1)(G).]

d. In senior credit claims against Hartman, the value is determined by multiplying the fair market value of the claim by a fraction. [This answer is correct. The value of a senior claim by a creditor in the bankruptcy is determined by multiplying the fair market value of the creditor's claim by a fraction. The numerator of the fraction is the aggregate fair market value of the proprietary interests in the issuing corporation received in exchange for the senior claims, and the denominator is the aggregate sum of the amount of money and the fair market value of all other consideration received in exchange for such claims.]

ADDITIONAL REORGANIZATION REQUIREMENTS

Identifying the Additional General Requirements

Beyond the statutory definitions of each type of reorganization, the courts and Treasury regulations over the years have added the following additional criteria governing reorganizations:

a. continuity of business enterprise,

b. continuity of shareholder interest, and

c. business purpose.

Continuity of Business Enterprise (COBE). Under this general rule, the acquiring corporation must either continue the acquired corporation's historic business (business continuity test) or use a significant portion of the acquired corporation's historic business assets in a business (asset continuity test).

Business Continuity. Business continuity is satisfied if the target corporation's most recent business is continued. If the target has operated more than one line of business, it is only necessary that a significant line is continued. The determination whether a line of business is "significant" depends on all facts and circumstances. The regulations provide an example in which a target corporation with three lines of business disposes of two lines prior to transferring the remaining line in a stock-for-assets reorganization. The remaining line of business is "significant" because it is equal in value to the two lines of business that were sold.

Asset Continuity. The alternative test, asset continuity, is met if the acquiring corporation uses a significant portion of the target corporation's business assets. Once again, the regulations do not define the term "significant," but adopt a facts-and-circumstances approach based on the relative importance of the assets to the operation of the business. An example in the regulations suggests that this test will be liberally applied: the target corporation, which manufactures components for computers, is merged into the acquiring corporation, which manufactures computers. However, the acquiring corporation continues to buy its computer components from a foreign source and retains the target's manufacturing equipment as a backup. The use of the target's assets as a backup supply source is considered significant asset continuity.

Under the COBE rules, the acquiring corporation is treated as holding all the businesses and assets of the members of a qualified group. A qualified group is defined as a chain of corporations connected through stock ownership, but only if the acquiring corporation directly meets the 80% control requirement in at least one other corporation, and stock meeting the 80% control requirement in each of the other corporations (other than the acquiring corporation) is owned directly by one of the other corporations. In addition, under prescribed conditions, transfers of target assets to partnerships will be permitted. The regulations provide examples to illustrate the COBE rules. In one example, a corporation acquires an auto parts dealership via a merger and then transfers the assets of the dealership to its subsidiaries. This transaction satisfies the COBE requirement. In another example, a corporation acquires all the assets of a ski boot manufacturer in a merger and transfers the assets of the manufacturer to its subsidiary, which then (acting in its capacity as a managing partner) transfers the assets to a partnership. This transaction also satisfies the COBE requirement.

Continuity of Shareholder Interest (COSI). A cornerstone of the reorganization provisions is that the shareholders of an acquired or transferor corporation retain a continuing equity interest in the transferee or acquiring corporation. Not all shareholders of the acquired entity must retain ownership, and the percentage of ownership and length of time to retain a substantial equity position are not well defined.

COSI for Advance Ruling Purposes. For advance ruling purposes, the IRS has traditionally required the former shareholders of the acquired corporation to receive stock of the acquiring corporation equal in value to at least 50% of the value of the former corporation's equity. However, the preamble to Reg. 1.368-1(e)(1)(ii) states that Rev. Procs. 77-37 and 86-42 do not apply to the extent they are inconsistent with the regulation.

The IRS has effectively lowered this requirement to 40%. [See Temp. Reg. 1.368-1T(e)(2)(v), Exs. 1 and 5, and the preambles to T.D. 9225 and T.D. 9316. Although the three-year term for the temporary regulation expired on March

19, 2010, IRS Notice 2010-25 provides interim guidance that allows taxpayers to apply the rules set out in identical proposed regulations as long as all the parties to the transaction elect to apply them. See the notice for details.]

Preserving a Substantial Part of the Value of the Proprietary Interests. For transactions (other than Type D reorganizations), the COSI requirement is satisfied if a substantial part of the value of the proprietary interests in the target corporation is preserved in the reorganization.

When a Proprietary Interest Is Preserved. In a reorganization, a proprietary interest in the target is preserved if:

a. it is exchanged for a proprietary interest in the acquiring corporation (e.g, a Type B stock-for-stock reorganization, or a Type C stock-for-assets reorganization),

b. it is exchanged by the acquiring corporation for a direct interest in the target (e.g., a Type C forward or reverse reorganization), or

c. it otherwise continues as a proprietary interest in the target (e.g., a Type A merger or consolidation).

When a Proprietary Interest Is Not Preserved. A proprietary interest in the target is not preserved if, in connection with a potential reorganization:

a. it is acquired by the acquiring corporation for consideration other than stock of the acquiring corporation, or

b. stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed.

Facts and Circumstances. All facts and circumstances are considered in determining whether a proprietary interest in the target corporation is preserved. A mere disposition of stock of the target prior to a reorganization to a corporation not related to either the target corporation or acquiring corporation is disregarded. Furthermore, a mere disposition of stock of the acquiring corporation received in a reorganization to a corporation not related to the acquiring corporation is disregarded. Corporations generally are considered related if they are members of the same affiliated group under IRC Sec. 1504 or the purchase of stock of one corporation by another corporation would be treated as a redemption under IRC Sec. 304(a)(2).

Business Purpose Test. A reorganization must have a real and substantial corporate business purpose other than the avoidance of tax. Personal nontax motives of the shareholders for the reorganization, such as splitting a corporation in two to allow separate control, generally will not satisfy this test. IRS regulations indicate that use of a reorganization to accomplish a federal S election is not by itself a sufficient business reason to qualify a divisive reorganization under the business-purpose test. However, if a reduction in state tax by reason of an S election exceeds the federal tax savings, the IRS will approve a business purpose. Also, another valid business purpose may qualify the reorganization, even if a subsequent S election is also made.

In requiring a corporate business purpose for a distribution of the stock of a controlled corporation, the regulations provide that approval will not be given if the business purpose can be accomplished through another nontaxable transaction that does not involve the distribution of stock of a controlled corporation. (On the other hand, the regulations imply that the additional step of distributing the stock of the controlled corporation may be allowed if the alternative is "impractical" or "unduly expensive.")

Example 3-9: Business purpose for a distribution of stock not met.

Problem Solvers, Inc., is an S corporation that manufactures household cleaning products as well as industrial solvents. The shareholders are concerned about product liability issues related to the solvents business and the impact a product liability lawsuit might have on their unblemished household products brand. Consequently, the shareholders would like to protect the household cleaning business by transferring the solvents business to a newly formed subsidiary corporation.

A corporation engaged in the manufacture of two different products may wish to protect one business from the risks and volatility of the second business. Accordingly, Problem Solvers could transfer the industrial

solvents business to a newly created subsidiary to accomplish this protection. A subsequent distribution of the stock of the controlled corporation would not be allowed because it would be beyond the corporate business purpose of simply segregating the businesses in two separate corporations.

Meeting the Net Value Requirement. In March 2005, the IRS issued proposed regulations that will add an additional requirement for a tax-free reorganization. The new requirement is that a transfer of net value take place. If the proposed regulations become final, this new requirement will be in addition to the other requirements that include continuity of business enterprise and continuity of shareholder interest. The net value requirement will not apply to Types E and F reorganizations, nor will it apply to certain Type D reorganizations.

The purpose of the net value requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss under the tax-free reorganization provisions. An exchange of net value requires both a surrender of net value and a receipt of net value. A corporation determines whether there is a surrender of net value by reference to the assets and liabilities of the acquired corporation. A corporation determines whether there is a receipt of net value by reference to the assets and liabilities of the acquiring corporation.

Further Requirements for Divisive Reorganizations

In addition to the COBE, COSI, and business purpose restrictions, the following four restrictions also apply to divisive reorganizations:

a. device restriction,

b. five-year history,

c. principal tax avoidance purpose, and

d. disqualified IRC Sec. 355 distributions.

Device Restriction. The transaction may not be used principally as a device to bail out earnings and profits of either the controlled corporation or the distributing corporation.

Reg. 1.355-2(d) provides extensive guidance as to facts and circumstances that indicate evidence of such a device to bail out earnings and profits. Possible evidence of a device includes:

a. a distribution of the controlled corporation stock that is prorata to the shareholders of the distributing corporation,

b. a distribution followed by a sale or exchange of the stock of the distributing or controlled corporation, and

c. the existence of cash or other liquid assets of the controlled corporation not used in a qualifying business.

Specifically, the regulation identifies any sale or exchange of the controlled corporation negotiated before the distribution as substantial evidence of a device to distribute earnings and profits. Conversely, evidence of a significant business purpose can overcome the potential taint of "device" factors.

Five-year History. With respect to divisive reorganizations, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a business (or be a holding company for an active corporation), with the trade or business having been actively conducted throughout the five-year period ending on the date of the distribution. The five-year active history requirement can be met by tacking on a predecessor's business history, as would occur in the case of a proprietorship or partnership that incorporates in a tax-deferred Section 351 transaction. However, there is no exception for a trade or business that has been in existence less than five years.

Example 3-10: Conducting an active trade or business through a partnership.

For more than five years, Distributors, Inc. has owned all the stock of Controlled, Inc. and a 20% interest in LP, a limited partnership that owns several commercial office buildings that it leases to unrelated third parties.

Distributor's officers perform active and substantial management functions with respect to LP, including the significant business decision-making of the partnership, and regularly participate in the supervision and control of LP's employees in operating LP's rental business.

For valid business reasons, Distributors wants to distribute all the stock of Controlled to its (Distributor's) shareholders, but is concerned about satisfying the active trade or business requirement through its 20% partnership interest in LP.

Under these facts, Distributors is considered to be engaged in the active conduct of a trade or business within the meaning of IRC Sec. 355(b) and may distribute the stock of Controlled tax-free to its shareholders.

Example 3-11: Conducting an active trade or business through an LLC.

Chord, Inc. and Camber, Inc. each own 20% interests in a member-managed LLC that is classified as a partnership for federal tax purposes. Chord and Camber jointly manage the LLC's business. Under these facts, both corporations are considered to be engaged in the active conduct of a trade or business.

Corporate Partner. A corporate partner in a partnership that engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation can be considered to be engaged in the active conduct of a trade or business for purposes of IRC Sec. 355(b) if the corporation's partnership interest is considered significant. For this purpose, a 33$^1/_3$% or greater partnership interest is considered significant, while a 20% or less partnership interest is not considered significant.

Example 3-12: Treating a significant partnership interest as the conduct of an active trade or business.

Distributors, Inc. owns all the stock of Controlled, Inc. and is one of three equal members of LLC, a limited liability company that owns several commercial office buildings leased to unrelated third parties.

Pursuant to the terms of its leases, LLC provides day-to-day upkeep and maintenance services for its office buildings. These services include trash collection, ground maintenance, electrical and plumbing repair, and insect control. Additionally, LLC advertises for new tenants, verifies information contained in lease applications, negotiates leases, handles tenant complaints, prepares eviction notices and warnings for delinquent tenants, collects rent, and pays all expenses, including gas, water, sewage, electricity and insurance for the office buildings. LLC also maintains financial and accounting records to reflect income and expenses relating to each of its rental properties as well as LLC's general expenses. Distributors does not otherwise participate in the activities of LLC.

For valid business reasons, Distributors wants to distribute all the stock of Controlled to its (Distributor's) shareholders, but is concerned about satisfying the active trade or business requirement through its 33$^1/_3$% interest in LLC.

Under these facts, Distributors is considered to be engaged in the active conduct of a trade or business for purposes of IRC Sec. 355(b) because it owns a significant interest in LLC, which performs the required activities that constitute an active trade or business.

Variation: Assume the same facts, except Distributors owns a 20% membership interest in LLC (rather than a 33$^1/_3$% interest). Under these revised facts, Distributors interest in LLC is not considered significant, so Distributors is not considered to be engaged in the active conduct of a trade or business for purposes of IRC Sec. 355(b).

Affiliated Group. Special rules apply to affiliated groups when determining whether the group meets the active trade or business requirement. All members of the distributing corporation's separate affiliated group are treated as one corporation. Similarly, all members of the controlled corporation's separate affiliated group are treated as one corporation. In essence, the distributing corporation satisfies the holding company requirement if it or any of the members of its separate affiliated group conduct an active trade or business. Similarly, the controlled corporation meets the requirement if it or any members of its affiliated group conduct an active trade or business.

Securities, Land, and Rental Activities. For purposes of the active trade or business requirement, the holding of securities or land or the operation of a rental activity is not considered the conduct of an active trade or business. However, a partner or LLC member who performs management functions may be treated as engaged in the active conduct of a trade or business.

Principal Tax Avoidance Purpose. This requirement is satisfied if either all the stock and securities of the controlled corporation is distributed, or at least 80% is distributed in a plan not having a principal tax avoidance purpose.

Disqualified Section 355 Distributions. Generally, a distributing corporation will not recognize gain or loss on the distribution of appreciated stock of a controlled (80% owned) corporation.

Nevertheless, the distributing corporation will recognize gain in an otherwise tax-free transaction on a "disqualified distribution" of stock or securities in a controlled corporation. A disqualified distribution is one in which the recipient, after the distribution, holds "disqualified stock" that represents a 50% or greater interest in either the distributing or controlled corporation. Disqualified stock generally is stock acquired by purchase after October 9, 1990, and within the five-year period ending on the date of the distribution.

An S corporation undergoing a divisive reorganization may be required to recognize income under IRC Sec. 355(d). The S corporation will have a basis in the controlled corporation's stock equal to its basis in the assets transferred to the controlled corporation. If the FMV of the controlled corporation stock that is distributed exceeds this basis, the S corporation will recognize gain.

Example 3-13: S corporation undergoing a divisive reorganization required to recognize income under IRC Sec. 355(d).

Two years ago, Tom Jones bought 25% of the outstanding stock of Parent Corp., an S corporation. On August 30 of the current year, because of conflict among the shareholders, Parent distributes assets that represent a separate trade or business to newly formed Sub Corp. in exchange for all of Sub's stock. Parent then distributes all of the Sub stock to Tom in exchange for his Parent stock. Since Tom holds "disqualified stock" that represents a 50% or greater interest in Sub, the distribution is a disqualified distribution. Parent will recognize gain, if any, on its distribution of the Sub stock to Tom. Presumably, any gain recognized by the S corporation will pass through prorata to the shareholders under the normal S corporation pass-through rules.

While there is no authority on point, if the S corporation is subject to the built-in gains tax of IRC Sec. 1374, the recognition of gain under IRC Sec. 355(d) may also be subject to the built-in gains tax.

Avoiding the Step Transaction Doctrine

The step transaction doctrine presents a final obstacle to achieving a tax-free (tax-deferred) reorganization.

Avoiding the Estate Freeze Rules

In addition to ensuring the reorganization qualifies for tax-deferred treatment and does not unintentionally terminate the company's S election, the reorganization may also have to comply with the special valuation rules of IRC Sec. 2701.

THE STEP TRANSACTION DOCTRINE

The step transaction doctrine presents a final obstacle to achieving a tax-free (tax-deferred) reorganization. Under this judicially developed doctrine, a series of formally separate steps will be treated as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Under the doctrine, a series of formally separate steps may be "stepped together" or "collapsed" and treated as if they constitute a single integrated transaction.

The courts have applied the following three tests to a wide variety of transactions to determine if the step transaction doctrine should apply:

a. binding commitment test,

b. mutual interdependence test, and

c. end result test.

Binding Commitment Test

Under the binding commitment test, a series of formally separate transactions will be stepped together or collapsed if, when the first step is taken, there is a binding commitment to take the later steps. Under this test, a court must make an objective determination as to whether the acquired shareholders are bound by an obligation to sell the shares received in an acquisition. Other factors, such as intent by the shareholders to sell their shares, are not considered (*Gordon*, 391 U.S. 83, at 96).

Mutual Interdependence Test

Under the mutual interdependence test, a series of formally separate transactions will be stepped together or collapsed if they "are so interdependent that the legal relations created by one transaction would be fruitless without a completion of the series" (*Penrod*, 88 TC 1415, at 1430, quoting *Redding*; see also *American Bantam Car Co.*) This test concentrates on the relationship between the steps, not the end result.

End Result Test

Under the end result test, a series of formally separate transactions will be stepped together or collapsed if they appear to be "really prearranged parts of a single transaction intended from the outset to reach the ultimate result" (*Penrod*, 88 TC 1415, at 1429). In contrast to the binding commitment test, the end result test is flexible and bases tax consequences on the real substance of the transactions, not on the formalisms chosen by the participants.

Step Transaction Doctrine Can Apply to the Deemed Liquidation of a QSub

The step transaction doctrine can apply to the deemed liquidation of a subsidiary when a QSub election is filed and to the deemed Section 351 transfer when a QSub election terminates.

THE ESTATE FREEZE SPECIAL VALUATION RULES

Rules on Valuing Retained Interests

In addition to ensuring the reorganization qualifies for tax-deferred treatment and does not unintentionally terminate the company's S election, the reorganization may also have to comply with the special valuation rules of IRC Sec. 2701. Under these rules, upon the transfer of stock to a "member of the transferor's family," most rights retained by the transferor will be valued at zero for estate and gift tax purposes. It should be noted that the word "transfer" can, under certain circumstances, include a recapitalization or other change in the capital structure of the corporation.

Example 3-14: Applying the special valuation rules of Section 2701.

Sam is the sole shareholder of an S corporation with one class of voting common stock that has a FMV of $100,000. The corporation is recapitalized to create a class of voting preferred stock and a class of nonvoting common stock (thus terminating S status). Sam transfers the common stock to his daughter Mattie, and, for gift tax purposes, assigns a $65,000 value to the retained preferred stock and a $35,000 value to the transferred common stock. If IRC Sec. 2701 applies, the preferred stock is valued at zero, and the gift of the common stock is valued at $100,000 instead of $35,000.

Using the Exceptions to the Special Valuation Rules

Two exceptions to the special valuation rules of IRC Sec. 2701 can apply to reorganizations or recapitalizations involving S corporations. The first involves the issuance or exchange of common stock only. The second involves no shift in ownership among the family group.

Exception for Common Stock. IRC Sec. 2701 does not apply if the retained interest is of the same class as the transferred interest, or if the retained interest is proportionately the same as the transferred interest, except for nonlapsing differences in voting power. Therefore, the special valuation rules do not apply to a transfer of common stock when the transferor retains common stock. In addition, the rules do not apply to a transfer of nonvoting common stock when the transferor retains voting common stock (and vice versa).

If the shareholders intend to retain S status (which means that only voting and nonvoting common stock will be issued and/or exchanged), a Section 2701 issue should not occur because an S corporation can have only one class of stock, which can include both voting and nonvoting stock. (See, for example, Ltr. Ruls. 200026011 and 200026012.) But, if S status is terminated, such as if preferred stock is involved or the issued and/or exchanged stock has differing distribution or liquidation rights, this exception will not apply.

Example 3-15: Same class of stock exception.

Helen is the sole shareholder of an S corporation that has one class of voting common stock and a FMV of $100,000. The corporation is recapitalized to create a new class of nonvoting common stock, which possesses the same distribution and liquidation rights as the outstanding voting stock. Helen exchanges part of her voting stock for the nonvoting stock and gives the nonvoting stock to her son, Ben. IRC Sec. 2701 does not apply because of the "same-class-of-stock" exception. If Helen assigns a value of $60,000 to the retained voting stock, the value of the transferred nonvoting stock for gift tax purposes is $40,000.

Exception for Family Ownership. A safe harbor exists for a transfer in which the transferor and certain designated family members own substantially identical interests before and after the transfer.

The scope of this safe harbor exception hinges on the definition of the phrase "substantially identical." While the Section 2701 regulations add that "common stock with nonlapsing voting rights and nonvoting common stock are interests that are substantially the same," this is simply a restatement of the exception for common stock. Since preferred stock and common stock evidently are not considered to be substantially the same, it appears that this safe harbor exception does not provide the S shareholder with any benefit not already provided by the "same-class-of-stock" exception.

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 would be considered business continuity, as opposed to asset continuity?

    a. Black Screen Manufacturers, manufacturers flat-screen TVs. They acquire Screen Pieces, Inc., a company that makes the parts for flat-screen TVs. Black Screen continues to buy their TV components from a foreign source, but keep Screen Pieces components as a backup supply source.

    b. Venus, a car manufacturer, makes three brands of cars: Pluto, Uranus and Jupiter. The sales of Jupiter are more than the other two lines combined. Venus decides to spin-off Pluto and Uranus to be their own companies, but keeps Jupiter as part of Venus.

8. In which of the following scenarios is the business purpose test met for a reorganization by the corporation?

    a. Pony Products decides to reorganize and spin-off one of their subsidiaries. The shareholders of the new company will receive stock in Pony Products. There are other ways for this to be accomplished in a nontaxable transaction.

    b. Johnson & Lavin, Inc. is owned by two owners. They have decided to reorganize and split the company in half to allow each of them to have separate control of their part, because they do not have an amicable working relationship.

    c. Hillside Selections, Inc. has decided to reorganize as an S corporation to reduce their state tax, since it previously exceeded their federal tax savings.

    d. The president of Family Resource Industries has decided to reorganize the company to change its status from a C corporation and elect a federal S status.

9. Regency Industries owns all the stock of Crowned Price, Inc. In addition, Regency is one of three equal partners in Lord Landcruisers, a LLC company that leases commercial trucks to unrelated third parties. As part of the lease, Lord Landcruisers provides maintenance on all the trucks. This includes oil changes, gas fill-up each night, any repairs and weekly washing of the trucks. In addition, Lord Landcruisers advertises for new lessees, verifies information in lease applications, negotiates new leases collects lease payments and pays expenses for the company. Lord Landcruisers maintain their own financial and accounting records. Regency does not participate in the activities of Lord Landcruisers. Can Regency distribute all the stock of Crowned Price to its shareholders tax-free?

    a. Yes.

    b. No.

10. When applying the step transaction doctrine to achieve a tax-free reorganization, in which of the following tests is the end result flexible?

    a. Mutual independence test.

    b. End result test.

    c. Binding commitment test.

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 would be considered business continuity, as opposed to asset continuity? **(Page 162)**

   a. Black Screen Manufacturers, manufacturers flat-screen TVs. They acquire Screen Pieces, Inc., a company that makes the parts for flat-screen TVs. Black Screen continues to buy their TV components from a foreign source, but keep Screen Pieces components as a backup supply source. [This answer is incorrect. This is an example of asset continuity, not business continuity. This test is met if the acquiring corporation uses a significant portion of the target corporation's business assets as stated in Reg. 1.368-1(d)(3).]

   b. Venus, a car manufacturer, makes three brands of cars: Pluto, Uranus and Jupiter. The sales of Jupiter are more than the other two lines combined. Venus decides to spin-off Pluto and Uranus to be their own companies, but keeps Jupiter as part of Venus. [This answer is correct. Business continuity is satisfied if the target corporation's most recent business is continued. If the target has operated more than one line of business, it is only necessary that the significant line is continued. A "significant" line can be defined as one that is equal in value to the two other lines of business, if there are three, so Venus has maintained their most significant line of business in the reorganization.]

8. In which of the following scenarios is the business purpose test met for a reorganization by the corporation? **(Page 163)**

   a. Pony Products decides to reorganize and spin-off one of their subsidiaries. The shareholders of the new company will receive stock in Pony Products. There are other ways for this to be accomplished in a nontaxable transaction. [This answer is incorrect. Reg. 1.355-2(b), in requiring a corporate business purpose for a distribution of the stock of a controlled corporation, provides that approval will not be given if the business purpose can be accomplished through another nontaxable transaction that does not involve the distribution of stock of a controlled corporation.]

   b. Johnson & Lavin, Inc. is owned by two owners. They have decided to reorganize and split the company in half to allow each of them to have separate control of their part, because they do not have an amicable working relationship. [This answer is incorrect. A reorganization must have a real and substantial corporate business purpose, as stated in the IRS regulations. Personal nontax motives of the shareholders for the reorganization, such as splitting a corporation in two to allow separate control, generally will not satisfy the business purpose test.]

   c. Hillside Selections, Inc. has decided to reorganize as an S corporation to reduce their state tax, since it previously exceeded their federal tax savings. [This answer is correct. A reorganization must have a real and substantial corporate business purpose other than the avoidance of tax per the IRS regulations. However, if a reduction in state tax by reason of an S election exceeds the federal tax savings, the IRS will approve a business purpose.]

   d. The president of Family Resource Industries has decided to reorganize the company to change its status from a C corporation and elect a federal S status. [This answer is incorrect. IRS regulations indicate that use of a reorganization to accomplish a federal S election is not by itself a sufficient business reason to qualify a divisive reorganization under the business-purpose test.]

9. Regency Industries owns all the stock of Crowned Price, Inc. In addition, Regency is one of three equal partners in Lord Landcruisers, a LLC company that leases commercial trucks to unrelated third parties. As part of the lease, Lord Landcruisers provides maintenance on all the trucks. This includes oil changes, gas fill-up each night, any repairs and weekly washing of the trucks. In addition, Lord Landcruisers advertises for new lessees, verifies information in lease applications, negotiates new leases collects lease payments and pays expenses for the company. Lord Landcruisers maintain their own financial and accounting records. Regency does not participate in the activities of Lord Landcruisers. Can Regency distribute all the stock of Crowned Price to its shareholders tax-free? **(Page 165)**

   a. Yes. [This answer is correct. Crowned Price's interest in Lord Landcruisers is deemed to be significant since the interest is 33 1/3%, therefore, Crowned Price is considered to be engaged in the active conduct of trade or business for the purposes of IRC Sec. 355(b) and Regency would be able to distribute the stock tax-free to its shareholders.]

   b. No. [This answer is incorrect. A corporate partner in a partnership that engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation can be considered to be engaged in the active conduct of a trade or business for purposes of IRC Sec. 355(b). Since Crowned Price is involved in the management functions of Lord Landcruises, it may be treated as engaged in the active conduct of a trade or business and distributions of stock are tax-free to its shareholders.]

10. When applying the step transaction doctrine to achieve a tax-free reorganization, in which of the following tests is the end result flexible? **(Page 167)**

   a. Mutual independence test. [This answer is incorrect. Under the mutual independence test, a series of formally separate transactions will be stepped together or collapsed if they are "so interdependent that the legal relations created by one transaction would be fruitless without a completion of the series" (Penrod, 88 TC 1415, at 1430, quoting Redding). This test concentrates on the relationship between the steps, not the end result.]

   b. End result test. [This answer is correct. Under the end result test, a series of formally separate transactions will be stepped together or collapsed if they appear to be "really prearranged parts of a single transaction intended from the outset to reach the ultimate result" (Penrod, 88 TC 1415, at 1429). The end result test is flexible and bases tax consequences on the real substance of the transactions, not on the formalisms chosen by the participants.]

   c. Binding commitment test. [This answer is incorrect. Under the binding commitment test, a series of formally separate transactions will be stepped together or collapsed if, when the first step is taken, there is a binding commitment to take the later steps. Under this test, a court must make an objective determination as to whether the acquired shareholders are bound by obligation to sell the share received in an acquisition.]

THE EFFECTS OF A REORGANIZATION ON AN S CORPORATION

Tax Consequences to Shareholders

Gain or Loss. In general, if the exchange is pursuant to a plan of reorganization, the shareholders do not recognize gain or loss when stock or securities of a corporation are exchanged solely for stock or securities in the same or another corporation. If the shareholder also receives money or other property (boot), the shareholder recognizes gain to the extent of the money and FMV of other property received.

Basis. The shareholder's basis in the stock or securities received depends on whether the shareholder receives boot. If the shareholder does not receive boot, the basis of stock or securities received is the same as the basis of the stock or securities given up.

Boot. If the shareholder receives boot, the basis of stock or securities received is increased by the amount of gain recognized and decreased by the FMV of the boot. The shareholder's basis in boot received is its FMV.

Holding Period. The holding period of the stock received includes the holding period of the stock given up. The holding period of boot received begins on the date it is received.

Allocating Basis. Depending on the nature of the transaction, it may be difficult to determine the basis of stock or securities received in exchange for stock and/or securities. Particularly troublesome are exchanges of stock and/or securities acquired on different dates.

Reg. 1.358-2 provides rules for the determination of the basis of each share of stock or security received in reorganization transactions involving:

- exchanges of stock and securities,
- distributions of stock or securities of a controlled corporation, or
- the receipt of boot.

Generally speaking, each share of stock or security received in an exchange has the same basis as each share of stock or security that is exchanged. However, when a shareholder or security holder cannot identify which particular share or security was exchanged for another particular share or security, the shareholder can designate a particular share or security, as long as the designation is consistent with the terms of the exchange or distribution. If the terms of the exchange do not specify which shares or securities are received in the exchange, a prorata portion of the shares and/or securities received is treated as received in the exchange, based on the relative fair market value of stock and/or securities surrendered.

Example 3-16: Designating basis for shares received in a reorganization.

Jim acquired 20 shares of Essco Corporation stock on January 1, 2009, for $3 each (the "first block"), and 10 shares of Essco stock on January 1, 2010, for $6 each (the "second block").

On March 31, 2010, Jim holds a total of 30 shares of Essco stock. On that date, Wesco Corporation acquires the assets of Essco in a Type A merger. Under the terms of the plan of reorganization, Jim receives two shares of Wesco stock in exchange for each share of Essco stock. Accordingly, Jim receives 60 shares of Wesco and recognizes no gain or loss on the exchange under IRC Sec. 354. However, because Jim is unable to identify which shares of Wesco stock he received in exchange for each of his shares of Essco stock, he must apply the allocation rules under Reg. 1.358-2.

Under Reg. 1.358-2(a)(2)(i), the first block has 40 shares of Wesco stock [60 Wesco shares received × (20 Essco shares ÷ 30 Essco shares)]. Each Wesco share in this block has a basis of $1.50 [(20 Essco shares × $3) ÷ 40 Wesco shares] and is treated as having been acquired on January 1, 2009.

Similarly, the second block has 20 shares of Wesco stock [60 Wesco shares received × (10 Essco shares ÷ 30 Essco shares)]. Each Wesco share in this block has a basis of $3 [(10 Essco shares × $6) ÷ 20 Wesco shares] and is treated as having been acquired on January 1, 2010.

Jim is allowed to designate which of the shares of Wesco stock have a basis of $1.50 and which have a basis of $3 under Reg. 1.358-2(a)(2)(vii), on or before the date on which the basis of a share of Wesco stock received becomes relevant (e.g., the date Jim decides to sell the Wesco shares or the date Jim must first compute stock basis under the normal S corporation basis adjustment rules).

Deducting Suspended S Corporation Pass-through Losses

An S shareholder's pass-through deductions and losses are limited to the sum of the shareholder's adjusted basis in the S corporation stock and direct loans to the S corporation. Losses and deductions that exceed the basis of stock and debt are suspended as carryover items in the hands of the shareholder and may be used in following years to the extent of increased taxpayer basis in stock and direct loans to the corporation.

If S status terminates in a reorganization, a one-year post-termination transition period allows a shareholder to restore basis in stock (but not debt) to permit the deduction of otherwise unusable suspended loss.

Although suspended S corporation pass-through losses are not identified by IRC Sec. 381 in the list of attributes that carry over in a reorganization, Reg. 1.1366-2(c) confirms that pass-through losses carryover in corporate reorganizations.

In addition, suspended pass-through losses are technically not corporate attributes, but rather are suspended at the shareholder level and are more properly attributes of the individual S shareholder.

Example 3-17: Deducting suspended losses if the S corporation is the acquiring or surviving S corporation.

If the S corporation is the acquiring (or surviving) corporation, and the corporation's S election is not terminated by the reorganization, the shareholders' suspended losses are unaffected by the reorganization.

Example 3-18: Deducting suspended losses if the S corporation is the target S corporation.

If the S corporation is the target and ceases to exist, the treatment of the target shareholders' suspended losses depends on whether the acquiring corporation is an S or C corporation. If it is an S corporation, the target shareholders who surrender their stock in exchange for stock in the acquiring corporation are entitled to allocate their suspended losses to the stock received.

The IRS has ruled that following a merger of an S corporation into a surviving C corporation in which a shareholder has historic stock basis, the shareholder can deduct suspended losses incurred as a shareholder of the S corporation and otherwise limited by stock basis in the nonsurviving S corporation.

Example 3-19: Deducting suspended loss following the merger of an S corporation.

Essco, an S corporation, merges into Ceeco, a C corporation, in a Type A merger. Prior to the merger, Angela owns stock in Essco with a basis of zero and stock in Ceeco with a basis of $100,000. She has $150,000 of S corporation pass-through losses suspended due to basis at the time of the merger. After the merger, Angela has two blocks of stock in Ceeco, the stock received in the merger with a basis of zero, and her historic Ceeco stock, with a basis of $100,000. Angela makes no contributions to, and receives no distributions from, Ceeco with respect to the Ceeco stock during the post-termination transition period (PTTP).

Angela is permitted to deduct $100,000 of the $150,000 suspended losses as a result of her historic basis in the Ceeco stock. The remaining $50,000 of suspended losses will be permanently disallowed. Angela is required to reduce her basis in Ceeco stock to zero ($100,000 − $100,000) for the losses deducted during the PTTP.

Handling Boot in S Corporation Reorganizations

When boot distributions are made by an S corporation as part of a reorganization transaction, the question arises as to whether the boot is taxable under the reorganization rules or under the general S distribution rules. IRC Sec.

356 indicates that gain is recognized to the extent boot is distributed as part of a reorganization (limited to the shareholder's realized gain). Conversely, IRC Sec. 1368 allows an S shareholder to receive a tax-free distribution to the extent of stock basis. While there is no clear resolution to this question, in addressing the coordination between Subchapter C rules and Subchapter S rules, IRC Sec. 1371(a) indicates that the Subchapter S provisions override the Subchapter C provisions when inconsistencies arise. Characterization of the distribution by the corporation as a payment from the accumulated adjustments account (AAA) would be preferable to characterization as boot paid in the reorganization.

The characterization of payments to S shareholders as a Section 1368 distribution, as opposed to boot, can be particularly critical in certain types of reorganizations. For example, a Type B stock-for-stock reorganization qualifies for nonrecognition only if the acquisition is solely for the stock of the acquiring entity, and a Type C reorganization qualifies for nonrecognition only if at least 80% of the FMV of the assets of the target entity is acquired with stock (rather than boot).

Carrying Over Corporate Tax Attributes

One of the more attractive aspects of a tax-free reorganization with C corporations is the ability of the acquiring corporation to succeed to the unused loss and credit carryovers of the corporation whose assets are acquired (Type A, C, D, F or G reorganizations). However, if the acquiring corporation is an S corporation, it is unable to use these credits and losses during any year in which it maintains its S status.

Such suspended credits and losses, however, become available if the acquiring corporation later converts to C status, or if it is liable for the built-in gains tax due to the disposition of assets obtained from the acquired corporation.

Similarly, a C corporation might convert to S status as a result of a recapitalization or reorganization and find itself prohibited from using its credit and loss carryovers during an S year. Years during which a corporation is in S status are treated as elapsed years in counting the number of years of C corporation tax benefit carryforward.

Carrying Over AAA, AE&P, and PTI

AE&P. In addition to the carryover of tax attributes for acquisitive reorganizations, the accumulated earnings and profits (AE&P) of the acquired entity also will carry over.

If the acquiring entity continues under S status, the newly acquired AE&P taint may adversely affect the taxation of future distributions or may subject the S corporation to the tax on passive gross receipts under IRC Sec. 1375.

AAA. It also appears that the accumulated adjustments account (AAA) of an acquired S corporation that is merged or liquidated out of existence in a reorganization should carry over to the acquiring entity. Per IRC Sec. 1368, the AAA is clearly a corporate account (rather than a shareholder account), and carryover status would be consistent with the statutory scheme applying to AE&P and other tax attributes. In letter rulings and regulations issued under IRC Sec. 1368, the IRS has stated that AAA is merged together in the case of an acquisitive reorganization involving two S corporations (although the regulations exclude Type B stock-for-stock exchanges from this rule). However, AAA is equitably allocated upon the separation of an S corporation into two or more corporations pursuant to a divisive reorganization (Ltr. Ruls. 8918080 and 8946052).

PTI. For corporations that were S corporations for their last tax year beginning before 1983, the shareholders may have pre-1983 previously taxed income (known as the shareholders' PTI account) that has never been distributed. PTI may be distributed tax free to the S shareholders, assuming the distribution is in money (rather than property) and occurs after distribution of AAA. The IRS has ruled that the merger of two S corporations does not terminate the shareholder's PTI accounts; instead, the combined PTI of the merged corporations carries over to the surviving corporation. However, if the S election terminates, a distribution of PTI can no longer be made.

Recapturing Business Credits

General Business Credits. General business credits can be subject to recapture because of the reorganization or recapitalization of an S corporation. IRC Sec. 38 lists the general business credits.

The low-income housing credit (LIHC) and the investment tax credit (ITC), which includes the credit for rehabilitation expenditures (RIC) and the energy credit, are typical of the credits included in general business credit. The following discussion of these credits illustrates the typical credit recapture planning concepts encountered in corporate reorganizations.

The LIHC and the RIC may be subject to recapture at the S shareholder level. (However, the corporation rather than the shareholder is subject to recapture if the S corporation previously was a C corporation and claimed the credit while in C status.)

Low-income Housing Credit. The LIHC authorized by IRC Sec. 42 is a business tax credit for residential rental property that qualifies as low-income housing under detailed statutory criteria. Unlike other credits, the LIHC is claimed over a 10-year period. However, compliance with the statutory criteria must be maintained over an extended 15-year "compliance period."

All or part of the LIHC is subject to recapture at the end of any tax year during the compliance period if the taxpayer's qualified basis in the building is less than such basis at the end of the preceding tax year. Committee Reports to IRC Sec. 42 state that "any change in ownership of a building subject to [i.e., during] the compliance period is also a recapture event."

A special rule applies to recapture events after July 30, 2008. Under the special rule, no credit recapture is necessary if it is reasonably expected that the building will continue to be operated as qualified low-income housing for the remainder of the compliance period. The trade-off for this exception to recapture is that the statute of limitations will not expire until three years from the date the Secretary is notified by the taxpayer of the reduction in qualified basis.

For recapture events before July 31, 2008, recapture is avoided if the shareholder furnishes a bond or pledges Treasury securities, in an amount and for the period required by the IRS, provided the property can reasonably be expected to be operated as a qualified low-income building during the remainder of the compliance period. The mechanics of the bond procedure are outlined in Rev. Rul. 90-60. The procedure for pledging Treasury securities is provided in Rev. Proc. 99-11. Under Rev. Proc. 2008-60, taxpayers can elect to have the special rule of IRC Sec. 42(j)(6) apply to dispositions before July 31, 2008.

Rehabilitation Investment Credit. The RIC authorized by IRC Sec. 47 can also be passed through from the S corporation. The RIC, along with the energy credit authorized by IRC Sec. 48, are included in the current investment tax credit (ITC). The RIC can be claimed for expenses incurred to rehabilitate certain older buildings or certified historic structures.

While the following discussion focuses on the RIC, the same rules apply to the energy credit.

The RIC will be recaptured if the property is disposed of or ceases to be used in a qualifying manner. The amount of recapture is reduced 20% for each year the property is held, so recapture is zero once the property has been held for five years.

Recapture Rules. IRC Sec. 50(a) generally requires credit recapture when there is an early disposition of investment credit property. However, IRC Sec. 50(a)(4) provides two exceptions to the recapture rule:

a. A transaction to which IRC Sec. 381(a) (relating to carryovers in certain corporate acquisitions) applies.

b. A "mere change in the form of conducting the business," if the investment credit property is retained by the successor corporation, and the shareholders retain a substantial interest in the successor corporation.

How Corporate Reorganizations Affect Credit Recapture. A corporate reorganization, because of its tax-free nature and carryover attributes, generally does not trigger credit recapture. But, recapture can occur in an acquisitive reorganization if there is a large enough reduction in the shareholder's proportionate stock ownership through expansion of the shareholder group (which can occur whether the S corporation is the acquiring or acquired entity).

Reg. 1.47-4(a)(2) provides that a reduction in stock ownership triggers recapture when the shareholder's interest falls below two-thirds, and then one-third, of what it was in the year the S corporation placed the ITC property in service. However, one district court has held that an S shareholder did not have to recapture ITC following the merger of an S corporation into a C corporation. The carryover provisions of IRC Sec. 381(a) applied (even though there was no carryover of tax attributes) because the merger qualified as a nontaxable reorganization; thus, former IRC Sec. 47(b) [the predecessor to IRC Sec. 50(a)(4)] prevented recapture.

The amount of recapture is determined by the actual percentage reduction in stock ownership. Thus, even though the transfer of the corporate assets is a nonrecapture event in a Type A merger or Type C assets-for-stock acquisition, the expansion of the shareholder group and the consequent reduction in the shareholder interest through the issuance of new shares of stock can be cause for S shareholder RIC recapture.

While acquisitive reorganizations generally do not trigger ITC recapture, divisive reorganizations under IRC Sec. 368(a)(1)(D) can result in recapture. The IRS has ruled that recapture occurs at the first event within the series of divisive reorganization steps even though completion of the reorganization does not occur until a later year (Rev. Rul. 89-18).

Example 3-20: Timing of ITC recapture in a divisive reorganization.

On May 1, 2010, Handorf, Inc. announced a plan to transfer the assets of one of its divisions to Anderson Corp., a newly formed corporation, in exchange for Anderson stock, and then transfer the stock to Handorf's shareholders. While the asset transfer took place on December 31, 2010, Handorf did not distribute the Anderson stock to its shareholders until February 1, 2011.

ITC recapture occurs in the year assets constituting a separate business are transferred to a newly formed subsidiary, even if the stock of the subsidiary is not distributed to shareholders of the parent corporation until the following year.

The courts have held that the general Section 381 tax attribute carryover rules applying to reorganizations do not otherwise prevent the imposition of recapture in a divisive reorganization (*Baicker*).

Loss of S Status—Transitory Subsidiary Exception for Momentary Control

An S corporation faces loss of its S status if any of its stock is owned by another corporation. Obviously, as part of many plans of reorganization, this situation will temporarily occur as newly formed corporations are being spun-off, exchanged, etc. The IRS has ruled that momentary control of a subsidiary or party to a merger as part of a liquidating or reorganizing transaction does not cause the termination of S status.

LIFO Recapture

A C corporation that elects S status while using the LIFO inventory method must recognize as income the excess of the inventory's FIFO value over its LIFO value at the end of the last C corporation year. The resulting increase in tax is payable in four equal installments beginning with the final C return.

The LIFO recapture tax applies in the last tax year a LIFO-method corporation is taxed as a C corporation before it elects S status. The tax also applies in the year of transfer if a LIFO-method C corporation transfers its inventory to an S corporation in a tax-free reorganization.

However, the IRS has ruled that a Type D vertical division of an S corporation will not trigger LIFO recapture. In the ruling, a parent S corporation formed a controlled subsidiary corporation that immediately elected S status. The parent (distributing) S corporation then transferred part of its assets, including LIFO inventory, to the controlled subsidiary corporation. Immediately after the transfer, the parent (distributing) S corporation distributed all of the controlled corporation's stock to the parent (distributing) S corporation's sole shareholder. The parent (distributing) S corporation was not subject to the LIFO recapture rules because it was an S corporation rather than a C corporation. The controlled corporation was not subject to the LIFO recapture rules because it had elected to be an S corporation beginning with its first year of existence.

Ability to File Consolidated Returns

As S corporations participate in corporate reorganizations, they may hold the stock of subsidiary corporations as either C corporations or as QSubs. The C corporation subsidiaries of an S corporation may qualify to file consolidated returns.

Affiliated Groups Can File Consolidated Returns. Certain parent-subsidiary controlled groups may elect to file consolidated returns if they also meet the definition of an affiliated group (IRC Sec. 1501). Ownership of 80% or more of the stock of a corporation establishes an "affiliated group" relationship.

While S corporations are permitted to hold up to 100% of the stock of a corporation, an S corporation parent cannot be included as a member of an affiliated group for federal tax purposes. Thus, only the S corporation's subsidiary C corporations can be included in the affiliated group. The S corporation and its QSubs, if any, cannot be included in the affiliated group.

Advantages of Filing a Consolidated Return for C Corporation Subsidiaries. Filing a consolidated return for the affiliated C corporation subsidiaries can result in substantial tax savings because only one federal tax return need be filed for the affiliated group's members. Some of the major advantages of filing a consolidated return may include the following:

- Income on intercompany transactions may be deferred.
- The ordinary and capital losses of one affiliated corporation may be used to offset the income and gains of another affiliated corporation.
- Increased ability to use carryovers and carrybacks by offsetting them against consolidated income.
- Certain credits of one member in excess of the applicable limitations on that individual member can be used by the consolidated group (e.g., foreign tax credit in excess of the foreign tax credit limitation).
- An increased charitable contribution limitation because the group's income as a whole is considered when calculating the limitation on charitable contributions.

Inclusion as a Member of a Controlled Group

Proposed regulations would provide that an S corporation is a member of a controlled group if the controlled group rules for qualification and stock ownership are met.

If the proposed regulations become final, apportionment of the Section 179 deduction will be required if the S corporation is a member of a controlled group, using the 50% stock ownership test. The proposed regulations are scheduled to become effective for tax years beginning on or after the date they are published as final regulations in the *Federal Register*. (See Example 5-33.)

USING REORGANIZATIONS TO MEET S CORPORATION ELIGIBILITY

A corporate reorganization can realign a corporation to qualify it as a corporation eligible for electing or maintaining S status.

Examples of using the reorganization provisions to secure the corporation's eligibility include:

a. Using a Type D divisive reorganization so a specific business activity is within a separate corporation that is eligible for the S election (such as by removing an ineligible shareholder, or reducing the total number of shareholders). However, a valid business purpose other than electing S status must be demonstrated.

b. Recapitalizing a single corporation (Type E) to eliminate nonqualifying debt or a second class of stock.

The exchange of new stock for debt (or debt for debt) qualifies as a Type E recapitalization if the debt meets the Section 354 definition of a "security." This rule may create a problem for an exchange involving unwritten or "open account" debt. Furthermore, the S corporation eligibility rules limit the planning opportunities when using a Type E recapitalization, as follows:

a. *Stock-for-stock Exchange.* Because of the single-class-of-stock requirement, this technique is limited to exchanges of voting and nonvoting common stock (that otherwise have identical distribution and liquidation rights).

b. *Debt-for-stock Exchange.* Stock issued for the debt must not run afoul of the single-class-of-stock rule.

c. *Debt-for-debt Exchange.* This type of exchange may be useful if the shareholder wants the newly issued debt to come within the "straight-debt" rules of IRC Sec. 1361(c)(5) to prevent the new debt from being treated as a second class of stock.

A reorganization or recapitalization may also be useful in restructuring the debt and equity instruments of an S corporation to avoid traps associated with debt instruments having reduced basis (if the tax basis of the debt in the hands of the individual holder has been reduced by prior S corporation losses). Examples of these situations include:

a. Swapping debt for stock in a reorganization (Type E) to avoid interest income on the debt and taxable gain on debt principal repayment.

b. Swapping old debt for new debt in a recapitalization (Type E) to convert an open account debt into a written instrument qualifying for capital gain upon repayment (assuming the old debt qualifies as a "security" under IRC Sec. 354).

SELF-STUDY QUIZ

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

11. Carson Creations, Inc., an S corporation has decided to reorganize the company. Shareholders were issued new stock as part of the reorganization, plus cash. The exchange of stock was done before the reorganization. Which of the following is true regarding the reorganization?

    a. The shareholders basis in Carson Creations does not change.

    b. The holding period of the stock and boot includes the holding period of the stock given up.

    c. Since the shareholders received boot, they recognize a gain to the extent of boot received.

    d. The shareholder's basis in the boot received is equal to the gain realized on the boot.

12. Which of the following is correct regarding the credit for rehabilitation expenditures (RIC)?

    a. An acquisitive reorganization can trigger a RIC (as part of the investment tax credit) recapture.

    b. The RIC is included in the investment tax credit and can be utilized by an S corporation.

    c. Recapture is triggered for the RIC when a small percentage of stock ownership is changed.

    d. The credit is claimed over 10 years.

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. Carson Creations, Inc., an S corporation has decided to reorganize the company. Shareholders were issued new stock as part of the reorganization, plus cash. The exchange of stock was done before the reorganization. Which of the following is true regarding the reorganization? **(Page 172)**

    a. The shareholders basis in Carson Creations does not change. [This answer is incorrect. Since the shareholders received boot, the basis of stock or securities received is increased by the amount of gain recognized and decreased by the FMV of the boot as stated in IRC Sec. 358(a).]

    b. The holding period of the stock and boot includes the holding period of the stock given up. [This answer is incorrect. The holding period of the stock received includes the holding period of the stock given up according to IRC Sec. 1223(1), but the holding period of the boot received begins on the date it is received.]

    c. Since the shareholders received boot, they recognize a gain to the extent of boot received. [This answer is correct. If the exchange is pursuant to a plan of reorganization, the shareholders do not recognize a gain or loss when stock or securities of a corporation are exchanged solely for stock or securities in the same or another corporation. If the shareholder also receives money or other property (boot), the shareholder recognizes gain to the extent of the money and FMV of other property received per IRC Sec. 356.]

    d. The shareholder's basis in the boot received is equal to the gain realized on the boot. [This answer is incorrect. If the shareholder receives boot, the basis of stock or securities received is increased by the amount of gain recognized and decreased by the FMV of the boot according to IRC Sec. 358(a). The shareholder's basis in boot received is its FMV, not the gain realized on the boot.]

12. Which of the following is correct regarding the credit for rehabilitation expenditures (RIC)? **(Page 175)**

    a. An acquisitive reorganization can trigger a RIC (as part of the investment tax credit) recapture. [This answer is incorrect. While acquisitive reorganizations generally do not trigger ITC recapture, divisive reorganizations under IRC Sec. 368(a)(1)(D) can result in recapture.]

    b. The RIC is included in the investment tax credit and can be utilized by an S corporation. [This answer is correct. The RIC authorized by IRC Sec. 47 can also be passed through from the S corporation. The RIC, along with the energy credit authorized by IRC Sec. 48, are included in the current investment tax credit (ITC).]

    c. Recapture is triggered for the RIC when a small percentage of stock ownership is changed. [This answer is incorrect. A corporate reorganization, because of its tax-free nature and carryover attributes, generally does not trigger credit recapture. However, recapture can occur in an acquisitive reorganization if there is a large enough reduction in the shareholder's proportionate stock ownership through expansion of the shareholder group (which can occur whether the S corporation is the acquiring or acquired entity).]

    d. The credit is claimed over 10 years. [This answer is incorrect. The amount of the recapture is reduced by 20% for each year the property is held, so recapture is zero once the property has been held for five years according to IRC Sec. 50(a)(1).]

PLANNING FOR AN S ELECTION AFTER REORGANIZATION

Assuming that a corporation in existence after a reorganization is otherwise an eligible or qualifying entity, an S election following the reorganization would be a possibility. However, IRC Sec. 1362(g) imposes a five-year waiting period if either the corporation or a predecessor has terminated S status. Under this rule, a corporation (and any successor corporation) is not eligible to make an S election for any tax year before the fifth tax year that begins after the first year for which the termination was effective, unless the IRS consents to an earlier election. In some instances (such as when two former S corporations are consolidated in a Type A reorganization), the IRS has waived the five-year waiting period.

WHEN TERMINATION OF S STATUS OCCURS IN A REORGANIZATION

Acquisitive Reorganizations (Types A, B, and C)

An S election can terminate in an acquisitive reorganization in the following ways:

a. *Type A Reorganization.* If the S corporation is merged or consolidated out of existence in a Type A reorganization, its S status will cease. If the S corporation is the acquiring corporation, it can lose S status by exceeding the maximum shareholder limitation, adding an ineligible shareholder, or absorbing a corporation with outstanding stock or debt that constitutes a prohibited second class of stock. Furthermore, it can acquire assets (or earnings and profits) from the target corporation that leads to excess net passive investment income and termination of S status after three consecutive years.

b. *Type B Reorganization.* If the S corporation is the acquired corporation in a Type B stock-for-stock reorganization, it loses its S status because it has a corporate shareholder or because it goes out of existence in a subsequent liquidation.

c. *Type C Reorganization.* If the S corporation is the acquiring corporation in a Type C reorganization, it can lose its S status because of the existence of a corporate shareholder. However, this risk can be avoided if the stock is transferred to the shareholders of the target corporation. As an alternative, it can liquidate the target in which case the "transitory subsidiary" exception should protect its S election. Other risks include gaining an ineligible shareholder, exceeding the shareholder limitation, assuming nonqualifying debt, or acquiring assets (or earnings and profits) from the target that lead to excess net passive investment income and termination of S status after three consecutive years. If the S corporation is the acquired corporation, it generally will be liquidated following the reorganization although the IRS has the authority to waive this requirement. If it remains in existence but transfers away its operating assets, its remaining assets may generate sufficient passive income to subject it to termination of S status after three years.

Acquisitive or Divisive Reorganizations (Type D)

Rules similar to those discussed in paragraph above apply to various steps in either acquisitive or divisive Type D reorganizations.

Recapitalizations (Type E)

Termination of the S election can occur in a Type E recapitalization if the stock or debt issued in exchange for the currently outstanding stock or debt violates the single-class-of-stock requirement.

In a Type E stock-for-stock exchange, the newly issued stock could have distribution or liquidation rights that differ from the original outstanding stock. In a debt-for-stock exchange, the newly issued debt could fail to meet the "straight-debt" rules of IRC Sec. 1361(c)(5), which would result in a second class of stock if the debt constitutes equity under general principles of tax law, and a principal purpose of the debt is to circumvent the distribution or liquidation rights conferred by the outstanding stock or to circumvent the maximum shareholder limitation.

Termination Due to Shareholder Control

Finally, if the new shareholders hold more than 50% of the outstanding stock of the S corporation after the reorganization, they can revoke the S election. If the revocation occurs by the 15th day of the third month of the tax year, it can be retroactive to the beginning of the tax year.

THE CONSEQUENCES OF S TERMINATION IN REORGANIZATION

Allocating Pass-through Items

If an S corporation terminates its S status as a result of a merger or other tax-free reorganization, the usual allocation issues arise.

The S corporation year (the S short year) ends on the day before the terminating event. If the corporation remains in existence as a C corporation, it is necessary to determine which method will apply for allocating income to the S short year:

a. the general prorata method where the income for the year is allocated to the S short year and the following C short year based on the number of days in each short period, or

b. the specific accounting method made via an election to close the books of the corporation at the end of the S short year.

If the reorganization has caused a termination of S status and an exchange of 50% or more of the stock of the corporation, the general prorata method is not available. The specific accounting method must be used, with the books closed as of the last day of the S short year.

Making Distributions

AAA. When S status terminates as a result of a reorganization, it may seem that the general distribution rules of IRC Sec. 1368 do not apply as that statute applies only to distributions "made by an S corporation." However, IRC Sec. 1371(e) allows a one-year (or more) post-termination transition period (PTTP) during which a corporation may make distributions of its AAA following termination of S status.

The ability to distribute money as a reduction against stock basis, to the extent of the AAA, during the one-year PTTP is an important privilege for an S corporation that is a party to a reorganization. It is important to note that the post-termination privilege only applies to cash distributions, not property distributions. As a planning point, if the shareholders of an S corporation that will lose its S status want to withdraw specific items of property from the corporation, they should do so prior to the reorganization.

PTI. A distribution of PTI (pre-1983 previously taxed income) is not permitted in any tax year following the termination of the S election.

Deducting Suspended Pass-through Losses

A one-year post-termination privilege is provided for carryover pass-through losses and deductions that have been limited because of insufficient shareholder basis. During the post-termination transition period, the shareholder is allowed to restore basis in stock (but not debt) to achieve deductibility of suspended pass-through losses.

ALLOCATING INCOME WHEN S STATUS IS RETAINED

In some forms of reorganizations, such as Type A mergers or Type C asset acquisitions, an existing S corporation often remains eligible for S status. However, the issuance of additional shares will require the allocation of the income on a per-share, per-day basis to the various shareholders.

Complete Termination of Interest

If a particular shareholder has entirely terminated his stock ownership, the Code authorizes a "specific accounting" election to close the books of the corporation as of the date of the merger. The election permits the allocation of income, deductions, and credits based on the actual transactions that occur during each shareholder's period of stock ownership. This election can be made only if all affected shareholders consent.

Qualifying Disposition

Although the Code does not authorize an S corporation to make a specific accounting election if the shareholder does not dispose of all of his stock, Reg. 1.1368-1(g) provides for such an election if the 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. The election can also be made when certain stock is issued or redeemed.

HOW TO REPORT REORGANIZATIONS AND RECAPITALIZATIONS

Reporting by Parties to the Reorganization

Each corporation that is a party to a reorganization must file an information statement with its return for the year of the reorganization. Information statements are also required from significant shareholders (1% shareholders of nonpublicly traded corporations, 5% shareholder of publicly traded corporations).

In addition, every corporation that makes a distribution (the distributing corporation) of stock or securities of a controlled corporation, as described in IRC Sec. 355 (or so much of IRC Sec. 356 as relates to IRC Sec. 355), must file an information statement. Information statements are also required from significant distributees (1% shareholder of nonpublicly traded distributing corporations, 5% shareholders of publicly traded distributing corporations).

In addition, each taxpayer should maintain substantiation information in his or her permanent records regarding the amount, basis, and fair market value of all property transferred, distributed, or exchanged, and liabilities assumed.

Filing the Final Tax Return

The nonsurviving corporation should file a final return for its tax year ending on the date of the merger. The surviving corporation should file a single return reporting the results of its "separate" operations through the date of the merger and results of its "combined" operations following the date of the merger through the end of its tax year.

Filing Information Returns

In general, each corporation that is a party to a corporate reorganization is responsible for filing its own information returns. However, Rev. Proc. 99-50 permits combined information reporting by a successor corporation when:

a. the successor acquires substantially all of the property used in the predecessor's trade or business or separate unit of the predecessor's trade or business;

b. the predecessor is required to file information returns for the pre-acquisition portion of the calendar year preceding the reorganization, but is not required to file such returns for the post-acquisition portion of the year following the reorganization; and

c. the instructions to the information reporting forms do not prohibit combined reporting.

Combined Reporting. Combined reporting under Rev. Proc. 99-50 is available for payments reported on Forms 1042-S, 1098, 1099, and W-2G and contributions reported on Forms 5498.

To qualify for combined reporting, the predecessor and successor corporations must agree that the successor corporation assumes the predecessor's information reporting obligation. The successor must file a statement with the IRS indicating that the appropriate information returns are being filed on a combined basis in accordance with Rev. Proc. 99-50. The statement must include the names, addresses, telephone numbers, employer identification numbers of the predecessor and successor corporations, and the name and telephone number of the person responsible for preparing the statement. In addition, the statement must reflect the amount of any tax that has been withheld by the predecessor and the successor for each type of tax reported on Form 945 (Annual Report of Withheld Federal Income Tax). Similarly, the statement must reflect the amount of tax withheld by the predecessor and the successor for Form 1042-S.

The statement should be filed separate from the information forms and should be mailed to the IRS by the information return due date. The mailing address is provided in Rev. Proc. 99-50.

Reporting Large Changes in Corporate Control and Recapitalizations

IRC Sec. 6043(c) requires reporting changes in control or substantial changes in the capital structure of a corporation. However, Reg. 1.6043-4(c) exempts transactions where less than $100 million of consideration changes hands.

Reg. 1.6043-4 provides that the Section 6043(c) reporting requirement is met by the filing of Form 8806 (Information Return For Acquisition of Control or Substantial Change in Capital Structure). Generally, a corporation that is required to file Form 8806 must also file an information return on Forms 1096 and 1099-CAP (Changes in Corporate Control and Capital Structure) for each shareholder of record in the corporation (before or after the change in control or the substantial change in capital structure) who receives cash, stock, or other property pursuant to the change in control or the substantial change in capital structure.

In addition to IRC Sec. 6043(c), IRC Sec. 6043A requires information reporting by an acquiring corporation in any taxable acquisition, according to the forms and rules prescribed by the Treasury Dept. Penalties for failure to comply with the information reporting requirements are contained in IRC Sec. 6721.

SELF-STUDY QUIZ

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

13. How does a corporation lose its S status in a Type B reorganization?

    a. If after the reorganization, it exceeds the maximum shareholder limitation.

    b. The stock issued to the shareholders after the reorganization is for more than one class of stock.

    c. The S corporation is obliterated through a subsequent liquidation.

    d. It acquires a corporate shareholder in the reorganization.

14. Johnson, Inc. completed a Type A reorganization with Mill Brothers, an S corporation on May 1, 2010. With this consolidation, the new company will have excess passive investment income due to Johnson acquiring assets from Mill Brothers. In addition, Johnson, Inc. shareholders acquired 65% of the stock of Mill Brothers. Which of the following is true?

    a. The new company can maintain the S status of Mill Brothers.

    b. Johnson, Inc. should close the books of the corporation at the end of the S short year.

    c. The new company can use the general prorata method for the short year.

15. What are the filing requirements involved in a reorganization by a corporation?

    a. The corporations involved in the reorganization will provide the shareholders with the information of the reorganization. It is not the shareholder's responsibility.

    b. The nonsurviving corporation is not required to file a tax return in their final year, since they will be included in the surviving corporation's return.

    c. The surviving corporation is required to file an information statement with its return in the year of the reorganization.

    d. Any corporation that makes a distribution as part of the reorganization must file an information statement with the IRS.

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. How does a corporation lose its S status in a Type B reorganization? **(Page 181)**

    a. If after the reorganization, it exceeds the maximum shareholder limitation. [This answer is incorrect. If the S corporation is the acquiring corporation and is merged or consolidated in a Type A reorganization, it can lose is S status by exceeding the maximum number of shareholders allowed, adding an ineligible shareholder, or absorbing a corporation with outstanding stock or debt that constitutes a prohibited second class of stock.]

    b. The stock issued to the shareholders after the reorganization is for more than one class of stock. [This answer is incorrect. Termination of the S election can occur in a Type E recapitalization if the stock or debt issued in exchange for the currently outstanding stock or debt violates the single-class-of-stock requirement.]

    c. The S corporation is obliterated through a subsequent liquidation. [This answer is correct. If the S corporation is the acquired corporation in a Type B stock-for-stock reorganization, it loses its S status because it goes out of existence in a subsequent liquidation because the acquired organization no longer exists.]

    d. It acquires a corporate shareholder in the reorganization. [This answer is incorrect. If the S corporation is the acquiring corporation in a Type C reorganization, it can lose its S status because of the existence of a corporate shareholder, which is not allowed for an S corporation.]

14. Johnson, Inc. completed a Type A reorganization with Mill Brothers, an S corporation on May 1, 2010. With this consolidation, the new company will have excess passive investment income due to Johnson acquiring assets from Mill Brothers. In addition, Johnson, Inc. shareholders acquired 65% of the stock of Mill Brothers. Which of the following is true? **(Page 182)**

    a. The new company can maintain the S status of Mill Brothers. [This answer is incorrect. Due to Johnson, Inc. acquiring assets from Mill Brothers that will lead to excess net passive investment income, the S status of the corporation will terminate after three consecutive years.]

    b. Johnson, Inc. should close the books of the corporation at the end of the S short year. [This answer is correct. The specific accounting method, which says that an election to close the books of the corporation at the end of the S short year, must be used since the S status is being terminated of Mill Brothers.]

    c. The new company can use the general prorata method for the short year. [This answer is incorrect. If the reorganization has caused a termination of S status and an exchange of 50% or more of the stock of the corporation, the general prorata method is not available.]

15. What are the filing requirements involved in a reorganization by a corporation? **(Page 183)**

    a. The corporations involved in the reorganization will provide the shareholders with the information of the reorganization. It is not the shareholder's responsibility. [This answer is incorrect. Each taxpayer should maintain substantiation information in his or her permanent records regarding the amount, basis, fair market value of property transferred, distributed, or exchanged and liabilities assumed as stated in Regs. 1.355-5(b). It is the shareholder's responsibility.]

    b. The nonsurviving corporation is not required to file a tax return in their final year, since they will be included in the surviving corporation's return. [This answer is incorrect. The nonsurviving corporation should file a return for its tax year ending on the date of the merger. The surviving corporation should file a single return reporting the results of its "separate" operations through the date of the merger and results of its "combined" operations following the date of the merger through the end of its tax year.]

c. The surviving corporation is required to file an information statement with its return in the year of the reorganization. [This answer is incorrect. Each corporation, according to IRS Reg. 1.368-3(a), that is party to the reorganization must file an information statement with its return for the year of the reorganization.]

d. Any corporation that makes a distribution as part of the reorganization must file an information statement with the IRS. [This answer is correct. Every corporation that makes a distribution of stock or securities of a controlled corporation, as described in IRS Sec. 355, must file an information statement with its return for the year of the reorganization.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TSCTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Greenhouse Corporation has been purchased and the corporation is being dissolved by the buyer. What would this transaction be classified as?

   a. Spin-off.

   b. Merger.

   c. Consolidation.

   d. Bankruptcy.

2. If a corporation was completing a reorganization that involved the acquisition of the target company's assets and wanted to simplify the transaction and reduce expenses, which type of reorganization should the corporation strive to complete?

   a. Type A.

   b. Type B.

   c. Type C.

   d. Type D.

3. Which of the following would be an example of a split-off?

   a. Horned Frog Enterprises (HFE) is being broken into two separate corporations, Frog Sportswear and Frog Supplies. The stockholders of HFE will be distributed stock in the two new corporations and HFE will be liquidated.

   b. Harris Foods decides to form a new corporation of its health foods and creates Good-4-U Corporation. Stockholders of Harris Foods receive a prorata share of the new corporation.

   c. Monkey Business, Inc. and Toys for Fun decide to become one corporation, Monkey Toys. The two original corporations dissolve and shareholders receive stock in the newly formed corporation.

   d. Wilson Corporation is formed and a printing business within Giant Industries is transferred to the newly formed corporation in exchange for all of its stock. The shareholders of Giant Industries forfeit part of their Giant stock in exchange for Wilson Corporation stock.

4. When a corporation is being reorganized due to shareholder discord, which of the following is the best solution to the issue?

   a. Merger.

   b. Split-up.

   c. Split-off.

   d. Spin-off.

5. Pumpkin Patch Clothes, a calendar year S corporation owned by eight individuals, owns all the stock of Pumpkin Patch Fabrics. In July of the current year, Pumpkin Patch Clothes distributes all of Pumpkin Patch Fabric's stock to the eight owners with the basis in the stock being $200,000. The stock is worth $1,000,000 when it is distributed to the owners. In August, Pumpkin Patch Clothes merges with another manufacturer, Tiny Tots Clothing, in a Type A reorganization. In the merger, each Pumpkin Patch Clothes shareholder exchanges his stock and receives a 10% interest in Tiny Tots Clothing. The original eight owners of Pumpkin Patch Clothing receive 80% (determined immediately after the merger) of the value and voting power of Tiny Tots Clothing and are treated as retaining a 80% interest in Pumpkin Patch Clothes. The original shareholders of Tiny Tots Clothing are treated as receiving the remaining 20% of Tiny Tot Clothing. Which of the following is true?

   a. The original shareholders of Pumpkin Patch Clothes have to recognize a gain of $800,000 if the distribution and merger are considered one transaction.

   b. The original shareholders of Pumpkin Patch Clothes do not have to recognize a gain under IRC Sec. 355(e).

   c. The original shareholders of Pumpkin Patch Clothes do not have to recognize a gain on the distribution of Pumpkin Patch Fabrics' stock if the stock distribution is separate from the merger.

   d. If the original owners of Pumpkin Patch Clothes had acquired 100% of Tiny Tots Clothing, they would have to recognize a gain on the distribution.

6. If an S corporation is reorganizing due to a bankruptcy, what type of reorganization is completed?

   a. Type B.

   b. Type D.

   c. Type F.

   d. Type G.

7. In a reorganization, if a target corporation verifies that shareholders of the acquired corporation retain a continuing equity interest in the acquiring corporation, which requirement of the IRS are they fulfilling?

   a. Continuity of shareholder interest.

   b. Asset continuity.

   c. Continuity of business enterprise.

   d. Business continuity.

8. In which of the following instances would the proprietary interest of the target corporation **not** be preserved?

   a. If the target corporation otherwise continues as a proprietary interest in the target after the reorganization, for example in a Type A merger.

   b. The proprietary interest is acquired by the acquiring corporation for consideration other than stock of the acquiring corporation.

   c. The acquiring corporation provided a proprietary interest in the acquiring corporation to the target.

   d. A direct interest in the target is provided the acquiring corporation.

9. Which of the following tests is an additional requirement required by the IRS for Type A, B, and C reorganizations?

   a. Continuity of shareholder interest.

   b. Five-year history test.

   c. Net value requirement.

   d. Device restriction.

10. Which test used to qualify for a tax-free reorganization is defined as a series of formally separate steps that will be treated as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result?

   a. Estate freeze.

   b. Propriety interest.

   c. Business purpose.

   d. Step transaction.

11. Sandra acquired 50 shares of ABC Corporation on January 1, 2009 for $5 each (the "first block") and an additional 20 shares of ABC Corporation on January 1, 2010 for $10 each ("the second block").

   On March 31, 2010, Sandra holds a total of 70 shares of ABC Corporation. On that date, DEF Enterprises acquires the assets of ABC in a Type A merger. Under the terms of the plan of reorganization, Sandra receives two shares of DEF Enterprises in exchange for each share of ABC Corporation. What is the basis of Sandra's first block of stock bought on January 1, 2009?

   a. $2.50.

   b. $2.92.

   c. $4.00.

   d. $5.00.

12. Which of the following is correct about pass-through losses in reorganizations for S corporations?

   a. If a S status is terminated in a reorganization, shareholders are given one year to restore the basis in debt.

   b. There is no limitation on pass-through deductions and losses for S shareholders.

   c. A shareholder may carryover losses and deductions to future years.

   d. In corporation reorganizations, carryover losses are not permitted by Reg. 1.1366-2(c).

13. Due to the reorganization of a S corporation, general business credits can be subject to recapture, but are still available. Which of the following business credits is available to a corporation that elects S status and maintains an inventory?

   a. Investment tax credit.

   b. LIFO recapture.

   c. Low-income housing credit.

   d. Credit for rehabilitation expenditures.

14. A reorganization or recapitalization can be aligned to qualify a corporation for electing S status. One way to accomplish this goal is to complete a Type E reorganization. Which of the following would qualify as a Type E recapitalization exchange for stock?

    a. Swapping old debt for new debt classified as preferred stock.

    b. Replacing preferred stock with common stock, but maintaining preferred stock for other shareholders.

    c. Exchanging voting stock for nonvoting common stock.

    d. Do not select this answer choice.

15. If the company elects to keep the S status after a Type A or Type C reorganization, which of the following is true?

    a. If a shareholder has eliminated all of their stock ownership, the corporation can elect to close their books on the date of the merger.

    b. If the S corporation issues more shares after the reorganization, then the allocation of income is done at the end of the calendar year.

    c. If the shareholder disposes of 10% or less of their stock in one or more transactions within 30 days, the specific accounting election can be used.

    d. The specific accounting election requires approval from the IRS for an S corporation to employ the method.

16. When is combined reporting for filing information returns allowed by companies completing a reorganization in cases where more than one company is involved?

    a. The target company acquires a portion of the successor's trade or business.

    b. The acquiring company obtains a portion of the property of the target's business.

    c. If the successor company files the information return for the pre-acquisition portion of the calendar year.

    d. When the instructions accompanying the reporting forms allow for combined reporting.

Lesson 2: Attributes and Advantages of Differing Types of Reorganizations

INTRODUCTION

This lesson details the different types of reorganizations – Types A through F – and how each can be advantageous or difficult for an S corporation. Examples of each type of reorganization are included for illustration and the requirements to complete the reorganizations are detailed for an S corporation.

The examples and discussion in this section illustrate the tax planning considerations involved in planning a merger or consolidation that preserves the survivor's S election or permits a C corporation survivor to elect S status.

Example 4-1: Planning a Type A merger that preserves or permits S status.

Able Corporation is an S corporation and Baker Corporation is a regular C corporation. Both entities are involved in similar businesses. The shareholders of each corporation agree to combine their two businesses to obtain certain cost advantages. With the advice of legal counsel, the two shareholder groups have tentatively agreed to structure the transaction so Able will acquire Baker in a statutory merger under IRC Sec. 368(a)(1)(A)—a Type A merger. Baker will go out of existence by transferring its assets to Able, and the Baker shareholders will receive newly issued Able stock in exchange for their stock in the former Baker Corporation. The Able shareholders recognize the importance of retaining S status and seek the advice of their tax practitioner about the implications of the proposed merger.

A statutory merger or consolidation, with Able (an S corporation) as the acquiring corporation, will not terminate Able's S election unless Able no longer meets the qualification tests for S status after the merger.

Variation: Conversely, assuming the situation is reversed and Baker acquires Able, could Baker, as the merger survivor, elect S status? If Baker is the acquiring entity, it can elect S status. However, if Able had earlier terminated its S status, Baker may be a successor corporation required to defer any S election under the five-year waiting period rule.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how built-in gains and boot affect a Type A merger in a reorganization.
- Identify the advantages and risk factors of a Type B, C, D, E and F reorganization for an S corporation.

HOW TO PLAN A TYPE A MERGER OR CONSOLIDATION THAT PRESERVES S STATUS OR PERMITS AN S ELECTION

Meeting the Formal Requirements for a Type A Merger or Consolidation

In a statutory merger, one corporation is merged out of existence into a surviving corporation. In a consolidation, two corporations are consolidated into a newly formed third corporation.

Shareholders who exchange stock or securities in one corporation solely for stock and securities in another corporation in a statutory merger or consolidation receive nonrecognition treatment of gains and losses. The Subchapter C reorganization provisions apply to S corporations unless otherwise expressly provided in the Code, or unless the provisions are inconsistent with Subchapter S.

Meeting the Additional Requirements Developed by the Courts and IRS

Additional requirements have been developed by the courts and the IRS over the years that must be met to ensure tax-free treatment. These requirements apply to the facts of Example 4-1 and are discussed in the following paragraphs.

Continuity of Business Enterprise (COBE). Under this rule, Able as the acquiring corporation must either continue Baker's historic business (business continuity test) or use a significant portion of Baker's historic business assets in the conduct of its business (asset continuity test).

a. *Business Continuity.* Business continuity is satisfied if Baker's most recent business is continued. If Baker has operated more than one line of business, it is only necessary that a significant line be continued.

b. *Asset Continuity.* The alternative test, asset continuity, is met if Able uses a significant portion of Baker's business assets. The regulations do not define the term "significant," but instead adopt a facts-and-circumstances approach based on the relative importance of the assets to the operation of the business. (However, examples appearing in the regulations suggest that this test will be liberally applied.)

In Example 4-1, Able and Baker are involved in similar businesses, and Able intends to continue conducting the same business following the merger. Furthermore, Able will continue to use Baker's assets in the conduct of that business. Therefore, the business continuity test and the asset continuity test are met.

Continuity of Shareholder Interest (COSI). Under this rule, the shareholders of Baker (the acquired corporation in Example 4-1) must retain a continuing proprietary interest in Able (the acquiring corporation).

As discussed previously, the tax planner would need to show that the former shareholders of Baker will receive stock of Able equal in value to at least 40% of the value of Baker's equity.

Not all shareholders of Baker must retain ownership, thus it is not necessary for all shareholders of Baker to receive at least half of their consideration in stock of Able. The IRS has held, for example, that when four equal shareholders of the acquired corporation in a Type A merger each received $25,000 of stock of the acquiring corporation and $25,000 of cash, this requirement was met. This requirement was also met if two of the shareholders each received $50,000 of stock while the other two each received $50,000 of cash.

For transactions (other than Type D reorganizations), the continuity of shareholder interest (COSI) requirement is satisfied if a substantial part of the value of the proprietary interests in the target corporation is preserved in the reorganization. All facts and circumstances are considered in determining whether a proprietary interest in the target corporation is preserved. A mere disposition of stock of the target prior to a reorganization to a corporation not related to either the target corporation or acquiring corporation is disregarded. Furthermore, a mere disposition of stock of the acquiring corporation received in a reorganization to a corporation not related to the acquiring corporation is disregarded. Corporations generally are considered related if they are members of the same affiliated group under IRC Sec. 1504 or the purchase of stock of one corporation by another corporation would be treated as a redemption under IRC Sec. 304(a)(2). Thus, a subsequent sale of Baker stock by any of the former Able shareholders to unrelated third parties would not cause the transaction to fail to qualify as a tax-free reorganization.

Business-purpose Test. The merger must have a real and substantial corporate business purpose, other than the avoidance of tax. The purpose for merging Baker into Able—the reduction of expenses—is a legitimate business purpose (particularly since both corporations are engaged in the same type of business). Additional factors include the desire to add complementary products in a competitive industry and to merge two skilled managerial staffs.

IRS regulations indicate that use of a reorganization to accomplish a federal S election is not a sufficient business reason alone to qualify a reorganization under the business-purpose test. Since the former shareholders of Baker, a regular C corporation, will now be shareholders in an S corporation, it is possible that the issue could be raised on audit asserting that the merger was accomplished solely for tax reasons (particularly if Baker itself is prevented from electing S status, such as through terminating an S election within the past five years). In such a case, the planner should be prepared to prove that the benefits of S status are simply one result of the merger and not the primary purpose.

Additional Criteria. The additional criteria discussed previously—the device restriction, five-year history, and principal tax avoidance purpose—apply only to divisive reorganizations and thus do not apply to the proposed acquisitive Type A merger.

Planning for S Corporation as Survivor of a Merger

S Status. In a merger, if an S corporation is the acquiring corporation (such as Able in Example 4-1), its S status ordinarily will not be affected. Since the transaction is treated as an acquisition of assets, the S corporation's status will not terminate and its tax year will continue as before. Able will simply issue additional shares of its stock to the former shareholders of Baker and receive Baker's assets in the merger.

Expansion of the Shareholder Group Might Jeopardize S Status. However, the expansion of the shareholder group in Example 4-1, as a result of the merger, might jeopardize Able's S status in any of the following circumstances:

a. An expansion of the number of S shareholders beyond 100, the statutory limit.

b. The addition of ineligible shareholders, such as corporations, partnerships, nonresident aliens, or certain types of trusts.

c. The issuance of a second class of stock to a group of former shareholders of Baker.

d. The acquisition of debt from Baker that does not meet the straight-debt safe harbor of IRC Sec. 1361(c)(5), if such debt constitutes equity under general principles of tax law and a principal purpose of the debt is to circumvent the distribution or liquidation rights conferred by the outstanding stock of Able upon the shareholders.

Termination of S Status Due To Shareholder Control. If the former shareholders of Baker hold more than 50% of Able's outstanding stock after the merger, they can voluntarily revoke Able's S election.

Termination of S Status Due to Excess Passive Income. The acquisition of passive assets or accumulated earnings and profits from Baker can increase the likelihood that passive income will exceed 25% of Able's gross receipts for three consecutive years, thus terminating Able's S election under IRC Sec. 1362(d)(3).

Planning for C Corporation as Survivor of a Merger

If the situation in Example 4-1 is reversed and Able as an S corporation is acquired in a statutory merger, its existence and thus its S corporation status will terminate.

Acquired S Corporation's S Status Will Terminate. Able's S corporation status will be maintained for its final taxable period ending on the merger date. Able's existence and its final S year terminate on the date of merger. Accordingly, there is no need to allocate Able's income between its final period as an S corporation and any subsequent period after the merger (post-merger operations are entirely reportable by Baker, the surviving corporation in the merger). The (final) S corporation short year items of income, deduction, and credit are allocated to the Able shareholders using the normal S corporation allocation rules.

Acquiring C Corporation May Be Eligible to Elect S Status. If Baker from Example 4-1 survives as a C corporation, assuming it is otherwise qualified to do so, it can elect S status. But if Baker was formerly an S corporation and lost that status prior to, or as a result of, the merger, then presumably it is subject to the five-year waiting period of IRC Sec. 1362(g). Under this rule, a corporation (and any successor corporation) is not eligible to make an S election for any tax year before the fifth tax year that begins after the first year for which the termination was effective, unless the IRS consents to an earlier election. If Baker terminated S status within the prior four years, it is temporarily barred from reelecting.

The tax planner would also need to determine whether Able had terminated S status during the prior four years before the merger. Its ineligibility under the five-year waiting period could carry over to Baker because it may be considered a successor to Able as a result of the merger. Under the successor rules, the five-year taint carries over to any corporation, 50% or more of the stock of which is owned, directly or indirectly, by the same persons who owned 50% or more of the stock of the former S corporation at its termination if that corporation acquires a substantial portion of the assets of the former S corporation.

Can the Survivor of Consolidation Make an S Election?

In a consolidation, the surviving entity is a new corporation resulting from the combination, and thus termination, of two corporations.

Example 4-2: Survivor of a consolidation may be eligible for S status.

Assume now that Able and Baker from Example 4-1 join in a consolidation rather than a merger.

If Able and Baker were both electing S corporations up to the point of the consolidation, an IRS ruling indicates that the new corporation could elect S status without regard to the five-year waiting period. However, a contrary result would likely occur if an S election of either corporation had been terminated prior to the consolidation.

Additional Tax Planning Considerations

In planning a merger or consolidation transactions, the tax planner must consider the issues discussed in the following paragraphs.

Built-in Gains Tax. As part of any S election following a reorganization, careful attention should be given to potential exposure to the built-in gains tax. If the acquiring corporation is an S corporation, it will become subject to the built-in gains tax on assets acquired from a C corporation or from another S corporation that was subject to the built in gains tax. If the acquiring corporation is a C corporation that plans to make an S election concurrent with or following the reorganization, it must also consider the built-in gains tax. As a prior C corporation, the acquiring corporation faces the possible imposition of the built-in gains tax on assets disposed of within 10 years of the S election. This could be a particular hazard because the acquiring corporation may sell extra assets as a result of combining the two businesses.

Tax on Excess Net Passive Income or Termination of S Status. As part of any S election following a reorganization, careful attention should be given to potential exposure to the tax on excess net passive income or potential termination of S status after three years.

Potential Credit Recapture. Whether the S corporation is the acquiring or acquired entity in a merger or consolidation, it is possible for one or more shareholders to incur a reduction in their proportionate stock interest, due to expansion of the shareholder group. Unless an exception applies, recapture occurs for S shareholders when their respective stock ownership percentage decreases by more than one-third of what it was in the year the investment credit property was placed in service. Thus, the tax planner may also want to consider potential recapture of the general business credit by any Able shareholders (in Example 4-20) who claimed pass-through credits on their prior year individual tax returns.

Carryover of AAA and PTI in Merger. While there is no clear authority, the IRS has ruled under pre-1983 law that "undistributed previously taxed income" carried over to the surviving corporation in the statutory merger of two S corporations, despite the status of PTI as a personal shareholder right.

Further, AAA is clearly a corporate account rather than an individual shareholder account and, presumably, carries over to the acquiring corporation in a merger in the same manner as corporate E&P and other corporate tax attributes.

Example 4-3: Carrying over target's AAA to Surviving C corporation.

Assume Able (an S corporation) merges into Baker (a C corporation) as described in the Variation to Example 4-1 and discussed previously. Assuming Baker is the surviving corporation, does Able's AAA carry over to Baker?

Generally, if an S corporation's status terminates, it is permitted to make tax-free cash distributions to the extent of its AAA during the one-year post-termination transition period. Baker can use this one-year period to make a tax-free distribution to shareholders during the one-year period to the extent of Able's old AAA.

Therefore, Baker should be entitled to make tax-free distributions to its shareholders for one year (to the extent of Able's AAA), whether or not those shareholders were former Able shareholders.

Reporting the Merger

The corporation that merges out of existence will file a final return. The survivor will file a return based on its income for the entire year.

Example 4-4: Reporting a mid-year merger.

Assume Baker (a C corporation) merges into Able (an S corporation) as described in Example 4-1. Baker should file a final Form 1120 for its short tax year ending on the date of the merger. Baker must annualize its taxable income for the short period.

Able should file a Form 1120S for its tax year. Under the general allocation rule, Able would allocate to shareholders items of income, loss, deduction, and credit on the per-share, per-day method based on the corporation's income for the entire year. However, if Able issued stock totaling 25% or more of its previously outstanding stock to one or more new shareholders during any 30-day period during its tax year, it can elect to treat its tax year as consisting of two tax years for purposes of allocating income, loss, deduction, and credits.

HOW TO USE A TYPE A MERGER TO AVOID THE BUILT-IN GAINS TAX

The example and discussion in this section illustrate the effect of a merger on the corporation's liability for the built-in gains tax. Although a merger cannot be used to completely avoid the built-in gains tax, the corporation's options for avoiding this tax are presented.

Example 4-5: Using a merger to avoid the built-in gains tax.

Tarnish is a C corporation that started business in 1960. It has a large number of highly appreciated assets, the gain from which would be subject to double taxation if a sale and liquidation occurred.

A receptive buyer, an S corporation, is discovered, and Tarnish's shareholders receive a proposal to exchange their stock for newly issued shares of the S corporation in a tax-free Type A statutory merger. Tarnish would cease to exist after the merger. The proposal from the acquiring S corporation includes a plan to sell a portion of Tarnish's assets in the years following the merger to generate cash to fund a redemption of the former Tarnish shareholders' stock.

The Tarnish shareholders understand that an S election, followed by a sale of assets, would generate a corporate-level built-in gains tax. Would a merger into an existing S corporation circumvent this tax?

The built-in gains tax applies to an S corporation's disposition of appreciated property received from a C corporation in a tax-free reorganization, assuming the property received and disposed of has a carryover (transferred) basis. This effectively prevents the strategy of avoiding the built-in gains tax by using a merger or reorganization to transfer appreciated assets to a corporation otherwise exempt from the built-in gains tax.

Built-in Gains Tax

Corporations Subject to the Built-in Gains Tax. S corporations that were formerly C corporations are subject to a corporate-level tax on built-in gains existing at the date of conversion to S status and subsequently recognized by the corporation during the first 10 years following conversion to S status. The built-in gains tax is intended to ensure that C corporations do not use S status to avoid double taxation on the disposition of appreciated assets. The built-in gains tax rate (currently 35%) is equal to the highest rate of tax imposed on corporations.

Exceptions and Limitations to the Built-In Gains Tax. When the tax applies, the aggregate gain of a corporation subject to the built-in gains tax is limited to the total net unrealized built-in gain in all assets held at the beginning of the corporation's first S year following conversion from C corporation status.

Recognized built-in gain is limited to the extent the S corporation establishes either that:

a. the asset disposed of was not held by the S corporation as of the beginning of its first tax year as an S corporation, or

b. that such recognized gain exceeds the excess of the asset's FMV over its adjusted basis as of the beginning of the first tax year as an S corporation. (Effectively, this rule limits the gain from the disposition of each asset to the appreciation existing at the point of conversion to S status, even if the gain on later disposition of the asset is greater.)

The built-in gains tax does not apply to a corporation that has always been an S corporation.

2009–2010 Built-in Gains Suspension Period for Certain S Corporations. Imposition of the built-in gains tax is suspended for tax years beginning in 2009 and 2010 for qualifying S corporations. The rule basically provides that built-in gains tax will not be imposed during 2009 and 2010 for an S corporation if the seventh tax year of the corporation's 10-year recognition period ended before those tax years.

Can a Merger Be Used to Avoid the Built-in Gains Tax?

The provisions discussed in the previous paragraphs raise the question of whether the built-in gains tax applies to the disposition by an S corporation of appreciated property received from a C corporation in a tax-free exchange. In other words, can a merger be used to transfer assets to an "always S" corporation to avoid the built-in gains tax?

Transferred Basis Assets. The regulations provide that the built-in gains tax applies to any asset acquired by an S corporation from a C corporation if the asset's basis is determined by reference to the C corporation's basis in the asset. [Transferred basis property is defined in IRC Sec. 7701(a)(43), and the built-in gains tax regulations refer to a transferred basis transaction as a "Section 1374(d)(8)" transaction.]

The acquisition of such transferred basis property will be treated as a conversion to S corporation status for such property. The 10-year built-in gains recognition period begins on the day transferred basis assets are acquired by an S corporation from a C corporation.

In contrast, property acquired in a taxable purchase usually has a cost basis. Consequently, the subsequent disposition of property acquired by a taxable purchase (rather than by a nontaxable reorganization) after the effective date of the S election will not generate the built-in gains tax.

Although the transferred basis assets will be subject to the built-in gains tax for a period of 10 years beginning on the date of the transfer (merger), the merger does not cause the S corporation's other assets (the assets owned by the S corporation prior to the merger) to be subject to the tax. Not only does the date of the transfer (merger) mark the beginning of the 10-year recognition period, but the amount of built-in gain attributable to the transferred basis assets is also measured as of that date.

Separate Built-in Gains Tax Determinations Are Required. Separate determinations of built-in gains tax are made for assets acquired in one transferred basis transaction, assets acquired in another such transaction, and assets the corporation held at the time it elected S status. Similarly, the S corporation's Section 1374 tax attributes when it became an S corporation (e.g., net operating losses, capital losses, business tax credits, and minimum tax credits carried over from C corporation tax years) can only be used to reduce the tax imposed on dispositions of the assets it held at that time. Section 1374 attributes acquired in a transferred basis transaction can only be used to reduce the tax imposed on dispositions of the assets acquired in the same transaction.

Taxable Income Limitation Must Be Allocated. The S corporation's taxable income limitation for any tax year must be allocated among each of the corporation's separate determinations of built-in gains tax. The corporation's taxable income limitation is allocated based on the ratio of each separately determined net recognized built-in gain (determined without regard to the taxable income limitation) to the total of such separately determined net recognized built-in gain.

Merger Cannot Be Used to Avoid the Built-in Gains Tax. Because the built-in gains tax applies to the disposition by an S corporation of appreciated property received from a C corporation in a tax-free reorganization, this

effectively prevents the strategy of avoiding the built-in gains tax by using a merger or reorganization to transfer appreciated assets to a corporation otherwise exempt from the built-in gains tax.

Limited Options to Avoid the Built-in Gains Tax

Options to avoid double tax on the appreciated corporate assets are very limited:

a. The corporation could elect S status and wait 10 years before disposing of the assets. (The disposition must occur after the 10-year period; an installment sale within the 10-year period, but with collections deferred until after the 10-year point, will not be an effective technique to avoid the built-in gains tax.

b. The shareholders could accomplish a reorganization or merger and require the acquiring S corporation to hold the target corporation's assets for at least 10 years. (A variation of this option would be to prohibit the acquiring S corporation from disposing of any appreciated assets received from the target corporation during the subsequent 10-year period as long as any of the target corporation shareholders own stock in the S corporation.)

c. The shareholders could accomplish a reorganization or merger with another C corporation and attempt to shift the tax consequences of asset disposition to the buyer.

d. Following the merger, the acquiring S corporation could use normal planning strategies for avoiding or reducing recognition of the built-in gains tax, such as reducing taxable income or recognizing built-in losses in the year of disposition of an appreciated asset.

e. If the target corporation has loss or credit carryforwards, it may be possible to use them to reduce the amount of the acquiring S corporation's built-in gains tax. IRC Sec. 1374(b) authorizes the reduction of recognized built-in gain by the corporation's net operating loss, capital loss, business credit, or minimum tax credit carryforward. However, this is limited to carryforwards arising in the same transferred basis transaction in which transferred basis assets are acquired. In addition, any target corporation carryforwards presumably would be subject to limitation under IRC Secs. 382, 383, and 384.

2009–2010 Built-in Gains Suspension Period for Certain S Corporations

Imposition of the built-in gains tax is suspended for tax years beginning in 2009 and 2010 for qualifying S corporations. The rule basically provides that built-in gains tax will not be imposed during 2009 and 2010 for an S corporation if the seventh tax year of the corporation's 10-year recognition period ended before those tax years.

Under the facts of Example 4-5, the 2009–2010 built-in gains suspension period would not apply. Assuming the planned merger takes place in 2009 or 2010, the 10-year recognition period for Tarnish's assets would begin on the date the merger occurs. Thus, the suspension period would never apply because the seventh year of the recognition period would occur well past 2010.

Built-in Gain Property Received in a Merger with an S Corporation Remains Subject to the Tax

If an S corporation that is subject to the built-in gains tax transfers property to another S corporation in a reorganization, the transferred property will be subject to the built-in gains tax. However, the 10-year recognition period for the assets received by the transferee S corporation will be reduced by the portion of the recognition period of the transferor that expired prior to the transfer.

As previously noted, the 10-year recognition period for transferred basis assets acquired from a regular C corporation begins on the date that the assets are acquired.

The 10-year recognition period for transferred basis assets acquired from an S corporation that previously was a C corporation also begins on the date the assets are acquired. However, the recognition period is reduced by the period of time prior to the merger that the transferring S corporation was subject to the built-in gains tax.

Example 4-6: Recognition period of assets acquired from an S corporation that previously converted from C corporation status.

If Tarnish, from Example 4-5, was formerly a C corporation that had elected S status three years before the merger, the recognition period for the assets acquired from it would be seven years rather than 10 years. This indicates that an acquiring S corporation that is itself subject to the built-in gains tax can be subject to more than one recognition period if it acquires transferred basis assets from another converted C corporation.

Variation: If Tarnish was formerly a calendar year C corporation that elected S status in 2002, it would evidently qualify for the built-in gains suspension period for both 2009 and 2010. If it elected S status in 2003, it would evidently qualify for the built-in gains suspension period for 2010.

Built-in Gains Tax Will Not Apply if Neither the Acquiring nor the Target S Corporation Is Subject to the Built-in Gains Tax

If an S corporation that is not subject to the built-in gains tax acquires (pursuant to a merger) transferred basis assets from another S corporation also not subject to the built-in gains tax, the merger will not cause the assets (now owned solely by the acquiring S corporation) to be subject to the built-in gains tax.

HOW TO DETERMINE IF BOOT RECEIVED IN A TYPE A MERGER HAS THE EFFECT OF A DIVIDEND

The example and discussion in this section illustrate how to determine if boot received in a Type A merger has the effect of the distribution of a dividend. The capital gain rules apply when boot does not have the effect of the distribution of a dividend. However, normal S corporation distribution rules apply when boot has the effect of the distribution of a dividend.

Example 4-7: Determining if boot received in a Type A merger has the effect of a dividend.

Sara owns all the outstanding shares of Target Corp. After extensive negotiations with Acquiring Corp., Sara agrees to merge Target into Acquiring. Both corporations are calendar year S corporations. The reorganization is structured to qualify as a Type A acquisitive reorganization and is scheduled to close on January 1 of the following year.

Target will transfer all of its assets and liabilities to Acquiring, and Sara will exchange all her stock in Target for 175 shares of Acquiring stock worth $1,000 per share and $75,000 cash. Acquiring has five unrelated shareholders who own all 1,000 shares of its currently outstanding stock.

Sara is concerned about the tax treatment of the cash payment and its effect on any gain realized on the merger. Must Sara recognize gain on the exchange of Target stock for Acquiring stock? Is the $75,000 cash payment equivalent to a distribution?

The $75,000 payment to Sara does not have the effect of the distribution of a dividend because it meets the mechanical test of IRC Sec. 302(b)(2) as a substantially disproportionate redemption of stock. Thus, the cash is treated as payment in exchange for stock (instead of a distribution). Sara must recognize $75,000 of the $200,000 gain realized on the exchange as capital gain.

Capital Gain Rules Apply if Boot Does Not Have the Effect of the Distribution of a Dividend

Gain Realized. The tax planner projects that Sara from Example 4-7 will have a $50,000 basis in her Target stock on the day of the merger. Thus, she will realize a gain of $200,000 on the exchange of her Target stock for Acquiring stock, determined as follows:

Amount realized	
FMV of 175 shares of Acquiring stock	$ 175,000
Cash	75,000
	250,000
Less: Adjusted basis of Target stock	(50,000)
Gain realized	$ 200,000

Gain Recognized. No gain or loss is recognized if stock or securities in a corporation that is a party to a reorganization are exchanged solely for stock or securities in the same or another corporation that is also a party to the reorganization. However, gain must be recognized to the extent of the gain realized or boot received, whichever is less.

The recipient of the boot must treat the gain recognized on the exchange as a distribution if the boot has the effect of the distribution of a dividend. In *Clark*, the Supreme Court applied the Section 302(b) dividend equivalency rules for redemptions to determine whether the boot payment had the effect of a dividend distribution. The Court held that in an acquisitive reorganization the dividend equivalency rules should be applied post-reorganization to the acquiring corporation. Thus, the boot payment should be treated as a redemption of the acquiring corporation in a hypothetical redemption of the acquiring corporation's stock that the shareholder would have received if there had been no boot distribution. (In other words, the transaction is recast as a reorganization followed by a hypothetical redemption.)

Testing for Dividend Equivalency. In Rev. Rul. 93-61, the IRS held that in an acquisitive reorganization, boot is tested for dividend equivalency by comparing the interest the shareholder actually received in the acquiring corporation with the interest the shareholder would have received in the acquiring corporation assuming solely stock had been received. The Section 302(b) tests are used for this purpose.

The cash received (boot) is treated as a distribution in exchange for the acquiring corporation's stock if the hypothetical redemption distribution is substantially disproportionate with respect to the shareholder. Thus, the mechanical test of IRC Sec. 302(b)(2) is applied under the facts of Example 4-7 to determine whether the $75,000 cash payment to Sara has the effect of a dividend.

The Section 302(b)(2) test for a substantially disproportionate redemption is applied by assuming that Sara (from Example 4-7) received only stock in Acquiring and no cash. Thus, Sara would have received an additional 75 shares ($75,000 ÷ $1,000 FMV per share) of Acquiring stock if she had not received the $75,000 cash payment. She would have received a total of 250 (175 + 75) shares in Acquiring, and Acquiring would have had 1,250 (1,000 + 250) shares outstanding as a result of the merger. The 250 shares would have represented 20% (250 ÷ 1250) of the outstanding stock in Acquiring. After the hypothetical redemption of the 75 shares, Sara owns 14.9% (175 ÷ 1175) of the outstanding shares of Acquiring. The $75,000 cash payment does not have the effect of a distribution because:

a. immediately after the hypothetical redemption Sara owns less than 50% of the total combined voting power of all classes of voting stock, and

b. Sara's voting stock ownership percentage after the hypothetical redemption (14.9%) is less than 80% of her hypothetical ownership percentage (20%) immediately before the redemption (80% of 20% equals 16%).

Conclusion. Thus, the $75,000 payment to Sara does not have the effect of the distribution of a dividend because it meets the mechanical test of IRC Sec. 302(b)(2) as a substantially disproportionate redemption of stock. Accordingly, the cash is treated as payment in exchange for stock (instead of a distribution). Sara must recognize $75,000 of the $200,000 gain realized on the exchange as capital gain.

Sara's basis in the Acquiring stock is $50,000, which equals her basis in Target stock ($50,000) less the cash payment received ($75,000) plus the capital gain recognized ($75,000). The AAA of Target is merged with the AAA of Acquiring [Reg. 1.1368-2(d)(2)]. Presumably, the post-reorganization combined AAA of Acquiring is reduced 6% (75 ÷ 1,250) for the shares redeemed in the hypothetical redemption. If Acquiring had any E&P, it would be similarly reduced by 6%.

Normal S Corporation Distribution Rules Apply if Boot Has the Effect of the Distribution of a Dividend

The normal S corporation distribution rules apply if boot has the effect of the distribution of a dividend. The following example and discussion illustrate how these rules are applied.

Example 4-8: Applying the normal distribution rules when boot has the effect of the distribution of a dividend.

Assume now that Sara from Example 4-7 received 225 shares of Acquiring stock and $25,000 cash in exchange for her Target stock (instead of 175 shares and $75,000 cash as in Example 4-7). As discussed in the following paragraphs, the $25,000 cash payment has the effect of the distribution of a dividend.

Gain Tentatively Realized. In Example 4-8, Sara tentatively realizes $200,000 of gain, of which $25,000 is potentially recognizable (if the $25,000 payment is treated as boot), determined as follows:

Amount realized	
FMV of 225 shares of Acquiring stock	$ 225,000
Cash	25,000
	250,000
Less: Adjusted basis of Target stock	(50,000)
Gain tentatively realized	$ 200,000

Testing for Dividend Equivalency. The Section 302(b)(2) test for a substantially disproportionate redemption is again applied by assuming that Sara in Example 4-8 received only stock in Acquiring and no cash. Thus, Sara would have received an additional 25 shares ($25,000 ÷ $1,000 FMV per share) of Acquiring stock if she had not received the $25,000 cash payment. She would have received a total of 250 (225 + 25) shares in Acquiring, and Acquiring would have had 1,250 (1,000 + 250) shares outstanding as a result of the merger. The 250 shares would have represented 20% (250 ÷ 1,250) of the outstanding stock in Acquiring. After the hypothetical redemption of the 25 shares, Sara owns 18.4% (225 ÷ 1,225) of the outstanding shares of Acquiring. The $25,000 cash payment has the effect of the distribution of a dividend because her voting stock ownership percentage after the hypothetical redemption (18.4%) is not less than 80% of her hypothetical ownership percentage (20%) immediately before the redemption (80% of 20% equals 16%).

Presumably, the $25,000 payment to Sara has the effect of a distribution. Under Rev. Rul. 95-14, when an S corporation shareholder receives a redemption payment that is characterized as a distribution that has the effect a dividend, the redemption payment is treated as an S corporation distribution under IRC Sec. 1368 that reduces AAA and stock basis. Evidently, under the reasoning in *Clark*, the post-reorganization AAA and stock basis is used in determining the tax consequences of the $25,000 distribution.

Gain Realized. Thus, Sara realizes $175,000 of gain, determined as follows:

Amount realized	
FMV of 225 shares of Acquiring stock	$ 225,000
Less: Adjusted basis of Target stock	(50,000)
Gain realized	$ 175,000

Basis. Sara's post-redemption stock basis equals her basis in the Target stock ($50,000). Presumably, the stock basis is not increased because no gain is recognized, and stock basis is not immediately reduced because the cash payment is treated as a distribution instead of as boot.

Presumably, the Section 358(a)(1)(B)(i) requirement to increase basis for the amount "treated as a dividend" does not apply. Because the corporation does not have AE&P, none of the distribution is treated as a dividend; similarly, if the corporation had AE&P but had sufficient AAA and the shareholder had sufficient stock basis, none of the distribution would be treated as a dividend.

AAA. In Example 4-8, the AAA of Target is merged with the AAA of Acquiring. Presumably, the combined AAA is reduced by the $25,000 payment and Sara's stock basis is reduced by the $25,000 distribution.

Conclusion. Under the facts of Example 4-8, the treatment of the $25,000 cash payment as a distribution results in the reduction of gain realized. The $25,000 deemed distribution is treated as a tax-free reduction in Sara's basis in Target stock. If the deemed distribution exceeds the combined AAA or Sara's stock basis, the excess would be treated as capital gain under IRC Sec. 1368. If either corporation had AE&P, a portion of the distribution could be treated as a dividend if the distribution exceeded the combined AAA.

Proposed Regulations. In January 2009, the IRS released proposed regulations that provide comprehensive guidance on the recovery of stock basis in distributions under IRC Sec. 301 (relating to dividend distributions), along with guidance on the resulting gain and the basis of stock or securities received. The regulations are designed to "harmonize" the tax treatment of economically similar transactions. Accordingly, the regulations adopt a single model for Section 301 (dividend equivalent) distributions and a single model for Section 302(a) sale or exchange (nondividend equivalent) transactions, regardless of whether IRC Sec. 301 or 302(a) applies. Consistent with the premise that a share of stock is the basic unit of property that can be disposed of, the proposed regulations would, for example, treat a Section 301 dividend equivalent distribution as received on a prorata, share-by-share basis with respect to the class of stock upon which the distribution is made. The proposed regulations are generally scheduled to become effective for transactions that occur after the date they are published as final regulations in the Federal Register.

SELF-STUDY QUIZ

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

16. If an S corporation is the acquiring company in a Type A merger, which of the following might endanger the S status of the company after the reorganization?

    a. One of the shareholders in the target company is a corporation.

    b. The acquisition of debt from the target company meets the straight-debt safe harbor of IRC Sec. 1361(c)(5).

    c. The target company's shareholders are issued the same class of stock as the acquiring company.

    d. The number of shareholders in the S corporation after the merger is 75.

17. Blueband, Inc., a C corporation, has a large number of highly appreciated assets. Redhouse, Inc., an S corporation, proposes a Type A statutory merger with Blueband, in which the Blueband stockholders will receive newly issued shares of Redhouse in exchange for their Blueband stock. After the merger, Blueband would cease to exist and Redhouse plans to sell a portion of Blueband's assets in the years following the merger to generate cash to fund a redemption of the former Blueband shareholder's stock. Which of the following is correct?

    a. The built-in gains tax is lower than double taxation owed by C corporations.

    b. No built-in gains tax will be due by Redhouse in the year of the merger since it is an S corporation.

    c. The built-in gains tax can be avoided if Redhouse holds the assets for 10 years.

    d. Any built-in gain is based on the asset's FMV over its adjusted basis at the time of disposition.

18. Holdings 123, Inc. is a former C corporation that elected S status in 2006. In 2010, a merger with another S corporation was completed and assets were transferred. In what year does the recognition period for assets that would be subject to built-in gains tax expire?

    a. 2010.

    b. 2016.

    c. 2020.

19. Shareholders can receive boot from an acquiring corporation in a Type A merger. Which of the following is correct regarding the tax treatment for boot in a reorganization?

    a. Boot should be tested for dividend equivalency in a Type A merger reorganization.

    b. No gain or loss is recognized by the shareholder, regardless of the distribution, if the transaction is part of a Type A merger reorganization.

    c. Gain will be recognized by the shareholder to the extent of either gain realized or boot received, whichever is greater.

    d. If the shareholder is a recipient of boot, they must treat the gain recognized as a distribution if the boot has the effect of the distribution of stock.

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.)**

16. If an S corporation is the acquiring company in a Type A merger, which of the following might endanger the S status of the company after the reorganization? **(Page 194)**

    a. One of the shareholders in the target company is a corporation. [This answer is correct. If the addition of an ineligible shareholder, such as a corporation, partnership, nonresident alien, or certain types of trusts, is added from the target company due to the merger, the S status of the acquiring corporation could be endangered.]

    b. The acquisition of debt from the target company meets the straight-debt safe harbor of IRC Sec. 1361(c)(5). [This answer is incorrect. The S status of the acquiring company may be jeopardized if the acquisition of debt from the target company does not meet the straight-debt safe harbor of IRC Sec. 1361(c)(5), if such debt constitutes equity under general principles of tax law and a principal purpose of the debt is to circumvent the distribution or liquidation rights conferred by the outstanding stock of the acquiring company upon the shareholders.]

    c. The target company's shareholders are issued the same class of stock as the acquiring company. [This answer is incorrect. If there was an issuance of a second class of stock to a group of former shareholders in the target company, it might jeopardize the acquiring company's S status, but if only one class of stock is maintained through the reorganization, the acquiring company should be able to maintain their S status.]

    d. The number of shareholders in the S corporation after the merger is 75. [This answer is incorrect. If an expansion in the number of S shareholders exceeds beyond 100, the statutory limit for a S corporation, there might be an issue with the S status of the acquiring company. With a shareholder count of 75, the acquiring company should be safe in their S status.]

17. Blueband, Inc., a C corporation, has a large number of highly appreciated assets. Redhouse, Inc., an S corporation, proposes a Type A statutory merger with Blueband, in which the Blueband stockholders will receive newly issued shares of Redhouse in exchange for their Blueband stock. After the merger, Blueband would cease to exist and Redhouse plans to sell a portion of Blueband's assets in the years following the merger to generate cash to fund a redemption of the former Blueband shareholder's stock. Which of the following is correct? **(Page 196)**

    a. The built-in gains tax is lower than double taxation owed by C corporations. [This answer is incorrect. The built-in gains tax rate (currently 35%) is equal to the highest rate of tax imposed on corporations.]

    b. No built-in gains tax will be due by Redhouse in the year of the merger since it is an S corporation. [This answer is incorrect. S corporations that were formally C corporations, like Blueband, Inc., are subject to corporate-level tax on built-in gains existing at the date of conversion to S status.]

    c. The built-in gains tax can be avoided if Redhouse holds the assets for 10 years. [This answer is correct. Redhouse, Inc. faces the possible imposition of the built-in gains tax on assets disposed of within 10 years of the S selection from the merger. The built-in gains tax is intended to ensure that C corporations do not use S status to avoid double taxation on the disposition of appreciated assets.]

    d. Any built-in gain is based on the asset's FMV over its adjusted basis at the time of disposition. [This answer is incorrect. Recognized built-in gain is limited to the extent the S corporation (Redhouse) establishes that such recognized gain exceeds the excess of the asset's FMV over its adjusted basis as of the beginning of the first tax year as an S corporation, not on the disposition date.]

18. Holdings 123, Inc. is a former C corporation that elected S status in 2006. In 2010, a merger with another S corporation was completed and assets were transferred. In what year does the recognition period for assets that would be subject to built-in gains tax expire? **(Page 198)**

    a. 2010. [This answer is incorrect. If an S corporation that is subject to the built-in gains tax transfers property to another S corporation in a reorganization, the transferred property will be subject to the built-in gains tax, thus the assets would not be able to be disposed of in 2010 without built-in gains tax imposed.]

    b. 2016. [This answer is correct. The recognition period for transferred basis assets acquired from a S corporation that previously was a C corporation begins on the date the assets were acquired. However, the recognition period is reduced by the period of time prior to the merger that the transferring S corporation was subject to built-in gains. Therefore, Holdings 123's time period would be reduced by the four year time period that they elected S status before the merger.]

    c. 2020. [This answer is incorrect. S corporations that were formerly C corporations are subject to a corporate-level tax on built-in gains existing at the date of the merger and subsequently recognized during the first 10 years following conversion to S status. However, since Holdings 123 elected S status before the merger, this time period will be abbreviated.]

19. Shareholders can receive boot from an acquiring corporation in a Type A merger. Which of the following is correct regarding the tax treatment for boot in a reorganization? **(Page 200)**

    a. Boot should be tested for dividend equivalency in a Type A merger reorganization. [This answer is correct. In Rev. Rul. 93-61, the IRS held that in an acquisitive reorganization, boot is tested for dividend equivalency by comparing the interest the shareholder actually received in the acquiring corporation with the interest the shareholder would have received in the acquiring corporation, assuming solely stock had been received.]

    b. No gain or loss is recognized by the shareholder, regardless of the distribution, if the transaction is part of a Type A merger reorganization. [This answer is incorrect. No gain or loss is recognized if stock or securities in a corporation that is a party to a reorganization are exchanged solely for stock or securities in the same or another corporation that is also a party to the reorganization per IRC Sec. 354 (a). If the distribution includes more than just stock or securities, for example, boot, the tax treatment may be different.]

    c. Gain will be recognized by the shareholder to the extent of either gain realized or boot received, whichever is greater. [This answer is incorrect. According to IRC Sec. 356 (a)(1), gain must be recognized to the extent of the gain realized or boot received by the shareholder, whichever is less, not greater.]

    d. If the shareholder is a recipient of boot, they must treat the gain recognized as a distribution if the boot has the effect of the distribution of stock. [This answer is incorrect. As stated in IRC Sec. 356(a)(2), the recipient of the boot must treat the gain recognized on the exchange as a distribution if the boot has the effect of the distribution of a dividend, not of stock.]

HOW TO ACHIEVE A TAX-DEFERRED DISPOSITION BY INCORPORATING A PARTNERSHIP AND USING A TYPE B STOCK-FOR-STOCK SWAP

The following examples and discussion consider whether it is possible to achieve a tax-deferred disposition of a business by first incorporating the business and then engaging in a Type B stock-for-stock swap with the acquiring corporation. The risk that the transaction could be collapsed as a taxable transaction is also considered.

Example 4-9: Working toward a Type B stock-for-stock swap.

Joe and Frank Pessimist are each 50% partners in a highly profitable small business. Although they presently have a competitive advantage in terms of quality and "trade secrets" over their much larger publicly traded competitors, they believe their position to be relatively short-term. One of the larger competitors (GiantCo) has approached them about purchasing their business.

For cash flow and current ratio purposes, the potential buyer has indicated that the corporation would be willing to pay a much higher price if the Pessimists would accept the company's publicly traded stock instead of cash or debt instruments. Both partners expect their income to drop in future years. They would like to accept the stock offer but are reluctant to enter into any arrangement that generates a current tax burden. Because they expect the value of the stock of the acquiring corporation to rise significantly in the years ahead, they would like to dispose of that stock gradually in future years.

Can an S corporation be used to assist Joe and Frank in the sale of their business?

By incorporating, electing S status, and then undergoing a Type B reorganization, Joe and Frank can dispose of the publicly traded stock they receive gradually during retirement years and achieve a deferral of the tax consequences.

Taking Advantage of the Corporate Reorganization Provisions

One major advantage of an S corporation when compared to a partnership is its ability to use the tax-free reorganization provisions of Subchapter C. These provisions apply to S corporations unless otherwise expressly provided by the Code or unless inconsistent with Subchapter S.

If Joe and Frank from Example 4-9 swap their partnership interests for publicly traded stock, they will have a fully taxable sale at the current time. (This transaction would not qualify as a tax-free incorporation under IRC Sec. 351 because Joe and Frank together would not be in control of the publicly traded corporation immediately after the exchange.) The tax costs of this sale would likely require a disposition of some of the shares to generate cash to cover the tax liabilities.

Working Toward a Tax-Fee Stock-for-stock Swap

Incorporate the Partnership. The tax planner can assist Joe and Frank in working toward a tax-deferred, stock-for-stock swap under the facts of Example 4-9 by first accomplishing a Section 351 tax-free incorporation of their partnership. (Assume that the incorporation of the partnership has not developed to the point of being a step in an integrated plan to enable the corporate suitor to acquire the partnership's assets in a tax-free corporate reorganization. See Example 4-10 later in this lesson.)

Liabilities. In considering this recommendation to incorporate, the planner examines the preincorporation tax-basis balance sheet of the partnership to test for the existence of either excess liabilities or liabilities unrelated to the business. To the extent that liabilities transferred to the corporation exceed the basis of the assets transferred, gain recognition will occur. This potential pitfall is quite common in converting a partnership to a corporation. Also, to the extent any liabilities unrelated to the partnership's business are transferred to the corporation, all liabilities conveyed will be considered to give rise to taxable boot to the incorporators.

S Election. To avoid the possibility of double taxation, the planner recommends the election of S status. As the negotiations for the sale of the business proceed, the company will operate as an S corporation. If the negotiations

fail, the conversion from partnership to S status will not have significantly changed the income tax structure of Frank's and Joe's business. Conversely, if S status was not initially elected and the acquisition failed, Joe and Frank would be trapped into potential double taxation on any future sale because the prior C corporation status would subject the corporation to the Section 1374 built-in gains tax.

Type B Reorganization. When the purchase agreement is finalized, the planner advises structuring the transaction as a Type B reorganization (an exchange of stock for stock). In a Type B reorganization, one corporation, solely in exchange for its voting stock, acquires the stock of another corporation and immediately thereafter has control of the acquired corporation. Joe and Frank from Example 4-9 must receive only stock of the acquiring company. No boot can be paid to Joe and Frank. Unlike a Type A or C reorganization, the acquired corporation is not liquidated in a Type B reorganization. It continues to exist as a subsidiary after the acquisition transaction.

S Status Terminates. The S status of Joe's and Frank's corporation terminates as of the date of the stock exchange because an S corporation cannot retain its eligibility once it has a corporate shareholder. This causes the filing of a short-period S corporation tax return and pass-through of the income or loss to the point of termination to Joe and Frank. However, the resulting tax consequences presumably would be similar if Joe and Frank had retained their partnership to the point of sale.

Conclusion

If properly structured and carefully executed, the exchange of stock will not be taxable to the Pessimists until they eventually sell the acquiring corporation's publicly traded stock. (If the transaction is not properly structured and carefully executed, the IRS may attempt to collapse the transaction under the step transition doctrine. See Example 4-10 later in this lesson.)

The Pessimists' adjusted tax basis in the former partnership carries over to the newly formed corporation's stock and from there carries over to the publicly traded stock received in the stock-for-stock exchange. Frank and Joe now each have the flexibility to sell shares of stock of the publicly traded company gradually during future years to fit their individual income tax and cash flow objectives.

Benefit. The overriding benefit is that Joe and Frank may succeed in deferring income taxation by structuring a Type B reorganization.

Detriments. There are, however, potential detriments to be considered. When an S corporation is acquired in a Type B reorganization, the decrease in the proportionate stock ownership of the former S corporation's shareholders could cause business credit recapture under the normal stock disposition rules.

Another potential detriment is the loss of Section 1244 ordinary loss treatment in the event the stock is subsequently sold at a loss or becomes worthless. Ordinary loss treatment is not available to a partner to whom the stock is distributed by the partnership. This problem can be overcome if the incorporation of the partnership is structured so that the partners, not the partnership, are the incorporators.

Step Transaction Doctrine May Apply to Collapse the Steps of a Prearranged Plan

The IRS may attempt to collapse the two steps of the transaction discussed in Example 4-9 under the step transaction doctrine as outlined in Rev. Rul. 70-140. The following example illustrates the application of the step transaction doctrine.

Example 4-10: Step transaction doctrine may turn a planned nontaxable reorganization into a taxable transaction.

Assume the same facts as in Example 4-9, except that in addition to expressing an interest in purchasing the partnership business, the potential buyer, GiantCo, has presented an integrated plan to accomplish the purchase. Under the plan, Joe and Frank would incorporate their partnership as J&F, Inc. and then they would exchange their stock in J&F, Inc. for newly issued stock in GiantCo. (No other consideration would be exchanged.)

The facts of this example are quite similar to the facts in Example 4-9, with one major exception. Here, the incorporation of the partnership has progressed to the point of being a step in a prearranged integrated plan to enable GiantCo to acquire the partnership's assets without the recognition of gain. In contrast, the facts in Example 4-9 do not indicate that the transaction had matured, so it had not reached the level of a prearranged plan subject to collapse under the step transaction doctrine.

Under the facts of this example, the IRS may attempt to collapse the two steps of the transaction under the step transaction doctrine as outlined in Rev. Rul. 70-140. If the IRS is successful, the incorporation of the partnership would be ignored and the transfer of the partnership's assets would evidently be treated as the taxable sale of its assets to GiantCo for FMV, followed by a transfer of these assets from GiantCo to the capital of J&F, Inc.

Due Diligence and Closing Considerations

Seller. Because the purchaser, GiantCo, in Examples 4-9 and 4-10, is a well-known publicly traded company, Joe and Frank will have relatively few due diligence investigation concerns if the transaction is an exchange of their stock in J&F, Inc. for stock in GiantCo. Due diligence and closing considerations for Joe and Frank include the following:

a. Joe and Frank should do enough investment research to be sure there is nothing to be learned that would have a significant negative effect on the value of the GiantCo shares they will receive. Of course, Joe and Frank realize the stock market in general and the shares of any company in particular can react negatively to totally unforeseen events. But, that is a risk they will have to accept if they agree to a stock-for-stock deal. Since GiantCo is a public company, investment research information will be available from its annual and quarterly reports, as well as from national organizations that analyze public companies (such as brokerage firms). In addition, information about public companies is available in numerous places online, including the Securities and Exchange Commission's EDGAR database at **www.sec.gov**. Joe and Frank may also have closing considerations (such as whether an escrow agreement should be used to accomplish the closing) and post-closing obligations (such as indemnifying GiantCo if their trade receivables are sold subject to their guarantee that collections will not fall below a stated value, such as $200,000).

b. If an agreement is reached, the purchase/sale document should specify who pays the transaction costs (for legal, accounting, due diligence, appraisal fees, etc.) incurred by the two parties and who will pay any applicable business broker's fee, which is often 5% to 10% of the purchase price.

Buyer. In a Type B stock-for-stock reorganization, the target (J&F, Inc.) continues in existence for legal purposes as a subsidiary of GiantCo. Therefore, GiantCo is exposed to the risk of an impaired investment if there are unknown or undisclosed liabilities resulting from J&F, Inc.'s operations. Assume that GiantCo's due diligence investigation finds no significant negative facts.

In addition (as discussed earlier under seller considerations), the final purchase/sale agreement should specify who pays the business broker's fee and the transaction costs incurred by the parties.

Determining Basis of Stock Acquired

The IRS has announced that it will issue additional guidance on the topic of determining the basis of stock acquired in Type B reorganizations (IRS Notice 2009-4). Earlier guidance, issued in Rev. Proc. 81-70, provided that the surrendering shareholders should be surveyed to determine the basis of the acquired stock, and offered sampling and estimation procedures to address shareholder nonresponsiveness. The IRS now believes that its guidance must be expanded to reflect changed market conditions in transferred basis transactions. Accordingly, until the IRS formally issues revised guidance in an expanded version of Rev. Proc. 81-70, taxpayers may rely on the guidelines provided in Notice 2009-4, including the methodologies of any of the four safe harbor methods described in the notice.

HOW TO USE A TYPE C REORGANIZATION TO ACQUIRE THE ASSETS OF AN S CORPORATION

The example and discussion in this section illustrate the use of a Type C stock-for-assets reorganization, which has more stringent requirements than a Type A merger, to acquire the target's assets.

Example 4-11: Using a Type C stock-for-assets reorganization to acquire the target's assets.

Bigco, Inc. is a successful closely held newspaper and printing business that has been operating as an S corporation since its inception. Bigco has been negotiating to acquire the assets of Adco, a small weekly advertising paper that is also organized as an S corporation. Joe Adcock owns 100% of Adco's stock. As part of the negotiations, Joe will become an employee of Bigco and will receive Bigco stock in exchange for the assets of Adco.

The attorneys for Bigco prefer not to have the acquisition structured as a merger. Also, a parcel of vacant real estate owned by Adco, constituting about 5% of its assets, will not be acquired by Bigco.

Bigco has agreed to pay all of the legal and accounting expenses associated with the acquisition, and also will be assuming all of Adco's liabilities, in addition to all of the operating assets other than the vacant real estate. Joe understands that he will be receiving Bigco stock in exchange for the assets of Adco and that he will also retain the land.

A plan of reorganization should be structured using a Type C reorganization to accomplish both the objectives of Bigco, the acquiring entity, and Adco, the target. While a Type C reorganization has more stringent requirements than a merger, the percentage tests for transfer of substantially all of the Adco assets and the limitations on nonstock consideration have been met.

Meeting the Requirements for a Type C Reorganization

In a Type C reorganization, the assets of the target corporation are received by the acquiring entity for its stock. The acquiring corporation generally takes a carryover basis in the target's assets. That is, the assets have the same basis as the target's basis, increased by any gain recognized by the target.

The initial step in the reorganization in Example 4-11 involves the transfer of Adco assets to Bigco in exchange for Bigco stock, followed by the liquidation of Adco. Joe should immediately liquidate Adco, distributing both the Bigco stock and the land parcel as part of the plan of reorganization.

Substantially All the Target's Assets Must Be Acquired. One of the criteria to accomplish a Type C reorganization is that substantially all of the assets of the target must be acquired by Bigco, the acquiring corporation. Retaining the land parcel, which constitutes about 5% of the assets, should not violate this criteria for a Type C reorganization.

While the statute does not contain a definition of the term "substantially all," the IRS suggests that at least 90% of the FMV of the net assets and at least 70% of the FMV of the gross assets of the target must be transferred. However, the preamble to Reg. 1.368-1(e)(1)(ii) states that Rev. Proc. 77-37 does not apply to the extent it is inconsistent with the regulation.

At Least 80% of the Target's Property Must Be Acquired Solely for Stock. As another criteria to qualify the Type C reorganization in Example 4-11, only a limited amount of additional consideration in addition to Bigco stock can be used. If Bigco acquires, solely for its voting stock, at least 80% of the FMV of all Adco's property, Adco or its shareholder may receive boot or assets in addition to the voting stock of Bigco.

While this 20% boot exception appears fairly liberal on the surface, the statute also requires that any liabilities of the target be treated as boot for the 20% test. Liabilities alone will not cause violation of the 20% test but, rather, are counted in determining whether other boot exceeds the 20% threshold. Accordingly, in the normal business situation where operating liabilities of the target exceed 20% of the assets, no consideration will be permitted in the reorganization other than the stock of the acquiring corporation.

Legal, Accounting, and Other Costs Associated with the Transaction

Because Bigco from Example 4-11 would not be allowed to tender any consideration other than its own stock (assuming Adco's liabilities exceed 20% of its assets), would the legal, accounting, and other costs associated with the transaction, which are being entirely assumed by Bigco, constitute boot in the reorganization?

The IRS has ruled that valid reorganization expenses of the target, including expenses incurred in evaluating the acquiring corporation's offer, do not constitute boot in a Type C reorganization.

Importance of Immediately Liquidating the Target S Corporation

Under the facts of Example 4-11, Joe should immediately liquidate Adco as part of the plan of reorganization so as not to jeopardize the continuing S status of Bigco, the acquiring corporation. If Adco should receive and hold the Bigco stock, Adco's status as a corporate shareholder of Bigco stock would cause immediate termination of Bigco's S election. Conversely, immediate liquidation as part of the plan of reorganization would not cause Bigco to lose S status (GCM 39768).

As a result of receiving both the parcel of land and stock of Bigco in liquidation of Adco, Joe would be required to treat the receipt of the land as boot in the reorganization. Accordingly, his otherwise tax-deferred gain on the reorganization is recognized to the extent of the value of the boot (i.e., the land). Under IRC Sec. 358, Joe's former basis in his Adco stock carries over to become the basis in his newly acquired Bigco stock.

Preserving S Status in a Type C Reorganization

The precautions discussed in the following paragraphs will help ensure that an S corporation's S status is not terminated in a Type C reorganization.

Distributing Stock Only to Eligible Shareholders. The tax planner representing the acquiring corporation (Bigco in Example 4-11) must ensure that the Type C reorganization does not unexpectedly terminate its S election. This could happen upon the distribution of its stock to the target corporation (Adco in Example 4-11), followed by the distribution of that stock to one or more of the target's shareholders who are ineligible S corporation shareholders. The acquiring corporation's S election would terminate if its stock is distributed, for example, to a nonresident alien individual, corporation, or partnership.

Complying with the 100-shareholder Limit. While the chances of the reorganization terminating Bigco's S election are diminished since all of Adco's current shareholders presumably are eligible S shareholders, the risk of termination still exists. For example, while the two corporations separately may have less than the maximum allowable number of shareholders, the combined shareholder group may exceed the maximum number.

A particular area of concern is stock held by a guardian, nominee, or trust, since the beneficiary is the shareholder for S corporation eligibility purposes. For example, one person could be the guardian for six minors, in which case each child is a shareholder. Or, a single qualified Subchapter S trust (QSST) could be composed of several subtrusts, in which case the beneficiary of each subtrust is a shareholder. Each potential current beneficiary (determined without regard to any unexercised powers of appointment) of an electing small business trust (ESBT) is considered a shareholder.

Ensuring That Debt Meets the Straight-debt Safe Harbor. If the target corporation has debt outstanding that the acquiring corporation assumes and that does not meet the requirements of the "straight-debt" safe harbor, the debt could be treated as a second class of stock, which would also terminate the acquiring corporation's S election.

Voluntarily Revoking S Status Due to Shareholder Realignments. Following the completion of the reorganization, if the current Adco shareholders hold more than 50% of the outstanding Bigco stock (or together with minority Bigco shareholders hold more than 50% of the outstanding Bigco stock), they could voluntarily revoke the S election.

SELF-STUDY QUIZ

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

20. Which of the following is true when a company is attempting to achieve a tax-deferred disposition of a business by first incorporating the business from a partnership and then engaging in a Type B stock-for-stock swap with the acquiring corporation?

    a. The acquiring corporation loses control of the company in a Type B reorganization.

    b. If the S status of the target company terminates on acquisition, the tax consequences to the target company shareholders are detrimental.

    c. If assets transferred from the partnership to the S corporation in the target company when electing S status exceed the liabilities, then gain will be recognized.

    d. To avoid double taxation, the target company should elect S status when incorporating.

21. Scott and Steve Smith are each 50% partners in a highly profitable small business. They are approached by Big Man, Inc., a competitor, to purchase their business in a Type B stock-for-stock swap. In the reorganization, the Smiths would receive the company's publicly traded stock instead of cash or debt instruments. What can the Smiths do to eliminate the tax burden on selling the shares after the reorganization?

    a. Remain a partnership and sell the publicly traded stock after the reorganization.

    b. Elect S status for the company before the reorganization and sell the publicly traded shares gradually during future years.

    c. Elect S status for the company before the reorganization and hold the shares through their eventual estates.

22. Which of the following is correct if a Type C reorganization is desired?

    a. At least 50% of the target's property must be exchanged solely for stock.

    b. The basis in the target company's assets will be carried over to the acquiring company.

    c. If the acquiring company pays the reorganization expenses for the target company, this is considered boot to the target.

    d. All assets must be transferred to the acquiring company from the target company in a Type C reorganization.

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.)**

20. Which of the following is true when a company is attempting to achieve a tax-deferred disposition of a business by first incorporating the business from a partnership and then engaging in a Type B stock-for-stock swap with the acquiring corporation? **(Page 206)**

    a. The acquiring corporation loses control of the company in a Type B reorganization. [This answer is incorrect. In a Type B reorganization, the acquiring corporation, solely in exchange for its voting stock, acquires the stock of the target corporation and immediately thereafter has control of the acquired corporation per IRC Sec. 368(a)(1)(B).]

    b. If the S status of the target company terminates on acquisition, the tax consequences to the target company shareholders are detrimental. [This answer is incorrect. If the S status of the target company terminates as of the date of the stock exchange with the acquiring company due to the acquiring company having a corporate shareholder, the resulting tax consequence would be similar to the target company shareholders as if they had retained the partnership at the point of sale.]

    c. If assets transferred from the partnership to the S corporation in the target company when electing S status exceed the liabilities, then gain will be recognized. [This answer is incorrect. To the extent that liabilities are transferred within the target company when electing S status exceeds the basis of the assets transferred, gain recognition will occur according to IRC Sec. 357(c).]

    d. To avoid double taxation, the target company should elect S status when incorporating. [This answer is correct. To avoid the possibility of double taxation, the target company should elect S status. As negotiations for the sale of the business proceed, the company will operate as an S corporation. If the negotiations fail, the conversion from partnership to S status will not have significantly changed the income tax structure of the target company's business.]

21. Scott and Steve Smith are each 50% partners in a highly profitable small business. They are approached by Big Man, Inc., a competitor, to purchase their business in a Type B stock-for-stock swap. In the reorganization, the Smiths would receive the company's publicly traded stock instead of cash or debt instruments. What can the Smiths do to eliminate the tax burden on selling the shares after the reorganization? **(Page 207)**

    a. Remain a partnership and sell the publicly traded stock after the reorganization. [This answer is incorrect. If the Smiths swap their partnership interests for publicly traded stock, they will have a fully taxable sale at the current time. This would not be the best way to reduce their tax burden.]

    b. Elect S status for the company before the reorganization and sell the publicly traded shares gradually during future years. [This answer is incorrect. If properly structured and carefully executed, the exchange of stock will not be taxable to the Smiths until they eventually sell the Big Man's publicly traded stock, at which point it would become taxable.]

    c. Elect S status for the company before the reorganization and hold the shares through their eventual estates. [This answer is correct. If the Smiths elect S status for their company before the reorganization and are able to hold their publicly traded shares by living on its dividends, this would accomplish a step-up in basis under IRC Sec. 1014 and would allow the estate or heirs to sell the stock without a gain.]

22. Which of the following is correct if a Type C reorganization is desired? **(Page 209)**

a. At least 50% of the target's property must be exchanged solely for stock. [This answer is incorrect. To qualify for a Type C reorganization, only a limited amount of additional consideration in addition to stock can be given to the target company. The acquiring company, solely for its voting stock, must acquire at least 80%, not 50%, of the FMV of the target company's property.]

b. The basis in the target company's assets will be carried over to the acquiring company. [This answer is correct. According to IRC Sec. 362(b), the acquiring company generally takes a carryover basis in the target's assets. That is, the assets have the same basis as the target's basis, increased by any gain recognized by the target.]

c. If the acquiring company pays the reorganization expenses for the target company, this is considered boot to the target. [This answer is incorrect. The IRS has ruled that valid reorganization expenses of the target, including expenses incurred evaluating the acquiring company's offer, do not constitute boot in a Type C reorganization.]

d. All assets must be transferred to the acquiring company from the target company in a Type C reorganization. [This answer is incorrect. One of the criteria to accomplish a Type C reorganization is that substantially all of the assets of the target must be acquired by the acquiring company, but not all the assets. The IRS suggests that at least 90% of the FMV of the net assets and at least 70% of the FMV of the gross assets must be transferred to qualify for "substantially" all the assets.]

HOW TO USE A DIVISIVE D REORGANIZATION TO SHIFT OWNERSHIP BY CREATING A NEW S CORPORATION THAT WILL QUALIFY FOR FISCAL-YEAR REPORTING

The examples and discussion in this section illustrate the use of a divisive Type D reorganization to divide an existing corporation. In the illustrated transaction, a new corporation is created and spun-off. The new corporation will be eligible to elect S status, and will be eligible for a fiscal year-end if it can meet the requirements of the mechanical 25% test.

Example 4-12: Using a divisive Type D reorganization to split an existing corporation.

Gold Clothiers, Inc., an S corporation from inception, operates a clothing business in two locations. The stock of Gold Clothiers is owned 50% by Mary Gold and 50% by her sister, Susan. Its main retail store is a long-standing enterprise that has been operated for more than 10 years in the heart of the community's central business district. The second location is a retail sporting goods outlet that has been open for six years in a nearby lakeshore resort community. The outlet is open the entire year, but the business is highly seasonal with substantial sales in June and July.

A divisive Type D reorganization is being considered that would allow Gold Clothiers to split into two corporations. The primary purpose for dividing the business into two corporations is to allow a shifting of ownership between the two sisters. Mary operates the older store, and Susan is primarily involved with the sporting goods outlet. The two sisters have had conflicting opinions about the management of the two stores. Further, a major renovation of the sporting goods store will require substantial capital input, but only Susan is financially able and willing to inject these funds. As part of the divisive reorganization, Mary would primarily take stock in the central store, and Susan would assume majority control of the resort store. Both the main retail operation and the seasonal sporting goods outlet have more than a five-year continuous business history.

Gold Clothiers currently uses a calendar year. The corporation did not make an election under IRC Sec. 444 to use a fiscal year because the sisters were reluctant to expend the "required payment" of IRC Sec. 7519 because of their lower personal tax brackets. The owners now realize the sports outlet could qualify for fiscal-year reporting, without the need for a Section 444 election if it existed as a separate corporation and established a three-year history of earning more than 25% of its gross receipts within two consecutive months. The owners consider retention of S status important but would also like to have at least a portion of their business back on a fiscal year to provide more flexibility in business and personal tax planning.

A Type D reorganization can be used to divide a corporation into two or more corporations. As an existing S corporation, Gold Clothiers can use a divisive reorganization to split into two successor S corporations. Whether the successor corporations would qualify for a year-end other than December 31 under the business purpose test depends on the transferor corporation's natural business year and whether the 25% test could be met. After operating the new entity for 47 months to establish a successful history of more than 25% gross receipts in a consecutive two-month period, a fiscal-year application could be made. Because of the regulatory and judicial requirement of a business purpose test in a reorganization, a divisive reorganization should have business reasons beyond the mere tax advantage associated with fiscal-year reporting.

Meeting the Requirements for a Divisive Type D Reorganization

Generally, in a divisive reorganization, a corporation transfers part of its assets to another corporation and, immediately after the transfer, the transferor corporation controls the transferee. Thereafter, the transferor distributes the transferee corporation's stock to one or more of its stockholders (but not necessarily in a prorata manner).

To accomplish such a reorganization under the facts of Example 4-12, Gold Clothiers would form a new subsidiary corporation and transfer the assets of the sporting goods store into that new corporation. Gold Clothiers would then distribute the stock of the new corporation primarily to Susan in exchange for her stock in the existing corporation. Mary might also exchange a portion of her stock, although the intent of the sisters indicates that Susan would receive the majority of the new corporation's stock.

Additional Requirements

In addition to conforming to the statutory structure for tax-deferred exchange treatment under IRC Sec. 368(a)(1)(D), the planner should verify that the reorganization meets the additional requirements, discussed previously, that apply to all types of reorganizations:

a. *Continuity of Business Enterprise (COBE).* A transferee or new corporation in a divisive reorganization must either continue the transferor's historic business or use a significant portion of the transferor's former business assets in a different continuing business.

b. *Continuity of Shareholder Interest (COSI).* One or more shareholders prior to the reorganization must continue to hold an equity interest in any new or surviving corporations.

c. *Business Purpose.* A reorganization must have a bona fide corporate business purpose other than the avoidance of tax. Personal nontax motives of the shareholders, such as splitting a corporate enterprise to allow separate control, generally will not satisfy the business purpose test; the business purpose must be that of the corporation. However, situations involving shareholder disagreement and the need to inject capital appear to make the shareholder and corporate needs coextensive and therefore qualifying. [See, for example, Ltr. Rul. 200301036 approving a Type D reorganization to resolve management problems associated with the operations of two businesses conducted by the distributing corporation and Ltr. Rul. 200305009 approving a Type D reorganization to resolve disagreements among the shareholders as to the expansion and diversification of the distributing corporation's businesses.] The objective of obtaining S status alone will not be considered a sufficient business purpose by the IRS. See Examples 4-13 and 4-14 later in this lesson for more on this issue.

The Gold Clothiers reorganization described in Example 4-12 satisfies all three tests:

a. Each store will continue to conduct its same business activity.

b. The former shareholders will continue as shareholders of the two remaining corporations (although in different proportionate ownership).

c. The primary purpose of the reorganization is to provide separate ownership of the two stores between the sisters to resolve management conflicts and to facilitate Susan's injection of capital into the sporting goods outlet.

Further Requirements for Divisive Reorganizations

The following additional restrictions apply only to divisive reorganizations, and must be met:

a. *The Device Restriction.* The transaction may not be used principally as a device to bail out earnings and profits of either the transferor or transferee corporation. IRS regulations provide guidance as to facts and circumstances that indicate evidence of such a device. Factors listed in the regulations as possible evidence of a device include:

(1) A prorata distribution of the transferee corporation stock to the shareholders of the transferor corporation.

(2) A distribution followed by a sale or exchange of the stock of the transferor or transferee corporation.

(3) The existence of cash or other liquid assets of the transferor corporation not used in a qualifying business.

Specifically, the regulations identify any sale or exchange of the transferee corporation negotiated before the distribution as evidence of a device to distribute earnings and profits. Conversely, evidence of a significant business purpose can overcome the potential taint of "device" factors.

b. *Five-year History.* Both the transferor and transferee corporations must be engaged in the active conduct of a business (or be a holding company for an active corporation), with the trade or business having been conducted throughout the five-year period ending on the date of the distribution.

c. *Principal Tax Avoidance Purpose.* Either all of the stock and securities of the transferee corporation is distributed, or at least 80% is distributed in a plan not having a principal tax avoidance purpose.

d. *Disqualified Section 355 Distributions.* The distributing corporation will recognize gain in an otherwise tax-free transaction on a "disqualified distribution" of stock or securities in a controlled corporation. A disqualified distribution is one in which the recipient, after the distribution, holds "disqualified stock" that represents a 50% or greater interest in either the distributing or controlled corporation. Disqualified stock generally is stock acquired by purchase after October 9, 1990, and within the five-year period ending on the date of the distribution.

Under the facts of Example 4-12, the Gold Clothiers divisive reorganization meets the further requirements for divisive reorganizations:

a. The transaction is not principally a device to bail out the earnings and profits of Gold Clothiers. The stock of the new transferee corporation will be distributed primarily (or exclusively) to Susan and thus will not be distributed prorata to the two shareholders. Furthermore, neither shareholder intends to sell her stock within the foreseeable future.

b. Following the reorganization, both the clothing store and sporting goods outlet will be engaged in the active conduct of a business. Furthermore, both outlets have been open for more than five years.

c. All of the stock of the transferee corporation will be distributed to Susan and Mary. The plan is intended to solve management conflicts and to enable Susan to inject additional capital into the sporting goods outlet, and so it does not have a principal tax avoidance purpose.

d. The distribution of the subsidiary stock would not cause the corporation to recognize gain under IRC Sec. 355(d). Since Gold Clothiers will have a basis in the new subsidiary's stock equal to its basis in the assets transferred to the subsidiary, gain recognition could occur if its basis in the assets comprising the retail sporting goods store is less than the current FMV of the assets. However, for the Section 355(d) rules to apply, the shareholders must have acquired their stock in Gold Clothiers or the new subsidiary within the prior five years. Stock acquired before October 10, 1990, is excluded. Since Mary and Susan acquired their stock more than five years ago, the corporation will not be required to recognize gain, if any, from the distribution of the new subsidiary's stock.

S Status

After a divisive reorganization, if the transferor corporation was previously an S corporation and had terminated its election within the prior four-year period, the spun-off corporation generally cannot elect S status until the fifth year following the former termination year. Presumably, the spun-off corporation is treated as a successor corporation, and it cannot make an S election (without IRS permission) until the fifth year after the transferor's prior S termination. If the transferor corporation was always a C corporation or has been for at least four years, the statutes do not prevent the spun-off corporation from electing S status. This assumes the new corporation meets all other qualifications necessary to elect S status.

In Example 4-12, since the transferor corporation (Gold Clothiers) is an S corporation that has not previously terminated its S election, the spun-off (sporting goods outlet) corporation can elect S status. Although the spun-off corporation technically must meet all S corporation eligibility requirements on each day of its first tax year to elect S status, the IRS has privately ruled that the fact the spun-off corporation had a corporate shareholder for at least the first day of its tax year did not prevent it from electing S status. Assuming S status is elected within two months and 15 days of its incorporation, the S election of the spun-off corporation will be effective as of the first day of its existence, and it will not be necessary to obtain the consent of the transferor corporation.

Planning for a Fiscal Year

Permitted Year. An S corporation must use a permitted year unless the special election to retain or adopt a fiscal year is made under IRC Sec. 444. A permitted year is a tax year that:

a. ends on December 31, or

b. is another accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS.

25% Gross Receipts Test. Under this business purpose test, the IRS will automatically approve a year based on a natural business year if it meets the "25% gross receipts test" (Rev. Proc. 2006-46). The test requires the company to have received 25% or more of its annual gross receipts within a two-month period in each of three consecutive years. To apply the test, the company (or a predecessor) must have a 47-month history. The 47-month history covers a 36-month period for the requested tax year plus an additional 11-month period for comparing the requested tax year with other potential tax years. If the company meets the 25% test, it can adopt a fiscal year that corresponds with the end of the two-month period, which is considered to be the end of the natural business year.

The issue of whether a spun-off corporation in a divisive reorganization can use its pre-reorganization experience to meet the 47-month history test is not entirely clear. However, the regulations indicate that, for S election purposes, a transferor corporation in a divisive reorganization is a predecessor to the spun-off transferee corporation; thus, the same conclusion could be reached for applying the 25% test. In discussing fiscal-year applications under the 25% gross receipts tests, Rev. Proc. 2006-46 holds that a taxpayer must use the gross receipts of its predecessor if it has a predecessor organization and is continuing the same business as its predecessor.

On the other hand, the 25% test presumably needs to be made using the "consolidated" gross receipts figures from the 47 prior months, including the gross receipts of both the transferor and transferee corporations. That the transferor's activity needs to be included in the case of the sporting goods outlet of Gold Clothiers apparently infringes on the ability of the sporting goods outlet to meet the 25% test until it has established its own 47-month seasonal history.

Recognition of Built-in Gain

Although not a factor under the facts of Example 4-12 (since Gold Clothiers has always been an S corporation), the IRS has ruled that the transfer of net unrealized built-in gain assets from the transferor corporation to the spun-off corporation will not constitute a recognized built-in gain transaction under IRC Sec. 1374. Thus, the reorganization will not cause the transferor corporation to be liable for the built-in gains tax. Furthermore, the spun-off (transferee) corporation also will not be liable for the tax unless the asset(s) are disposed of within the remainder of the 10-year recognition period.

Allocation of AAA

In a Type D divisive reorganization, the S corporation's AAA will be allocated in a manner similar to the allocation of a regular C corporation's earnings and profits (E&P) under IRC Sec. 312(h) and the regulations thereunder. Pursuant to the Section 312 rules, a C corporation's E&P generally is allocated based on the FMV of assets retained and transferred, although in appropriate cases the allocation can be made on a "net basis" (i.e., assets less liabilities).

Therefore, the AAA of Gold Clothiers (the transferor corporation in Example 4-12) will be allocated based on the FMV of the assets retained and transferred to the spun-off corporation.

Using a Type D Reorganization to Qualify for S Status

As discussed previously, the regulations require a corporate business purpose other than reduction of federal taxes for the reorganization. By way of example, the regulations state that the business purpose requirement for a divisive reorganization is not met if the objective is to elect S status and the reduction in federal taxes is greater than the reduction in state taxes as a result of the S election. However, another valid business purpose may qualify the reorganization, even if a subsequent S election is also made.

Example 4-13: Spin-off solely for the purpose of electing S status is not a valid business purpose.

Assume that Gold Clothiers from Example 4-12 is already organized as two regular C corporations in a parent-subsidiary relationship. Gold Clothiers, Inc., the parent corporation, operates the main retail store, while its subsidiary, Gold Sports, Inc., operates the resort sporting goods store.

Assume further that both shareholders are involved in each store, and there is no management conflict providing a corporate business reason for separating the ownership. Rather, the shareholders desire to accomplish a spin-off of Gold Sports, Inc., so Mary and Susan each own 50% of each corporation (that is, the two corporations would then be owned in a brother-sister relationship rather than parent-subsidiary). The sisters seek this arrangement to allow election of S status for each corporation, recognizing that the former parent-subsidiary status allowed only the parent corporation to elect S status (and, if desired, QSub status for its subsidiary).

The business purpose requirement for a divisive reorganization is not met if the sole objective is to elect S status.

Example 4-14: Spin-off for the purpose of transferring stock to a key employee and coincidentally qualifying to elect S status is a valid business purpose.

Assume the same facts as in Example 4-13, except that the distribution of the subsidiary stock of Gold Sports, Inc. is made to enable a key employee of the sporting goods store, Steve Edburg, to acquire stock of Gold Sports without investing in the parent corporation. Edburg is critical to the success of Gold Sports, and there is the risk he will leave the company if not admitted to an equity position.

If the facts and circumstances establish that the reorganization was substantially motivated by the need to issue stock to an employee, it will meet the corporate business purpose requirement, notwithstanding that the filing of an S election was also a relevant factor.

HOW TO DETERMINE IF BOOT RECEIVED IN A DIVISIVE D REORGANIZATION HAS THE EFFECT OF A DIVIDEND

The example and discussion in this section illustrate how to determine if boot received in a divisive Type D reorganization has the effect of the distribution of a dividend.

Example 4-15: Determining if boot received in a divisive D reorganization has the effect of a dividend.

Distributing Corp., a calendar year S corporation, is a wholesale mineral water distributor with net assets worth $1 million. Sahara Jones owns 400 shares of Distributing stock (with a basis of $50,000), and four other unrelated individuals own the remaining 600 shares.

Because of differences in opinion regarding the marketing of imported mineral waters, the shareholders have decided to separate the imported mineral water distribution business from the domestic mineral water distribution business. The reorganization is scheduled to close on January 1 of the following year and will be structured as a divisive Type D split-off.

Distributing will transfer the assets of the imported mineral water distribution business worth $200,000 to a newly created corporation, Controlled Corp., in exchange for all of its stock and will immediately distribute all the Controlled stock plus $200,000 cash to Sahara in exchange for all his Distributing stock. Controlled will immediately elect S status.

Sahara is concerned about the cash payment and its effect on any gain realized on the exchange of his Distributing stock for Controlled stock. Must Sahara recognize gain on the exchange of Distributing stock for Controlled stock? Is the $200,000 cash payment equivalent to a distribution?

The $200,000 payment to Sahara does not have the effect of the distribution of a dividend because it meets the mechanical test of IRC Sec. 302(b)(2) as a substantially disproportionate redemption of stock. Thus, Sahara must recognize $200,000 of the $350,000 gain realized on the exchange ($200,000 stock + $200,000 cash − $50,000 basis) as capital gain.

Capital Gain Rules Apply if Boot Does Not Have the Effect of the Distribution of a Dividend

Gain Realized. The tax planner projects that, under the facts of Example 4-15, Sahara will have a basis in his Distributing stock of $50,000 on the day of the merger. Sahara will realize a gain of $350,000 on the exchange of his Distributing stock for Controlled stock, determined as follows:

Amount realized	
FMV of all the shares of Controlled stock	$ 200,000
Cash	200,000
	400,000
Less: Adjusted basis of Distributing stock	(50,000)
Gain realized	$ 350,000

Gain Recognized. The shareholders of a distributing corporation do not recognize gain or loss on the exchange of their stock solely for the stock or securities of a controlled corporation if the requirements of IRC Sec. 355 are met. (See previous discussion for the requirements for a valid Type D reorganization.) However, gain must be recognized to the extent of the gain realized or boot received, whichever is less.

The recipient of the boot must treat the gain recognized on the exchange as a distribution if the boot has the effect of the distribution of a dividend. In *Clark*, (involving an acquisitive reorganization that could be classified as either a Type A merger or an acquisitive Type D reorganization) the Supreme Court applied the Section 302(b) dividend equivalency rules for redemptions to determine whether the boot payment had the effect of a dividend distribution.

Testing for Dividend Equivalency. In Rev. Rul. 93-62, the IRS held that in a divisive reorganization, the determination of whether boot is treated as a dividend distribution is made prior to the reorganization exchange. The determination is made by treating the recipient shareholder as if he had retained his stock in the distributing corporation and had received the boot in exchange for some of his distributing corporation stock equal in value to the boot. (In other words, the transaction is recast as a hypothetical redemption followed by a reorganization.) The determination is made by applying the tests of IRC Sec. 302(b).

One of the Section 302(b) tests permits exchange (i.e., capital gain) treatment if the hypothetical redemption distribution is substantially disproportionate with respect to the shareholder. Accordingly, the mechanical test of IRC Sec. 302(b)(2) can be used to determine whether the $200,000 cash payment to Sahara from Example 4-15 has the effect of a dividend.

Under the hypothetical assumption that Sahara retained his Distributing stock, Sahara would have owned 40% (400 ÷ 1,000) of the stock of Distributing prior to the exchange. The $200,000 cash payment would have redeemed 200 shares ($200,000 ÷ $1,000 FMV per share) of Distributing stock. Thus, after the hypothetical redemption, Sahara would have owned 25% [(400 − 200) ÷ (1,000 − 200)] of the stock of Distributing. The $200,000 cash payment does not have the effect of a distribution of a dividend because:

a. immediately after the hypothetical redemption, Sahara owns less that 50% of the total combined voting power of all classes of voting stock, and

b. Sahara's voting stock ownership percentage after the hypothetical redemption (25%) is less than 80% of his hypothetical ownership percentage (40%) immediately before the redemption (80% of 40% equals 32%).

Conclusion. The $200,000 payment to Sahara in Example 4-15 does not have the effect of the distribution of a dividend because it meets the mechanical test of IRC Sec. 302(b)(2) as a substantially disproportionate redemption of stock. Thus, Sahara must recognize $200,000 of the $350,000 gain realized on the exchange as capital gain.

Sahara's basis in the Controlled stock is $50,000, which equals his basis in the Distributing stock ($50,000) less the cash payment ($200,000) plus the capital gain he recognizes ($200,000) (IRC Sec. 358). Presumably, the AAA of Distributing is reduced 20% (200/1,000) for the shares redeemed in the hypothetical redemption. If Distributing had any AE&P, it would be similarly reduced by 20%.

Normal S Corporation Distribution Rules Apply if Boot Has the Effect of the Distribution of a Dividend

The normal S corporation distribution rules apply if boot has the effect of the distribution of a dividend. The following example and discussion illustrate how these rules are applied.

Example 4-16: Applying the normal distribution rules when boot has the effect of the distribution of a dividend.

Assume the same facts as in Example 4-15 except the assets of the imported mineral water business that Distributing transfers to Controlled are worth $380,000. In addition, assume that Distributing immediately distributes all the Controlled stock plus $20,000 (instead of $200,000) cash to Sahara in exchange for all his Distributing stock. As in the previous example, Controlled will immediately elect S status.

The $20,000 cash payment has the effect of the distribution of a dividend, and the $20,000 payment to Sahara is presumably treated as a distribution. Accordingly, Distributing's AAA is reduced by $20,000, and Sahara reduces the basis of his Distributing stock to $30,000.

Gain Tentatively Realized. Under the facts of Example 4-16, Sahara tentatively realizes $350,000 of gain, of which $20,000 is potentially recognizable (if the $20,000 payment is treated as boot), determined as follows:

Amount realized	
FMV of all the shares of Controlled stock	$ 380,000
Cash	20,000
	400,000
Less: Adjusted basis of Distributing stock	(50,000)
Gain tentatively realized	$ 350,000

Testing for Dividend Equivalency. Under the hypothetical assumption that Sahara retained his Distributing stock, he would have owned 40% (400 ÷ 1,000) of the stock of Distributing prior to the exchange. The $20,000 cash payment would have redeemed 20 shares ($20,000 ÷ $1,000 FMV per share) of Distributing stock. Thus, after the hypothetical redemption, Sahara would have owned 38.7% [(400 − 20) ÷ (1,000 − 20)] of the Distributing stock. The $20,000 cash payment has the effect of the distribution of a dividend because his voting stock ownership percentage after the hypothetical redemption (38.7%) is not less than 80% of his hypothetical ownership percentage (40%) immediately before the redemption (80% of 40% equals 32%).

The tax treatment of the $20,000 payment is not clear. Presumably, the $20,000 payment to Sahara is treated as a distribution. Under Rev. Rul. 95-14, when an S corporation shareholder receives a redemption payment that is characterized as a dividend distribution, it is treated as an S corporation distribution under IRC Sec. 1368 that reduces AAA and stock basis. Under the reasoning in Rev. Rul. 93-62, pre-reorganization AAA and stock basis are used in determining the tax consequences of the $20,000 distribution. Accordingly, Distributing's AAA is reduced by $20,000, and Sahara reduces the basis of his Distributing stock to $30,000.

Gain Realized. Thus, in Example 4-16 Sahara realizes $350,000 of gain, determined as follows:

Amount realized	
FMV of all the shares of Controlled stock	$ 380,000
Less: Adjusted basis of Distributing stock	(30,000)
Gain realized	$ 350,000

Basis. Under the facts of Example 4-16, Sahara's basis in the Controlled stock is $30,000, which equals his basis in the Distributing stock. Presumably, the stock basis is not increased because no gain is recognized, and stock basis is not reduced because the cash payment is treated as a distribution instead of boot.

Recap. In Example 4-16, the treatment of the $20,000 cash payment as a distribution has no effect on the total gain realized, but its treatment avoids current gain recognition. The $20,000 cash payment reduces the AAA of Distributing and Sahara's basis in the Distributing stock by the same amount. If Distributing's AAA or Sahara's stock basis were less than the deemed distribution, the character and amount of the gain realized and recognized would be affected. If Distributing had AE&P, a portion of the distribution could be treated as a dividend if the distribution exceeded AAA.

Proposed Regulations. In January 2009, the IRS released proposed regulations that provide comprehensive guidance on the recovery of stock basis in distributions under IRC Sec. 301 (relating to dividend distributions), along with guidance on the resulting gain and the basis of stock or securities received. The regulations are designed to "harmonize" the tax treatment of economically similar transactions. Accordingly, the regulations adopt a single model for Section 301 (dividend equivalent) distributions and a single model for Section 302(a) sale or exchange (nondividend equivalent) transactions, regardless of whether IRC Sec. 301 or 302(a) applies. Consistent with the premise that a share of stock is the basic unit of property that can be disposed of, the proposed regulations would, for example, treat a Section 301 dividend equivalent distribution as received on a prorata, share-by-share basis with respect to the class of stock upon which the distribution is made. The proposed regulations are generally scheduled to become effective for transactions that occur after the date they are published as final regulations in the Federal Register.

HOW TO SPLIT UP A C CORPORATION TO FACILITATE DEVELOPMENT OF NATURAL RESOURCE PROPERTY, AVOID DOUBLE TAXATION, AND MINIMIZE LIABILITY FOR THE BUILT-IN GAINS TAX

The examples and discussion in this section illustrate the use of a Type D split-up to divide an existing corporation. The illustrated transaction minimizes the tax consequences to the shareholders.

Example 4-17: Using a Type D split-off to divide an existing corporation.

Rancho Grande, Inc., a family-owned C corporation, owns ranching property in west Texas. The corporation was founded by the family many years ago, and the current shareholders have acquired their stock by inheritance. Exploratory drilling activity in surrounding areas shows that oil and gas can be profitably produced in certain areas of Rancho Grande's land. Most of the family members want to develop the oil and gas property.

If the Rancho Grande develops the property, the oil and gas income will be taxed on the corporation's Form 1120. Furthermore, Rancho Grande's shareholders will be taxed on their returns if they receive dividends. If Rancho Grande elects S status, all of its assets become subject to the built-in gains tax.

Can Rancho Grande develop its natural resource properties in a way that avoids double taxation on the income it derives from its mineral interests and minimizes its liability for the built-in gains tax?

A Type D split-up can be used to separate Rancho Grande's ranching and natural resource production activities, and the split-up can be accomplished tax free to all the parties.

Meeting the Requirements for a Type D Split-up

After reviewing the available types of tax-free reorganizations, the tax planner recommends that Rancho Grande, the corporation in Example 4-17, use a Type D reorganization to split up its ranching and oil and gas activities.

Structuring the Transaction. Rancho Grande forms two subsidiaries: Farmco, Inc. and Petro, Inc. Rancho Grande transfers the assets and liabilities of its ranching operations to Farmco in exchange for all the stock in Farmco. Rancho Grande then transfers all mineral interests to Petro in exchange for all the stock in Petro. Rancho Grande immediately distributes the Farmco and Petro stock it now owns to its shareholders in exchange for their Rancho Grande stock and goes out of existence. Petro elects S status.

Meeting the Reorganization Requirements. The reorganization appears to meet the requirements (continuity of business enterprise, continuity of shareholder interest, and business purpose test) for a reorganization. Corporate

business reasons for the reorganization include minimizing the risks involved in the development and production of oil and gas properties, and the desire to separate the new business activity of developing the natural resources from the unrelated ranching activity. A split-up permits the disproportionate distributions of Farmco and Petro stock to the Rancho Grande shareholders in exchange for their Rancho Grande stock. This allows Rancho Grande to distribute only Farmco stock to the shareholders who prefer ranching activities and not the development of the natural resources. The reorganization also appears to meet the additional requirements (the device restriction, five-year history, principal tax avoidance purpose, and disqualified Section 355 distributions) discussed previously.

Target Corporation

Rancho Grande (the target in Example 4-17) does not recognize any gain or loss on the transfer of the assets and liabilities of its ranching operation to Farmco. Similarly, it recognizes no gain or loss on the transfer of its mineral interests to Petro. In addition, Rancho Grande does not recognize any gain or loss on the distribution of the Farmco and Petro stock to its shareholders in exchange for their Rancho Grande stock.

Acquiring Corporations

The acquiring corporations recognize no gain or loss on the issuance of their stock in exchange for the assets and liabilities they receive from Rancho Grande. The acquiring corporations take a transferred adjusted basis in the assets and liabilities they receive equal to the adjusted basis they have in Rancho Grande's hands. The holding period of Rancho Grande tacks on to the holding period of the assets in the acquiring corporations' hands.

Shareholders

The shareholders in Example 4-17 do not recognize gain or loss on the exchange of their Rancho Grande stock for stock in Farmco and Petro. Since this reorganization is for valid business reasons (oil and gas production is a risky business), it is probably not a device for the distribution of E&P. Actually, Petro will generate its own earnings (AAA, in this case, because Petro intends to immediately elect S status) and make distributions (if any) from those earnings. Gain is recognized to the extent of any boot received by the shareholders. In this example, the shareholders received no boot. The shareholders' adjusted basis in the Farmco and Petro stock they receive is the same as the adjusted basis in the Rancho Grande stock they surrender. They would allocate their basis in Rancho Grande stock to the stock they receive in Farmco and Petro.

Built-in Gains Tax

Petro's assets in Example 4-17 are subject to the built-in gains tax. If Petro sells any of its mineral interests within the 10-year period following its S election, the corporation is liable for built-in gains tax. However, Petro can produce oil and gas without having to recognize built-in gain. Evidently, neither royalty income nor income derived from the sale of oil and gas produced from a working interest are subject to built-in gains tax.

Double Taxation

Under Subchapter S, Petro in Example 4-17 will pass its oil and gas income through to its shareholders. The income will increase their stock basis. Petro's shareholders can receive tax-free distributions to the extent of Petro's AAA and their stock basis.

Other Considerations

Caution is advisable since Petro acquires a proportionate share of Rancho Grande's AE&P. Under IRC Sec. 1368(c), Petro could inadvertently make taxable dividend distributions if its distributions exceed its AAA. In addition, oil and gas royalties are considered passive investment income. Income derived from sales of oil and gas produced from a working interest are not passive investment income. Thus, Petro must take steps to avoid possible termination of its S election due to having more than 25% of its gross receipts from passive investment income while the corporation has C corporation AE&P. Furthermore, Petro may be subject to the tax on passive investment income. The risks of inadvertent taxable dividend distributions, termination, and the tax on excess net passive income can be avoided if Petro makes an election to distribute its AE&P.

Conclusion

Under the facts of Example 4-17 and paragraph above, a Type D split-up can be used to separate Rancho Grande's ranching and natural resource production activities. The split-up can be accomplished tax free to all the parties. The disproportionate distribution of Farmco and Petro stock in exchange for Rancho Grande stock allows the family members to adjust their ownership interests in the ranching and natural resource production activities. The assets of Farmco remain in a C corporation and are not subject to the built-in gains tax. Petro's assets on hand at the date the S election becomes effective are subject to the built-in gains tax if they are sold within the 10-year recognition period. However, the royalty income and income from working interests are not subject to the built-in gains tax. The shareholders can receive tax-free distributions from Petro to the extent of Petro's AAA and their basis in Petro stock.

Petro may be subject to the tax on passive investment income or suffer an involuntary termination of S status after three years if Petro has C corporation AE&P and 25% of its gross receipts are from passive investments. However, both the tax and termination can be avoided by making an election to distribute Petro's AE&P. The election also eliminates the risk of inadvertent taxable dividend distributions.

Standing Timber and the Built-in Gains Tax

The letter rulings on timber and the built-in gains tax regulations on oil and gas are consistent in holding that income from the production of a natural resource property held on the first day of the corporation's first year as an S corporation is not subject to the built-in gains tax. However, income from the sales of previously severed or extracted natural resources held on the effective date of the corporation's S election are subject to the built-in gains tax. Evidently, other types of natural resources such as minerals, gravel, or coal would be treated similarly.

Example 4-18: Income derived from the cutting of timber is not subject to the built-in gains tax.

Assume now that Rancho Grande from Example 4-17 has standing timber (instead of oil and gas deposits) and engages in the Type D split-up as previously discussed.

The IRS has privately ruled that the income derived by the S corporation from the cutting of timber and sale of logs produced from the cut timber during the 10-year built-in gains recognition period does not constitute recognized built-in gain. However, if any timber is cut before the corporation's S election becomes effective and the logs produced from the cut timber are held as inventory on the day the S election becomes effective, any income derived by the S corporation on the sale of such logs during the 10-year recognition period will constitute recognized built-in gain.

HOW TO USE A TYPE E DEBT-FOR-EQUITY SWAP TO ELIMINATE REDUCED BASIS DEBT

The example and discussion in this section illustrate a method of swapping reduced basis debt for stock in an S corporation. When the swap qualifies as a Type E recapitalization, the transaction is tax-free. However, the transaction is taxable if it does not qualify as a Type E recapitalization. When the transaction qualifies as a Type E recapitalization, the shareholder can eliminate the threat of gain recognition on the repayment of the reduced basis debt, and the shareholder's basis in the swapped debt becomes additional stock basis.

Example 4-19: Using a Type E debt-for-equity swap to eliminate reduced basis debt.

Vancorp was formed five years ago and has been an S corporation for all years since incorporation. When the corporation was formed, its sole shareholder, Van, contributed $20,000 in exchange for 100% of the stock and loaned $60,000 to the corporation. This loan was evidenced by a written debt instrument, due and payable 10 years after incorporation.

During the first several years of existence, the corporation incurred total losses of $35,000, resulting in a $20,000 reduction of Van's basis in his stock and a $15,000 reduction of basis in the debt. For the current year, the tax planner estimates the corporation will have net income of $40,000, and Van anticipates that the corporation will be profitable in future years. In the current year, Van expects to receive distributions of $40,000.

Now that Vancorp is becoming successful, Van would like to expand. He has discussed with his banker the possibility of securing a bank loan for the expansion. However, the banker is reluctant to make the loan because of the $60,000 shareholder loan. The tax planner explains that repayment of the note by the corporation will result in a $15,000 capital gain to Van. The planner suggests that an alternative might be to convert the debt to equity, which could avoid the gain recognition by Van.

What action can Vancorp take to ensure Van is not taxed on the conversion of the loan to equity? In a plan of recapitalization, Van can exchange the debt instrument for additional stock of Vancorp without gain on the recapitalization. Vancorp's financial position then permits Van to negotiate a bank loan for expansion of Vancorp's business.

Gain on Repayment of Reduced Basis Debt

To determine any potential gain on repayment of the debt or debt cancellation under the facts of Example 4-19, the tax planner must determine the effect of the current year's operation on debt basis. Under IRC Sec. 1366(d)(1), a shareholder whose stock basis has been reduced to zero may take into account losses and deductions (but not distributions) allocated to the shareholder to the extent of the shareholder's basis in S corporation debt owed to the shareholder. Under the Section 1367 basis regulations, if the amount of the items that decrease the basis of a shareholder's stock (other than distributions) exceeds the basis of all the shareholder's stock, the excess is applied to reduce (but not below zero) the shareholder's debt basis. Debt basis reduction generally applies only to debt held by the shareholder at the end of the corporation's tax year and does not apply to debt that is satisfied, disposed of, or forgiven during the year. Under these rules, Van's basis in stock and debt is as follows:

	Stock Basis	Debt Basis
Initial capital and debt at formation	$ 20,000	$ 60,000
Cumulative losses to date	(20,000)	(15,000)
Current tax basis	$ -0-	$ 45,000

A "Net Increase" Restores Debt Basis. The Section 1367 regulations state that if for any year there has been a reduction of the shareholder's debt basis, a "net increase" must occur in a subsequent tax year before debt basis can be restored. A "net increase" is the amount by which the sum of the shareholder's items of income and excess deductions for depletion exceeds the sum of the items of loss, deduction, nondeductible noncapital expenses, distributions, and certain oil and gas depletion deductions. The basis restoration rules apply to S corporation debt held by the shareholder on the first day of the tax year in which the net increase arises, with basis restoration limited to the outstanding balance of the S corporation debt as of that day.

Potential Gain on Repayment of Reduced Basis Debt. Because, under the facts of Example 4-19, Van will receive distributions that equal the corporation's net income ($40,000), there will be no "net increase," so debt basis will remain unchanged ($45,000) at the end of the current year. Repayment of the debt will thus result in a $15,000 capital gain to Van.

Meeting the Requirements for a Type E Recapitalization

To avoid potential gain on repayment of reduced basis debt under the facts of Example 4-19, the planner suggests a recapitalization. Under this recapitalization plan, Van would swap his debt for additional stock in Vancorp via a Type E reorganization. A Type E reorganization involves the recapitalization of a single corporation. Type E reorganizations include transactions such as the exchange of common stock for preferred stock, old debt for new debt, or debt for new stock in a single corporate entity.

Of course, the debt-for-equity swap must meet both the statutory and judicial requirements to be a tax-free reorganization. The proposed plan in Example 4-19 meets the statutory requirements for a Type E reorganization and the judicial requirements of continuity of business enterprise and continuity of shareholder interest. It also appears that the business purpose is satisfied because the shareholder debt must be canceled before the banker is willing to loan funds for the expansion (that is, a specific corporate purpose, the need for an expansion loan, has been identified).

In addition, for the exchange in Example 4-19 to qualify as a tax-free reorganization, the shareholder debt that is surrendered must qualify as a "security" under IRC Sec. 354. The word "security" is defined in the Code in two places. First, IRC Sec. 1236(c) defines a security as an "interest in any corporation, note, bond, debenture, or evidence of indebtedness." Second, IRC Sec. 6323(h)(4) defines a security as "any bond, debenture, note, or other certificate of indebtedness, issued by a corporation."

While the test as to whether a debt is a "security" is "not a mechanical determination of the time period of the note" (*Camp Wolters Enterprises*), in general, a short-term note is less likely to be classified as a security. In Rev. Rul. 2004-78, the IRS states that, under case law, a debt instrument with a term of less than five years generally is not a security. In Example 4-19, the stock will be issued in exchange for a written 10-year note. The courts have held that a long-term note can qualify as a security, and the tax practitioner concludes that the Vancorp note will qualify under these rules (*Burnham*).

Because Type E reorganizations typically involve only slight changes in a corporation's capitalization, a transaction of this type is not considered a sale. Regulations under IRC Sec. 368(a)(1) provide that continuity of shareholder interest (COSI) and continuity of business enterprise (COBE) are not required for a transaction to qualify as a tax-free Type E reorganization.

Conclusion

By eliminating the debt instrument in Example 4-19, Van's remaining basis in the debt of $45,000 will become basis in corporate stock. Unfortunately, stock received in exchange for a security will not qualify as Section 1244 stock. Thus, to the extent the debt qualifies as a security, the shareholder's new stock will not qualify for ordinary loss treatment under IRC Sec. 1244.

A Debt-for-equity Swap May Be Taxable

A debt-for-equity swap that does not qualify as a Type E recapitalization is a taxable transaction.

Example 4-20: Taxable debt-for-equity swap.

Assume the same facts as in Example 4-19, except that Van's loan to Vancorp is not evidenced by a written debt instrument, but instead is an unwritten "open account" that is payable on demand. It is doubtful that an unwritten open account qualifies as a "security" for Section 354 purposes. Assuming that the planner concludes that the open account does not qualify as a security, the debt-for-equity swap will not qualify as a tax-free Type E reorganization.

Under these facts, the effect of the "discharge of indebtedness rules" must be considered. At the corporate level, Vancorp has been relieved of a $60,000 debt obligation.

If a shareholder-creditor forgives debt owed by the corporation, the corporation generally is required to recognize income from the discharge of indebtedness. However, if the corporation is in bankruptcy (referred to as a "Title 11 case" in the Code) or is insolvent (but only to the extent of the corporation's insolvency), it is not required to recognize income from the discharge of indebtedness. The corporation pays for nonrecognition treatment by reducing certain tax attributes to the extent of the income not recognized. Some of the attributes subject to reduction are NOL carryovers, general business credit carryovers, minimum tax credit carryovers, capital loss carryovers, PAL credit and loss carryovers, and asset bases.

Since Vancorp in Example 4-20 is not in bankruptcy and is not insolvent it must recognize any income realized on the debt-for-equity swap. The Code defines the term "insolvent" as the "excess of liabilities over the fair market value of assets".

If Vancorp transfers stock to Van in Example 4-20 in satisfaction of the debt, the corporation is treated as having satisfied the debt with money equal to the FMV of the stock. Assume the FMV of the stock issued to Van in exchange for the debt is $50,000. Vancorp recognizes $10,000 of ordinary income, the difference between the face amount of the debt ($60,000) and the FMV of the stock ($50,000). This income passes through to Van under the normal S corporation pass-through rules. In addition, Van recognizes a capital gain of $5,000, the difference

between the FMV of the stock received ($50,000) and his basis in the debt ($45,000). Van's basis in the new stock is $50,000.

Debt-for-equity swaps result in recognition of income from the cancellation of debt, unless the corporation qualifies for nonrecognition treatment under the general nonrecognition rule of IRC Sec. 108(a). As discussed previously, bankrupt or insolvent corporations qualify for nonrecognition under IRC Sec. 108(a) but must reduce certain tax attributes to the extent of the excluded income. A bankrupt or insolvent corporation can qualify to exclude cancellation of debt income only under the general nonrecognition rule and at the cost of reducing its tax attributes.

Contributing Debt to Capital May Be Tax Free

Generally, contributions to capital do not result in income at the corporate level. But, if a shareholder contributes corporate debt to capital, the corporation is treated as satisfying the debt with an amount of money equal to the shareholder's basis in the debt. For determining debt forgiveness income under IRC Sec. 108, a special rule states that the shareholder's debt basis does not take into account any reduction in basis under IRC Sec. 1367 due to S corporation loss or deduction items. In this situation, when debt basis has been reduced by prior year pass-through losses, contribution of debt to capital generally results in no corporate-level income.

A contribution of debt to capital may be tax free.

Example 4-21: Contributing debt to capital.

Instead of swapping equity for the existing open account debt as in Example 4-20, assume Van contributes the debt to the capital of the corporation (forgives the debt owed by the corporation).

If Van contributes the debt to capital (rather than issuing new stock for debt, as in Example 4-20), Vancorp is deemed to have satisfied the debt for an amount equal to Van's basis without considering the $15,000 of pass-through losses previously allocated to the debt. Vancorp will have no income from the transaction because the $60,000 loan is deemed to be satisfied for $60,000. Van's stock basis is increased by his basis in the debt, $45,000.

Issuing Straight Debt in a Debt-for-debt Swap Minimizes the Second Class of Stock Issue

A Type E recapitalization can also be used to exchange old debt in a corporation for new debt qualifying as safe harbor "straight debt." This may be advisable to minimize the risk of contending with a second-class-of-stock issue with the IRS.

Alternatively, a Type E reorganization can convert an open account debt into a new written debt instrument, qualifying for capital gain treatment upon eventual repayment. The problem with this technique is that for the recapitalization to be tax free, both the old open account and the new written debt must meet the definition of a "security" under IRC Sec. 354. And, as already noted in Example 4-20 and previously in the lesson, it is debatable whether an unwritten debt can qualify as a "security."

HOW TO STRUCTURE A TYPE F REORGANIZATION TO CHANGE THE IDENTITY, FORM, OR PLACE OF ORGANIZATION

A Type F reorganization involves only changes in the identity, form, or place of organization of one corporation.

a. An example of a change in identity is an amendment of the articles of incorporation to change the corporate name. The shareholders exchange their old stock certificates for new ones, with the only difference between the two being the name of the corporation.

b. An example of a change in form is a corporation that converts to a limited partnership under state law and then elects to be treated as a corporation under the "check-the-box" regulations; specifically, Reg. 301.7701-3.

c. An example of a change in place is the reincorporation of a corporation in a new state.

Typically, a transaction will not qualify as a Type F reorganization unless there is no change in the existing shareholders or assets of the corporation involved. However, Prop. Reg. 1.368-2(m) will relax this standard if the proposed regulation becomes final. The proposed regulation will allow a transaction to remain eligible for a Type F reorganization, even if the reincorporation phase is preceded or followed by related events such as the redemption of a substantial amount of dissenting shareholder's stock. The parties to the reorganization would have to meet the following conditions:

a. all the stock of the resulting corporation, including stock issued before the transfer, is issued in respect of stock of the transferring corporation;

b. there is no change in the ownership of the corporation, except a change that has no effect other than that of a redemption of less than all the shares of the corporation;

c. the transferring corporation completely liquidates in the transaction; and

d. the resulting corporation does not hold any property or have any tax attributes [including those specified in IRC Sec. 381(c)] immediately before the transfer.

For most tax purposes, a Type F reorganization is treated as if there had been no change to the corporation (i.e., the new corporation is the same entity as the pre-reorganization corporation). Thus, the corporation's tax year does not change and its tax attributes are not affected. Also, the corporation's Section 1244 status is not affected.

Because Type F reorganizations typically involve only slight changes in a corporation's identity, form, or place of organization, a transaction of this type is not considered a sale. Regulations under IRC Sec. 368(a)(1) provide that continuity of shareholder interest (COSI) and continuity of business enterprise (COBE) are not required for a transaction to qualify as a tax-free Type F reorganization.

Preserving S Corporation Status

An entity that has filed a check-the-box election to be taxed as a corporation is eligible for S status.

The IRS has privately ruled that the merger of an S corporation into a general partnership with an election by the general partnership to be treated as a corporation would qualify as a Type F reorganization. The following example illustrates this letter ruling:

Example 4-22: S corporation Type F reorganization.

Antique Autos is an S corporation that wants to reorganize as a general partnership. Antique will form a general partnership, Grand Prairie Partners, that will elect to be treated as a corporation and will continue to be taxed as an S corporation. Thus, Grand Prairie Partners will never exist as a partnership for federal tax purposes. Antique Autos will merge into the general partnership.

The merger of the S corporation into the general partnership and the election by the general partnership to be treated as a corporation will qualify as a Type F reorganization.

In general, an S corporation is treated as having one class of stock only if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are ignored. The IRS has ruled that general and limited partnership interests that confer identical rights to distribution and liquidation proceeds satisfy the one class of stock requirement. However, the IRS has announced that it 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.

Converting an S Corporation to a Co-tenancy

An S corporation can convert to a co-tenancy under local law, and the co-tenants can immediately elect to treat the co-tenancy as a corporation in a transaction that preserves the entity's S corporation status.

Example 4-23: Converting an S corporation to a co-tenancy without terminating the entity's S election.

Assume that Essco, an S corporation, owns a building that it leases to a variety of tenants. Essco provides services beyond those necessary for maintenance and repair, including (but not limited to) security services and improvements on behalf of tenants.

Essco plans to liquidate under local law, causing its property to be held by its shareholders as tenants-in-common. As co-tenants, the shareholders will retain their proportionate interests for the foreseeable future. The shareholders will have equal rights to operating and liquidating proceeds based on their proportionate interests. The co-tenancy will provide the same services to the tenants as previously provided by the corporation.

The co-tenancy plans to file a Form 8832 (Entity Classification Election) electing to be classified as an association taxable as a corporation, effective for the start of its existence as a state law co-tenancy. Essco represents that it will continue to meet the requirements of an S corporation under IRC Sec. 1361 after this transaction.

In a similar situation, the IRS ruled that an S corporation's election would not terminate. The transaction would evidently qualify as a Type F reorganization.

Only One Form 1120S Required

A Type F reorganization does not require the filing of short-year returns. The converted entity should file a return for the full year under its name. The converted entity does not need to obtain a new federal tax identification number (TIN). It continues using the same TIN it has previously used.

When the converting entity is an S corporation, the conversion will not terminate its S election, assuming the post-conversion shareholders are eligible to own S stock. However, the converted entity should notify the IRS that it retains its status as an S corporation by, for example, attaching a statement to its Form 1120S for the year of conversion.

Example 4-24: Retaining the taxpayer's ID number following a Type F reorganization.

Betty owns all of the stock in Oldco, an S corporation. During the current year, Betty forms Newco and contributes all of her Oldco stock to Newco. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Oldco as a QSub, effective immediately following the transaction. The transaction meets the requirements of a Type F reorganization.

Consistent with Rev. Rul. 64-250, Oldco's original S election does not terminate but continues for Newco. Newco must obtain a new TIN. Oldco must retain its TIN, even though a QSub election is made for it. Oldco must use its original TIN any time it is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes) or if the QSub election terminates.

Variation: During the following year, Newco sells a 1% interest in Oldco to Dora. As a result, Oldco's QSub election terminates. Oldco must use its original TIN following the termination of Oldco's QSub election.

Example 4-25: Taxpayer ID number following a Type F reorganization.

Cynthia owns all of the stock of Zeno, an S corporation. During the current year, Zeno forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merges with and into Zeno, with Zeno surviving and Cynthia receiving solely Newco stock in exchange for Zeno stock. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Zeno as a QSub, effective immediately following the transaction. The transaction meets the requirements of a Type F reorganization.

Consistent with Rev. Rul. 64-250, Zeno's original S election does not terminate but continues for Newco. Newco must obtain a new TIN. Zeno must retain its TIN, even though a QSub election is made for it. Zeno must use its original TIN any time it is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes) or if the QSub election terminates.

SELF-STUDY QUIZ

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

23. One restriction of a divisive reorganization is that the reorganization cannot be used as a method to extract earnings and profits out of either the transferor or transferee corporation. What is the label of this restriction in a divisive reorganization?

    a. Five-year history.

    b. Principal Tax Avoidance Purpose.

    c. Disqualified Section 355 Distribution.

    d. Device restriction.

24. Which of the following would **not** be a valid business purpose for a divisive Type D reorganization?

    a. Sally and Sue decide to spin off the bakery portion of their catering business so that they can elect S status for each new corporation.

    b. Eric decide to reorganize his business to spin-off the home building company from the commercial builders in order to transfer stock to his president of the home building company, since he is critical to the success of the company.

    c. Scott and Nick decide to spin off the appliance repair shop from the appliance sales warehouse because they cannot agree on how to run the corporation together. Nick will be the primary owner of the repair shop and run it.

25. Shipley Wines, a calendar year S corporation, owns three wineries. One winery is Fat Cat Wine, in Sonoma, CA. The other two are located in Napa Valley, CA. The Shipley family owns Shipley Wines, with the largest shareholder being Ryan Shipley, the father of the Shipley family. He owns 400 shares of the outstanding 1000 shares, equal to $1,000,000. His basis in Shipley Wines is $60,000. The shareholders have decided to separate the Sonoma winery from the Napa Valley wineries due to marketing issues. The reorganization has been set up as a divisive Type D split-off and a newly created corporation, Shipley Sonoma is set up, worth, $500,000. The assets were transferred to the new company in exchange for all of Ryan's stock in Shipley Wines. All of the stock in Shipley Sonoma was distributed to Ryan Shipley, plus $100,000 in cash for his Shipley Wines stock. What is Ryan's basis in the new Shipley Sonoma stock?

    a. $0.

    b. $60,000.

    c. $160,000.

26. Which of the following is true regarding a Type E reorganization?

    a. A Type E reorganization is considered a sale of the company.

    b. All the same requirements mandatory for a tax-free reorganization are required in a Type E reorganization.

    c. Nothing is required of the corporation if the shareholder-creditor forgives the debt owed by the corporation in a Type E reorganization.

    d. To qualify for a Type E tax-free reorganization, the shareholder must surrender debt that is a security.

27. Which of the following reorganizations would not be classified as a Type F reorganization?

    a. Wilson Enterprises has decided to reincorporate in the state of Texas. They are currently incorporated in California and they would like to move to a state with no state income tax.

    b. Longman Brothers Boat Manufacturing has decided to change from a corporation to a limited partnership under Florida state law, but decides to be treated as a corporation under the "check-the-box" regulations.

    c. Pretty Pet Products purchases 85% of the stock of Quality Dog Food. The shareholders of Quality will receive voting stock of Pretty Pet Products in return.

    d. Future Finds, Inc. has decided to change the legal name of the corporation to Future Finds and Rare Coins, Inc. Management feels the new name is more representative of the company's mission.

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. One restriction of a divisive reorganization is that the reorganization cannot be used as a method to extract earnings and profits out of either the transferor or transferee corporation. What is the label of this restriction in a divisive reorganization? **(Page 209)**

    a. Five-year history. [This answer is incorrect. The five-year history is a restriction of a divisive reorganization, but it states that both the transferor and transferee corporations must be engaged in the active conduct of a business, with the trade or business having been conducted throughout the five-year period ending on the date of the distribution.]

    b. Principal Tax Avoidance Purpose. [This answer is incorrect. The principal tax avoidance purpose states either all of the stock and securities of the transferee corporation is distributed, or at least 80% distributed in a plan not having a principal tax avoidance purpose. It does not relate to trying to get earnings and profits out of the corporations in the reorganization.]

    c. Disqualified Section 355 Distribution. [This answer is incorrect. The disqualified section 355 distribution is a divisive reorganization restriction, but this restriction requires the distributing corporation to recognize gain in an otherwise tax-free transaction on a "disqualified distribution" of stock or securities in a controlled corporation.]

    d. Device restriction. [This answer is correct. One restriction of a divisive reorganization is that the transaction may not be used principally as a device to bail out earnings and profits of either the transferor or transferee corporation as stated in IRC Sec. 355(a)(1)(B). This is called a device restriction. Factors listed in the regulation as possible evidence of a device include: a prorate distribution of the transferee corporation stock to the shareholders of the transferor corporation; a distribution followed by a sale or exchange of the stock of the transferor or transferee corporation; or the existence of cash or other liquid assets of the transferor corporation not used in a qualifying business.]

24. Which of the following would **not** be a valid business purpose for a divisive Type D reorganization? **(Page 218)**

    a. Sally and Sue decide to spin off the bakery portion of their catering business so that they can elect S status for each new corporation. [This answer is correct. A reorganization must have a bona fide corporate business purpose other than the avoidance of tax. The objective of obtaining S status alone will not be considered a sufficient business purpose by the IRS according to Reg. 1.355-2(b)(5).]

    b. Eric decide to reorganize his business to spin-off the home building company from the commercial builders in order to transfer stock to his president of the home building company, since he is critical to the success of the company. [This answer is incorrect. If the facts and circumstances establish that the reorganization was substantially motivated by the need to issue stock to an employee, it will meet the corporate business purpose requirement as stated in Reg. 1.355-2(b)(5).]

    c. Scott and Nick decide to spin off the appliance repair shop from the appliance sales warehouse because they cannot agree on how to run the corporation together. Nick will be the primary owner of the repair shop and run it. [This answer is incorrect. Personal nontax motives of the shareholders, such as splitting a corporation enterprise to allow separate control, generally will not satisfy the business purpose test. According to Reg. 1.355-2(b)(1) the business purpose must be that of the corporation. However, situations involving shareholder disagreement and the need to inject capital appear to make the shareholder and corporate needs coextensive and therefore qualify.]

25. Shipley Wines, a calendar year S corporation, owns three wineries. One winery is Fat Cat Wine, in Sonoma, CA. The other two are located in Napa Valley, CA. The Shipley family owns Shipley Wines, with the largest shareholder being Ryan Shipley, the father of the Shipley family. He owns 400 shares of the outstanding 1000 shares, equal to $1,000,000. His basis in Shipley Wines is $60,000. The shareholders have decided to separate the Sonoma winery from the Napa Valley wineries due to marketing issues. The reorganization has been set up as a divisive Type D split-off and a newly created corporation, Shipley Sonoma is set up, worth, $500,000. The assets were transferred to the new company in exchange for all of Ryan's stock in Shipley Wines. All of the stock in Shipley Sonoma was distributed to Ryan Shipley, plus $100,000 in cash for his Shipley Wines stock. What is Ryan's basis in the new Shipley Sonoma stock? **(Page 220)**

    a. $0. [This answer is incorrect. Ryan will have a basis for his stock in the new company, even though he did not pay for it due to the transfer of all of the assets from the previous company, Shipley Wines.]

    b. $60,000. [This answer is correct. Ryan's basis in the newly created company Shipley Sonoma is $60,000, which is equal to the basis in Shipley Wines less the cash payment received plus the capital gain recognized, according to IRC Sec. 358.]

    c. $160,000. [This answer is incorrect. The stock basis is not increased by the cash given to Ryan because the cash payment is treated as a distribution instead of boot. The $100,000 cash payment has the effect of a distribution of dividend because his voting stock ownership percentage after the hypothetical redemption (33.33%) is not less than 80% of his hypothetical ownership percentage (40%) immediately before the redemption (80% of 40% equals 32%).]

26. Which of the following is true regarding a Type E reorganization? **(Page 225)**

    a. A Type E reorganization is considered a sale of the company. [This answer is incorrect. Because Type E reorganizations typically involve only slight changes in a corporation's capitalization, a transaction of this type is not considered a sale.]

    b. All the same requirements mandatory for a tax-free reorganization are required in a Type E reorganization. [This answer is incorrect. Regulations under IRC Sec. 368(a)(1) provide that continuity of shareholder interest (COSI) and continuity of business enterprise (COBE) are not required for a transaction to qualify as a tax-free Type E reorganization as stated in Reg. 1.368-1(b).]

    c. Nothing is required of the corporation if the shareholder-creditor forgives the debt owed by the corporation in a Type E reorganization. [This answer is incorrect. If a shareholder-creditor forgives debts owed by the corporation, the corporation generally is required to recognize income from the discharge of indebtedness according to IRC Sec. 61(a)(12).]

    d. To qualify for a Type E tax-free reorganization, the shareholder must surrender debt that is a security. [This answer is correct. For the exchange to qualify as a tax-free reorganization, the shareholder debt that is surrendered must qualify as a "security" under IRC Sec. 354. The word "security" is defined in the Code as an "interest in any corporation, note, bond, debenture, or evidence of indebtedness".]

27. Which of the following reorganizations would not be classified as a Type F reorganization? **(Page 226)**

    a. Wilson Enterprises has decided to reincorporate in the state of Texas. They are currently incorporated in California and they would like to move to a state with no state income tax. [This answer is incorrect. One example of a Type F reorganization is a change in place per IRC Sec. 368(a)(1)(F). A change in place can be a reincorporation of a corporation in a new state.]

    b. Longman Brothers Boat Manufacturing has decided to change from a corporation to a limited partnership under Florida state law, but decides to be treated as a corporation under the "check-the-box" regulations. [This answer is incorrect. A Type F reorganization involves only certain changes, one being form. According to Reg. 301.7701-3, an example of a change in form is a corporation that converts to a limited partnership under state law and then elects to be treated as a corporation under the "check-the-box" regulations.]

c. Pretty Pet Products purchases 85% of the stock of Quality Dog Food. The shareholders of Quality will receive voting stock of Pretty Pet Products in return. [This answer is correct. This is not a Type F reorganization, but a Type B—stock-for-stock exchange. In a Type B reorganization, one corporation acquires 80% or more of the stock of another corporation in exchange solely for the voting stock of the acquiring corporation.]

d. Future Finds, Inc. has decided to change the legal name of the corporation to Future Finds and Rare Coins, Inc. Management feels the new name is more representative of the company's mission. [This answer is incorrect. One kind of Type F reorganization is a change in the identity of a company. An example of a change in identity is an amendment of the articles of incorporation to change the corporation's name. The shareholders exchange their old stock certificates for new ones, with the only difference between the two being the name of the corporation.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TSCTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

17. Smith Corporation is an S corporation and Jones Enterprises is a regular C corporation. Both entities are involved in a similar business. The shareholders of each corporation agree to combine their two businesses in a statutory merger—Type A merger. Jones Enterprises will go out of existence by transferring its assets to Smith Corporation and the Jones shareholders will receive newly issued Smith stock in exchange for their stock in the former Jones Enterprises. To ensure tax-free treatment for the reorganization, which of the following requirements must be met?

    I. Asset Continuity

    II. Continuity of Shareholder Interest

    III. Business-purpose Test

    IV. Five-year Test.

    V. Device Restriction.

    a. I, II.

    b. II, IV, V.

    c. I, II, III.

    d. I, II, III, IV, V.

18. After a reorganization, the acquiring company, organized as a C corporation, plans to elect S status. The two companies had numerous assets that were duplicates as a result of combining the two companies in the merger and plan to sell the spares. What will tax problems could this present, if the S status is elected?

    a. Carryover of PTI from the merger.

    b. Built-in gains tax.

    c. Net passive income.

    d. Potential credit recapture.

19. How can a C corporation that has elected S status after a merger avoid built-in gains tax?

    a. After electing S status, the corporation could hold the assets for a year before disposing of them.

    b. Require shareholder approval from previous C corporation shareholders before disposing of any assets.

    c. Sell the assets on an installment plan with collections deferred until after the 10-year point.

    d. Not allow any disposition of assets from the target corporation as long as any of the shareholders from the target corporation still own stock in the S corporation.

20. Lucy owns all the outstanding shares of Tasty Cakes, Inc. She decides to merge Tasty Cakes with Scrumptious Desserts, Co. with Scrumptious being the acquiring company in a Type A acquisitive reorganization. Tasty Cakes will transfer all of its assets and liabilities to Scrumptious and Lucy will exchange all of her stock in Tasty Cakes for 200 shares of Scrumptious worth $750 per share and $75,000 cash. Lucy's previous basis in Tasty Cakes was $100,000. How much gain will Lucy realize on the merger of the two companies?

    a. $0.

    b. $75,000.

    c. $125,000.

    d. $225,000.

21. Based on the information in the previous question, what percentage of the company does Lucy own based on the dividend equivalency test if there are 1,800 shares of Scrumptious Desserts Co. outstanding after the merger, but before the hypothetical redemption of the shares?

    a. 0%.

    b. 11.11%.

    c. 16.66%.

    d. 20%.

22. When a company elects S status before entering into a Type B reorganization with an acquiring company, what is the advantage to the target company?

    a. A tax-free reorganization.

    b. Section 1244 ordinary loss treatment.

    c. The loss of boot being paid to the sellers.

    d. Business credit recapture.

23. Clear Waters, Inc., a large pool construction and remodeling company, has decided to acquire the assets of Clean & Bright, a pool cleaning company. Both companies are set up as S corporations. Clean & Bright is 100% owned by John Jackson. Clear Waters is going to purchase all of the assets of Clean & Bright, with the exception of John Jackson's company truck. Mr. Jackson will receive Clear Water stock in exchange for the assets of Clean & Bright in a Type C reorganization. Which of the following would endanger the S status of Clear Waters after the reorganization?

    a. After the reorganization, John Jackson owns 35% of Clear Waters' open stock.

    b. With the addition of John Jackson, Clear Waters would have 86 shareholders.

    c. After the reorganization, John Jackson does not immediately liquidate Clean & Bright.

    d. Clean & Bright had one class of stock before the reorganization with Clear Waters.

24. Which of the following is a requirement of a divisive reorganization, but not other types of reorganizations?

    a. Business purpose.

    b. Continuity of shareholder interest.

    c. Continuity of business enterprise.

    d. Principal tax avoidance purpose.

25. Ed and Frank own Brothers Fine Dining, Inc. The company is made of two restaurants, Brothers Steak House and Brothers Home Cooking. Each own 50% of the corporation. When they established the company in 2006, they elected S status for the company. They terminated the S status and made it a C corporation in 2008. Ed and Frank have decided in 2010 to reorganize the business where Ed will be the primary shareholder in Brothers Steak House and Frank will be the primary shareholder in Brothers Home Cooking. They decide to accomplish this by completing a divisive D reorganization. After completing the reorganization, Frank would like to set up Brothers Home Cooking as an S corporation again. When is the earliest that Frank would be able to accomplish this?

    a. Immediately upon completion of the reorganization.

    b. At the end of 2010.

    c. 2011.

    d. 2012.

26. Three years ago, Logan created LogCorp, an S corporation. At that time, Logan contributed $30,000 in exchange for all of the stock and loaned $50,000 to the corporation. This loan was evidenced by a written debt instrument, due and payable 10 years after incorporation. The first two years, the corporation incurred total losses of $50,000, but in the current year, the company anticipates making a profit. Logan would like to expand his company and is looking at a Type E reorganization. Before the profit this year, what is Logan's debt basis in the company?

    a. $0.

    b. $20,000.

    c. $30,000.

    d. $50,000.

27. Which of the following is correct for a Type F reorganization?

    a. The new corporation is the same entity as it was before the reorganization.

    b. The corporation will lose its Section 1244 status in a Type F reorganization.

    c. All Type F reorganizations are classified as sales of the company.

    d. The corporation is required to change its tax year in a Type F reorganization.

Lesson 3: Understanding Various Aspects of Qualified Subchapter S Subsidiaries

INTRODUCTION

A qualified Subchapter S subsidiary (QSub) is a subsidiary corporation 100% owned by an S corporation that has made a valid QSub election for that subsidiary. In addition to being 100% owned by an S corporation, a QSub must be a domestic corporation that otherwise qualifies to be an S corporation.

A QSub is technically neither a C corporation nor an S corporation. Instead, a QSub is not treated as a separate corporation for federal tax purposes (although it is still treated as a separate corporation for other purposes). A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify various aspects of qualified subchapter S subsidiaries such as uses, eligibility, status, liquidation, operation, and termination.

HOW TO PLAN FOR THE BENEFICIAL USE OF QSUBS

The following paragraphs summarize when it may be beneficial for an S corporation to utilize a subsidiary as a QSub.

Facilitate Operating in Multiple Locations

A QSub might be used when a corporation is operating in multiple locations.

Example 5-1: Using QSubs for multiple locations.

Hardware, Inc., is a successful S corporation that has decided to expand by opening several new stores in various locations. Hardware can form a subsidiary and make a QSub election for each store. This structure protects the assets of the parent corporation (Hardware) and each store from liabilities arising from operations at another location.

Increase Stock and Debt Basis

Debt issued by a QSub to a shareholder of a parent S corporation is treated as debt of the parent for purposes of determining shareholder debt basis. Thus, a QSub can be used to aggregate stockholder basis in stock or debt to increase the amount that can be deducted for current or suspended pass-through losses.

Reduce or Eliminate Built-in Gains on Intercompany Asset Sales

For an existing corporation, making a QSub election for a subsidiary that was a C corporation can subject the S corporation to the built-in gains tax if the built-in gain property is sold to an entity outside the group. However, the built-in gains tax does not apply to asset sales between a QSub and its parent because they are considered to be one entity for these purposes.

Facilitate Acquisition of a New Business

To facilitate acquisition of another business, the S corporation can form a subsidiary made up of the new business and elect QSub status for the subsidiary. Under this arrangement, the parent and the QSub are each protected under a separate corporate liability shield.

Hold Real Estate

An S corporation may find it advantageous to use a QSub to hold real property in order to gain another layer of liability protection. Furthermore, a QSub can be used to provide liability protection when the parent corporation engages in a Section 1033 tax-deferred replacement of property involuntarily converted due to condemnation or destruction. For example, in Ltr. Rul. 1999909054, an S corporation wanted to use a QSub to acquire Section 1033 replacement property after the original property (which was directly owned by the S corporation) was condemned. The ruling concludes that the existence of the QSub would be ignored if it was used to own the replacement property. Therefore, the parent S corporation could make the Section 1033 gain deferral election even though the replacement property would be legally owned by the QSub. The same logic would evidently apply when a QSub is used to own property involved in a Section 1031 like-kind exchange.

Coping with State Tax Issues Relating to QSubs

For federal income tax purposes, a QSub is disregarded and its income, expenses, assets, and liabilities are treated as owned by the parent S corporation. States may try to assert that the parent corporation has nexus in the state if the QSub has nexus there. This would be one result of disregarding the QSub for state tax purposes, since its property, payroll, and receipts would be included in the parent's totals and arguably be used to apportion the parent's income (which includes the QSub's income) to the state. Not all states, however, will follow the federal treatment and disregard the QSub.

If the QSub is not disregarded, the state's normal rules for parent and subsidiary corporations should apply. Also, if the parent engages in activities related to its subsidiary (e.g., opening a bank account in the state where the QSub is located, or holding director's meetings there), those activities may result in the parent having nexus in the state. Practitioners should be cautious and examine potential state income tax ramifications when advising clients who use QSubs, especially if the QSub is engaged in business in a different state from the parent.

HOW TO DETERMINE ELIGIBILITY TO ELECT QSUB STATUS

100% Owned Requirement

A qualified Subchapter S subsidiary (QSub) is a subsidiary corporation 100% owned by an S corporation that has made a valid QSub election for that subsidiary.

Example 5-2: Electing QSub status.

BigCo is an S corporation that owns 100% of the stock of two subsidiary corporations. BigCo can make a QSub election for either, neither, or both of its subsidiaries.

For purposes of the 100% stock ownership requirement, the stock of a subsidiary corporation is considered owned by an S corporation if the S corporation is treated as the owner of that stock for federal tax purposes.

Example 5-3: Subsidiary held through a disregarded LLC is eligible for QSub election.

Essco, an S corporation, is the sole member of Lucky, an LLC. Lucky owns all the stock in Zeno, a corporation otherwise eligible for QSub status. Under the check-the-box regulations, Lucky is a business entity that is disregarded as an entity separate from its owner [Reg. 301.7701-2(c)(2)]. Essco is treated as owning all the stock of Zeno and can elect to treat Zeno as a QSub.

Example 5-4: Subsidiary held through a disregarded QSub is eligible for QSub election.

Essco, an S corporation, owns 100% of Quiggley, a corporation for which a valid QSub election is in effect. Quiggley owns 100% of Zeno, a corporation otherwise eligible for QSub status. For purposes of the 100% of stock ownership requirement, Quiggley is disregarded as an entity separate from Essco, and all of Quiggley's assets, including its stock in Zeno, are considered owned by Essco. Essco can elect to treat Zeno as a QSub.

Example 5-5: Subsidiary held by an S corporation and its disregarded QSub is eligible for QSub election.

Assume the same facts as in Example 5-4, except that Quiggley owns 50% of Zeno, and Essco owns the other 50%. Essco is considered the owner of Zeno's stock and can elect to treat Zeno as a QSub.

Example 5-6: Subsidiary held by a C corporation is not eligible for QSub election.

Assume the same facts as in Example 5-4, except that Quiggley is a C corporation. Although Quiggley is a domestic corporation that is otherwise eligible to be a QSub, no QSub election has been made for it. Quiggley is considered the owner of the stock of Zeno. Consequently, Essco cannot elect to treat Zeno as a QSub. Furthermore, since Quiggley is not an S corporation, Quiggley cannot make a QSub election for Zeno.

Other Basic Requirements

In addition to being 100% owned by an S corporation, a QSub must be a domestic corporation that otherwise meets the basic requirements to be an S corporation. Thus, certain financial institutions that use the reserve method of accounting for bad debts, insurance companies, DISCs and former DISCs are not eligible for QSub status.

QSub Status as a Disregarded Entity

A QSub is technically neither a C corporation nor an S corporation. Instead, a QSub is not treated as a separate corporation for federal tax purposes (although it is still treated as a separate corporation for other purposes). A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation.

HOW TO ELECT QSUB STATUS

Form 8869

The S corporation that owns 100% of the stock of a corporation that is eligible for QSub status must file the QSub election. Form 8869 (Qualified Subchapter S Subsidiary Election) is used for this purpose.

QSub Election Can Specify an Effective Date

A QSub election filed on Form 8869 will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. The term "month" is defined as the period starting on a given day within the calendar month and ending on the day before that same numerical day in the next calendar month. If an election form specifies an effective date more than two months and 15 days prior to the date the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date the election is filed, it will be effective 12 months after the date it is filed. The corporation for which the QSub election is made must meet all the requirements of IRC Sec. 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.

Example 5-7: Effective date of QSub election.

Essco is a calendar year S corporation. On April 1, 2010, it acquires the stock of Quill, a calendar year C corporation. On August 10, 2010, Essco files an election to treat Quill as a QSub. The election may be effective on any date specified on the election form, provided that date is not more than two months and 15 days prior to August 10, 2010, and not more than 12 months after August 10, 2010. Thus, the earliest possible effective date is May 27, 2010 and the latest possible date is August 9, 2011. If no effective date is specified on the form, the election will be effective as of August 10, 2010.

Tiered Subsidiaries

When QSub elections for a tiered group of subsidiaries are effective on the same date, the S corporation may specify the order of the liquidations. If no order is specified, the deemed liquidations are treated as occurring first for the lowest tier entity and proceed successively upward until all of the QSub liquidations have occurred.

Example 5-8: Timing of the deemed liquidations for a group of tiered subsidiaries.

TopCo, an S corporation, owns 100 percent of Boats, the C corporation common parent of an affiliated group of C corporations that includes Sails and Motors. Boats owns all of the stock of Sails and Sails owns all of the stock of Motors. TopCo elects to treat Boats, Sails, and Motors as QSubs effective on the same date.

If no order is specified for the elections, they are deemed to occur from the bottom up. Accordingly, Motors is treated as liquidating into Sails, then Sails is treated as liquidating into Boats, and finally Boats is treated as liquidating into TopCo. Each successive liquidation occurs on the same day immediately after the preceding liquidation.

According to the instructions to Form 8869, a separate sheet should be attached for each subsidiary. The attached statements should be of the same size and format, and have the same line numbers as in Part II of the printed Form 8869. The parent corporation's name and employer identification number should be provided at the top of each separate sheet.

Existing Corporation's Final Short Year Ending the Day before the QSub Election Takes Effect

The IRS has provided no specific guidance for how an existing corporation reports a final short year ending the day before its QSub election takes effect. The regulations state that the QSub election generally becomes effective on the date the election is filed or the date specified in the QSub election form, Form 8869. The regulations also state the deemed liquidation of the QSub generally occurs on the day before the effective date of the QSub election.

Although it seems reasonable to file a short-year C corporation return on Form 1120 for the subsidiary's short-period ending the day before the QSub election becomes effective, it is not clear whether the "final return" box should be checked on the subsidiary's final short year Form 1120. Lines 12 through 16 of Form 8869 require certain information about the corporation for which the QSub election is made. This includes information about a previously filed return. Presumably, this provides adequate information to the IRS to allow it to update its records properly. In the authors' opinion, the "final return" box on the short-period Form 1120 should not be checked. However, a statement should be attached to the short-year Form 1120 explaining that a QSub election has been made for the subsidiary.

RELIEF FOR LATE QSUB ELECTIONS

Relief for Late QSub Election When Form 1120S Has Not Been Filed

If the parent S corporation has not yet filed Form 1120S for the year the QSub would first take effect, it may obtain relief for the late QSub election under Rev. Proc. 2003-43. Relief is obtained by filing Form 8869 with a statement establishing a reasonable cause for the failure to timely file Form 8869.

The Form 8869 should have "FILED PURSUANT TO REV. PROC. 2003-43" typed across the top.

The Form 8869 with its attachment must be filed within 18 months of the original due date of the Form 8869, but no later than six months after the due date (excluding extensions) of Form 1120S for the first year the QSub election is to take effect.

As a final requirement, the S corporation and all shareholders whose tax liabilities or tax returns would be affected by the QSub election must report consistently with the QSub election. Thus, the S corporation must file Form 1120S and the related Schedules K-1 consistently with the QSub election, and the shareholders must report their allocable shares of pass-though consistently with those Schedules K-1.

Relief for Late QSub Election When Form 1120S Has Been Filed

If the parent S corporation has filed Form 1120S no later than six months after its original due date (excluding extensions) for the year the QSub election is first intended to take effect, it may obtain relief for the late QSub under Rev. Proc. 2003-43. Relief is obtained by filing Form 8869 with the following attachments:

a. A statement establishing a reasonable cause for the failure to timely file Form 8869.

b. A statement that the corporation satisfies the QSub requirements of IRC Sec. 1361(b)(3)(B) and that all assets, liabilities, and items of income, deduction, and credit of the QSub have been treated as assets, liabilities, and items of income, deduction, and credit of the S corporation (on all affected returns) consistent with the QSub election for the year the election was intended and for all subsequent years.

c. A dated declaration signed by an officer of the S corporation authorized to sign that states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

The Form 8869 should have "FILED PURSUANT TO REV. PROC. 2003-43" typed across the top.

The Form 8869 with its attachment must be filed within 24 months of the original due date of the Form 8869 for the first year the QSub election is to take effect.

As a final requirement, the S corporation and all shareholders whose tax liabilities or tax returns would be affected by the QSub election must have reported consistently with the QSub election. Thus, the S corporation must have filed Form 1120S and the related Schedules K-1 consistently with the QSub election, and the shareholders must have reported their allocable shares of pass-though consistently with those Schedules K-1 for the year the QSub election was intended to take effect and any subsequent years.

User Fee

Rev. Proc. 2003-43 is in lieu of requesting a private letter ruling, so no user fee is required.

Relief for Late QSub Election When Rev. Proc. 2003-43 Is Not Available

The IRS has the authority to waive inadvertently invalid QSub elections. Thus, corporations that are ineligible for relief or are denied relief under Rev. Proc. 2003-43 can still seek relief. To obtain relief, the QSub and the S corporation parent must: (a) take steps to qualify the corporation as a QSub within a reasonable period of time after discovering the circumstances causing the invalid election or termination and (b) agree to any adjustments proposed by the IRS to treat the corporation as a QSub during the relevant period. Presumably, relief is obtained by requesting a letter ruling and paying the applicable user fee.

WHAT IS DEEMED LIQUIDATION ON ELECTING QSUB STATUS

When a parent S corporation makes a QSub election for an existing corporation (whether or not the subsidiary's stock is acquired from another person or previously held by the S corporation), the subsidiary is generally deemed to have engaged in a tax-free liquidation under IRC Secs. 332 and 337. Filing a QSub election is treated as the adoption of a plan of liquidation for purposes of IRC Sec. 332.

The tax treatment of the deemed liquidation (or of a larger transaction that includes the deemed liquidation) must be determined under the general principles of federal tax law, including the step-transaction doctrine. According to the step-transaction doctrine, the steps of a corporate reorganization, if related, will be treated as one transaction. Thus, the tax consequences of the transaction (e.g., whether the transferors are in control of the transferee) will be determined after all the steps are completed rather than at each step of the transaction.

Example 5-9: Step transaction doctrine applies and deemed liquidation fails to qualify a parent-subsidiary liquidation.

Pam owns 100% of the stock of Pizza, an S corporation. Pizza owns 79% of the stock of Deliveries, a solvent corporation, and Pam owns the remaining 21%. On May 1 of the current year, she contributes her Deliveries

stock to Pizza in exchange for additional Pizza stock. Pizza makes a QSub election for Deliveries effective immediately after the transfer. Assuming the transaction is collapsed under the step-transaction doctrine, the liquidation evidently fails to qualify under IRC Secs. 332 and 337 because the 80% control test is not met. In this situation, the deemed liquidation would not qualify under IRC Secs. 332 and 337 as a tax-free parent/subsidiary liquidation. Thus, the subsidiary would recognize gain on the transaction.

The Deemed Liquidation May Be Taxable

If the deemed liquidation does not qualify under IRC Secs. 332 and 337 as a tax-free parent/subsidiary liquidation, the subsidiary must recognize gain on the transaction. Losses are generally not recognized due to the limitation imposed by IRC Sec. 267.

Example 5-10: Taxable deemed liquidation on electing QSub status.

Essco, an S corporation, owns 100% of the stock of Quash, a C corporation. Quash is indebted to Essco for an amount that exceeds the fair market value of Quash's assets. Essco makes a QSub election for Quash that is effective on the day it is filed. The deemed liquidation does not qualify under IRC Secs. 332 and 337 and, thus, Quash recognizes gain or loss on the assets distributed, subject to the limitations of IRC Sec. 267. [IRC Sec. 332(a) requires the parent corporation to receive property. Even though Essco receives assets in this example, Quash's insolvency prevents the application of IRC Sec. 332 because Essco is not considered to have received property in the distribution. See Rev. Rul. 68-602.]

Because the liquidation is a taxable rather than tax-free transaction, Quash's tax attributes generally will not carry over to Essco under IRC Sec. 381. However, Essco may be able to deduct a loss under the worthless stock rules of IRC Sec. 165(g).

The deemed liquidation may also be taxable for reasons other than failure to qualify as a tax-free parent/subsidiary liquidation. As the following example shows, a transaction treated as a Type D reorganization may result in gain recognition under IRC Sec. 357(c).

Example 5-11: Step transaction doctrine applies and the transaction is treated as a Type D reorganization.

Steven owns 100% of the stock of two solvent corporations, Movies and Popcorn. Movies is an S corporation and Popcorn is a C corporation.

On May 1 of the current year, Steven contributes the stock of Popcorn to Movies. Movies elects QSub status for Popcorn effective immediately following the stock transfer. Assuming the transaction is collapsed under the step-transaction doctrine as a Type D reorganization, gain could be recognized under IRC Sec. 357(c) to the extent the total amount of the liabilities assumed exceed the total adjusted basis of the property transferred in the exchange.

A Deemed QSub Liquidation May Not Be Necessary for a Newly Formed Subsidiary

A deemed QSub liquidation does not occur when the QSub election is effective on the date of a subsidiary's formation.

Example 5-12: Deemed QSub liquidation is not necessary.

Essco, an S corporation, forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary. There is no deemed liquidation of the new subsidiary. Instead, the subsidiary is deemed to be a QSub from its inception.

Carryover of S Corporation Losses Suspended under the Basis Limitation Rules

In certain cases, losses suspended under the basis limitation rules of IRC Sec. 1366(d) remain available to the shareholder who initially incurred them.

Example 5-13: Suspended shareholder losses carry over when S corporation becomes a QSub.

Essco, an S corporation, acquires the stock of Kwick, another S corporation, in a transaction in which the basis of the Kwick stock is determined in whole or in part by reference to the transferor's basis. Essco elects to treat Kwick as a QSub effective on the day of the acquisition. Any loss or deduction disallowed under IRC Sec. 1366(d) with respect to a former shareholder of Kwick remains available to that shareholder as a shareholder of Essco. Thus, a loss or deduction of a former Kwick shareholder disallowed prior to or during the year of the transaction is treated as incurred by Essco with respect to that shareholder provided the shareholder is a shareholder of Essco after the transaction.

Built-in Gains Tax

If the subsidiary was a C corporation or an S corporation subject to the built-in gains tax before the QSub election, its assets are subject to the built-in gains tax.

LIFO Recapture Tax

If the subsidiary was a C corporation using the LIFO method for inventory prior to the QSub election, the LIFO recapture tax applies. However, the transfer of LIFO inventory from an S corporation parent to its QSub is not an event that triggers liability for the LIFO recapture tax.

Debt of the QSub Issued to a Shareholder of the Parent S Corporation

Debt issued by a QSub to a shareholder of a parent S corporation is treated as debt of the parent for purposes of determining the shareholder debt basis. However, the IRS is authorized to issue rules for determining the order in which losses pass through when debt of both the parent and subsidiary are held by the parent S corporation shareholders. To the extent a shareholder of the parent S corporation is subject to the at-risk rules of IRC Sec. 465, the QSub's pass-through losses may be nondeductible and carried over to future years.

THE TIMING OF THE DEEMED LIQUIDATION

Parent Corporation Owns 100% of the Stock of the Subsidiary on the Day before the QSub Election

The deemed liquidation of the subsidiary corporation occurs at the close of the day before the QSub election is effective.

Example 5-14: Deemed liquidation occurs at close of the day before the effective date of QSub election.

Essco, an S corporation, owns 100% of the stock of Quirk, a calendar-year C corporation. On June 1, 2010, Essco makes a valid QSub election for Quirk, effective on that date. The deemed liquidation of Quirk occurs at the close of the day on May 31, the day before the QSub election is effective, and the plan of liquidation is considered adopted on that date. Quirk's tax year and separate existence for federal tax purposes end at the close of May 31. The deemed liquidation is reported in Quirk's final return (Form 1120) for the short tax year beginning January 1 and ending May 31, 2010.

If a C corporation elects to be treated as an S corporation and makes a QSub election (effective the same date as the S election) for a subsidiary, the deemed liquidation occurs immediately before the S election becomes effective, while the parent is still a C corporation.

Example 5-15: Deemed QSub liquidation occurs immediately before parent's S election becomes effective.

Smithco, a C corporation, owns 100% of the stock of Quinn, another C corporation. Smithco makes an S election to be treated as an S corporation and a valid QSub election for Quinn, both effective January 1, 2011. The deemed liquidation of Quinn occurs at the close of December 31, the day before the QSub election is

effective. The QSub election for Quinn is effective on the same day that Smithco's S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when Smithco is still a C corporation. Quinn files a final Form 1120 for its tax year ending at the close of December 31, 2010, and the deemed liquidation is reported on that return.

Parent Corporation Does Not Own 100% of the Stock of the Subsidiary on the Day before the QSub Election

If an S corporation does not own 100% of the stock of the subsidiary on the day before the QSub election is effective, the deemed liquidation occurs immediately after the time at which the S corporation first owns 100% of the stock.

Qualified Stock Purchase

An S corporation that makes a qualified stock purchase of a target can make a Section 338 election if it otherwise meets the requirements for the election, and may make a QSub election with respect to the target. If an S corporation makes a Section 338 election for a subsidiary acquired in a qualified stock purchase, a QSub election made for that subsidiary is effective on the day after the acquisition date. Thus, the deemed QSub liquidation occurs immediately after the IRC Sec. 338 deemed asset purchase by the new target corporation. If an S corporation makes an election under IRC Sec. 338 [without a Section 338(h)(10) election] for a target, the target must file a final or deemed sale return as a C corporation reflecting the deemed sale.

Example 5-16: Deemed QSub occurs on day after date of a qualified stock purchase.

On May 31, 2010, Essco, an S corporation, acquires 100% of the stock of QualiCare, an existing S corporation, for cash in a transaction meeting the requirements of a qualified stock purchase under IRC Sec. 338. Essco immediately makes a QSub election for QualiCare effective on the following day, June 1, and also makes a joint election under IRC Sec. 338(h)(10) with QualiCare's shareholder. QualiCare is treated as having sold all of its assets at the close of the acquisition date, May 31, 2010. QualiCare is treated as a new corporation that purchased all of those assets as of the beginning of June 1, 2010, the day after the acquisition date. The QSub election is effective on June 1, 2010, and the deemed QSub liquidation occurs immediately after the deemed asset purchase by the new corporation.

HOW TO OPERATE A QSUB

QSub's Disregarded Status

Because a QSub's separate existence is ignored, 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, and built-in gains) are considered items of the parent. The QSub election terminates the QSub's former identity as a separate entity for federal tax purposes. Thus, a final income tax return must be filed. This final return generally includes the deemed liquidation transaction.

QSub's Separate Status for Employment Taxes and Certain Tax Liabilities

A QSub is normally treated as a disregarded entity for all purposes of the Code. However, the IRS can require separate responsibility and reporting for employment taxes and certain tax liabilities.

Under this authority, the IRS has issued regulations that treat QSubs as separate entities for the following purposes:

a. Employment taxes.

b. Certain federal liabilities, refunds, and credits of federal tax.

c. Certain excise taxes.

Employment Taxes

Separate Reporting for Federal Employment Taxes. A QSub is treated as a separate entity for federal employment taxes. Accordingly, the QSub is liable for employment taxes on wages paid to its employees and is responsible for satisfying its other employment tax obligations (e.g., backup withholding, making timely deposits of employment taxes, filing returns, and providing wage statements to its employees on Forms W-2).

QSubs Treated Separately for Federal Tax Liabilities, Refunds, and Credits

Although a QSub is generally treated as a disregarded entity for federal tax purposes, it will be treated separately from its S corporation parent for purposes of the following:

a. The QSub's federal tax liabilities for any tax year in which it is not treated as a QSub.

b. The federal tax liabilities of any other entity for which the QSub is liable.

c. Refunds or credits of federal tax.

Example 5-17: QSub treated as a separate corporation for certain federal tax purposes.

Esco has owned all the stock of Subco for the last six years. Both corporations are calendar year corporations but have never reported their taxes on a consolidated basis. Esco elects to treat Subco as a QSub effective January 1, 2010.

In August 2010, following an IRS audit of Subco's 2007 tax return, the IRS seeks an extension of the statute of limitations on assessment of Subco's taxes. Because Subco was treated as a separate corporation for its 2007 tax year, Subco's officers must sign the extension on behalf of Subco. Similarly, if Subco fails to pay its audit assessment, the IRS will attach a general tax lien against Subco's property.

QSubs Treated Separately for Federal Excise Taxes

A QSub is generally treated as a separate entity for purposes of certain federal excise taxes.

Information Returns

An S corporation and a QSub are recognized as separate entities for purposes of making information returns (filed under IRC Secs. 6031 through 6040), except as otherwise required by the IRS.

Special Rules for Banks Apply Separately

If the S corporation is a bank or if the S corporation makes a QSub election for a subsidiary that is a bank, any special rules applicable to banks under the Code continue to apply separately to the bank parent or bank subsidiary.

Organizational Expenditures of the 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, regardless of whether the *de minimis* exception applies, it appears that the traditional organizational expenditures incurred in the process of forming or organizing a QSub continue to qualify for amortization under IRC Sec. 248. More guidance from the IRS is needed.

Example 5-18: Distinguishing organizational and start-up expenditures from other nondeductible preopening expenditures.

Essco is an S corporation that provides airframe and powerplant repair and maintenance services for aircraft. Early in the 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 makes payments totaling $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 amortization under IRC Sec. 248.

The $16,000 of expenditures for employee recruitment and training, and the expenditures for advertising qualify as start-up expenditures and are amortizable under IRC Sec. 195 [Reg. 1.263(a)-4(b)(4)].

The $9,000 payments 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: Assume the investigative expenditures total $4,700 (instead of $7,000). Assume further the payments to acquire the lease agreement total $4,500 (instead of $9,000). Now, 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 IRC Sec. 162.

Similarly, the $4,500 payment qualifies for a separate *de minimis* exception. Because the regulations exclude payments aggregating $5,000 or less, the $4,500 lease acquisition payment is not required to be capitalized under IRC Sec. 263. It is not clear exactly how the $4,500 payment should be treated. The expenditure may now qualify as an amount that must be amortized over the life of the lease. Alternatively, it may qualify as a start-up expenditure eligible for amortization under IRC Sec. 195, or it may be currently deductible under IRC Sec. 162.

Accounting Methods of Parent and QSub

When a subsidiary of an S corporation becomes a QSub, the QSub is deemed to be liquidated into the parent S corporation and the former wholly-owned subsidiary's assets and liabilities are treated as those of the parent S corporation. The wholly-owned subsidiary's separate existence terminates for federal tax purposes. Therefore, the parent S corporation's overall method of accounting does not change, and the QSub apparently uses the same method of accounting as the parent. (Remember, only one Form 1120S is filed, and the accounting method is indicated on the form.)

If, however, the parent has been using the cash method and the subsidiary carries inventory, the transfer of the QSub's merchandise would evidently trigger the parent S corporation's requirement to maintain inventory and use the accrual method of accounting (at least for the inventory), assuming that none of the exceptions to the accrual method requirement apply.

HOW TO TERMINATE QSUB ELECTION

The QSub election terminates if a QSub corporation fails to meet any of the basic requirements to be a QSub, or if the election is voluntarily revoked.

Revocation

An S corporation can revoke a QSub election by filing a statement with the IRS Service Center where the S corporation's most recent tax return was filed. The QSub election will terminate on the date specified in the statement. The statement must include the names, addresses, and TINs of both the parent S corporation and the QSub. The statement must be signed by a person authorized to sign the S corporation's return.

QSub Termination When the Parent S Corporation's S Election Terminates

If the parent's S election terminates, the QSub election will terminate at the close of the last day of the parent's last tax year as an S corporation.

QSub Loses Eligibility for QSub Status

If the QSub fails to meet the basic QSub eligibility requirements, the QSub election will terminate at the close of the day on which an event occurs that renders the subsidiary ineligible for QSub status.

IRS Notification Required

When the QSub election terminates because the parent's S election terminates or the QSub loses eligibility for QSub status, the S corporation must attach to its return for the tax year in which the termination occurs a statement of notification that a QSub election has terminated, the date of the termination, and the names, addresses, and employer identification numbers of both the parent corporation and the QSub.

QSub Treated as a New Corporation after QSub Termination

When a QSub election terminates, the QSub is treated as a new corporation that acquires all the QSub's assets and assumes all its liabilities from the parent S corporation in exchange for the QSub's stock immediately before the termination. The deemed issuance of the subsidiary's stock for its assets will generally qualify as a tax-free Section 351 transfer, provided the parent S corporation is still in control of the subsidiary by continuing to own at least 80% of the subsidiary's stock. However, the tax treatment of this deemed transaction (or of a larger transaction that includes the deemed transaction) must be determined under general tax law principles, including the step transaction doctrine.

When a parent S corporation sells some QSub stock and so terminates a subsidiary's QSub status, the transaction will be treated as the sale of an undivided interest in the subsidiary's assets (based on the percentage of stock sold) and a subsequent acquisition of the subsidiary's assets and an assumption of all of its liabilities by a "new" corporation in a Section 351 transaction. Typically, Section 351 transactions are tax-free. Therefore, this rule will normally result in taxable gain for the portion of the stock sold to unrelated parties, and no additional taxable gain for the parent S corporation (or its shareholders) upon the deemed formation of the "new" corporation.

Example 5-19: Sale of QSub stock to an unrelated purchaser.

Essco, a calendar year S corporation, owns 100% of the stock of Quiggley, a QSub. Essco sells 21% of Quiggley's stock to Zeno, an unrelated corporation, for cash. This causes termination of the QSub election because Essco no longer owns 100% of Quiggley's stock.

When the sale of stock of a QSub results in the termination of the QSub election, the sale is treated as a sale of an undivided interest in the assets of the QSub (based on the percentage of the stock sold) followed by a deemed transfer to the QSub in a transaction to which Section 351 applies. Thus, Essco is treated as selling a 21% interest in Quiggley's assets to Zeno, followed by a transfer of all the assets to a new corporation (new Quiggley) in a transaction to which IRC Sec. 351 applies. Accordingly, the S corporation will recognize 21% of the gain or loss in the assets of the QSub, but the transfer of the assets back to new Quiggley will be a nontaxable Section 351 transfer.

Example 5-20: Deemed QSub liquidation qualifies as tax-free Section 351 transfer.

Assume the same facts as in Example 5-19, except that Zeno contributes an operating asset to Quiggley in exchange for 21% of the Quiggley stock (instead of purchasing Quiggley stock from Essco). Under these facts, the QSub election terminates, but the termination is not caused by a sale of Quiggley's stock. Therefore, Quiggley is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for its stock immediately before the termination. The transaction qualifies as a Section 351 transfer because Essco and Zeno are treated as co-transferors that together control the transferee immediately after the transfer.

Example 5-21: Distribution of QSub stock may qualify as a spin-off.

Essco, an S corporation, owns 100% of the stock of Quade, a corporation for which a QSub election is in effect. Essco distributes all of the Quade stock prorata to its shareholders thus terminating the QSub election. The transaction can qualify as a spin-off distribution to which IRC Secs. 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.

Example 5-22: Deemed exchange upon revocation of QSub election qualifies as a tax-free 351 exchange when step-transition doctrine does not apply.

Essco, an S corporation, owns 100% of the stock of Quail, a QSub. Essco revokes the QSub election and Quail is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from Essco in a deemed exchange for Quail stock. Later in the year, Essco sells 21% of the Quail stock to Zeno, an unrelated corporation, for cash.

Assume the step-transaction doctrine does not apply. Thus, the stock sale is not considered when determining if Essco is in control of Quail immediately after the deemed asset transfer. Under these facts, IRC Sec. 1361(b)(3)(C)(ii) does not apply because Quail's QSub election was revoked rather than terminated as a result of a stock transfer. (Compare Example 5-19.)

Accordingly, the deemed exchange by Essco of assets for Quail stock and the deemed assumption by Quail of its liabilities qualify under IRC Sec. 351 because Essco is in control of Quail immediately after the transfer.

Transfers of QSub Stock in Corporate Reorganizations

A QSub election generally does not terminate solely because the QSub's parent S corporation engages in a Type F reorganization (Rev. Rul. 2004-85).

Example 5-23: QSub stock transferred in a Type F reorganization.

EssCo is an S corporation that owns 100% of the stock of SubCo, a corporation that EssCo has elected to treat as a QSub. The shareholders of EssCo form NewCo. EssCo then merges with and into NewCo in a transaction qualifying as a Type F reorganization. EssCo's shareholders own 100% of the stock of NewCo and NewCo is eligible to be an S corporation.

Under Rev. Rul. 2004-85, NewCo is treated as a continuation of EssCo and will be an S corporation immediately after the merger. Because NewCo is treated as a continuation of EssCo, the reorganization does not terminate EssCo's election to treat SubCo as a QSub.

If a parent S corporation transfers (via a sale, or via a Type A, C, or D reorganization) its assets, including the stock of a QSub, to another S corporation, the subsidiary's QSub election terminates. Thus, a transferee S corporation that wants to treat the subsidiary as a QSub must immediately make a new QSub election for it (Rev. Rul. 2004-85). When the transferee S corporation fails to immediately file the required QSub election, Rev. Proc. 2004-49 generally provides relief for a late QSub election.

Example 5-24: QSub stock transferred in a Type A, C, or D reorganizaton.

EssOne is an S corporation that owns 100% of the stock of Quality, a corporation that EssOne has elected to treat as a QSub. EssOne transfers its assets, including 100% of Quality's stock, to EssTwo, an S corporation, in a transaction that qualifies as Type A, C, or D reorganization.

Because the reorganization does not qualify as a Type F reorganization, EssTwo is not treated as a continuation of EssOne. After the transaction, EssOne no longer owns Quality, and EssOne's QSub election for Quality does not carry over to EssTwo. Therefore, the Quality's QSub election terminates at the close of the day on which the transaction takes place unless EssTwo makes a QSub election for Quality, effective immediately following the termination.

Variation 1: If EssTwo makes a QSub election for Quality, effective immediately following the termination of Quality's QSub election, EssTwo's deemed transfer of Quality's assets in exchange for Quality's stock and the immediate liquidation of Quality as a consequence of the QSub election are disregarded for federal income tax purposes. There will be no period between the termination of Quality's QSub election and the deemed liquidation of Quality during which Quality is a C corporation.

Variation 2: If EssTwo does not make a QSub election for Quality, effective immediately following the termination of Quality's QSub election, the transaction will be treated as a transfer of Quality's assets to EssTwo, followed by EssTwo's contribution of Quality's assets back to Quality in exchange for Quality stock. Quality will not be eligible to be treated as a QSub or an S corporation before the expiration of the five-year waiting period.

Carryover of S Corporation Losses Suspended under the Basis Limitation Rules

If a QSub election terminates because the S corporation distributes the QSub stock to some or all of the S corporation's shareholders in a Type D reorganization or a spin-off distribution, any loss or deduction disallowed to the S shareholder under the basis limitation rules of IRC Sec. 1366(d) is allocated between the S corporation and the former QSub with respect to the shareholder. The amount of the disallowed loss or deduction allocated to the S corporation is an amount that bears the same ratio to each item of disallowed loss or deduction as the value of the shareholder's stock in the S corporation bears to the total value of the shareholder's stock in both the S corporation and the former QSub, determined immediately after the distribution.

THE ELECTION OF S STATUS OR REELECTION OF QSUB STATUS FOLLOWING A QSUB TERMINATION

Following a QSub termination, unless the IRS grants permission, a subsequent S election or QSub election cannot be made for the former QSub corporation before its fifth tax year that begins after the first tax year for which the termination was effective. However, if the QSub termination occurs as a result of a disposition of the subsidiary corporation's stock, the corporation may, without first obtaining consent from the IRS, make an S election or have a QSub election made for it before the expiration of the five-year waiting period, provided that:

a. immediately following the disposition of its stock, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it; and

b. the S or QSub election is made effective immediately following the disposition of the corporation's stock.

Example 5-25: New shareholders of former QSub can immediately elect S status.

Essco, an S corporation, owns Quick, a QSub. Essco distributes all of its Quick stock to its (Essco's) shareholders. The distribution terminates the QSub election because Essco no longer owns 100% of the stock of Quick. If Quick is otherwise eligible to be treated as an S corporation, its shareholders can elect to treat it as an S corporation effective on the date of the stock distribution without first obtaining the IRS's consent.

Example 5-26: New S corporation parent of former QSub can elect QSub status.

Essco, an S corporation, owns Quack, a QSub. Essco sells 100% of the stock of Quack to Zeno, an unrelated S corporation. Zeno may elect to treat Quack as a QSub effective on the date of purchase without first obtaining the IRS's consent.

If the corporation is not eligible for this special waiver of the five-year waiting period, it can file a private letter ruling request for permission to reelect QSub status or make an S election before the end of the five-year period.

HOW TO OBTAIN RELIEF FROM INADVERTENT TERMINATIONS

The IRS has the authority to waive inadvertent terminations of QSub elections. To obtain relief, the QSub and the S corporation parent must: (a) take steps to qualify the corporation as a QSub within a reasonable period of time after

discovering the circumstances causing the invalid election or termination, and (b) agree to any adjustments proposed by the IRS to treat the corporation as a QSub during the relevant period. Presumably, relief is obtained by requesting a letter ruling and paying the applicable user fee .

The IRS has flexibility in the way the QSub and S corporation parent are treated during the period after the QSub election terminated (or the invalid election occurred), and before the IRS determined that the termination (or invalid election) was inadvertent. The inadvertent termination or inadvertent invalid election relief may be granted retroactively for all years for which the terminating event or circumstance giving rise to invalidity is effective. In this case, the corporation is treated as if its election was valid or had not terminated. Alternatively, relief may be granted only for the period during which the corporation was eligible for QSub treatment. In this case, the corporation is treated as a separate C corporation during the period of its ineligibility for QSub status.

HOW TO REORGANIZE AN S CORPORATION TO INCLUDE A SUBSIDIARY CORPORATION

The example and discussion in this section identify several methods for acquiring and reorganizing the corporate structure to include a subsidiary corporation. The subsidiary can be operated as either a C corporation or a qualified Subchapter S subsidiary (QSub). To operate the subsidiary as a QSub, it must be 100% owned by the parent S corporation, and the parent S corporation must make a QSub election. For an existing corporation, making a QSub election for a subsidiary that was a C corporation can subject the S corporation to the built-in gains tax and the LIFO recapture tax. Debt of the subsidiary issued to a shareholder of the parent S corporation provides the shareholder with debt basis.

Example 5-27: Reorganizing an S corporation to include a subsidiary corporation.

Essco, Inc., is a calendar year S corporation that has been successful in the construction business for many years. Essco is exploring the acquisition of a gravel mining business. The gravel business is operated by Rubble Corporation, a regular C corporation. Corporate counsel advises Essco to operate the new business within a separate corporation rather than within Essco, Inc.

The chairman of Essco's board of directors, Bill Esson, wants to evaluate Essco's options for acquiring the gravel business and operating it within a separate corporation.

Several methods of acquiring and reorganizing the corporate structure to include a subsidiary corporation are available. Following the reorganization, the subsidiary can be operated as either a C corporation or a QSub. To operate the subsidiary as a QSub, it must be 100% owned by the parent S corporation, and the parent S corporation must make a QSub election.

Methods of Acquiring the Target Corporation

S corporations are permitted to own up to 100% of the stock in another corporation. With this in mind, Essco's tax planner (from Example 5-27) identifies several methods of acquiring the gravel business. These include variations on two basic methods:

a. Essco can acquire the stock of Rubble Corporation and operate Rubble as a subsidiary.

b. Essco can form a new subsidiary corporation to acquire either the assets of the gravel business or the stock of Rubble corporation.

Acquiring the Stock of the Target Corporation

The stock of the target can be acquired by purchase or in a Type B stock-for-stock swap.

Stock Purchase. Under the facts of Example 5-27, Essco can simply purchase the stock of Rubble Corporation. Essco is free to purchase any amount of the Rubble stock. Assuming Essco purchases more than 50% of Rubble's stock, Essco can operate the gravel business as a subsidiary corporation. Essco would have a cost basis in the Rubble stock and the shareholders of Rubble would recognize capital gain or loss on the sale of their stock.

Type B Reorganization. Essco can issue its stock in exchange for all the outstanding shares of Rubble Corporation. This option assumes the shareholders of Essco are willing to expand the stock ownership of Essco to the current shareholders of Rubble. It also assumes that all the Rubble shareholders are eligible S shareholders. Essco's S election would terminate if it issued stock to an ineligible shareholder or if the number of shareholders exceeds the 100 shareholder limit. This stock-for-stock swap qualifies as a Type B reorganization. Essco would recognize no gain or loss on the issuance of its stock. Essco's basis in the Rubble stock would take a transferred basis; thus, Essco's basis in the Rubble stock would be the same as the basis of the stock in the hands of the former Rubble shareholders. The tax attributes of Rubble would remain within the Rubble corporation and would carry over unchanged. The shareholders of Rubble would recognize no gain or loss on the exchange of their stock for Essco stock and would take a substituted basis in their new Essco stock equal to their former basis in Rubble stock.

Acquiring the Assets of the Target Corporation

Under the facts of Example 5-27, Essco can form a new subsidiary corporation, Subco, to purchase the assets of the gravel business. Essco can organize Subco by transferring cash and other property to Subco in exchange for all of Subco's stock. Essco would be in control of Subco immediately after the transaction because it would own 80% or more of Subco's stock. Neither Essco nor Subco would recognize gain or loss on this transaction because it qualifies as a tax-free Section 351 transfer. Subco would take a transferred basis in any property received from Essco.

Subco can then use the cash and other property it received in the Section 351 transfer to purchase the assets of the gravel business from Rubble. Subco would take a cost basis in the assets it purchases. These assets would not be subject to the built-in gains tax because they were purchased. Rubble would have to recognize gain or loss on the sale of its assets.

An S Corporation Can Drop Assets into a Subsidiary and Elect QSub Status

If Essco already owned the gravel business and merely wanted to drop that business into a subsidiary it could do so. Essco would accomplish this by means of a tax-free Section 351 transfer. Essco could then operate the subsidiary as either a C corporation or as a QSub.

HOW TO OPERATE THE SUBSIDIARY AS A C CORPORATION

Evaluating the Option of Holding a Subsidiary as a C Corporation

Having identified several methods of placing a business within a subsidiary corporation, the planner next evaluates the consequences of operating the subsidiary corporation as a C corporation.

Consolidated Return

As discussed previously in this lesson, S corporations are permitted to hold up to 100% of the stock of a corporation. Ownership of more than 50% of the stock of a corporation gives the owner the right to control the subsidiary corporation. Ownership of 80% or more of the stock of a corporation establishes an "affiliated group" relationship. However, the S corporation parent cannot be included as a member of the affiliated group for federal tax purposes [IRC Sec. 1504(b)(8)]. Thus, only the S corporation's subsidiary C corporations can be included in the affiliated group; the S corporation and its QSubs, if any, cannot be included in the affiliated group.

Since S corporations cannot be included as a member of an affiliated group, an S corporation cannot join in the filing of a consolidated return. However, a C corporation subsidiary can elect to join in the filing of a consolidated return with its affiliated C corporations.

Example 5-28: Filing a consolidated return for C corporation subsidiaries.

Assume Essco (an S corporation) owns all the stock of Accelerators, Brakes, and Castings (all C corporations).

Accelerators owns all the stock of A-One, and A-One owns all the stock of A-Two (both C corporations). This chain of corporations forms an affiliated group of C corporations. (IRC Sec. 1501 provides that an affiliated

group of C corporations can file a consolidated return. IRC Sec. 1504 generally defines "affiliated group" for this purpose as one or more chains of includable corporations connected through stock ownership with a common parent that is also an includable corporation.)

Brakes owns all the stock of B-One and B-Two (both C corporations). This brother-sister group forms a separate affiliated group of C corporations. Castings owns no subsidiary corporations.

Evidently, Accelerators can file a consolidated return for itself, A-One, and A-Two. Similarly, Brakes can file a consolidated return for itself, B-One, and B-Two. The Accelerators group and the Brakes group cannot be further combined to form a larger affiliated group. Castings is not includable in either the Accelerators group or the Brakes affiliated group.

Dividends Received Deduction

Dividends received by an S corporation from a C corporation are not eligible for the dividends received deduction. Thus, dividends received by an S corporation are taxable pass-through items of income.

Passive Investment Income

The term "passive investment income" does not include dividends received from an 80% or more owned C corporation subsidiary to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active trade or business ("active earnings and profits"). Earnings and profits of a C corporation are active earnings and profits to the extent they are derived from activities that would not produce passive investment income (determined as if the C corporation were an S corporation). As long as Subco is exclusively engaged in an active trade or business, Essco does not include dividends from Subco as passive investment income for determining:

a. The tax imposed by IRC Sec. 1375 when an S corporation with earnings and profits has passive investment income that exceeds 25% of its gross income.

b. Termination of S corporation status when an S corporation with Subchapter C earnings and profits has passive investment income that exceeds 25% of its gross receipts for three consecutive years.

According to the QSub regulations, an S corporation may use any reasonable method to determine the amount of dividends not treated as passive investment income. The safe harbor method (discussed previously) can be used for this purpose. If less than 10% of a C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income (determined as if the C corporation were an S corporation), all the C corporation's earnings and profits produced during that tax year are considered active earnings and profits.

Built-in Gains Tax

The built-in gains tax applies only to S corporations. Thus, the built-in gains tax does not apply to assets held by a subsidiary C corporation. However, the tax does apply when the parent S corporation elects QSub status for a C corporation or an S corporation that is subject to the built-in gains tax.

Carryover of Tax Attributes

When a subsidiary C corporation has valuable tax attributes, or when it has substantial AE&P, it may be preferable to continue operating the subsidiary as a C corporation rather than making a QSub election.

HOW TO OPERATE THE SUBSIDIARY AS A QSUB

Evaluating the Option of Holding the Subsidiary as a QSub

Having identified several methods of placing a business within a subsidiary corporation, the planner next evaluates the consequences of operating the subsidiary as a QSub.

A QSub is a subsidiary corporation that is 100% owned by an S corporation that has made a 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. Instead, a QSub is not treated as a separate corporation for federal tax purposes (although it is still treated as a separate corporation for other purposes).

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.

QSub Election

A QSub must be a domestic corporation that is (a) eligible for S status, and (b) 100% owned by an S corporation parent. Thus, certain financial institutions that use the reserve method of accounting for bad debts, insurance companies, DISCs or former DISCs are not eligible to be QSubs. In addition, the S corporation parent must make a QSub election for the subsidiary.

A QSub election is made by filing Form 8869 (Qualified Subchapter S Subsidiary Election).

Deemed Liquidation of an Existing Subsidiary

When a parent S corporation makes a QSub election for an existing corporation (whether or not its stock was acquired from another person or previously held by the S corporation), the subsidiary is generally deemed to have engaged in a tax-free liquidation under IRC Secs. 332 and 337 immediately before the election is effective. (See also the Committee Reports to SBJPA Sec. 1308 and IRS Notice 2000-58.) Filing a QSub election is treated as the adoption of a plan of liquidation for purposes of IRC Sec. 332. If the deemed liquidation does not qualify under IRC Secs. 332 and 337 as a tax-free parent/subsidiary liquidation, the subsidiary must recognize gain on the transaction. Losses are generally not recognized due to the limitation imposed by IRC Sec. 267.

Under IRC Sec. 337, the subsidiary corporation recognizes no gain or loss on the deemed liquidating distribution of its property. Under IRC Sec. 332, the parent S corporation recognizes no gain or loss on the deemed receipt of the subsidiary's property. The parent S corporation takes a transferred basis in the subsidiary's property.

When the stock of the subsidiary corporation is acquired by the S corporation in a qualified stock purchase, the parent and subsidiary can join in making a Section 338 election.

Step Transaction Doctrine

The tax treatment of the deemed liquidation (or of a larger transaction that includes the deemed liquidation) must be determined under the general principles of federal tax law, including the step transaction doctrine. According to the step transaction doctrine, the steps of a corporate reorganization, if related, will be treated as one transaction. Thus, the tax consequences of the transaction (e.g., whether the transferors are in control of the transferee) will be determined after all the steps are completed rather than at each step of the transaction.

Effect of the QSub Election

The subsidiary is ignored for federal tax purposes because the QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation. Furthermore, 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, and built-in gains) are considered items of the parent.

Built-in Gains Tax

If the subsidiary was a C corporation before the QSub election, its assets become subject to the built-in gains tax following the election. If the subsidiary was an S corporation subject to the built-in gains tax before the election, its assets remain subject to the built-in gains tax.

A subsidiary generally is deemed to have engaged in a tax-free liquidation under IRC Secs. 332 and 337 when the parent corporation makes the QSub election. If the deemed liquidation is tax-free, no built-in gain is recognized when the QSub election is made. Rather, the QSub's assets are treated as transferred basis property. The asset transfer is considered to occur on the date the QSub election is made.

QSub Was a C Corporation on Date the QSub Election Was Made. If the QSub was previously a C corporation, the net unrealized built-in gain related to the QSub's assets is measured as of the date the QSub election is made, and the 10-year recognition period begins on that date.

QSub Was an S Corporation Subject to the Built-in Gains Tax. If the QSub was previously an S corporation subject to the built-in gains tax, the recognition period relating to the QSub's property begins on the date the QSub election is made, but the 10-year period is reduced by the months that the subsidiary was subject to the built-in gains tax. Thus, the last day of the recognition period for the QSub's assets is 10 years from the date the subsidiary became subject to the built-in gains tax, rather than from the date the QSub election was made.

QSub Was Previously an S Corporation Not Subject to the Built-in Gains Tax. If the QSub was an S corporation that was not subject to the built-in gains tax, the QSub's assets do not become subject to the built-in gains tax after the QSub election is made.

Avoiding Potential Duplicate Built-in Gains Tax Liability. Regulations eliminate a potential built-in gains tax trap for parent S corporations subject to the built-in gains. The following example illustrates the trap and how it is avoided under the regulations.

Example 5-29: Avoiding potential duplicate built-in gains tax liability.

Day, Inc., is a C corporation that holds all the stock of Subco, Inc., a C corporation that it acquired several years ago for $18,000. Both corporations report on a calendar year basis. Day elected S status effective January 1 of Year 1, but did not make a QSub election for Subco at the same time. Consequently, the stock Day holds in Subco will be included among Day's assets (the first pool of assets) that are subject to the built-in gains tax. Assume that at the time Day's S election became effective, the Subco stock was worth $33,000. Assume further that Day's net unrealized built-in gain (i.e., the overall limit on the amount of built-in gain subject to tax in the first pool of assets) is $17,000, and that Day had no recognized built-in gain in Year 1 or Year 2.

In Year 2, Day makes a QSub election for Subco, effective June 1 of Year 2. Assume the deemed liquidation is treated as a tax-free parent/subsidiary liquidation under IRC Secs. 332 and 337. The assets that Day is deemed to receive from Subco are treated as a separate (second) pool of assets subject to the built-in gains tax. On Day's books, these assets generally take a transferred basis equal to the basis they had on Subco's books immediately before the deemed liquidation. This second pool of assets is subject to the built-in gains tax for the 10-year recognition period beginning on the date Subco's QSub election takes effect. In addition, a separate overall limit on the amount of built-in gain subject to tax applies to this second pool of assets.

To eliminate the potential for duplicate built-in gains tax on future sales of these transferred-basis assets, Day reduces its net unrealized built-in gain (on the first pool of assets) by the amount that Subco's stock had appreciated at the date Day's S election became effective, which equals $15,000 ($33,000 – $18,000). This reduces Day's overall limit from $17,000 to $2,000.

As a result of Subco's QSub election, Day has two overall limits. The overall limit on the assets remaining in the first pool of assets is $2,000, as explained in the previous paragraph. The separate overall limit on the assets in the second pool of assets is calculated immediately following Subco's QSub election and equals the difference between their aggregate FMV at the time Subco's QSub election takes effect and their transferred basis on Day's books.

Intercompany Transactions Do Not Trigger Liability for the Built-in Gains Tax. Because a QSub's separate existence is ignored, transactions between the S corporation parent and QSub are not taken into account, and items of the subsidiary (including built-in gains) are considered items of the parent. Thus, the built-in gains tax does not apply to asset sales between a QSub and its parent S corporation because they are considered to be one entity for this purpose.

LIFO Recapture Tax

If the subsidiary was a C corporation using the LIFO method for inventory prior to the QSub election, the LIFO recapture tax applies.

Debt of the QSub

Debt issued by a QSub to a shareholder of a parent S corporation is treated as debt of the parent for purposes of determining the shareholder debt basis. However, the IRS is authorized to issue rules for determining the order in which losses pass through when debt of both the parent and subsidiary are held by the parent S corporation shareholders. (The QSub regulations do not address this, and the IRS has not yet issued these rules.) To the extent a shareholder of the parent S corporation is subject to the at-risk rules of IRC Sec. 465, of the QSub's losses may be suspended (See the Committee Reports to SBJPA Sec. 1308.)

Example 5-30: Shareholder loan to QSub increases the shareholder's debt basis.

Casey owns all the stock of Casements, an S corporation. Casements, in turn, owns all the stock of Subco, a QSub. In a previous year, Casey loaned $50,000 directly to Casements. During the current year, Casey loans $25,000 directly to Subco. As a result, she increases her debt basis in Casements to $75,000.

If Casements passes through losses in excess of her stock basis, it is clear that she can deduct the losses to the extent of her combined debt basis, but, as explained above, it is not clear exactly the order in which she reduces her debt basis.

Termination of QSub Status

The QSub election terminates if a QSub corporation fails to meet any of the requirements to be a QSub or if the election is voluntarily revoked. When this occurs, the QSub is treated as a new C corporation that acquires all its assets and assumes all its liabilities from the parent S corporation in exchange for its stock immediately before the termination. The deemed exchange will generally qualify as a tax-free Section 351 transfer, provided the parent S corporation is still in control of the subsidiary by continuing to own at least 80% of the subsidiary's stock. However, the tax treatment of this deemed transaction (or larger transaction that includes the deemed transaction) must be determined under general tax law principles, including the step transaction doctrine.

In addition, unless the IRS grants permission, a subsequent S election or QSub election generally cannot be made for that subsidiary corporation before its fifth tax year that begins after the first tax year for which the termination was effective.

Conclusion

Several methods have been identified for acquiring and reorganizing the corporate structure to include a subsidiary corporation. The subsidiary can be operated as either a C corporation or a QSub. To operate the subsidiary as a QSub, it must be 100% owned by the parent S corporation, and the parent S corporation must make a QSub election. For an existing corporation, making a QSub election for a subsidiary that was a C corporation can subject the S corporation to the built-in gains tax and the LIFO recapture tax. Debt of the subsidiary issued to a shareholder of the parent S corporation provides the shareholder with debt basis.

SELF-STUDY QUIZ

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

28. There are a number of beneficial uses of qualified Subchapter S subsidiaries (QSubs). Which of the following would fail the test as a beneficial use of a QSub?

    a. Real estate divestiture.

    b. Operating a business in multiple locations.

    c. Facilitate acquiring a new business.

    d. Increase basis in stock and debt.

29. Brasscorp is a calendar year S corporation. On June 1, 2009, it acquired the stock of Coppercorp, a calendar year C corporation. On October 20, 2009, Brasscorp filed an election to treat Coppercorp as a QSub. Which of the following dates can Brasscorp use as the effective date of the election?

    a. October 19, 2009.

    b. December 19, 2010.

30. Glenco is a parent S corporation that did not meet the original due date for submission of Form 8869 for the first year the QSub election was to take effect. Glenco must file Form 8869 no later than how many months after the due date (without extensions) of Form 1120S for the first year the QSub election is to take effect?

    a. Three months.

    b. Six months.

    c. One year.

31. Jack owns 100% of the stock of Giles, an S corporation. Giles owns 76% of the stock of Barko, a solvent corporation, and Jack owns the remaining 24%. On June 15 of the current year, Jack contributes his Barko stock to Giles in exchange for additional Giles stock. Giles makes a QSub election for Barko effective immediately after the transfer. If the transaction is collapsed under the step-transaction doctrine, which of the following circumstances applies?

    a. The deemed liquidation qualifies under IRC Secs. 332 and 337.

    b. The subsidiary recognizes gain on the transaction.

32. Jessup, an S corporation, owns 100% of the stock of Johnco, a C corporation. Johnco is indebted to Jessup for an amount that exceeds the fair market value of Johnco's assets. Jessup makes a QSub election for Johnco that is effective on the day it is filed. The deemed liquidation does not qualify under IRC Secs. 332 and 337 and, as a result, Johnco recognizes gain or loss on the assets distributed, subject to the limitations of IRC Sec. 267. Which of the following statements regarding the deemed liquidation is accurate?

    a. Johnco's tax attributes generally will carry over to Jessup.

    b. Jessup may be able to deduct a loss.

33. Which of the following statements regarding deemed liquidation on electing QSub status is correct?

    a. Losses suspended under the basis limitation rules of IRC Sec. 1366(d) are not available to the shareholder who initially incurred them.

    b. The deemed liquidation of the subsidiary corporation occurs the same day the QSub election is effective.

    c. Last-in-first-out (LIFO) recapture tax applies when the subsidiary was a C corporation using the LIFO method for inventory prior to the QSub election.

    d. There are no rules available for determining the order in which losses pass through when debt of both the parent and subsidiary are held by the parent S corporation shareholders.

34. Which of the following statements accurately reflects one of the options an S corporation has regarding the qualified stock purchase of a target?

    a. An S corporation is always eligible to make a Section 338 election.

    b. An S corporation may make a QSub election regarding the target.

35. A QSub is generally treated separately from its S corporation parent for:

    a. Federal tax purposes.

    b. Refunds or credits of federal tax.

36. Servcorp is an S corporation that provides repair services for the appliance market. Early in the year, Servcorp pays $10,000 to investigate whether to form a QSub for the purpose of expanding its business to include appliance sales. The investigation provides compelling reasons why organizing a QSub to conduct the retail sale of appliances is a good business decision. Therefore, Servcorp forms a corporation (Appco) and immediately makes a QSub election for it. Appco subsequently establishes a new retail appliance business to sell major appliances. In the process of establishing the new retail business, Appco experiences various additional pre-opening expenditures including expenditures totaling $20,000 to recruit and train employees for the new retail store and expenditures to advertise the new store. Appco also makes payments totaling $15,000 to acquire a 7-year lease agreement for the new store. Which of the above amounts are amortizable expenses?

    a. The $15,000 to acquire the lease.

    b. The $20,000 for employee recruitment/training and advertising the new store.

    c. The $10,000 incurred to investigate the feasibility of establishing a QSub.

37. Camco, a calendar year S corporation, owns 100% of the stock of J-Ram, a QSub. Camco sells 25% of J-Ram's stock to ABC, an unrelated corporation, for cash. The QSub election thus terminates since Camco no longer owns 100% of J-Ram's stock. Since the sale of J-Ram's (a QSub) stock results in the termination of the QSub election, the sale is treated as a sale of an undivided interest in the assets of J-Ram followed by a deemed transfer to J-Ram in a transaction to which Section 351 applies. Therefore, Camco is treated as selling a 25% interest in J-Ram's assets to ABC, followed by a transfer of all the assets to a new corporation (new J-Ram) in a transaction to which IRC Sec. 351 applies. Based on these facts, which of the following actions will result?

    a. Camco will recognize 25% of the gain or loss in the assets of J-Ram.

    b. Camco will transfer the assets back to new J-Ram as a taxable Section 351 transfer.

38. If a QSub termination occurs due to a disposition of the QSub's stock, the corporation may make an S election or have a QSub election made prior to expiration of the required waiting period (without IRS consent) if (1) immediately after the disposition of its stock, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it, and (2):

    a. The S or QSub election is made effective within three business days of the disposition of the corporation's stock.

    b. The S or QSub election is made immediately following the disposition of the corporation's stock.

    c. The S or QSub election is made effective within a "reasonable period of time", as determined by the corporation, following the disposition of the corporation's stock.

39. The IRS has discretion in how the QSub and S corporation parent are treated during the period after the QSub election terminated, and before the IRS determined that the termination was inadvertent. If the IRS grants inadvertent termination retroactively for all years for which the terminating event giving rise to invalidity is effective, the corporation is treated:

    a. As a separate C corporation during the period of its ineligibility for QSub status.

    b. As if its election was valid or had not terminated.

40. ABC is a calendar year S corporation that can issue its stock in exchange for all the outstanding shares of DEF Corporation. This option makes the assumption that the shareholders of ABC are willing to expand the stock ownership of ABC to the current shareholders of DEF. It also assumes that all the DEF shareholders are eligible S shareholders. Based on this information, which of the following statements is accurate?

    a. ABC's S election would not terminate, even if it issued stock to an ineligible shareholder.

    b. ABC's S election would not terminate unless there are more than 150 shareholders.

    c. This stock-for-stock swap qualifies as a Type B reorganization.

    d. ABC would recognize gain or loss on the issuance of its stock.

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.)**

28. There are a number of beneficial uses of qualified Subchapter S subsidiaries (QSubs). Which of the following would fail the test as a beneficial use of a QSub? **(Page 238)**

    a. Real estate divestiture. [This answer is correct. Real estate divestiture would not be considered a beneficial use of a QSub because an S corporation may find it to their advantage to use a QSub to hold real property for the purpose of gaining another layer of liability protection.]

    b. Operating a business in multiple locations. [This answer is incorrect. By operating a business in multiple locations, a QSub can be used to protect the assets of the parent corporation and each subsidiary from liabilities that result from operations at another location.]

    c. Facilitate acquiring a new business. [This answer is incorrect. Acquiring a new business is a beneficial use of a QSub due to the fact that an S corporation can form a subsidiary made up of the new business and elect QSub status for the subsidiary. By doing this, the parent and the QSub are each protected under a separate corporate liability shield.]

    d. Increase basis in stock and debt. [This answer is incorrect. One beneficial use of a QSub is to increase basis in stock and debt. Debt that is issued by a QSub to a shareholder of a parent S corporation is treated as debt of the parent when calculating shareholder debt basis. As a result, a QSub can be used to combine stockholder basis in stock or debt to increase the amount that can be deducted for current or suspended pass-through losses.]

29. Brasscorp is a calendar year S corporation. On June 1, 2009, it acquired the stock of Coppercorp, a calendar year C corporation. On October 20, 2009, Brasscorp filed an election to treat Coppercorp as a QSub. Which of the following dates can Brasscorp use as the effective date of the election? **(Page 239)**

    a. October 19, 2009. [This answer is correct. As detailed in IRC Sec. 1361(b)(3)(B), Brasscorp can use an effective date of October 19, 2009 for the election to treat Coppercorp as a QSub since the effective date is not more than two months and 15 days prior to the filing date of October 20, 2009.]

    b. December 19, 2010. [This answer is incorrect. The effective date for the election to treat Coppercorp as a QSub must be no more than 12 months after the filing date, which is October 20, 2009. Since December 19, 2010 is more than 12 months after October 20, 2009, Brasscorp cannot use December 19, 2010 as the effective date of the election based on the requirements of IRC Sec. 1361(b)(3)(B).]

30. Glenco is a parent S corporation that did not meet the original due date for submission of Form 8869 for the first year the QSub election was to take effect. Glenco must file Form 8869 no later than how many months after the due date (without extensions) of Form 1120S for the first year the QSub election is to take effect? **(Page 240)**

    a. Three months. [This answer is incorrect. According to Rev. Proc. 2003-43, Glenco can file Form 8869 more than three months after the due date of Form 1120S for the first year the QSub election is to take effect.]

    b. Six months. [This answer is correct. Rev. Proc. 2003-43 allows Glenco to file Form 8869 up to six months after the due date (less extensions) of Form 1120S for the first year the QSub election is to take effect.]

    c. One year. [This answer is incorrect. Glenco cannot file Form 8869 as late as one year following the due date of Form 1120S for the first year the QSub election is to take effect per the requirements of Rev. Proc. 2003-43.]

31. Jack owns 100% of the stock of Giles, an S corporation. Giles owns 76% of the stock of Barko, a solvent corporation, and Jack owns the remaining 24%. On June 15 of the current year, Jack contributes his Barko stock to Giles in exchange for additional Giles stock. Giles makes a QSub election for Barko effective immediately after the transfer. If the transaction is collapsed under the step-transaction doctrine, which of the following circumstances applies? **(Page 241)**

    a. The deemed liquidation qualifies under IRC Secs. 332 and 337. [This answer is incorrect. The liquidation fails to qualify under IRC Secs. 332 and 337 since the 80% control test has not been met.]

    b. The subsidiary recognizes gain on the transaction. [This answer is correct. If the 80% control test has not been met, the deemed liquidation does not qualify under IRC Secs. 332 and 337 as a tax-free parent/subsidiary liquidation; therefore, the subsidiary recognizes gain on the transaction.]

32. Jessup, an S corporation, owns 100% of the stock of Johnco, a C corporation. Johnco is indebted to Jessup for an amount that exceeds the fair market value of Johnco's assets. Jessup makes a QSub election for Johnco that is effective on the day it is filed. The deemed liquidation does not qualify under IRC Secs. 332 and 337 and, as a result, Johnco recognizes gain or loss on the assets distributed, subject to the limitations of IRC Sec. 267. Which of the following statements regarding the deemed liquidation is accurate? **(Page 242)**

    a. Johnco's tax attributes generally will carry over to Jessup. [This answer is incorrect. Johnco's tax attributes generally will not carry over to Jessup under IRC Sec. 381 since the liquidation is a taxable rather than a tax-free transaction.]

    b. Jessup may be able to deduct a loss. [This answer is correct. Pursuant to the worthless stock rules of IRC Sec. 165(g), Jessup may be able to deduct a loss.]

33. Which of the following statements regarding deemed liquidation on electing QSub status is correct? **(Page 243)**

    a. Losses suspended under the basis limitation rules of IRC Sec. 1366(d) are not available to the shareholder who initially incurred them. [This answer is incorrect. Losses suspended under the basis limitation rules of IRC Sec. 1366(d) continue to be available to the shareholder who initially incurred them under certain circumstances, per Reg. 1.1361-4(c).]

    b. The deemed liquidation of the subsidiary corporation occurs the same day the QSub election is effective. [This answer is incorrect. The deemed liquidation of the subsidiary corporation occurs at the close of the day prior to the day the QSub election is effective in accordance with Reg. 1.1361-4(b)(1).]

    c. Last-in-first-out (LIFO) recapture tax applies when the subsidiary was a C corporation using the LIFO method for inventory prior to the QSub election. [This answer is correct. If the subsidiary was a C corporation using the LIFO method for inventory prior to the QSub election, the LIFO recapture tax applies as required by IRC Sec. 1363(d).]

    d. There are no rules available for determining the order in which losses pass through when debt of both the parent and subsidiary are held by the parent S corporation shareholders. [This answer is incorrect. The IRS has the authority to issue rules for determining the order in which losses pass through when debt of both the parent and subsidiary are held by the parent S corporation shareholders.]

34. Which of the following statements accurately reflects one of the options an S corporation has regarding the qualified stock purchase of a target? **(Page 244)**

    a. An S corporation is always eligible to make a Section 338 election. [This answer is incorrect. An S corporation can only make a Section 338 election if it also meets all other requirements for the election per Reg. 1.1368-4(b)(4).]

    b. An S corporation may make a QSub election regarding the target. [This answer is correct. Reg. 1.1368-4(b)(4) indicates that an S corporation may make a QSub election with respect to the qualified stock purchase of a target.]

35. A QSub is generally treated separately from its S corporation parent for: **(Page 245)**

    a. Federal tax purposes. [This answer is incorrect. A QSub is generally treated as a disregarded entity for federal tax purposes per Reg. 1.1361-1(a)(6).]

    b. Refunds or credits of federal tax. [This answer is correct. A QSub will be treated separately from its S corporation parent for purposes of refunds or credits of federal tax, the QSub's federal tax liabilities for any tax year in which it is not treated as a QSub, and for the federal tax liabilities of any other entity for which the QSub is liable as detailed in Reg. 1.1361-1(a)(6).]

36. Servcorp is an S corporation that provides repair services for the appliance market. Early in the year, Servcorp pays $10,000 to investigate whether to form a QSub for the purpose of expanding its business to include appliance sales. The investigation provides compelling reasons why organizing a QSub to conduct the retail sale of appliances is a good business decision. Therefore, Servcorp forms a corporation (Appco) and immediately makes a QSub election for it. Appco subsequently establishes a new retail appliance business to sell major appliances. In the process of establishing the new retail business, Appco experiences various additional pre-opening expenditures including expenditures totaling $20,000 to recruit and train employees for the new retail store and expenditures to advertise the new store. Appco also makes payments totaling $15,000 to acquire a 7-year lease agreement for the new store. Which of the above amounts are amortizable expenses? **(Page 245)**

    a. The $15,000 to acquire the lease. [This answer is incorrect. The $15,000 payments to acquire the lease must be capitalized under IRC Sec. 263 because they create an intangible contract right.]

    b. The $20,000 for employee recruitment/training and advertising the new store. [This answer is correct. The $20,000 of expenditures for employee recruitment and training, as well as the advertising expenditure are amortizable under IRC Sec. 195 since they qualify as start-up expenditures.]

    c. The $10,000 incurred to investigate the feasibility of establishing a QSub. [This answer is incorrect. The $10,000 expenditure incurred to investigate whether to establish a QSub must be capitalized under IRC Sec. 263 because it exceeds the threshold for a de minimis exception. However, normal organizational expenditures incurred in the process of organizing Appco generally qualify for amortization under IRC Sec. 248.]

37. Camco, a calendar year S corporation, owns 100% of the stock of J-Ram, a QSub. Camco sells 25% of J-Ram's stock to ABC, an unrelated corporation, for cash. The QSub election thus terminates since Camco no longer owns 100% of J-Ram's stock. Since the sale of J-Ram's (a QSub) stock results in the termination of the QSub election, the sale is treated as a sale of an undivided interest in the assets of J-Ram followed by a deemed transfer to J-Ram in a transaction to which Section 351 applies. Based on these facts, which of the following actions will result? **(Page 247)**

    a. Camco will recognize 25% of the gain or loss in the assets of J-Ram. [This answer is correct. Camco is treated as selling a 25% interest in J-Ram's assets to ABC, followed by a transfer of all the assets to a new corporation (new J-Ram) in a transaction to which IRC Sec. 351 applies. Thus, Camco will recognize 25% of the gain or loss in the assets of J-Ram (the QSub), but the transfer of the assets back to new J-Ram will be a nontaxable Section 351 transfer.]

    b. Camco will transfer the assets back to new J-Ram as a taxable Section 351 transfer. [This answer is incorrect. Typically, Section 351 transactions are tax-free. If Camco had sold stock to unrelated parties, such portion of the stock would result in taxable gain. However, there is not additional taxable gain for Camco upon the deemed formation of the new J-Ram corporation.]

38. If a QSub termination occurs due to a disposition of the QSub's stock, the corporation may make an S election or have a QSub election made prior to expiration of the required waiting period (without IRS consent) if (1) immediately after the disposition of its stock, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it, and (2): **(Page 249)**

    a. The S or QSub election is made effective within three business days of the disposition of the corporation's stock. [This answer is incorrect. IRC Sec. 1361(b)(3)(D) does not stipulate that the corporation must make the S or QSub election within three business days of the disposition of the corporation's stock.]

    b. The S or QSub election is made immediately following the disposition of the corporation's stock. This answer is correct. IRC Sec. 1361(b)(3)(D) indicates that the corporation must make the S or QSub election effective immediately following the disposition of the corporation's stock.]

    c. The S or QSub election is made effective within a "reasonable period of time", as determined by the corporation, following the disposition of the corporation's stock. [This answer is incorrect. The timing of the S or QSub election by the corporation is not at the corporation's discretion; it is specified in IRC Sec. 1361(b)(3)(D).]

39. The IRS has discretion in how the QSub and S corporation parent are treated during the period after the QSub election terminated, and before the IRS determined that the termination was inadvertent. If the IRS grants inadvertent termination retroactively for all years for which the terminating event giving rise to invalidity is effective, the corporation is treated: **(Page 250)**

    a. As a separate C corporation during the period of its ineligibility for QSub status. [This answer is incorrect. The corporation is treated as a separate C corporation during the period of its ineligibility for QSub status in cases where the IRS only grants relief for the period during which the corporation was eligible for QSub treatment as detailed in Reg. 1.1361-4(f).]

    b. As if its election was valid or had not terminated. [This answer is correct. The corporation is treated as if its election was valid or had not terminated in cases where the IRS grants relief retroactively for all years for which the terminating event or circumstance giving rise to invalidity is effective per Reg. 1.1361-4(f).]

40. ABC is a calendar year S corporation that can issue its stock in exchange for all the outstanding shares of DEF Corporation. This option makes the assumption that the shareholders of ABC are willing to expand the stock ownership of ABC to the current shareholders of DEF. It also assumes that all the DEF shareholders are eligible S shareholders. Based on this information, which of the following statements is accurate? **(Page 251)**

    a. ABC's S election would not terminate, even if it issued stock to an ineligible shareholder. [This answer is incorrect. ABC's S election would terminate if it issued stock to an ineligible shareholder per IRC Sec. 368(a)(1)(B).]

    b. ABC's S election would not terminate unless there are more than 150 shareholders. [This answer is incorrect. ABC's election would terminate if the number of shareholders exceeds 100, the shareholder limit specified in IRC Sec. 368(a)(1)(B).]

    c. This stock-for-stock swap qualifies as a Type B reorganization. [This answer is correct. This stock-for-stock swap qualifies as a Type B reorganization as defined in IRC Sec. 368(a)(1)(B).]

    d. ABC would recognize gain or loss on the issuance of its stock. [This answer is incorrect. ABC would recognize no gain or loss on the issuance of its stock per IRC Sec. 368(a)(1)(B).]

EXAMINATION FOR CPE CREDIT

Lesson 3 (TSCTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

28. For federal tax purposes, a qualified Subchapter S subsidiary (QSub) is treated:

    a. As a separate S corporation.

    b. As a separate C corporation.

    c. As owned by the parent S corporation.

    d. The same for federal tax purposes as for other purposes.

29. Railco, an S corporation, has filed a QSub election on Form 8869 with a filing date of February 28, 2010. In accordance with the requirements of IRC Sec. 1361(b)(3)(B), which of the following effective dates for the QSub election can Railco specify when filing Form 8869?

    a. November 15, 2009.

    b. December 1, 2009.

    c. December 15, 2009.

    d. March 15, 2011.

30. If the parent S corporation did not file Form 1120S for the year a QSub election would first take effect, which of the following statements is true?

    a. The parent S corporation must change the year the QSub will first take effect to provide for timely submission of Form 1120S.

    b. The parent S corporation can request an exemption from the Form 1120S filing requirements.

    c. The parent S corporation can obtain relief by filing Form 8869 with attachments detailed in Rev. Proc. 2003-43.

    d. Do not select this answer choice.

31. A user fee applies to relief granted for late QSub election in which of the following circumstances?

    a. The IRS grants relief under Rev. Proc 2003-43.

    b. The IRS grants relief by means of a letter ruling.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

32. Bancorp, an S corporation, forms a subsidiary and makes a valid QSub election for the subsidiary with an effective date as the date of the subsidiary's formation. Which of the following circumstances results from this action by Bancorp?

    a. The new subsidiary is deemed to be a QSub from its inception.

    b. A deemed liquidation of the new subsidiary occurs.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

33. If the subsidiary was a C corporation or an S corporation subject to the built-in gains tax before the QSub election, are its assets subject to the built-in gains tax after the QSub election?

    a. Yes.

    b. No.

    c. Depends on how long the subsidiary was subject to built-in gains tax prior to QSub election.

    d. The QSub election has no bearing on whether the subsidiary's assets are subject to built-in gains tax.

34. If an S corporation owns less than 100% of the stock of the subsidiary on the day before the QSub election is effective, how soon should the deemed liquidation occur following the time when the S corporation first owns 100% of the stock?

    a. Within 30 days.

    b. Within 21 days.

    c. Within 10 days.

    d. Immediately.

35. Once the QSub election is made by the S corporation, which of the following items of the QSub is recognized for federal tax purposes?

    a. Accumulated earnings/profits.

    b. Passive investment income.

    c. Built-in gains.

    d. Certain excise taxes.

36. Company XYZ is investigating whether to establish a QSub and the investigative expenditures to make this determination qualify for a de minimis exception. As a result, expenditures aggregating _____ are not required to be capitalized under IRC Sec. 263.

    a. $2,500 or less.

    b. $5,000 or less.

    c. $7,000 or less.

    d. $8,000 or less.

37. When a S corporation files a statement with the IRS to revoke a QSub election, what date is used as the date the QSub election will terminate?

    a. The date the statement is filed with the IRS.

    b. The date provided by the IRS.

    c. The date specified in the statement.

    d. The date it is first determined the QSub has failed to meet basic requirements.

38. Jamisco, an S corporation, terminates Bobcom, a QSub. The termination did not occur as a result of a disposition of Bobcom's stock. Absent permission being granted by the IRS, Jamisco cannot make a subsequent S election or QSub election for Bobcom before it's:

    a. Second tax year that begins after the first tax year for which the termination was effective.

    b. Third tax year that begins after the first tax year for which the termination was effective.

    c. Fourth tax year that begins after the first tax year for which the termination was effective.

    d. Fifth tax year that begins after the first tax year for which the termination was effective.

39. An "affiliated group" relationship is established when S corporations own what percent of the stock of a corporation?

    a. 25% or more.

    b. More than 50%.

    c. 80% or more.

    d. 100%.

40. Which of the following can elect to join in the filing of a consolidated return?

    a. An S corporation with an affiliated group.

    b. A C corporation subsidiary with its affiliated C corporations.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

GLOSSARY

Acquisitive Type D Reorganization: When the transfer of assets to a controlled subsidiary in connection with a distribution of the stock and securities of the subsidiary to the transferor's shareholders.

Basis: The amount assigned to an asset from which gain or loss is determined for income tax purposes. For assets acquired by purchase, basis is cost. Special rules govern the basis of property received by virtue of another's death, by gift, or in an exchange; the basis of stock received on a transfer of property to a controlled corporation; the basis of the property transferred to the corporation; and the basis of property received upon the liquidation of a corporation.

Boot: A monetary consideration, usually cash, received or given (in a small amount) in a nonmonetary exchange. Boot often causes a gain that must be recognized.

Consolidation: The action of two or more corporations in joining together into one corporation. The existing corporations are extinguished and a new one is created, taking over the assets and assuming the liabilities of the other corporations. A consolidation is distinguished from a merger, whereby one corporation absorbs the other and remains in existence while the second corporation is dissolved.

Continuity of Business Enterprise (COBE): Under this general rule, the acquiring corporation must either continue the acquired corporation's historic business (business continuity test) or use a significant portion of the acquired corporation's historic business assets in a business (asset continuity test).

Continuity of Shareholder Interest (COSI) In a reorganization, the shareholders of an acquired or transferor corporation retain a continuing equity interest in the transferee or acquiring corporation.

Dividend equivalency: Boot is tested by comparing the interest the shareholder actually received in the acquiring corporation with the interest the shareholder would have received in the acquiring corporation assuming solely stock had been received.

FIFO Stands for last-in, first-out, meaning that the most recently purchased items are recorded as sold first.

Fiscal year: An accounting year ending on the last day of any month except December.

Inadvertent Termination: S corporations can terminate their S corporation tax status under IRC section 1361(b) in many ways such as having too many stockholders, creating a second class of stock and joining an affiliated group. However, the IRS may grant permission to regain the status if the termination was inadvertent, outside of the stockholders' control and not motivated by tax avoidance or retroactive tax planning. Normally, a terminated status cannot be regained until after five taxable years, but if a corporation corrects the event in a timely manner and agrees to IRS required adjustments, a waiver may be attained.

LIFO: Stands for first-in, first-out, meaning that the oldest inventory items are recorded as sold first.

Merger: When one company (A) acquires another (B) with the latter (B) ceasing to exist: A + B = A. It is a fusion. It is when two or more companies physically combine operations with all but one ceasing to exist as a legally recognized entity. A merger must be accounted for as a purchase. Pooling of interests for new mergers is no longer allowed.

Qualified Subchapter S subsidiary (QSub): A subsidiary corporation 100% owned by an S corporation that has made a valid QSub election for that subsidiary.

Reorganization: The act or process of organizing again or anew and indicates a corporate readjustment of existing interests. A reorganization is distinguishable from a consolidation or merger. It is not ordinarily the combination of several existing corporations but is simply the carrying out by proper agreements and legal proceedings of a business plan or scheme to effect changes in the existing corporation (usually when financially distressed).

Spin-off: Distribution of stock of a controlled corporation to the shareholders of the controlling corporation.

Split-up: Distribution of the stock of two or more controlled corporations as part of the complete liquidation of the controlling corporation.

Split-off: Same as a spin-off, except the shareholders of the controlling corporation surrender stock in exchange for the stock of the controlled corporation.

Step Transaction Doctrine: A series of formally separate steps that will be treated as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result.

Type A reorganization: Statutory mergers and consolidations.

Type B reorganization: Stock-for-stock exchanges.

Type C reorganization: Stock-for-asset exchanges.

Type E reorganization: Debt-for-equity swap.

Type F reorganization: Involves only changes in the identity, form, or place of organization of one corporation.

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COMPANION TO PPC'S TAX PLANNING GUIDE—S CORPORATIONS

COURSE 3

TAX ACCOUNTING METHODS FOR S CORPORATIONS (TSCTG103)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to the accounting periods and methods unique to S Corporations. The course includes topics such as choosing a fiscal year and selecting the appropriate accounting method. Other topics include: when to capitalize a business expense and how S Corporations can claim the Section 199 deduction.

PUBLICATION/REVISION DATE: May 2010

RECOMMENDED FOR: Users of *PPC's Tax Planning Guide—S Corporations*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **May 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Choosing the Fiscal Year

Completion of this lesson will enable you to:

- Determine the fiscal year that best fits the circumstances of the client.
- Define required payments and related terms.
- Differentiate between S corporation fiscal year requiring IRS approval, those that do not and those that may experience a short tax year.

Lesson 2—Selecting the Appropriate Accounting Method

Completion of this lesson will enable you to:

- Determine the appropriate accounting method for an S corporation.
- Differentiate between costs that should be capitalized and those that should be expensed.
- Claim the Section 199 Producer Deduction.

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Lesson 1: Choosing the Fiscal Year

INTRODUCTION

This lesson covers a range of topics—tax years (including the use of fiscal years), accounting methods, and reporting income or claiming certain deductions within the taxpayer's method of accounting.

S corporations, partnerships, and personal service corporations can retain or adopt fiscal tax years only if certain conditions are met. Most S corporations using a fiscal year must make an election under IRC Sec. 444 and must pay for the privilege by making "required payments." However, an S corporation can retain or adopt a fiscal year without making required payments if it has an approved business purpose for the year.

An S corporation's tax year normally will be composed of a 12-month period, but short tax years may occur for several reasons, including an S corporation changing to a fiscal year, changing to a calendar year, or terminating its S corporation election.

S corporations, like other tax entities, must use an accounting method that clearly reflects income. S corporations, unlike C corporations, are not subject to the Section 448(a) requirement to use the accrual method of accounting, but may not use the cash method if they are a "tax shelter."

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the fiscal year that best fits the circumstances of the client.
- Define required payments and related terms.
- Differentiate between S corporation fiscal year requiring IRS approval, those that do not and those that may experience a short tax year.

THE CALENDAR YEAR TAX YEAR

Choosing the Tax Year When the S Election Is Made

An S election requires consideration of the tax year to be used. When Form 2553 (Election by a Small Business Corporation) is filed, the new S corporation can (a) use a calendar year; (b) make the Section 444 election and use an acceptable fiscal year; (c) apply for a fiscal year that will be approved automatically (e.g., a year that is deemed to have a business purpose because of conformity with its natural business year); or (d) apply for a fiscal year for which there is a business purpose (based on facts and circumstances) that must be approved by the IRS.

Using a Calendar Year Beginning with the First S Year. A calendar year is chosen simply by checking the "calendar year" box on Form 2553.

Using a Calendar Year When a Newly Formed Corporation Elects 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).

Using a Calendar Year When a C Corporation Elects S Status. An existing fiscal-year C corporation that elects S status is not automatically entitled to retain its fiscal tax year. Assuming the C corporation cannot obtain IRS approval to retain its fiscal year based on "business purpose," it must switch to a calendar tax year or, if eligible, make a Section 444 election.

The S corporation's first tax year begins on the first day following the calendar or fiscal tax year of the electing C corporation.

Example 1-1: Using a calendar year when a C corporation elects S status.

XYZ Inc., a C corporation, uses a June 30 fiscal year and elects S status. The first S year begins July 1, 2010. The corporation does not qualify for an automatically approved natural year-end, nor is there any business

purpose for which the IRS will approve a fiscal year. The shareholders do not want to make the required payments that would be necessary if the corporation made the Section 444 election and used a fiscal year ending on the last day of September, October, or November. The only option is to use a calendar tax year. Thus, the first tax year begins on July 1 and ends on December 31, 2010.

Changing an Existing S Corporation's Fiscal Year to a Calendar Year

Changing to a Calendar Year When S Corporation Is Not Terminating a Section 444 Election. An S corporation using a fiscal year can change to a calendar year automatically. If the S corporation is not terminating a Section 444 election, it makes the change to a calendar year by filing Form 1128 (Application to Adopt, Change, or Retain a Tax Year) with the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the S corporation files its tax return.

Changing to a Calendar Year When S Corporation Is Terminating a Section 444 Election. When the S corporation changes to a calendar year and the change terminates a Section 444 election, no special election is necessary and the corporation is not required to file Form 1128. Instead, the corporation simply files a short-period return (ending December 31) to switch to a calendar year. According to Temp. Reg. 1.444-1T(a)(5), "SECTION 444 ELECTION TERMINATED" must be typed or printed at the top of the first page of the short period return, Form 1120S.

Changing to Calendar Year Causes More Than 12 Months of Pass-through

Changing to a calendar year will cause the shareholders to include income or loss for more than 12 months on their personal returns. For example, if a corporation using a fiscal year ending September 30 changed to a calendar year, the shareholders would report on their personal returns the results of 15 months of the corporation's operations; that is, the year ending September 30 and the three-month short period ending December 31. One effective tax planning device would be to change to a calendar year in a year when the short period shows a loss so the loss is available to offset the previous 12 months' income.

FISCAL YEAR UNDER IRC SECTION 444

Choosing an Acceptable Year End

A newly formed corporation that elects S status and a C corporation electing to be an S corporation generally must either use a "permitted year," or make the Section 444 election. Under IRC Sec. 1378(b), a permitted year is generally a tax year that either (a) ends on December 31 or (b) is based on a business purpose for which IRS approval has been obtained.

Another option is for the S corporation to elect a fiscal year under Section 444, as discussed throughout this lesson.

Choosing a Section 444 Year Instead of a Permitted Year

IRC Sec. 444 allows an S corporation to elect to use a fiscal year if it meets certain criteria. However, Sec. 7519 provides that the entity must make required payments if a fiscal year is elected under IRC Section 444. The required payments are intended to approximate the amount of tax that would be paid by the shareholder if the corporation changed to a calendar year. Thus, in most cases, the payments offset the income tax deferral provided by the fiscal year.

Applying Restrictions on Section 444 Fiscal Years

Deferral Period Is Limited to Three Months. An S corporation can elect a Section 444 fiscal year that results in deferral of income for only three months or less. This restriction limits the corporation to a September 30, October 31, or November 30 year-end. (Certain S corporations may have kept their year beginning in 1986 under grandfather rules.) Further, the Section 444 fiscal year cannot increase the deferral period when a C corporation elects S status or when an existing S corporation elects to use a new fiscal year. (See Examples 1-2, 1-3, and 1-4.)

Identifying the Deferral Period. The deferral period is the number of months between the beginning of the fiscal year and the end of the required (normally calendar) year. For example, a year ending September 30 has a three-month deferral period.

Section 444 Election Cannot Be Used by a Tiered Structure. Members of a tiered structure cannot make the Section 444 election. An S corporation is a member of a tiered structure if it owns any portion of a partnership, personal service corporation, or trust, or if a trust owns any of the S corporation's shares. Grantor trusts, qualified Subchapter S trusts, electing small business trusts, qualified retirement plan trusts, and trusts exempt from tax under IRC Sec. 501(c)(3) are excluded from the definition of "trust" for these purposes. An exception is made (that is, members of a tiered structure can make the Section 444 election) if the tiered structure consists of partnerships or S corporations (or both) and all of the entities use the same tax year.

Choosing a Section 444 Tax Year When a Newly Formed Corporation Elects S Status

If a newly formed S corporation makes the Section 444 election, the year-end can only be September 30, October 31, or November 30.

Example 1-2: Choosing a Section 444 tax year when a newly formed corporation elects S status.

On March 1, 2010, Tots, Inc. is incorporated and elects S corporation status. Tim owns all the stock. For tax deferral purposes, Tim would like February 28 to be the corporate year-end. However, Tots does not qualify for an automatically approved natural business year-end, nor is there any business purpose based on facts and circumstances for which the IRS would likely approve fiscal year status. The corporation can automatically use a year ending December 31. Alternatively, Tots can make the Section 444 election and adopt a fiscal year ending on September 30, October 31, or November 30.

Tots makes the Section 444 election and uses a fiscal year ending September 30. Its first tax year begins on March 1 and ends on September 30, 2010.

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).

Choosing a Section 444 Tax Year When a C Corporation Elects S Status

A fiscal-year C corporation is not automatically entitled to retain its fiscal year when it elects S status. A C corporation electing S status generally has the same choices as a newly incorporated S corporation (i.e., use a calendar year, make the Section 444 election, apply for an automatically approved fiscal year, or apply for a fiscal year for which there is a business purpose based on facts and circumstances). If the corporation makes the Section 444 election, the year-end can only be September 30, October 31, or November 30. Furthermore, a C corporation electing S status cannot make a Section 444 election that results in a deferral period greater than its present fiscal year.

Example 1-3: Choosing a Section 444 tax year when a C corporation elects S status.

Neat, Inc., a C corporation, uses a June 30 year-end. The corporation elects S status on July 1, 2010. There is no acceptable business purpose that would allow the corporation to use a fiscal year. Therefore, Neat cannot retain its June 30 year end. It can automatically use a year that ends on December 31. Alternatively, the S corporation can make the Section 444 election and use a year that ends at September 30, October 31, or November 30 because these year-ends shorten the deferral period. If an October 31 year-end is elected, the first S corporation return would be filed for the short period from July 1 through October 31, 2010.

Assume now that Neat, Inc. uses an October 31 year-end. The corporation elects S status on November 1, 2010. The S corporation can make the Section 444 election to retain its October year-end. Or, it can make the Section 444 election to use a November 30 year-end because the change shortens the deferral period. It cannot, however, make the Section 444 election to use a September 30 year-end because that increases the deferral period. If a November year-end was elected, the first S corporation return would be filed for the short period from November 1 through November 30, 2010.

If the C corporation had used a calendar year, it could not make a Section 444 election because any year-end other than December 31 would increase the deferral period.

Partnerships and Proprietorships. Partnerships and proprietorships evidently do not have to consider the previous entity's year when choosing an S corporation year-end. A proprietorship, for example, that has been operating on a calendar year can elect S corporation status upon incorporation and can apparently choose a September, October, or November year-end. To do so, a Section 444 election must be made, and the company is responsible for submitting required payments.

Changing to Fiscal Year When an Existing S Corporation Makes the Section 444 Election

If an existing S corporation makes the Section 444 election, the year-end can only be September 30, October 31, or November 30. Furthermore, the Section 444 election cannot result in a deferral period greater than its present fiscal year.

Example 1-4: Changing to an allowable fiscal year when an existing S corporation makes the Section 444 election.

Tom, the sole shareholder of Marshall, Inc., an existing calendar year S corporation, wants Marshall to make a Section 444 election to adopt a September 30 fiscal year. The deferral period of Marshall's current calendar year is zero months. Therefore, Marshall, Inc. cannot make a Section 444 election because the deferral period of a tax year ending the last day of any other month will be more than zero months. (Here, the deferral period of the desired September 30 fiscal year is three months.)

Assume instead that Marshall, Inc. has a June 30 fiscal year but no longer has a business purpose for using that year. However, Tom wants the corporation to make a Section 444 election to adopt a September 30 fiscal year. The corporation can make the Section 444 election because the deferral period of the desired September 30 fiscal year (three months) does not exceed the shorter of three months or the deferral period of the existing June 30 fiscal year (six months).

An existing S corporation is often ineligible or unwilling to make the Section 444 election. A calendar year S corporation cannot make a Section 444 election because the deferral period would be increased. Furthermore, only in rare situations will an existing fiscal-year S corporation want to make the Section 444 election. If the Section 444 election is made, the income tax deferral provided by the existing fiscal year will be lost, and the corporation will be liable for required payments, which approximate the amount of tax that would be paid if the corporation changed to a calendar year.

Deciding Whether to Make a Section 444 Election. As a general rule, high tax bracket owners of a business with rapidly growing levels of taxable income will benefit from the Section 444 election. A business with stagnant or declining profitability should not make the election. Practical considerations may also influence the decision to change the fiscal year. For instance, some logistical problems may be encountered in changing internal financial reporting to conform to the new fiscal year. The following are some of the other considerations:

a. *Return Preparation.* The corporation's practitioner may be able to file tax returns sooner if the tax year ends during a time that is not busy (for example, a September 30 year-end as opposed to a December 31 year-end).

b. *Shareholder Year-end Planning.* The elected year-end may put the practitioner in a better position to do year-end planning at the shareholder level. If, for example, the corporation had a September 30 year-end, the pass-through income on which the shareholder must pay tax could be estimated with greater accuracy than if the entity had a December 31 year-end. Thus, the shareholder will have more meaningful numbers for year-end planning purposes.

c. *Professional Fees.* The election can avoid additional professional fees that might otherwise result if an entity with a fiscal year for financial reporting purposes were forced to adopt a calendar year for tax purposes. However, the election could result in additional accounting fees from the computation of the required payments.

Filing the Section 444 Election

The Section 444 election is made on Form 8716 (Election To Have a Tax Year Other Than a Required Tax Year). The form must be filed by the earlier of:

a. the 15th day of the fifth month following the month that includes the first day of the tax year for which the election is first effective, or

b. the due date (without regard to extensions) of the income tax return resulting from the Section 444 election.

Automatic Extension for Filing Form 8716. Reg. 301.9100-2 grants an automatic 12-month extension to make an election on Form 8716. If the form is filed late, but within 12 months of the original due date, the words "Filed Pursuant to Section 301.9100-2" should be written or typed at the top of the form.

Newly Electing S Corporations. If the Section 444 election is to be made by a newly electing S corporation, the appropriate year-end is written in the proper space on the S election Form 2553. The Form 2553 contains a box (on page 3 of the form) that should be checked to indicate that the Section 444 election will be made. If the box is not checked, the IRS may not accept the Form 8716. Form 2553 also contains a box to check that states that the corporation will use a calendar year if the Section 444 year is not allowed (for example, because the Form 8716 is filed late or a deferral period longer than the old deferral period is requested). If the calendar year backup box is not checked and if the Section 444 election year is not allowed, the S corporation election is invalid. Thus, the backup box should be checked when the corporation intends to make the Section 444 election.

Existing S Corporations Changing to a Section 444 Year. An existing S corporation may change its tax year to an allowable fiscal year, including a Section 444 year. Form 8716 is used to apply for a change under IRC Sec. 444.

Attaching Copy of Form 8716 to Tax Return. A copy of the Form 8716 should be attached to the S corporation's tax return for the first year the Section 444 election is effective.

Personal Service Corporations

A personal service corporation (PSC) with a Section 444 election in effect that elects to be an S corporation can continue the Section 444 election. Similarly, an S corporation with a Section 444 election in effect that terminates S status and becomes a PSC can continue the Section 444 election. In general, a PSC is a C corporation whose principal activity is the performance of personal services by employee-owners, and employee-owners own more than 10% of the FMV of the outstanding stock. Personal services include health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.

Quantifying the Benefits of Continuing the Election

If the tax deferral benefits are minimal or nonexistent in relation to the costs, the corporation should consider revoking its Section 444 election. The following example illustrates how to make this analysis.

Example 1-5: Measuring the benefits and costs of a Section 444 election.

PQR Corporation's required tax deposit payment amount to keep its Section 444 election in effect for the current year (October 1, 2009 to September 30, 2010) is $35,000. Having that amount on deposit with the government is advantageous only if the foreseeable tax deferral benefits are worth more than $35,000, after discounting by an appropriate time value of money factor.

Assume PQR earns taxable income of $150,000 during the last three months of calendar year 2009. (This amount should be known well before the May 15, 2010 deadline for filing Form 8752 to keep the Section 444 election in effect for the current year.) Further assume that all of PQR's shareholders are individuals in the 35% marginal tax bracket. Therefore, keeping PQR's Section 444 election will allow its shareholders to defer $150,000 of taxable income from 2009 to 2010.

The tax deferral benefits are worth at least $52,500 (35% × $150,000) to PQR's shareholders, before discounting that amount to its present value. If the appropriate time value of money discount factor is 15%, the

discounted present value of the tax deferral benefits is $45,650 ($52,500 ÷ 1.15). That amount comfortably exceeds the required tax deposit payment of $35,000, assuming that PQR does not have to pay much to have the necessary calculations made and Form 8752 filed.

Variation: Now assume the discounted present value of deferring taxable income earned by PQR Corporation during the last three months of calendar year 2009 is $35,000 or less. Even so, it might still be advantageous to pay the required tax deposit amount to keep the Section 444 election in place. This would be the case if PQR is expected to earn a large amount of taxable income during the last three months of calendar year 2010. The PQR shareholders can effectively defer that income from calendar year 2010 into calendar year 2011, if the corporation's Section 444 election is kept in place.

Terminating the Section 444 Election

Duration of the Election. The Section 444 election remains in effect until terminated. An S corporation's Section 444 election can be terminated if the S corporation (not a complete list): (a) changes to a calendar year, (b) liquidates, (c) willfully fails to comply with the required payment rules, or terminates the S election. If the Section 444 election is terminated, it cannot be made again.

Terminating the Section 444 Election by Changing to a Calendar Year. An S corporation can change to a calendar year at any time. If a Section 444 election is in effect, the change is accomplished by filing a short-period S return converting the entity to a December 31 year-end. No special election is necessary; the corporation simply files a short-period return (ending December 31) to switch to a calendar year. According to Temp. Reg. 1.444-1T(a)(5), "SECTION 444 ELECTION TERMINATED" must be typed or printed at the top of the first page of the short period return, Form 1120S. When the Section 444 election is terminated, an S corporation will be entitled to a refund of the cumulative amount of its required payments.

SELF-STUDY QUIZ

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

1. The owners of Ochre Rose, a dance club, are considering adopting S corporation status. The majority of the business generated by Ochre Rose occurs in the Spring, Summer and Fall when their outdoor venue of live music is filled. The owners of Ochre Rose would like to retain their fiscal year closing of November 30th. The owners consult their accountant. What is the accountant likely to advise?

   a. Ochre Rose can retain the fiscal year as long as there is an approved business purpose for the year.

   b. The owners of Ochre Rose should change to a calendar year end as that is the only choice for S corporations.

   c. The owners should expect a short tax year the first year of S corporation status.

2. Using a calendar year beginning with the first S year is accomplished by doing which of the following on Form 2553?

   a. Making the Section 444 election.

   b. Checking the calendar year box.

   c. Apply for a calendar year that will be approved automatically.

   d. Apply for a calendar year due to a business purpose.

3. On March 1, 200X, Finn becomes the sole shareholder of a new S corporation that acquires assets and begins doing business on the same date. For tax deferral purposes, he would like to have a fiscal year that ends on June 30. However, the corporation does not qualify for an automatically approved natural year-end, nor is there any business purpose for which the IRS will approve a June 30 fiscal year. Finn does not want to make the required payments that would be necessary if the corporation made the Section 444 election and used a fiscal year ending on the last day of September, October, or November. What is the beginning and ending date of Finn's new corporation?

   a. January 1 and December 31.

   b. January 1 and September 30.

   c. March 1 and December 31.

   d. March 1 and September 30.

4. Which of the following statements concerning a fiscal year C corporation electing S status is **incorrect**?

   a. A fiscal year C corporations electing S status may need to make Section 444 payments to retain its fiscal tax year.

   b. A fiscal year C corporations electing S status may need to obtain IRS approval based on "business purpose" to retain its fiscal tax year.

   c. An existing fiscal year C corporation electing S status will automatically retain its fiscal tax year.

5. Which of the following best describes the reason why an S corporation making a Section 444 election may only select a September 30, October 31 or November 30 year end?

   a. The Section 444 election is made by a member of a tiered structure.

   b. These are the due dates for required payments made by an entity making a Section 444 election.

   c. These dates provide the best tax deferral for S corporation shareholders.

   d. The deferral period is limited to three months.

6. On March 1, 20X1, Doughts, Inc. is incorporated and elects S corporation status. Allen owns all the stock. For tax deferral purposes, Allen would like February 28 to be the corporate year-end. However, Doughts does not qualify for an automatically approved natural business year-end, nor is there any business purpose based on facts and circumstances for which the IRS would likely approve fiscal year status. The corporation can automatically use a year ending December 31. Alternatively, Doughts can make the Section 444 election and adopt a fiscal year ending on September 30, October 31, or November 30. Doughts makes the Section 444 election and uses a fiscal year ending September 30. What is the beginning and ending date for the first tax year for Doughts, Inc.?

   a. Begins on March 1 and ends on September 30, 20X1.

   b. Begins on October 1, 20X2 and ends on September 30, 20X2.

   c. Begins on March 1, 20X1 and ends on February 28, 20X2.

   d. Begins on October 1, 20X1 and ends on February 28, 20X2.

7. When a C corporation elects S status and makes the Section 444 election, the year-end **cannot** be on which of the following dates?

   a. September 30.

   b. October 31.

   c. November 30.

   d. December 31.

8. Icebreakers, Inc., a C corporation, uses a June 30 year-end. The corporation elects S status on July 1, 20X1. There is no acceptable business purpose that would allow the corporation to use a fiscal year. Therefore, Icebreakers cannot retain its June 30 year end. It can automatically use a year that ends on December 31. Alternatively, the S corporation can make the Section 444 election and use a year that ends at September 30, October 31, or November 30. If an October 31 year-end is elected, what is the short period for the first S corporation return?

   a. November 1 through December 31, 20X1.

   b. July 1 through October 31, 20X1.

   c. January 1 through June 30, 20X1.

   d. July 1 though December 31, 20X1.

9. From the answer choices below, select the best reason for making a Section 444 election.

   a. The corporation may receive a break on the tax return preparation if the return can be filed on a fiscal year end.

   b. High tax bracket owners of a rapidly growing business with increasing levels of taxable income will benefit from a Section 444 election.

   c. Shareholders will be able to do year-end tax planning if the corporation has a fiscal year prior to December 31.

   d. A business with declining profitability will get a boost by deferring taxes when it makes a Section 444 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.)**

1. The owners of Ochre Rose, a dance club, are considering adopting S corporation status. The majority of the business generated by Ochre Rose occurs in the Spring, Summer and Fall when their outdoor venue of live music is filled. The owners of Ochre Rose would like to retain their fiscal year closing of November 30th. The owners consult their accountant. What is the accountant likely to advise? **(Page 273)**

   a. Ochre Rose can retain the fiscal year as long as there is an approved business purpose for the year. [This answer is correct. As long as the owners of Ochre Rose can establish a business purpose tax year on the basis of facts and circumstances, the IRS is likely to allow the retention of a fiscal year.]

   b. The owners of Ochre Rose should change to a calendar year end as that is the only choice for S corporations. [This answer is incorrect. S corporations are allowed to adopt or retain fiscal tax years if certain conditions are met under the IRC Sec. 444 election.]

   c. The owners should expect a short tax year the first year of S corporation status. [This answer is incorrect. Although the owners of Ochre Rose are changing their tax status, this will not automatically lead to a short tax year.]

2. Using a calendar year beginning with the first S year is accomplished by doing which of the following on Form 2553? **(Page 273)**

   a. Making the Section 444 election. [This answer is incorrect. The Section 444 election would be used when electing an acceptable fiscal year.]

   b. Checking the calendar year box. [This answer is correct. A calendar year can be chosen simply by checking the "calendar year" box on Form 2553.]

   c. Apply for a calendar year that will be approved automatically. [This answer is incorrect. The new S corporation can apply for a *fiscal* year that will be approved automatically using Form 2553.]

   d. Apply for a calendar year due to a business purpose. [This answer is incorrect. When Form 2553 is filed, the new S corporation can apply for a *fiscal* year where there is a business purpose that can be substantiated, and is approved by the IRS.]

3. On March 1, 200X, Finn becomes the sole shareholder of a new S corporation that acquires assets and begins doing business on the same date. For tax deferral purposes, he would like to have a fiscal year that ends on June 30. However, the corporation does not qualify for an automatically approved natural year-end, nor is there any business purpose for which the IRS will approve a June 30 fiscal year. Finn does not want to make the required payments that would be necessary if the corporation made the Section 444 election and used a fiscal year ending on the last day of September, October, or November. What is the beginning and ending date of Finn's new corporation? **(Page 273)**

   a. January 1 and December 31. [This answer is incorrect. 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.]

   b. January 1 and September 30. [This answer is incorrect. The facts of the scenario presented indicate Finn would need to pay a fee to elect a fiscal year end and Finn does not want to make the cash outlay. In addition, 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.]

c. March 1 and December 31. [This answer is correct. From the facts presented in the scenario, the only option opened to Finn is to use a calendar year end.]

d. March 1 and September 30. [This answer is incorrect. According to the Internal Revenue Code, the first tax year for Finn's new business is a short tax year; however, this answer choice does not include the correct dates for the short tax year.]

4. Which of the following statements concerning a fiscal year C corporation electing S status is **incorrect**? **(Page 273)**

a. A fiscal year C corporations electing S status may need to make Section 444 payments to retain its fiscal tax year. [This answer is incorrect. An existing C corporation may make a Section 444 election to retain its fiscal year if it is eligible to make such an election.]

b. A fiscal year C corporations electing S status may need to obtain IRS approval based on "business purpose" to retain its fiscal tax year. [This answer is incorrect. An existing C corporation may apply for IRS approval to retain its fiscal year if it has a business purpose for the fiscal year.]

c. An existing fiscal year C corporation electing S status will automatically retain its fiscal tax year. [This answer is correct. An existing fiscal year C corporation will not automatically retain its fiscal year. There must be a business purpose for the fiscal year and the corporation must make an application to the IRS or an existing fiscal year C corporation may make a Section 444 election and pay for the privilege of retaining a fiscal year end.]

5. Which of the following best describes the reason why an S corporation making a Section 444 election may only select a September 30, October 31 or November 30 year end? **(Page 274)**

a. The Section 444 election is made by a member of a tiered structure. [This answer is incorrect. A Section 444 election cannot be used by a tiered structure.]

b. These are the due dates for required payments made by an entity making a Section 444 election. [This answer is incorrect. Per IRC Sec. 7519, the required payments are not due monthly.]

c. These dates provide the best tax deferral for S corporation shareholders. [This answer is incorrect. Generally, the payments made under a Section 444 election approximate the amount of tax that would be paid by the shareholder if the corporation was on a calendar year tax year.]

d. The deferral period is limited to three months. [This answer is correct. The Section 444 election will only allow a corporation to defer income for three months or less.]

6. On March 1, 20X1, Doughts, Inc. is incorporated and elects S corporation status. Allen owns all the stock. For tax deferral purposes, Allen would like February 28 to be the corporate year-end. However, Doughts does not qualify for an automatically approved natural business year-end, nor is there any business purpose based on facts and circumstances for which the IRS would likely approve fiscal year status. The corporation can automatically use a year ending December 31. Alternatively, Doughts can make the Section 444 election and adopt a fiscal year ending on September 30, October 31, or November 30. Doughts makes the Section 444 election and uses a fiscal year ending September 30. What is the beginning and ending date for the first tax year for Doughts, Inc.? **(Page 275)**

a. Begins on March 1 and ends on September 30, 20X1. [This answer is correct. Doughts, Inc. will experience a short tax year during the first year of operations.]

b. Begins on October 1, 20X2 and ends on September 30, 20X2. [This answer is incorrect. This answer choice reflects the beginning and ending date of the second tax year for Doughts, Inc.]

c. Begins on March 1, 20X1 and ends on February 28, 20X2. [This answer is incorrect. This is the tax year that the business owner, Allen, would prefer. However, the facts of the question indicate Doughts does not qualify for an automatically approved natural business year-end, nor is there any business purpose based on facts and circumstances for which the IRS would likely approve fiscal year status.]

d. Begins on October 1, 20X1 and ends on February 28, 20X2. [This answer is incorrect. The first tax year of Doughts, Inc. would be required to begin on the earliest date on which the corporation has shareholders, acquires assets, or begins doing business.]

7. When a C corporation elects S status and makes the Section 444 election, the year-end **cannot** be on which of the following dates? **(Page 275)**

   a. September 30. [This answer is incorrect. When a C corporation elects S status and makes the Section 444 election, the year-end can be on any of three dates. One such date is September 30.]

   b. October 31. [This answer is incorrect. October 31 is one of three dates the year-end can be on when a C corporation elects S status and makes the Section 444 election.]

   c. November 30. [This answer is incorrect. The year-end for a C corporation that elects S status and makes the Section 444 election can have the year-end fall on November 30.]

   d. December 31. [This answer is correct. The year-end can be on one of three dates when a C corporation elects S status and makes the Section 444 election. December 31 is not one of those dates.]

8. Icebreakers, Inc., a C corporation, uses a June 30 year-end. The corporation elects S status on July 1, 20X1. There is no acceptable business purpose that would allow the corporation to use a fiscal year. Therefore, Icebreakers cannot retain its June 30 year end. It can automatically use a year that ends on December 31. Alternatively, the S corporation can make the Section 444 election and use a year that ends at September 30, October 31, or November 30. If an October 31 year-end is elected, what is the short period for the first S corporation return? **(Page 276)**

   a. November 1 through December 31, 20X1. [This answer is incorrect. If Icebreakers, Inc. had been using an October 31 fiscal year before electing S status, this may have been the correct date for the short period. It would depend on what year end the new S corporation had selected.]

   b. July 1 through October 31, 20X1. [This answer is correct. This answer choice properly reflects the date of the beginning of the first year of S corporation status and the date of the end of the fiscal year selected by the S corporation.]

   c. January 1 through June 30, 20X1. [This answer is incorrect. The short year would occur after the S corporation election, not prior to the election.]

   d. July 1 though December 31, 20X1. [This answer is incorrect. This would be the correct period of the short year if Icebreakers had automatically selected a year that ends on December 31.]

9. From the answer choices below, select the best reason for making a Section 444 election. **(Page 276)**

   a. The corporation may receive a break on the tax return preparation if the return can be filed on a fiscal year end. [This answer is incorrect. It is true that a corporation may receive a lower fee on the return preparation, however, this is not the best reason to file a Section 444 election.]

   b. High tax bracket owners of a rapidly growing business with increasing levels of taxable income will benefit from a Section 444 election. [This answer is correct. If a calendar year business is expected to make the majority of its profit in the last quarter, a Section 444 election will allow the business to defer the last quarter of income into the next taxable year.]

   c. Shareholders will be able to do year-end tax planning if the corporation has a fiscal year prior to December 31. [This answer is incorrect. It is true that shareholders will be able to perform year end tax planning if they have better numbers for the pass-through income, however, there is a better answer choice.]

   d. A business with declining profitability will get a boost by deferring taxes when it makes a Section 444 election. [This answer is incorrect. A business with declining profitability is not a good candidate for a Section 444 election.]

REQUIRED PAYMENTS

Defining Required Payments

An S corporation generally must make a required payment in each year for which the Section 444 election is effective. The S corporation, rather than the shareholder, makes the payments. Generally, the payments are due by May 15 following the calendar year in which the election year begins.

Required payments are not deductible by the S corporation or by the shareholders. Instead, required payments are in the nature of deposits. The S corporation receives no interest on them, but interest is charged on underpayments. Required payments can be subject to the 10% underpayment penalty and the negligence and fraud penalties of IRS Sect. 6662–6664. Also, the Section 444 election will be revoked if the taxpayer willfully fails to comply with the rules.

The required payment is equal to:

a. the adjusted highest individual tax rate multiplied by the S corporation's net base year income, less

b. the cumulative amount of the required payments for all preceding Section 444 election years (reduced by the cumulative amount of payments refunded for preceding years).

Required payments are based on cumulative calculations. That is, the current year's required payment is reduced by the cumulative amount of previous required payments. If the current amount is less than the cumulative previous amounts, the difference will be refunded by the IRS.

No payment is due unless the required payment for the current or any previous year exceeds $500.

Form 8752 (Required Payment or Refund under Section 7519) showing the calculated required payment must be filed even if the required payment for the applicable election year is zero. No payment is required for the first year of a newly formed S corporation because it does not have a base year.

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 following answer choices properly describes the following items: who must make the required payments under the Section 444 election, the deductibility of those payments, when those payments are due and the minimum amount due?

    a. The shareholder(s) make the required payments, take(s) the deduction for the payment made by May 15 following the calendar year in which the election year begins, and no payment is required unless the payment for the current or any previous year exceeds $250.

    b. The S corporation makes the required payments, takes the deduction for the payment made by June 15 following the calendar year in which the election year begins, and no payment is required unless the payment for the current or any previous year exceeds $250.

    c. The S corporation makes the required payments, the payments are not deductible by the corporation or by the shareholders, the payments are due by May 15 following the calendar year in which the election year begins, and no payment is required unless the payment for the current or any previous year exceeds $500.

    d. The shareholder(s) make the required payments, take(s) no deduction for the payment made by May 15 following the calendar year in which the election year begins, and no payment is required unless the payment for the current or any previous year exceeds $500.

11. Which of the following statements regarding required payments is most accurate?

    a. Required payments should be made by the shareholder.

    b. Required payments generally are made in the year the Section 444 election is effective.

    c. Required payment must be made by December 31.

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 following answer choices properly describes the following items: who must make the required payments under the Section 444 election, the deductibility of those payments, when those payments are due and the minimum amount due? **(Page 285)**

    a. The shareholder(s) make the required payments, take(s) the deduction for the payment made by May 15 following the calendar year in which the election year begins, and no payment is required unless the payment for the current or any previous year exceeds $250. [This answer is incorrect. More than one attribute of the Section 444 election payment is described incorrectly by this answer choice.]

    b. The S corporation makes the required payments, takes the deduction for the payment made by June 15 following the calendar year in which the election year begins, and no payment is required unless the payment for the current or any previous year exceeds $250. [This answer is incorrect. Only one attribute of the Section 444 election payment is described correctly by this answer choice.]

    c. The S corporation makes the required payments, the payments are not deductible by the corporation or by the shareholders, the payments are due by May 15 following the calendar year in which the election year begins, and no payment is required unless the payment for the current or any previous year exceeds $500. [This answer is correct. This answer choice correctly describes the deductibility of the payment in the amount of at least $501 made by the S corporation by May 15.]

    d. The shareholder(s) make the required payments, take(s) no deduction for the payment made by May 15 following the calendar year in which the election year begins, and no payment is required unless the payment for the current or any previous year exceeds $500. [This answer is incorrect. More than one, yet not all attributes of the Section 444 election payment are described correctly by this answer choice.]

11. Which of the following statements regarding required payments is most accurate? **(Page 289)**

    a. Required payments should be made by the shareholder. [This answer is incorrect. The S corporation should make the required payments.]

    b. Required payments generally are made in the year the Section 444 election is effective. [This answer is correct. Generally, required payments must be made in each year for which the Section 444 election is effective.]

    c. Required payment must be made by December 31. [This answer is incorrect. Generally, the payments are due by Mary15 following the calendar year in which the election begins.]

THE AUTOMATICALLY APPROVED FISCAL YEAR

Identifying Tax Years That Will Be Automatically Approved by the IRS

The automatic approval provisions allow a company to use simplified procedures to apply for a fiscal year. The number of corporations that will qualify, however, is limited because of the strict requirements. S corporations that receive automatically approved years (or any approved business-purpose year) are not required to file an election under IRC Sec. 444 or make "required payments."

Automatically approved years require no user fee. IRS consideration of other business-purpose fiscal years subjects the corporation to a user fee.

Automatic approval is provided only if one of the following circumstances is met:

a. The S corporation is adopting, changing to, or retaining a calendar year.

b. The S corporation is changing to a certain 52-53 week year.

c. The corporation is adopting, retaining, or changing to a tax year that qualifies as an ownership year.

d. The S corporation, or the corporation electing S status, is adopting, retaining, or changing to a fiscal year that qualifies as a natural business year because it meets the mechanical 25% test.

Using an Ownership Tax Year

The automatic approval provisions provide that an S corporation can adopt, retain, or change to the same tax year as shareholders owning more than half of the corporation's stock. For this purpose, stock ownership is tested on the first day of the tax year to which the request relates. A fiscal year approved under the ownership tax year provisions will remain in effect as long as the corporation's tax year coincides with the tax year of persons owning more than half the corporation's stock. If, as of the first day of any tax year, the S corporation no longer meets the ownership tax year test, it must change to a permitted year by following the instructions in Rev. Proc. 2006-46.

Changing to or Retaining a Business Year Meeting the 25% Test

The IRS will automatically approve changing to or retaining a natural business year that meets the requirements of a mechanical "25% test."

The test requires that the company receive 25% or more of its annual gross income within a two-month period for three consecutive years. If this condition is met, the company can choose the fiscal year that corresponds with the end of the two-month period.

The 25% test is accomplished by first determining the gross income for two consecutive months ending with the desired fiscal year. Next, the gross income for the 12 months ending with the desired fiscal year is determined. Finally, the percentage of gross income received during the two months is calculated. The percentage must be 25% or more if the corporation is to pass the test.

To pass the 25% test, the company must have at least a 47-month history. The company is not required to have been an S corporation for the test period. If the predecessor business (corporation, partnership, or proprietorship) was operating for the 47-month period and the S corporation is continuing the same business, the predecessor's gross receipts are used for test purposes. Gross receipts are computed using the same method of accounting as that used on the tax return.

The 25% test must be met in each of the preceding three years. If the percentage of the income in the two months drops below 25% in one year, the company fails the test.

If a corporation meets the requirements of the test for more than one period, the natural business year ends with the two-month period that has the highest average percentage of gross receipts.

An S corporation that is using a natural business year because it passed the 25% test must continue to meet the 25% test in order to retain the natural business year.

Example 1-6: Applying for an automatically approved fiscal year under the 25% test.

Paula owns Lift Co., a retail proprietorship in a ski resort community. On January 1, 2011, the company incorporates and elects S status to take advantage of limited liability. The tax practitioner believes April 30 is the end of the company's natural business year and suggests the corporation consider using a fiscal year for tax purposes. The proprietorship books reflect the following gross income:

	2007	2008	2009	2010
January	$ 25,000	$ 25,000	$ 28,000	$ 33,000
February	25,000	30,000	46,000	45,000
March	44,000	45,000	56,000	51,000
April	26,000	25,000	35,000	37,000
May	19,000	20,000	20,000	20,000
June–December	100,000	100,000	100,000	100,000
Totals	$ 239,000	$ 245,000	$ 285,000	$ 286,000

The company's taxable net income was 20% of its gross income each year. Can Lift Co. obtain approval for a fiscal year ending April 30?

To determine if the April 30 year-end passes the 25% test, the practitioner notes that gross income for March and April 2008 is $70,000. The gross income for the 12 months ending April 30, 2008, is $244,000. The percentage of income received during March and April is 29% of the total. The practitioner performs the same calculations for the 12-month periods ending April 30, 2009, and 2010.

The practitioner repeats the process to determine the percentages for the years ending February 28, March 31, and May 31 to see if another year-end passes the test. The results of these calculations for the three-year period are as follows:

	2008	2009	2010
January and February	23%	28%	27%
February and March	31%	37%	34%
March and April	29%	32%	31%
April and May	18%	19%	20%

April 30 passes the test; 25% or more of the company's annual gross income is received in March and April in each of the three years. March 31 qualifies as well. If a corporation meets the requirements of the test for more than one period, the natural business year ends with the two-month period that has the highest average percentage of gross receipts. Consequently, the natural business year that will be automatically approved ends on March 31. If that year is adopted, the first corporate return will be filed for the short period beginning January 1 and ending March 31, 2011.

The corporation elects to use a natural business year ending on March 31 when it files Form 2553 (Election by a Small Business Corporation). Filing the Form 2553 when the corporation is applying for a fiscal year under the 25% test is discussed later in this lesson.

Deferring Taxable Income and Facilitating Tax Planning by Using a Fiscal Year

Use of a fiscal year can cause a deferral of taxable income, as illustrated in the following example.

Example 1-7: Use of fiscal year can result in deferral of taxable income and facilitate tax planning.

Assume the same facts as in Example 1-6, except that Lift Co.'s 2011 income is the same as in 2010. Paula will enjoy a deferral of the taxable income received from April 1 to December 31, 2011, as compared with the

results if the corporation had chosen a 2011 calendar year. The deferral in this instance is $31,400 ($157,000 gross income × 20% profit margin), and that amount will be deferred indefinitely. If taxable income increases in the period from April through December in future years, the deferral will also increase from year to year. Note, however, that net income does not always follow gross income. For instance, if the company experiences losses from April 1 to December 31, using a calendar year may be more advantageous. (See Example 1-8.)

Aside from the deferral, a fiscal year allows the shareholder opportunities for tax planning. Here, Paula will know the results of the S corporation's operations at the end of March so that she and the practitioner can proceed with her individual tax planning from that point to the end of the year with the knowledge of the exact amount that will be reportable from the S corporation.

Using a Calendar Year May Allow Earlier Use of Loss

The following example illustrates that an S corporation that anticipates losses may want to use a calendar year so that the losses can be utilized earlier.

Example 1-8: Using a calendar year may allow earlier use of losses.

Assume the same facts as in Example 1-6, except that Lift Co. has a taxable loss at March 31 of $10,000, and an additional loss of $25,000 through the end of the calendar year is anticipated. Using a March 31 fiscal year would, in effect, defer the deductibility of $25,000 of the loss until the next year. If a fiscal year is chosen, a loss of $10,000 will be passed through to Paula in the corporation's initial S year. If a calendar year is chosen instead, a loss of $35,000 will be passed through.

Given this fact pattern (and assuming that she has sufficient basis to deduct the losses), the practitioner may recommend that the company report on a calendar year so losses can be used as soon as possible. However, the practitioner must also consider the long-term planning consequences. If Lift Co. begins to generate taxable income, the March 31 fiscal year may be advantageous so future income will be deferred. If Lift Co. begins using a calendar year and it turns out later that it becomes beneficial to use a March 31 year, the corporation can automatically change to that year-end, provided it still meets the 25% test. (See the following discussion.)

Filing Form 2553 When a Corporation Electing S Status Passes the 25% Test

A request by a corporation electing S status for automatic approval to use a fiscal year that corresponds to a natural business year that passes the mechanical 25% test is made by checking the first box in item P of Part II of Form 2553. The company should type or print the statement "FILED UNDER REV. PROC. 2006-46" across the top of the front page of Form 2553. A schedule showing the company's gross receipts for the preceding 47 months must be attached to the form, as discussed in Example 1-6. The taxpayer must attach a copy of the Form 2553 to the federal income tax return (Form 1120S) for the first effective year.

The IRS has the power to deny the request if the corporation fails to qualify for or comply with the conditions for automatic approval. (For example, the IRS could deny the request if the 25% test is not actually met.) Consequently, a backup Section 444 election request and/or a backup calendar year election request should be made.

Filing for a Change in Tax Year When an Existing S Corporation Passes the 25% Test

An existing S corporation can receive automatic approval to change to a fiscal year that passes the 25% test. To change to a fiscal year under the 25% test, an existing S corporation must file Form 1128 on or before the time (including extensions) for filing the return for the resulting short period. The form must be signed by a corporate officer and submitted to the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the corporate federal income tax return is filed. The company should type or print the statement "FILED UNDER REV. PROC. 2006-46" across the top of page 1 of the form. The amount of gross receipts for the company's most recent 47 months should be furnished with the form. The taxpayer must attach a copy of the Form 1128 to the federal income tax return filed for the first effective year.

THE BUSINESS-PURPOSE FISCAL YEAR BASED ON FACTS AND CIRCUMSTANCES

An S corporation must either use a "permitted year," or make the Section 444 election. Under IRC Sec. 1378(b), a permitted year is generally a tax year that either (a) ends on December 31 or (b) is based on a business purpose for which IRS approval has been obtained. If an S corporation uses a year with an approved business purpose, the Section 444 election and required payments do not have to be made. There are certain year-ends that the IRS will approve automatically.

The IRS can grant permission for an S corporation to use a fiscal year that has a business purpose based on the particular facts and circumstances relating to that corporation. As discussed in the following paragraphs, however, it is unusual for the IRS to grant a request for such a year. A new S corporation makes the request on Form 2553, and the IRS will make its determination based on the information shown on the form and on the business purpose described in supporting schedules. Existing S corporations apply for a fiscal year on Form 1128.

Determining Acceptable Facts and Circumstances for Business-purpose Fiscal Year

The fact that the C corporation (that is electing S status) used a fiscal year-end will not, by itself, be accepted by the IRS as a good business reason. The IRS has ruled that if the reason for the fiscal year is to report a full year's operations in the accounting period, or to make it convenient to file shareholders' returns, the request will not be granted. (Much of the guidance available concerning fiscal years relates to partnerships, but the concepts should be the same for S corporations.)

None of the following factors (by themselves) will normally establish a business purpose for a fiscal year:

a. the use of a particular year for regulatory or financial accounting purposes;

b. hiring patterns of a particular business (e.g., the fact that a firm typically hires staff during certain times of the year);

c. use of a particular year for administrative purposes, such as the admission or retirement of shareholders, compensation, or retirement arrangements;

d. the use of price lists, model year, or other items that change on an annual basis;

e. the use of a particular year by related entities; and

f. the use of a particular year by competitors.

However, in the following situations, the taxpayer did establish a business purpose for the use of its requested tax year:

a. The taxpayer established that the tax year satisfied the 25% gross receipts test and resulted in less deferral than its other natural business year.

b. The taxpayer would have established a natural business year under the 25% gross receipts test except that a labor strike closed the taxpayer's business during a period that included its normal peak season.

c. For the past 10 years, the taxpayer had a three-month period of insignificant gross receipts during which, due to weather conditions, its business was not operational.

d. The taxpayer, which previously used the cash method of accounting but changed to the accrual method, would have established a natural business year under the 25% gross receipts test if it had calculated its gross receipts using the accrual method.

Generally speaking, the IRS will take a hard line when considering fiscal-year applications. Rev. Proc. 2002-39 states that a taxpayer will be granted permission to adopt, change, or retain a fiscal year under the facts and circumstances test only in "rare and unusual circumstances." The practitioner cannot rely on the IRS to grant a fiscal year other than one that will be approved automatically. In some cases, though, the practitioner may feel there are reasons to justify a fiscal year. In those cases, it may be worth filing the application, and the following discussion provides some guidance if that situation occurs.

Natural Business Year Based on an Annual Business Cycle. One business reason may be that the company has a natural business year based on an annual business cycle, even if the 25% test is not met. If the business is seasonal, the company can apply for a fiscal year based on the natural business year. A natural business year is considered to end at, or soon after, the close of the peak period of business. There is no natural business year if income is steady from month to month throughout the year.

Example 1-9: Qualifying for a natural business year based on an annual business cycle.

Acorp operates a retail business. The highest peak of Acorp's annual business cycle occurs in December each year. In January, a significant amount of the merchandise sold in December is returned or exchanged by customers. Acorp's natural business year is deemed to end at December 31, or on January 31, which is considered to be soon after the close of the highest peak period of business in December. The revenue procedure says that the IRS would grant a January 31 fiscal year-end under those circumstances. Unfortunately, not many details are given, such as how to determine whether the returns in January are "significant."

Seasonal Business. A fiscal year may also be granted because the S corporation conducts a seasonal business.

Example 1-10: Qualifying for a natural business year based on a seasonal business.

Beecorp operates a ski resort from November through March of each year. The resort earns less than 10% of its annual gross receipts during the period of April through October, when it is closed to guests. Beecorp's natural business year is deemed to end at March 31, the close of its operations, or April 30, soon after the close. The revenue procedure says that the IRS would grant a tax year ending either March 31 or April 30.

Documentation to IRS. The documentation furnished to the IRS should also specify all of the other business reasons for the year. Other business reasons might include those previously listed (model years, hiring practices, etc.). Even though, by themselves, they are not considered sufficient reasons to justify a fiscal year, they can be legitimate supplementary reasons. In other words, every business reason that the practitioner can legitimately present should be included.

Rev. Proc. 2002-39, Sec. 6.01, requires that certain information be provided so the IRS can determine whether a substantial distortion of income will occur because of the fiscal year. Sec. 5.05 of Rev. Proc. 2002-39 states that the IRS may require that certain adjustments be made to offset distortion of income, but will not require the adjustments if the distortion is less than both (a) 5% of the taxpayer's estimated gross receipts for its current tax year, and (b) $500,000. Best practices indicate the likelihood of approval is substantially increased if the documentation shows that a significant amount of income is not being deferred and that losses are not being accelerated by use of the fiscal year.

Electing S Corporation Filing a Section 444 Backup Request

If a fiscal year is denied by the IRS, the S election may be invalid unless a backup request is filed stating that the taxpayer will either make a Section 444 election or adopt a calendar tax year. The corporation makes the election by checking the appropriate box on page 3 of the Form 2553. It is important to check this box to protect the S corporation election. If the box is not checked and the requested fiscal year is denied, the IRS may not approve the S election and may not accept a later Section 444 election.

There can be severe consequences if the S election of a newly formed corporation is denied. Denial results in the entity becoming a C corporation in its first year, and the corporation would then be subject to the built-in gains tax provisions when it elects S status for its second year. However, the corporation could request the IRS to waive the invalid election.

Electing S Corporation Filing a Calendar Year Backup Request

Generally, the corporation should also indicate on the Form 2553 that a calendar year will be acceptable if the Section 444 election is not allowed. (Disallowance of the Section 444 election could occur, for instance, because the Form 8716 was not filed timely or because the requested fiscal year resulted in a longer deferral period than the old year.) If the Section 444 election is not allowed, the S election will be invalid unless the calendar year backup request is made. It is made simply by checking the appropriate box on page 3 of Form 2553, and it probably should be made to protect the S election.

Applying for an Existing S Corporation to Change to a Facts and Circumstances Fiscal Year

An existing corporation that does not satisfy the requirements for an automatically approved fiscal year can attempt to obtain IRS permission for the use of a business purpose fiscal year based on a consideration of all facts and circumstances, as discussed in this lesson. An existing S corporation files Form 1128 (Application To Adopt, Change, or Retain a Tax Year) to request a change to a business-purpose fiscal year. A user fee applies, as discussed in the following paragraphs.

Submitting a User Fee for Certain Business-Purpose Year Applications

Newly Electing S Corporation. A newly electing S corporation that applies for a business-purpose fiscal year that is established by facts and circumstances is subject to a user fee. The IRS bills the S corporation for the fee; the fee should not be remitted with Form 2553 and is published in the first revenue procedure of the year. The user fee does not apply if the corporation is changing to a Section 444 year or a fiscal year that will be approved automatically.

Existing S Corporation. If an existing S corporation files Form 1128 and requests a change to a business-purpose fiscal year, the user fee should accompany the form. The user fees are published in the first revenue procedure of the year. The fee is not assessed if the corporation is making the Section 444 election or applying for a year that will be automatically approved.

THE FISCAL YEAR UNDER THE GRANDFATHER RULES

Most S corporations using a fiscal year for their tax year ending in 1987 were required to make the Section 444 election or switch to a calendar year. However, if an S corporation's fiscal year ending in 1987 qualified as a "grandfathered fiscal year," the corporation could continue using it without having to make the Section 444 election or switch to a calendar year.

The IRS defines a grandfathered fiscal year as:

a. a fiscal year that an S corporation received IRS permission to use on or after July 1, 1974, and

b. that did not result in a three-month-or-less deferral period.

The revenue procedure specifies that the S corporation must have received permission to use the fiscal year by obtaining a letter ruling, not through the automatic approval procedures. Thus, a private letter ruling granting permission to use a fiscal year (other than one ending on September 30, October 31, or November 30) is needed to justify a year as a grandfathered fiscal year.

Example 1-11: Using fiscal year allowable because of grandfather rules.

Esscorp elected to become an S corporation in 1983. At that time, it requested a July 31 year-end and obtained a letter ruling granting permission to use that year. Esscorp retained its fiscal year in 1987 and can continue to do so because it meets the test of grandfathered fiscal year. The Section 444 election and required payments do not have to be made.

As an alternative to the grandfathered fiscal year rules, IRC Sec. 444(b)(3) permitted an S corporation to retain its tax year that began in 1986 if a Section 444 election was made by July 26, 1988. The Section 444 election was

made by filing a properly completed Form 8716 (Election to Have a Tax Year Other Than a Required Tax Year) by that date. Section 444 elections under this provision could have resulted in deferral periods of over three months.

The disadvantage of retaining a fiscal year under IRC Sec. 444(b)(3) is that the deferral of income to shareholders is achieved at the cost of making required payments.

PLANNING FOR SHORT TAX YEARS

Determining Causes of Short Tax Years

Changing to a fiscal year or changing from a fiscal year to a calendar year can create short tax years. Short tax years also are frequently involved when a C corporation elects S status or when a corporation voluntarily or involuntarily terminates its S election. Reorganization and recapitalization transactions may result in short tax years for the corporate parties involved. A sale or other disposition of stock by an S corporation shareholder to an ineligible shareholder may cause a short tax year. Finally, a short-period return is often involved when an S corporation is liquidated.

Regardless of the cause of a short tax year, the effects can be significant in the determination of pass-through income, loss, deductions and credits, shareholder basis, and the measurement or characterization of distributions to shareholders.

Identifying the Beginning of the S Year When a C Corporation Elects S Status

When a C corporation elects to become an S corporation, the S corporation's first tax year begins on the first day following the calendar or fiscal tax year of the electing C corporation.

Example 1-12: Identifying beginning of S year when C corporation elects S status.

A C corporation uses a June 30 fiscal year and elects S status. The first S year begins July 1, 2010. If the S corporation uses a calendar year, its first year will begin on July 1 and end on December 31, 2010.

Changing a C Corporation Year Before Electing S Status

It is not possible for the S election to become effective before the end of the C corporation's year. However, an option similar to having the S election effective during the C year does exist. A C corporation that meets certain requirements can automatically change its tax year to a calendar year (or other permitted year), then elect S status effective for the tax year immediately following the C corporation's short period.

Example 1-13: Changing a C corporation year before electing S status.

A C corporation using a June 30 fiscal year meets all the requirements of Rev. Proc. 2006-45 and automatically changes to a calendar year ending December 31, 2010. The corporation files a short year C corporation return for the period July 1 through December 31, 2010. If the corporation elects S status on January 1, 2011, the S corporation's first return will cover the 2011 calendar year.

Changing Fiscal Year-end Following Termination of S Status

A corporation generally must obtain IRS approval before changing its tax year by showing a business purpose for the change. However, a C corporation can change its tax year without obtaining prior approval if it meets the requirements of Rev. Proc. 2006-45.

Example 1-14: Changing fiscal year-end following termination of S status.

Exessco, Inc. was organized 11 years ago, and immediately elected S status. It elected to use the calendar year as its tax year. On December 31, 2009, its S status terminated. For valid business reasons, Exessco wants to change to a July 31 tax year.

Exessco can change its tax year beginning January 1, 2010 to a July 31 fiscal year because it meets all of the requirements of Rev. Proc. 2006-45 for a change in fiscal year. The change requires Exessco to file Form 1128 (Application to Adopt, Change, or Retain a Tax Year) and a short period Form 1120 for January 1 through July 31, 2010. In computing the tax due with this short period return, Exessco is required to annualize its taxable income.

Exessco will not be able to elect S status until its fifth tax year beginning after the tax year in which its S status terminates, unless it receives permission from the IRS to do so.

SELF-STUDY QUIZ

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

12. Entendo, an S corporation established in 200X is changing to a calendar year end. Which of the following best describes how the IRS will react to this change in fiscal year?

    a. The IRS will react favorably because Entendo Corp. is changing to a fiscal year which the IRS automatically approves.

    b. The IRS will react favorably because Entendo Corp. is electing a tax year that qualifies as an ownership year.

    c. The IRS will require Entendo Corp. to file a Section 444 election because Entendo Corp is not electing a permitted year.

    d. The IRS will require Entendo Corp. to file a Section 444 election because Entendo Corp. is electing a fiscal year under the grandfather rules.

13. The shareholders owning 51% of the stock of Sail-Si, an S corporation established in 199X, have a tax year ending September 30th. What tax year end is Sail-Si most likely to have?

    a. A natural business year that meets the mechanical 25% test.

    b. A grandfathered year ending on December 31st.

    c. An ownership tax year ending on December 31st.

    d. An ownership tax year ending on September 30th.

14. Pat, the accountant for Ale-ore-on, an S corporation; is attempting to determine if Ale-ore-on can qualify for a business year under the "25% test." Listed below are the determinations Pat may or may not need to make in order to establish that Ale-ore-on meets the 25% test. For purposes of this question, assume that Ale-ore-on has been in business for the required number of months and assist Pat by placing the determinations in order.

    i Calculate the percentage of gross income received in the two months ending with the desired fiscal year.

    ii Calculate the gross income for two consecutive months ending with the desired fiscal year.

    iii Calculate the net income for two consecutive months ending with the desired fiscal year.

    iv. Calculate the gross income for the 12 months ending with the desired fiscal year.

    v. Calculate the net income for the 12 months ending with the desired fiscal year.

    a. i, ii, iii, iv and v.

    b. ii, iv, and i.

    c. i, iii, and v.

    d. iv, iii, and i.

15. S corporations that elect S status for automatic approval to use a fiscal year that corresponds to a natural year that passes a specific test is made by checking the first box in item P of Form 2553, Part II. Which of the following test must be passed for this to occur?

    a. Facts and circumstances.

    b. Gross receipts.

    c. Mechanical 25% test.

    d. All-events.

16. Sail-Si has fallen on tough times. Sail-Si has a taxable loss at September 30 of $10,000 and additional loss of $25,000 is expected for the current calendar year. What is the maximum loss Sail-Si can pass through to the shareholders and what year end must Sail-Si have in order to pass the maximum loss through?

    a. $35,000 with a September 30 year end.

    b. $10,000 with a September 30 year end.

    c. $35,000 with a December 31 year end.

    d. $10,000 with a December 31 year end.

17. All of the corporations described in the scenarios below are C corporations with a fiscal year end that are now electing S corporation status. In which of the following instances will the taxpayer be most likely to establish a business purpose for retaining its fiscal year?

    a. Typical of the industry, Sigfreed Airlines is heavily regulated. Sigfreed wants to retain its fiscal year due to the regulatory requirements.

    b. All Sales Final, a retail establishment, does most of its new hire orientation in October to be prepared for the crush of Christmas shoppers. All Sales Final wants to retain its fiscal year due to the hiring pattern of the business.

    c. Old Goat Corporation has several members of upper management who are about to retire. Retaining the fiscal year will make it easy for these long time employees to do some tax planning before they retire and Old Goat Corporation wants to retain its fiscal year.

    d. Snowhomish Corporation, a manufacturer of building products used in log homes, was involved in the blizzard of the century and the business was not operational for three months. This was the only period of business interruption over a 10 year period.

18. Which of the following S corporations will **not** be able to establish a natural business year based on an annual business cycle?

    a. Treaty Oak Animal Clinic has a steady stream of pets needing treatment all during the year and income is steady, month after month.

    b. Endless Winter, a snow ski training facility located in a major metropolitan area in the Rocky Mountains, trains snow skiing enthusiasts on its artificial slopes during the months of May through September. Business drops sharply once the mountains receive their first snow in October.

    c. The Eyes Have It, an optical business specializing in sunglasses, has a business cycle that is fairly steady all year and peaks in August. The Eyes Have It is unable to meet the 25% test.

19. E-Rave, a newly formed S corporation is filing for a business purpose fiscal year. What documentation should be filed with the IRS?

    a. All business reasons for the fiscal year, information indicating there is no substantial distortion of income, Form 2553 (Election by a Small Business Corporation) and a Form 8752 (Required Payment or Refund Under Section 7519).

    b. All business reasons for the fiscal year, information indicating there is no substantial distortion of income, Form 2553 (Election by a Small Business Corporation) and Form 8716 (Election to Have a Tax Year Other Than a Required Tax Year).

    c. All business reasons for the fiscal year, information indicating there is no substantial distortion of income, Form 2553 (Election by a Small Business Corporation) and a Form 1128 (Application to Adopt, Change, or Retain a Tax Year.)

    d. All business reasons for the fiscal year, information indicating there is no substantial distortion of income, Form 2553 (Election by a Small Business Corporation) and a Form 1120S (U.S. Income Tax Return for an S Corporation).

20. Which of the following statements regarding submitting a user-fee for specific business-purpose year applications is most accurate?

    a. Once an existing S corporation requests a change to a business-purpose fiscal year, the user fee should be attached to Form 2553.

    b. For newly electing S corporations that are automatically changing to a fiscal year, the user fee will not apply.

    c. User fees are published in the second revenue procedure of the year for existing S corporations.

21. Which of the following corporations is granted a fiscal year under the grandfather rules?

    a. Aesop Corporation elected to become an S corporation in 1984. At that time, it requested a July 31 year-end and obtained a letter ruling granting permission to use that year.

    b. Beta Corporation began operations in 1986 and made a Section 444 election by July 26, 1990.

    c. Charlie Corporation began operations in 1990 and obtained a letter ruling granting a business purpose fiscal year end that same year.

    d. Delta Corporation began operations in 2002 and filed a calendar year backup request that same year.

22. Which of the following S corporations will experience a short tax year?

    a. A calendar year S corporation voluntarily terminates its S election as of December 31.

    b. A C corporation uses a July 31 fiscal year and elects S status. The first S year begins August 1, 200X. If the S corporation uses a calendar year, its first year will end on December 31, 200X.

    c. A C corporation using a June 30 fiscal year end meets all the requirements of Rev. Proc. 2006-45 and automatically changes to a calendar year ending December 31, 200X. The corporation elects S status on January 1 200Y.

    d. Arthur, one of several shareholders of an S corporation with a fiscal year end of October 31 completes the sale of shares he owns to Bernice, an ineligible shareholder, on October 31.

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.)**

12. Entendo, an S corporation established in 200X is changing to a calendar year end. Which of the following best describes how the IRS will react to this change in fiscal year? **(Page 289)**

    a. The IRS will react favorably because Entendo Corp. is changing to a fiscal year which the IRS automatically approves. [This answer is correct. Entendo Corp. is electing an automatically approved fiscal year. The IRS will automatically approve a fiscal year whenever an S corporation adopts, changes to, or retains a calendar year.]

    b. The IRS will react favorably because Entendo Corp. is electing a tax year that qualifies as an ownership year. [This answer is incorrect. This answer is not the best answer choice as the scenario does not give enough facts to make the determination that Entendo Corp is electing an ownership year.]

    c. The IRS will require Entendo Corp. to file a Section 444 election because Entendo Corp is not electing a permitted year. [This answer is incorrect. Entendo Corp. is actually electing a permitted year.]

    d. The IRS will require Entendo Corp. to file a Section 444 election because Entendo Corp. is electing a fiscal year under the grandfather rules. [This answer is incorrect. Entendo Corp. does not qualify under the grandfather rules because the corporation was established after 1987.]

13. The shareholders owning 51% of the stock of Sail-Si, an S corporation established in 199X, have a tax year ending September 30th. What tax year end is Sail-Si most likely to have? **(Page 289)**

    a. A natural business year that meets the mechanical 25% test. [This answer is incorrect. This answer choice is not the best answer choice as the scenario does not give enough facts to make the determination that Sail-Si has a natural business year or that Sail-Si meets the 25% test.]

    b. A grandfathered year ending on December 31st. [This answer is incorrect. Sail-Si cannot have a grandfathered year because it began business after 1987.]

    c. An ownership tax year ending on December 31st. [This answer is incorrect. This answer choice does not reflect the correct date of the year end.]

    d. An ownership tax year ending on September 30th. [This answer is correct. The IRS will automatically approve an S corporation that retains the same tax year as shareholders owning more than half of the corporation's stock.]

14. Pat, the accountant for Ale-ore-on, an S corporation; is attempting to determine if Ale-ore-on can qualify for a business year under the "25% test." Listed below are the determinations Pat may or may not need to make in order to establish that Ale-ore-on meets the 25% test. For purposes of this question, assume that Ale-ore-on has been in business for the required number of months and assist Pat by placing the determinations in order. **(Page 289)**

    i. Calculate the percentage of income received in the two months ending with the desired fiscal year.

    ii. Calculate the gross income for two consecutive months ending with the desired fiscal year.

    iii. Calculate the net income for two consecutive months ending with the desired fiscal year.

    iv. Calculate the gross income for the 12 months ending with the desired fiscal year.

    v. Calculate the net income for the 12 months ending with the desired fiscal year.

a. i, ii, iii, iv and v. [This answer is incorrect. Not all steps listed above are used to meet the 25% test.]

b. ii, iv, and i. [This answer is correct. The first step is to determine the gross income for two consecutive months ending with the desired fiscal year. Next Pat determines the gross income for the 12 months ending with the desired fiscal year and lastly, Pat determines the percentage of gross income received during the two months. The percentage must be 25% or more if Ale-ore-on is to pass the test.]

c. i, iii, and v. [This answer is incorrect. Net income is not used in the calculation.]

d. iv, iii, and i. [This answer is incorrect. This answer choice does not include the correct steps in the correct order.]

15. S corporations that elect S status for automatic approval to use a fiscal year that corresponds to a natural year that passes a specific test is made by checking the first box in item P of Form 2553, Part II. Which of the following test must be passed for this to occur? **(Page 289)**

a. Facts and circumstances. [This answer is incorrect. Rev. Proc. 2002-39, and Rev. Rul. 87-57 contain the IRS position on granting business-purpose fiscal years established by facts and circumstances. Apparently, obtaining a year that requires IRS approval will be very difficult. Rev. Proc. 2002-39 states that a taxpayer will be granted permission to adopt, change, or retain a fiscal year under the facts and circumstances test only in "rare and unusual circumstances.]

b. Gross receipts. [This answer is incorrect. Generally, to satisfy the gross receipts test, the average annual gross receipts of the taxpayer must be no more than $1 million. Specifically, for each prior tax year ending after December 16, 1998, the taxpayer's average annual gross receipts must be $1 million or less for the three-tax-year period ending with the prior tax year.]

c. Mechanical 25% test. [This answer is correct. A request by a corporation electing S status for automatic approval to use a fiscal year that corresponds to a natural business year that passes the mechanical 25% test is made by checking the first box in item P of Part II of Form 2553. The company should type or print the statement "FILED UNDER REV. PROC. 2006-46" across the top of the front page of Form. The taxpayer must attach a copy of the Form 2553 to the federal income tax return (Form 1120S) for the first effective year.]

d. All-events. [This answer is incorrect. An accrual method S corporation can adopt the recurring item exception to the economic performance rules. The recurring item exception allows an S corporation using the accrual method to elect to treat certain recurring liabilities as being incurred during the current year if the all-events test is met even if economic performance has not occurred before the end of the year. This exception is important because the payment equals performance rule effectively takes away the accrual method for many expenses unless the S corporation qualifies for the recurring item exception.]

16. Sail-Si has fallen on tough times. Sail-Si has a taxable loss at September 30 of $10,000 and additional loss of $25,000 is expected for the current calendar year. What is the maximum loss Sail-Si can pass through to the shareholders and what year end must Sail-Si have in order to pass the maximum loss through? **(Page 291)**

a. $35,000 with a September 30 year end. [This answer is incorrect. The amount of tax loss in this answer choice would not be permitted with a September 30 year end.]

b. $10,000 with a September 30 year end. [This answer is incorrect. This year end does not yield the most advantageous tax loss for the Sail-Si shareholders.]

c. $35,000 with a December 31 year end. [This answer is correct. Using a calendar year may enable the Sail-Si shareholders to utilize a loss earlier.]

d. $10,000 with a December 31 year end. [This answer is incorrect. An additional amount of pass through loss is available.]

17. All of the corporations described in the scenarios below are C corporations with a fiscal year end that are now electing S corporation status. In which of the following instances will the taxpayer be most likely to establish a business purpose for retaining its fiscal year? **(Page 292)**

    a. Typical of the industry, Sigfreed Airlines is heavily regulated. Sigfreed wants to retain its fiscal year due to the regulatory requirements. [This answer is incorrect. Regulatory requirements will not establish a business purpose for a fiscal year.]

    b. All Sales Final, a retail establishment, does most of its new hire orientation in October to be prepared for the crush of Christmas shoppers. All Sales Final wants to retain its fiscal year due to the hiring pattern of the business. [This answer is incorrect. Hiring patterns will not establish a business purpose for a fiscal year.]

    c. Old Goat Corporation has several members of upper management who are about to retire. Retaining the fiscal year will make it easy for these long time employees to do some tax planning before they retire and Old Goat Corporation wants to retain its fiscal year. [This answer is incorrect. Use of a particular year end for administrative purposes will not establish a business purpose for a fiscal year.]

    d. Snowhomish Corporation, a manufacturer of building products used in log homes, was involved in the blizzard of the century and the business was not operational for three months. This was the only period of business interruption over a 10 year period. [This answer is correct. The taxpayer is likely to prevail in this instance because the Showhomish Corporation actually established a business purpose for the use of its requested tax year.]

18. Which of the following S corporations will **not** be able to establish a natural business year based on an annual business cycle? **(Page 293)**

    a. Treaty Oak Animal Clinic has a steady stream of pets needing treatment all during the year and income is steady, month after month. [This answer is correct. A business with steady income throughout the year has no natural business year.]

    b. Endless Winter, a snow ski training facility located in a major metropolitan area in the Rocky Mountains, trains snow skiing enthusiasts on its artificial slopes during the months of May through September. Business drops sharply once the mountains receive their first snow in October. [This answer is incorrect. The snow ski training business described has an obvious seasonal year end and therefore would be able to establish a natural business year.]

    c. The Eyes Have It, an optical business specializing in sunglasses, has a business cycle that is fairly steady all year and peaks in August. The Eyes Have It is unable to meet the 25% test. [This answer is incorrect. The sunglasses business described has an annual business cycle and will most likely be able to meet the IRS criteria for a natural business year even if the corporation is unable to meet the 25% test.]

19. E-Rave, a newly formed S corporation is filing for a business purpose fiscal year. What documentation should be filed with the IRS? **(Page 293)**

    a. All business reasons for the fiscal year, information indicating there is no substantial distortion of income, Form 2553 (Election by a Small Business Corporation) and a Form 8752 (Required Payment or Refund Under Section 7519). [This answer is incorrect. Form 8752 used by a newly formed S corporation once the application for a business purpose fiscal year is denied. This form activates the Section 444 backup election.]

    b. All business reasons for the fiscal year, information indicating there is no substantial distortion of income, Form 2553 (Election by a Small Business Corporation) and Form 8716 (Election to Have a Tax Year Other Than a Required Tax Year). [This answer is correct. All of these items must be filed with the IRS when a newly formed S corporation desires a fiscal year and does not want the risk of having the fiscal year denied.]

c. All business reasons for the fiscal year, information indicating there is no substantial distortion of income, Form 2553 (Election by a Small Business Corporation) and a Form 1128 (Application to Adopt, Change, or Retain a Tax Year). [This answer is incorrect. The Form 1128 is used for an existing S corporation requesting a change to a business purpose fiscal year.]

d. All business reasons for the fiscal year, information indicating there is no substantial distortion of income, Form 2553 (Election by a Small Business Corporation) and a Form 1120S (U.S. Income Tax Return for an S Corporation). [This answer is incorrect. Form 1120S is used to report year end tax information once the S corporation year end has been established.]

20. Which of the following statements regarding submitting a user-fee for specific business-purpose year applications is most accurate? **(Page 294)**

a. Once an existing S corporation requests a change to a business-purpose fiscal year, the user fee should be attached to Form 2553. [This answer is incorrect. Existing S corporations should use Form 1128 to request a change to a business purpose fiscal year. The user-fee should be attached to the Form 1128.]

b. For newly electing S corporations that are automatically changing to a fiscal year, the user fee will not apply. [This answer is correct. The user fee does not apply if a corporation is changing to a fiscal year or a Section 444 year that is automatically approved.]

c. User fees are published in the second revenue procedure of the year for existing S corporations. [This answer is incorrect. The user fees are published in the first revenue procedure of the year for existing S corporations.]

21. Which of the following corporations is granted a fiscal year under the grandfather rules? **(Page 294)**

a. Aesop Corporation elected to become an S corporation in 1984. At that time, it requested a July 31 year-end and obtained a letter ruling granting permission to use that year. [This answer is correct. Aesop Corporation meets the requirements for a fiscal year under the grandfather rules.]

b. Beta Corporation began operations in 1986 and made a Section 444 election by July 26, 1990. [This answer is incorrect. As stated in Rev. Proc. 2006-46, Sec. 5.09, the deadline for filing the Section 444 election under the grandfather rules is a date other than July 26, 1990.]

c. Charlie Corporation began operations in 1990 and obtained a letter ruling granting a business purpose fiscal year end that same year. [This answer is incorrect. As stated in Rev. Proc. 2006-46, Sec. 5.09, this is not the correct year for filing a letter ruling requesting retention of a fiscal year S corporation under the grandfather rules.]

d. Delta Corporation began operations in 2002 and filed a calendar year backup request that same year. [This answer is incorrect. The grandfather rules do not require the filing of a calendar year backup request.]

22. Which of the following S corporations will experience a short tax year? **(Page 295)**

a. A calendar year S corporation voluntarily terminates its S election as of December 31. [This answer is incorrect. The termination occurs on the last day of the tax year for the S corporation and no short tax year occurs.]

b. A C corporation uses a July 31 fiscal year and elects S status. The first S year begins August 1, 200X. If the S corporation uses a calendar year, its first year will end on December 31, 200X. [This answer is correct. In this scenario, the S corporation will have a short tax year its first year of operations.]

c. A C corporation using a June 30 fiscal year end meets all the requirements of Rev. Proc. 2006-45 and automatically changes to a calendar year ending December 31, 200X. The corporation elects S status on January 1 200Y. [This answer is incorrect. The S corporation has elected a calendar year end and its operations begin on January 1. This S corporation will experience 12 months of operations its first year.]

d. Arthur, one of several shareholders of an S corporation with a fiscal year end of October 31 completes the sale of shares he owns to Bernice, an ineligible shareholder, on October 31. [This answer is incorrect. The sale of shares to an ineligible shareholder on the date of the fiscal year end of the S corporation will terminate the S status on that date, so no short tax year occurs.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TSCTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Eloise, Inc., is electing S corporation status and would prefer to retain its fiscal year. There is no business purpose for retaining the fiscal year and there are no facts and circumstances which indicate a business purpose for the fiscal year. Under these circumstances, Eloise, Inc. will most likely take which of the following actions?

   a. Make a Section 444 election.

   b. Apply to the IRS for a business purpose fiscal year.

   c. Elect the fiscal year under the grandfather rules.

   d. Change to the cash method of accounting.

2. Peek and Peck operates a snow cone stand. The business is very seasonal. Peek and Peck opens in mid-May, the business usually peaks in August and tapers off by mid-September. Which of the following best describes the business year Peek and Peck experiences?

   a. A calendar business year.

   b. A natural business year.

   c. A business year requiring IRS approval.

   d. A short tax year.

3. Sam Taxmen, CPA is looking at the tax records for a new client. Sam notes the following dates: Acquired shareholders 10-11-0X, acquired assets 10-01-0X, doors opened for business 11-01-0X, and grand opening 11-21-0X. What date should Sam use as the first date of the first S year for the newly formed S corporation?

   a. 10-01-0X.

   b. 10-11-0X.

   c. 11-01-0X.

   d. 11-21-0X.

4. Lettre Inc., a C corporation, uses a June 30 fiscal year and elects S status. The first S year begins July 1, 200X. The corporation does not qualify for an automatically approved natural year-end, nor is there any business purpose for which the IRS will approve a fiscal year. The shareholders do not want to make the required payments that would be necessary if the corporation made the Section 444 election and used a fiscal year ending on the last day of September, October, or November. The only option is to use a calendar tax year. What are the dates the first tax year for Lettre, Inc. begins and ends?

   a. January 1 and December 31, 200X.

   b. January 1 and November 30, 200X.

   c. July 1 and December 31, 200X.

   d. July 1 and November 30, 200X.

5. Arts and Letters, Inc. is changing to a calendar year tax year. Arts and Letters, Inc. was previously using a September 30 year end. How many months of pass-through income can the Arts and Letters shareholders expect to report?

   a. 3.

   b. 9.

   c. 12.

   d. 15.

6. Described below are several year ends an S corporation may select. Which one is **not** a permitted year?

   a. A calendar year.

   b. A fiscal year elected under Section 444.

   c. A business purpose year that will be approved automatically by the IRS.

   d. A business purpose year that is established by facts and circumstances.

7. Candy Bytes, a newly formed S corporation preparing chocolate confections in the form of computer parts, experienced the following milestones as they began business:

      a. Acquired assets February 14, 20X1.

      b. Obtained shareholders February 1, 20X1.

      c. Began doing business March 1, 20X1.

      d. Filed for a Section 444 election June 1, 20X1.

   What is the date Candy Bytes first S year begins?

   a. February 1, 20X1.

   b. February 14, 20X1.

   c. March 1, 20X1.

   d. June 1, 20X1.

8. Listed below are some scenarios regarding changing fiscal years. Which of the following businesses would not be able to change their fiscal year because it would result in an increased deferral period?

   a. Chanchee Sails, a sail loft, is adopting S status on July 1 and wants to make a Section 444 election to change from a June 30th year end to a November 30th year end.

   b. Birthday Parties Galore, a fiscal year S corporation with a June 30 year end, wants to adopt a September 30 fiscal year by making a Section 444 election.

   c. Edenfield Pottery, a calendar year C corporation is electing S status on January 1 and wants to make a Section 444 election to establish a fiscal year ending November 30th.

   d. Sixteen Candles, a fiscal year S corporation with a September 30 year end, wants to adopt a calendar year end on October 1st.

9. Slowsilver Corporation's required tax deposit payment amount to keep its Section 444 election in effect for the current year (October 1, 20X1 to September 30, 20X2) is $70,000. Assume Slowsilver earns taxable income of $300,000 during the last three months of calendar year 20X1. Further assume that all of Slowsilver's shareholders are individuals (using a calendar year) in the top 35% marginal tax bracket. Therefore, keeping Slowsilver's Section 444 election in place will allow its shareholders to defer $300,000 of taxable income from calendar year 20X1 into calendar year 20X2. The tax deferral benefits are worth at least $105,000 (35% × $300,000) to Slowsilver's shareholders, before discounting that amount to its present value. If the appropriate time value of money discount factor is 15%, the discounted present value of the tax deferral benefits is $91,300. It cost Slowsilver $2,000 to pay their consultant to help them with the decision of retaining the Section 444 election. Select the answer choice below which best describes why Slowsilver should or should not retain the Section 444 election.

    a. No, terminate the Section 444 election because the corporation and the shareholders should have the same year end.

    b. No, terminate the Section 444 election because it costs too much to make the necessary calculations and file Form 8752.

    c. Yes, retain election because the present value of the tax deferral benefits exceeds the required tax deposit payment.

    d. Yes, retain the election because having that amount on deposit with the government is advantageous.

10. When can an S corporation change to a calendar year?

    a. Beginning of the tax year.

    b. End of the tax year.

    c. End of the natural business year.

    d. At any time.

11. Robert Discombobulate, the accountant for Pandemonium Corporation, has failed to make the required Section 444 election deposits for the last 2 years. His actions do not represent a willful lack of compliance, just lack of skill and knowledge. What consequences can Pandemonium Corporation expect from Robert's lack of action?

    a. Revocation of their Section 444 election.

    b. Receipt of interest from the IRS on the payments made previously.

    c. Receipt of a payment extension from the IRS.

    d. Payment of a 10% underpayment penalty as well as negligence penalties.

12. Required payments are based on which of the following calculations?

    a. Cumulative.

    b. Look-back.

    c. The taxpayer's Section 199 calculation.

    d. Do not select this answer choice.

13. Which of the following statements regarding required payments is most accurate?

    a. If the required payment for the current or any previous year exceeds $1,000, no payment is due.

b. Newly formed S corporations are not required to make a payment for their first year.

c. S corporations must file Form 2553 confirming the calculated payment.

d. If the current amount is less than the cumulative previous amounts, the difference will not be refunded.

14. Which of the following S corporations has the best chance of passing the 25% test for this fiscal year?

a. Popo Geeho, a puppet manufacturer, has a November 30th year end and has met the 25% test for the preceding three years. For October and November of this year, the percentage of income has dropped below 25%.

b. Friedmont, a well respected purveyor of fried apple pies with an October 31st year end, has been in business for 48 months.

c. Pantaloons, a fast growing costume maker with a September 30th year end, began business 36 months ago.

d. Allenton, a panelizer, began business as a C corporation 48 months ago, has an October 31st year end and has elected S status this month. The accountant is calculating the 25% test and determines that Allenton met the 25% for two out of the last four years.

15. Which of the following statements regarding automatic approval provisions is **not** accurate?

a. The automatic approval provisions allow a company to apply for a fiscal year using simplified procedures.

b. Only a limited number of corporations will qualify for automatic approval because of the strict requirements.

c. S corporations that receive automatically approved years must file a Section 444 election.

d. S corporations that receive automatically approved years do not make required payments.

16. How many months of history must a company have to pass the 25% test?

a. 36.

b. 37.

c. 47.

d. 48.

17. The owners of Achtung, a snow shoe manufacturer, currently has a calendar year end. For tax planning purposes, the owners want to change to an April year end. The Achtung accountant prepares the following gross income schedule.

	200W	200X	200Y	200Z
January	12,500	12,500	14,000	16,500
February	12,500	15,000	23,000	22,500
March	22,000	22,500	28,000	25,500
April	13,000	12,500	17,500	18,500

May	9,500	10,000	10,000	10,000
June-December	50,000	50,000	50,000	50,000
Totals	119,500	122,500	142,500	143,000

Based on the results of the accountant's calculations, what is the natural year end for Achtung corporation?

a. February 28.

b. March 31.

c. April 30.

d. May 31.

18. The accountant for Allright Shoe Repair, a newly formed S corporation is filing with the IRS for a fiscal year. Listed below are some reasons which when combined may cause the IRS to allow the fiscal year. Select the correct combination of business reasons.

    i. The use of a particular year for regulatory purposes.

    ii. The use of a particular year for financial accounting purposes.

    iii. Hiring patterns of the business.

    iv. The use of a particular year for administrative purposes.

    a. i and ii.

    b. ii and iii.

    c. i, ii and iii.

    d. i, ii, iii and iv.

19. The newly formed S corporations described in each of the answer choices below are electing a fiscal year end for business purposes. Which one is likely to obtain approval for the fiscal year end from the IRS?

    a. Newby Corporation, is able to show documentation indicating that a significant amount of income is not being deferred and losses are not being accelerated.

    b. Maxim Corporation's estimated gross receipts for the current year is one million dollars. The distortion of income due to the election of a fiscal year is $60,000.

    c. Lucout Corporation's estimated gross receipts for the current year is one million dollars. The distortion of income due to the election of a fiscal year is $600,000.

    d. Kahnchee Corporation presents documentation indicating competitors use the same fiscal year end.

20. The S election of a newly formed corporation is denied. Which of the consequences below is most complete?

    a. There are no severe consequences; the corporation can file for S status again next year.

    b. The entity becomes a C corporation in its first year.

c. The entity is subject to built-in gains tax when it elects S status for its second year.

d. The entity becomes a C corporation its first year and is subject to built-in gains tax when it elects S status for its second year.

21. The IRS has two requirements that must be met to define a grandfathered fiscal year. The first requirement is that a fiscal year S corporation received IRS permission to use the fiscal year on or after July 1, 1974. Name the other requirement.

a. The fiscal year did not result in a four-month-or-less deferral period.

b. The fiscal year did not result in a three-month-or-more deferral period.

c. The fiscal year did not result in a three-month-or-less deferral period.

d. The fiscal year did not result in a short tax year.

22. Which of the following actions will **not** result in the creation of a short tax year for the S corp.?

a. A calendar S corporation terminates the S election on October 31.

b. A newly created corporation elects S status on January 1.

c. A fiscal year S corporation fails the 25% test.

d. A fiscal year S corporation changes to a calendar year end.

Lesson 2: Selecting the Appropriate Accounting Method

INTRODUCTION

An accounting method is a set of rules used to determine when and how income and expenses are reported. It includes not only the overall method of accounting used by the company, but also the accounting treatment used for any material item. No single accounting method is required of all businesses. The company must use a system that clearly reflects income and expense and must maintain books and records allowing it to file a correct tax return based on that method.

An S corporation can use accounting methods separate from those used by its shareholders. For example, an S corporation may use the cash or accrual method of accounting, subject to the general rule of IRC Sec. 446 that the method chosen should clearly reflect income. The rule that C corporations must use the accrual method unless the corporation is in the farming business, is a personal service corporation, or has gross receipts of $5 million or less does not apply. An S corporation, however, must use the accrual method if it is a "tax shelter."

LEARNING OBJECTIVES:

- Determine the appropriate accounting method for an S corporation.
- Differentiate between costs that should be capitalized and those that should be expensed.
- Claim the Section 199 Producer Deduction.

Cash Method Exception for Certain Small Corporations. Corporations that have average annual gross receipts of $1 million or less for each of the previous tax years ending after December 16, 1998, are permitted to use the cash method of accounting. Furthermore, the IRS has raised the $1 million threshold for some (but not all) corporations to $10 million, effective for tax years ending on or after December 31, 2001.

Electing Specific Accounting Methods

An S corporation, like all tax entities, elects a particular overall accounting method on its initial tax return. Specific methods of accounting for such items as depreciation and installment reporting are elected at the appropriate times at the corporate level. Generally, once a method is adopted, the corporation must obtain IRS approval to change methods, even if an improper method was initially adopted. IRS approval method is generally obtained by filing Form 3115 (Application for Change in Accounting Method).

Reporting Income under the Cash Method

Most businesses prefer to use the cash method of accounting for tax purposes. Under the cash method, income is reported when it is actually or constructively received. Income is constructively received when the cash is credited to an account or made available without restriction. Thus, instructing customers to hold checks will not prevent a cash basis taxpayer from recognizing income if the income-producing activity has been performed and the taxpayer has the right to the payment. The receipt of a check is constructive receipt, even if the check is not deposited or cashed in the tax year it is received.

Deducting Expenses under the Cash Method

Subject to certain exceptions, businesses using the cash method deduct business expenses in the year they are paid. But as a practical matter, the IRS looks closely at businesses using the cash method to see if its use clearly reflects income. If the IRS determines it does not, it has the authority under IRC Sec. 446(b) to change the taxpayer's method to one that does (from its perspective) clearly reflect income.

The issuance of a note by a cash-basis taxpayer does not constitute actual payment for current deductibility. However, expenses paid with borrowed funds are deductible when paid. Payment by check becomes deductible when it is delivered to the payee or when placed in the mail, provided the check is subsequently paid by the bank.

Expenses paid in advance may not be fully deductible in the year paid if the payment creates an asset extending "substantially beyond" the end of the year. In such a case, the taxpayer may deduct only the portion attributable to that year. For prepaid interest, the application of this rule is made clear by IRC Sec. 461(g), which states that prepaid interest (other than points paid for the purchase of a principal residence) can be deducted only in the periods to which it relates.

However, the application of this rule to other ordinary and necessary business expenses is less clear. The courts and the IRS have provided various interpretations. In *Martin Zaninovich*, the 9th Circuit adopted a "one-year rule" for prepaid rent, allowing a current deduction for prepaid rent when the rental period did not extend beyond the close of the following year. The IRS seemed to acknowledge the existence of this rule in Rev. Rul. 68-643 when it stated that deducting prepayments that extend beyond the close of the following tax year distorts income while prepayments for shorter periods would be evaluated on a case-by-case basis.

Whether particular costs should be capitalized or expensed is one of the most common, and sometimes most difficult, tax questions encountered. The Supreme Court concluded in *INDOPCO* that the creation of a separate and distinct asset was not a prerequisite to capitalization of expenditures. If the expenditure gave rise to a significant future benefit (i.e., beyond the year in which the expenditure was incurred), it must be capitalized. Subsequent to this decision, the Treasury issued final regulations specifying the categories of intangible assets that must be capitalized. More recently, proposed regulations were issued specifying when amounts paid to acquire, produce, or improve tangible real and personal property must be capitalized.

Weighing the Pluses and Minuses of the Cash Method

Under the cash method, income and expenses for the year are readily determinable, without the uncertainty that accompanies the valuation and quantities of beginning and ending inventories. Further, the cash method provides the ability to plan and adjust income through year-end acceleration or deferral of sales and expenditures. This allows the S corporation to target an optimum level of net income.

Because of the reliance on actual payment or receipt, rather than on economic accrual, the cash method is rarely used for financial accounting purposes. For this same reason, the IRS dislikes the cash method, particularly the ability of cash method users to defer the recognition of income.

Assuming that a corporation qualifies for the cash method, one specific benefit is that trade receivables do not have to be recognized as income until they are collected. Of course, accounts payable cannot be deducted until paid. However, for many businesses, receivables exceed payables, so there will be a net benefit if an accrual method business converts to the cash method. If the business is growing, this benefit will increase as the gap between receivables and payables widens.

Another benefit of using the cash method is the ability to avoid the inventory accounting rules. Inventory is treated as a material or supply under Reg. 1.162-3, and so purchases cannot be deducted until actually sold. Thus, qualifying small corporations need not worry about the last in, first out (LIFO) and first in, first out (FIFO) inventory accounting methods. Nor do the Section 263A inventory capitalization rules apply (although resellers with gross receipts of $10 million or less and producers with no more than $200,000 of indirect costs are already exempt from the Section 263A inventory rules even if they do not qualify for cash method accounting relief).

Although the inventory accounting rules do not apply to qualifying small businesses using the cash method, merchandise on hand at the end of the year still cannot be deducted as part of the cost of sales. Instead, it is accounted for in the same manner as materials or supplies that are not incidental. Such merchandise is deductible only in the year in which it is actually consumed and used in the corporation's business, which is the year in which the corporation sells the merchandise or finished goods. Thus, under the cash method, the cost of such inventoriable items is deductible only in that year, or in the year in which the corporation actually pays for the inventoriable items, whichever is later.

Reporting Income under the Accrual Method

Under the accrual method of accounting, income is reported in the tax year earned. This is the tax year in which both of the following tests are satisfied:

a. All events that fix the company's right to receive the income have occurred. This requires items to be included in income in the year the right to receive the income is fixed. For retailers and other resellers, for example, income is fixed at the earliest date goods are delivered or billed to the customer or when the retailer receives payment.

b. The amount of income can be determined with reasonable accuracy. This part of the test requires the reporting of income if a reasonable estimate of the amount can be made. If income is recognized on the basis of a reasonable estimate and the exact amount as later determined is different, the difference is taken into account in the year in which the determination of the exact amount is made.

Deducting Expenses under the Accrual Method

Corporations using the accrual method of accounting recognize expenses as they are "accrued" (or "incurred"). For generally accepted accounting principle (GAAP) purposes, an expense is accrued if it is both fixed and determinable. Tax law adopts this two-part requirement [known as the "all-events test" under IRC Sec. 461(h)] but adds an additional requirement that economic performance must occur.

Economic performance is deemed to occur when the corporation has, from an economic perspective, completed the business transaction. If a liability arises from property or services provided to the business by another person, economic performance occurs as the property or services are provided. If a liability arises from providing services or property to others, economic performance occurs as the S corporation provides the property or services.

Weighing the Pluses and Minuses of the Accrual Method

The underlying principle behind the accrual method is to match income and expenses in the appropriate year. For this reason, the accrual method is generally required for the purchase and sale of inventory. Income would not be clearly reflected if purchases were deducted in a different period from which sales of those items were recognized.

The accrual method generally requires more recordkeeping than the cash method, is more complex, and, in some cases produces a less certain result. Furthermore, the accrual method is less concerned with matching the tax liability with the taxpayer's ability to pay the tax. However, because of the special rules allowing or requiring accrual method taxpayers to recognize certain items of income as payments are received (such as under the installment method or when certain "advance payments" or "prepayments" are received), and to defer the recognition of other items of income beyond the year of receipt, the accrual method can approximate the end result from using the cash method,or even the recognition of income compared to the cash method (such as income received from advance payments for goods).

Reporting Income under the Installment Method

Sales of inventories of personal property and dealer sales of real or personal property generally may not be reported using the installment method. S corporations that allow customers to pay for these items using an installment plan must instead report gross profit from the installments in accordance with its regular accounting method. Therefore, an accrual method business must treat the total amount of the installment obligation for these items received as income in the year of sale, with the amount received deemed to be the installment obligation's fair market value.

However, there are situations where the company may elect to report gross profit from dealer or inventory sales under the installment method including:

a. *Residential Lots and Timeshares.* Businesses that sell residential lots or timeshares can elect to use the installment method for these sales. The election, which is made at the S corporation level, applies to inventory sales made to individuals in the ordinary course of business. The election cannot be made if the

installment obligation is guaranteed or insured by any person other than an individual. If the election is made, interest is due on the amount of deferred tax attributable to the use of the installment method. For S corporations, the interest charge is determined at the shareholder level.

b. *Property Used or Produced in a Farming Business.* Also excluded from the installment sale prohibition are sales of property used or produced in the business of farming. Property eligible for installment reporting generally includes all real and personal property used in farming and ranching operations. Property regularly produced in farming and ranching operations (e.g., livestock and crops) also can be reported on the installment method if the property is produced in the taxpayer's farming business and if the property is not required to be included in inventory if on hand at the end of the tax year. These installment sales are not subject to an interest charge.

Installment Sales to Related Parties. The sale of property eligible for installment reporting to a related person must overcome two hurdles before it can be reported on the installment method. The first applies to sales of depreciable property, while the second applies when the purchaser resells the property within two years.

Depreciable Property Rule. The first rule prohibits the use of the installment method to report gain on sale of depreciable property to a related person. This rule is designed to prohibit a related-party purchaser from depreciating property on a stepped-up basis before the seller has recognized the gain on sale. All payments to be received are to be treated as received in the year of disposition.

For these purposes, the term "related person" includes an S corporation and a shareholder who owns (directly or indirectly) more than 50% of its stock, as well as an S corporation and another corporation (C or S corporation) if the same persons own more than 50% of the stock of each corporation. Although family members are considered in determining whether a shareholder owns more than 50% of the corporation's stock, family members are not otherwise considered related persons for purposes of IRC Sec. 453(g).

There is an exception if the taxpayer can demonstrate that the principal purpose of the transaction was not the avoidance of federal income taxes. Lack of a significant tax deferral can be used to qualify for this exception. Conversely, a significant tax benefit may mean that tax avoidance was a principal purpose.

Resale Rule. The second rule applies when the related party disposes of the property within two years (and before all payments have been made on the first installment sale). In such cases, the original seller treats amounts received by the second seller as amounts received on the original sale. Related parties for this purpose includes a corporation and a shareholder who owns more than 50% of its stock, and an S corporation and another corporation (S or C) if the same person owns more than 50% of the stock of both corporations. Family members are also considered related parties.

The two-year period is a safe harbor that precludes the application of the resale rule. Thus, the related party can avoid triggering the resale rule on a subsequent disposition of the property by waiting until after the two-year period has expired to dispose of the property. Furthermore, several exceptions permit installment reporting without gain recognition upon the second disposition, including reacquisitions of stock, involuntary conversions, dispositions after death of a shareholder, and no tax avoidance motive for either disposition. IRS Pub. 537, "Installment Sales" (2009), cites foreclosures and bankruptcy proceedings as examples of "no tax avoidance motive" dispositions.

Changing Accounting Methods

A change in accounting method can be voluntary or involuntary (required by the IRS) and includes a change in the overall method of accounting used by the corporation (e.g., cash or accrual) as well as a change in the treatment of a material item. Certain accounting method changes receive automatic IRS consent if the taxpayer complies with the guidance permitting the change. When available, the automatic change procedures are generally easier to follow and do not require payment of a user fee.

HOW TO MEET THE $1 MILLION CASH METHOD AND INVENTORY EXCEPTION

The "small taxpayer exception" under Rev. Proc. 2001-10, allows an S corporation (as well as other taxpayers) to use the cash method of accounting if it satisfies a gross receipts test. The cash method is available to such an S

corporation even if, under Reg. 1.446-1(c)(2)(i), it would otherwise be required to use the accrual method of accounting due to the presence of inventories. However, Rev. Proc. 2001-10 does not apply to tax shelters under IRC Sec. 448(a)(3).

Meeting the Gross Receipts Test

Generally, to satisfy the gross receipts test, the average annual gross receipts of the taxpayer must be no more than $1 million. Specifically, for each prior tax year ending after December 16, 1998, the taxpayer's average annual gross receipts must be $1 million or less for the three-tax-year period ending with the prior tax year.

All businesses under common control must be aggregated for purposes of the test. If an S corporation has not been in business for the three-year period, the test is made using the number of years it has been in business. Finally, gross receipts for any short years must be annualized (i.e., multiplied by 12, then divided by the number of months in the short year) in determining whether the three-year test has been met.

Defining Gross Receipts. For purposes of the test, gross receipts include all sales (net of returns and allowances), all service income, interest, dividends, rents, and royalties, plus any income from incidental or outside sources. Although gross receipts are not reduced by costs of goods sold, in the case of sales of capital assets or Section 1231 assets, gross receipts are reduced by the taxpayer's adjusted basis in the property.

Gross receipts do not include any state or local taxes imposed on any transaction if the applicable state or local law imposes the tax on the purchaser and the seller simply collects the tax and remits it to the appropriate tax authority. Thus, for S corporations that are close to the $1 million limit, practitioners should review whether the sales figures include such taxes. If so, the corporation should start accounting for the taxes separately so that there is no question about whether the $1 million test has been met.

Using Cash Method for Tax Purposes and Accrual Method for Books

Taxpayers using the cash method under the small taxpayer exception are not required to use the cash method of accounting for book and reporting purposes. Thus, an S corporation can use the cash method for tax purposes and issue reports on the accrual method. However, the S corporation must maintain adequate books and records, which may include a reconciliation of any differences between such books and records and its tax return.

Deducting Cost of Sales When Merchandise Is Sold

Although the inventory accounting rules do not apply to businesses using the cash method under the small taxpayer's exception, merchandise on hand at the end of the year still cannot be deducted as part of the cost of sales. Instead, it is accounted for in the same manner as material or supplies that are not incidental. Such merchandise must be inventoried and accounted for on the cost basis under Reg. 1.162-3. There is no guidance under this regulation or in Rev. Proc. 2001-10 as to whether such cost must be determined under FIFO or whether LIFO might also be an option. However, Rev. Proc. 2002-28, specifically states that a specific identification, FIFO, or average cost method may be used, but the LIFO method is prohibited.

Converting to the Cash Method

New or Existing Cash Method S Corporations. An existing cash method S corporation continues using the cash method. A new business meeting the gross receipts test can use the cash method for its first tax year. However, a business that maintains inventories will have to change to the accrual method if it does not meet the gross receipts tests in subsequent years (unless some other exception applies).

Existing Accrual Method S Corporations. For an existing accrual method S corporation, changing to the cash method is more involved. For qualifying taxpayers who can satisfy the gross receipts test, Rev. Proc. 2001-10 grants automatic consent to change to the cash method of accounting if the automatic accounting method change procedures of Rev. Procs. 2008-52 and 2001-10, Sec. 6.02(1) are followed. Under these procedures, a Form 3115 (Change in Accounting Method) must be filed with the first tax return for which the cash method is used, and a copy of the Form 3115 must be sent to the IRS National Office. The Form 3115 should include the notation "Filed under Rev. Proc. 2001-10" at the top of page one.

The adjustment to convert from accrual to cash [the Section 481(a) adjustment] will generally be a negative amount, and if so the deduction is claimed in the year of change. If the adjustment is positive, it may be spread equally over four years, or electively reported in one year if the net change is under $25,000. In general, the Section 481(a) adjustment is calculated by reversing accrual items reflected in the opening balance sheet. This will include the reversal of accounts receivable and the reversal of accrued expenses. Inventory accounts are only reduced to the extent the opening balance sheet reflects capitalized labor and overhead—raw materials and nonincidental material costs must continue to be held.

Example 2-1: Meeting the $1 million cash method and inventory exception.

Balloon, Inc., an accrual basis calendar year manufacturer, started business on January 1, 2006. Balloon manufactures toys and had gross receipts of $200,000 in 2006; $600,000 in 2007; $900,000 in 2008; and $950,000 in 2009. Can Balloon convert to the cash method of accounting?

Balloon's first year of business was 2006, and its gross receipts were $200,000. For the 2006 tax year, Balloon's average annual gross receipts are $400,000 [($200,000 + $600,000 ÷ 2]. For the 2007 tax year, its average annual gross receipts are $566,667 [($200,000 + $600,000 + $900,000) ÷ 3]. For the 2009 tax year, its average annual gross receipts are $816,667 [($600,000 + $900,000 + $950,000) ÷ 3]. Balloon can change to the cash method effective January 1, 2010, because its average annual gross receipts for each tax year ending after December 16, 1998, is $1 million or less.

Converting Back to the Accrual Method When $1 Million Test Is No Longer Met

What happens if a client initially qualifies to use the cash method but subsequently fails the $1 million test? In that case, the client must use an appropriate inventory method and convert to the accrual method of accounting, at least for the sale and purchase of merchandise. Such a change will qualify for the automatic accounting method change procedures under Rev. Proc. 2008-52, which means that Form 3115 must be filed with the tax return for the year of change, with a copy sent to the National Office. A positive Section 481(a) adjustment from such a reconversion would normally be recognized over four years, although a *de minimis* rule allows a one-year period if the adjustment is less than $25,000.

Example 2-2: Converting back to the accrual method when $1 million test is no longer met.

Assume the same facts as in Example 2-1 except that Balloon has gross receipts of $1.1 million in 2009 and $1.5 million in 2010. Its average gross receipts for 2009 is $866,669 [($600,000 + $900,000 + $1,100,000) ÷ 3]. Balloon qualifies to use the cash method for tax year 2010. However, it cannot use the cash method for 2011 and must convert back to the accrual method because the average annual gross receipts for 20010 are $1,166,667 [($900,000 + $1,100,000 + $1,500,000) ÷ 3].

Rev. Proc. 2002-28 allows certain S corporations to use the cash method if their average annual gross receipts are more than $1 million, but no more than $10 million. Balloon cannot continue to use the cash method because it is a manufacturer, and manufacturing is one of the activities that do not qualify to use the cash method provisions of Rev. Proc. 2002-28.

HOW TO MEET THE $10 MILLION CASH METHOD AND INVENTORY EXCEPTION

Increasing the Threshold for Using the Cash Method to $10 Million

An S corporation can use the cash method of accounting if it has average annual gross receipts of no more than $1 million. Certain S corporations (as well as other taxpayers) may still be eligible to use the cash method even if their average annual gross receipts exceed $1 million.

Qualifying Taxpayers Are Eligible to Use the Cash Method. Under Rev. Proc. 2002-28, qualifying businesses with average annual gross receipts of more than $1 million but no more than $10 million are generally allowed to use the cash method of accounting.

For Rev. Proc. 2002-28 purposes, a qualifying taxpayer is any taxpayer that reasonably determines that the activity from which it derived (a) its largest percentage of gross receipts in its prior tax year or (b) its largest percentage of average gross receipts derived over the three-tax-year period ending with the prior tax year was something other than one described in the following North American Industry Classification System (NAICS) codes (i.e., businesses within these codes do not qualify):

- Mining activities within the meaning of NAICS codes 211 and 212. This includes oil and gas extraction and various mining activities.
- Manufacturing within the meaning of NAICS codes 31–33 (all types of manufacturing activities).
- Wholesale trades within the meaning of NAICS code 42 (all types of wholesale activities).
- Retail trade within the meaning of NAICS codes 44 and 45 (all types of retail activities).
- Information industries within the meaning of NAICS codes 5111 and 5122. This includes newspaper, periodical, book, and database publishers as well as the sound recording industry.

In addition to this rather large group of taxpayers, in Rev. Proc. 2002-28 also does not apply to a farming business of a qualifying taxpayer or to taxpayers that are prohibited from using the cash method by IRC Sec. 448, which includes:

a. C corporations with gross receipts of more than $5 million,

b. partnerships with C corporation partners that have more than $5 million of gross receipts, and

c. tax shelters.

Finding NAICS Codes. To determine who can benefit from the ability to use the cash method under Rev. Proc. 2002-28, practitioners can scan the NAICS codes at **www.census.gov**. They can be found by clicking on "NAICS" under "Business and Industry". An abbreviated list is included in the 2009 Form 1120S instructions beginning at page 39 where they are called Principal Business Activity Codes. The first two or three numbers of each principal business activity code represent the primary NAICS code. For example, mining activities within the meaning of NAICS code 211 do not qualify for the cash method under Rev. Proc. 2002-28. In the Form 1120S instructions, "Oil and Gas Extraction" under the heading "Mining" carries a principal business activity code of 211110.

Industries Benefiting from Cash Basis Rules. The types of industries that can potentially benefit from Rev. Proc. 2002-28 include:

Administrative and support services
Arts, entertainment, and recreation
Construction
Educational services
Finance and insurance
Health care and social assistance
Lodging and food services
Management of companies (holding companies)
Personal and laundry services
Professional, scientific, and technical services
Real estate and rental and leasing
Repair and maintenance
Transportation and warehousing
Utilities
Waste management and remediation services

In addition to this list of industries that should qualify (assuming they meet the average gross receipts requirement), Rev. Proc. 2002-28 provides the following additional situations where a business can potentially use the cash method of accounting:

- An otherwise qualifying business, whose principal business activity (i.e., the activity generating the largest percentage of its gross receipts) is not one of the prohibited NAICS codes, can use the cash method for all of its trades or businesses, even if part of its activities fit within a prohibited code.
- An otherwise qualifying business may use the cash method for all of its trades or businesses if its principal business activity is the provision of services, including the provision of property incident to those services,

even if its principal business activity is described in an ineligible NAICS code. Thus, a publisher whose principal business activity is selling advertising space in its publications may use the cash method even though publishing fits within one of the ineligible NAICS codes.

- An otherwise qualifying business may use the cash method (subject to the potential application of the Section 460 long-term contract rules) for all of its trades or businesses if its principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specification. For this purpose, allowing the customer to choose among pre-defined options (such as size, color, or materials) or making minor modifications to a basic design to meet customer specifications does not count as fabrication or modification.

- An otherwise qualifying business may use the cash method for separate and distinct trades or businesses (for which a complete and separable set of books and records are kept), if such trade or business's principal business activity is not one of the prohibited NAICS codes. This is true even if the taxpayer's principal business activity fits within an ineligible NAICS code.

Calculating Average Annual Gross Receipts

For purposes of Rev. Proc. 2002-28, a taxpayer has average annual gross receipts of $10 million or less if, for each prior tax year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the three-tax-year period ending with that prior tax year do not exceed $10 million.

All taxpayers treated as a single employer under IRC Secs. 52(a) or (b) or 414(m) or (o) are treated as a single taxpayer for this purpose. If a taxpayer has been in existence less than three years, it determines its average annual gross receipts for the number of years that it has been in existence—including short tax years, for which gross receipts must be annualized.

Gross receipts for a tax year are all receipts derived from all of a taxpayer's trades or businesses that must be recognized under the accounting method actually used by the taxpayer for that tax year for federal income tax purposes. Thus, gross receipts include total sales (net of returns and allowances), plus all amounts received from services, interest, dividends, and rents. In addition, gross receipts include any income from investments and from incidental or outside sources. Although gross receipts are not reduced by costs of goods sold, in the case of sales of capital assets or Section 1231 assets, gross receipts are reduced by the taxpayer's adjusted basis in the property.

Gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax. Thus, for clients who are close to the $10 million limit, practitioners should review whether the sales figures include such taxes. If so, the client should be advised to start accounting for the sales taxes separately so that there is no question about whether the $10 million test has been met.

Deducting the Cost of Inventory Items When Sold or Consumed

Qualifying businesses that elect under Rev. Proc. 2002-28 to switch to (or start out using) the cash method are not required to follow the normal Section 471 inventory accounting rules. Instead, inventory on hand at the end of the year is treated in the same manner as material or supplies that are not incidental. This means it must be counted and the cost is only deductible in the later of (a) the year the taxpayer sells the item (or consumes it in the process of providing services) to a customer or (b) the year the taxpayer pays for the item. Under Rev. Proc. 2002-28, a specific identification, FIFO, or average cost method may be used to determine the allowable deduction if used consistently. However, LIFO is prohibited.

UNICAP Rules. The UNICAP rules of IRC Sec. 263A do not apply to S corporations that qualify to use the cash method under Rev. Proc. 2002-28.

Converting to the Cash Method

New or Existing Cash Method S Corporations. An existing cash method S corporation continues using the cash method. A new business not engaged in a disqualifying activity that meets the gross receipts test can use the cash method for its first tax year.

Existing Accrual Method S Corporations. For existing accrual method taxpayers, however, the process is more involved. Rev. Proc. 2002-28 grants qualifying taxpayers automatic consent to change to the cash method of accounting (and to change to treating inventory as material and supplies) if the procedures in Rev. Proc. 2008-52 are followed. Under these procedures, a Form 3115 (Application for Change in Accounting Method) must be filed with the first tax return for which the cash method is used, and a copy of the Form 3115 must be sent to the IRS National Office. Forms 3115 filed under this revenue procedure should include the notation "Filed under Rev. Proc. 2002-28" at the top of page one.

The adjustment to convert from accrual to cash [the Section 481(a) adjustment] will generally be a negative amount, and if so the deduction is claimed in the year of change. If the adjustment is positive, it may be spread equally over four years, or electively reported in one year if the net change is under $25,000. In general, the Section 481(a) adjustment is calculated by reversing accrual items reflected in the opening balance sheet. This will include the reversal of accounts receivable and the reversal of accrued expenses. Inventory accounts are only reduced to the extent the opening balance sheet reflects capitalized labor and overhead—raw materials and nonincidental material costs must continue to be held.

Example 2-3: Meeting the $10 million cash method and inventory exception.

Buildem, Inc., an electrical contractor, is an accrual-basis calendar-year S corporation with gross receipts of $9 million each year. Buildem can switch to the cash method of accounting because its average annual gross receipts do not exceed $10 million, and it is not engaged in one of the disqualified activities. (Electrical contractors have a Code for Principal Business Activity of 238210, as shown in the Form 1120S instructions. This means that construction activities carry an NAICS code of 23, which is not on the list of disqualified activities.)

Converting Back to the Accrual Method When $10 Million Test Is No Longer Met

If a taxpayer initially qualifies for the relief provided by Rev. Proc. 2002-28 but subsequently fails to have gross receipts of $10 million or less, the taxpayer must use an appropriate inventory method and, in all probability, convert to the accrual method of accounting, at least for the purchase and sale of merchandise. Such a change will qualify under the automatic change in accounting method provisions of Rev. Proc. 2008-52. A positive Section 481 adjustment from such a reconversion to the accrual method would normally be recognized over four years, although a *de minimis* rule allows a one-year period if the adjustment is less than $25,000.

THE ACCRUAL METHOD OF ACCOUNTING

Taxpayers using the accrual method of accounting recognize income in the year it is earned and deduct expenses in the year incurred to properly match income and expenses within the appropriate year. This is why the accrual method is required when the production, purchase, or sale of merchandise is a material income-producing factor. Income would not be clearly reflected if purchases were deducted in a tax year different from the year when the sale of the items was recognized.

Reporting Income under the Accrual Method

Under the accrual method, sales are reported in the tax year earned. This is the tax year in which both of the following tests are satisfied. First, all events that fix the company's right to receive the income have occurred. The second test is that the amount of income can be determined with reasonable accuracy. If the exact amount as later determined is different, the difference is taken into account in the year in which the determination of the exact amount is made.

Recognizing Income from Advance Payments

Accrual basis taxpayers may elect to defer taxability of advance payments received in connection with services, and in some cases for nonservices. Rev. Proc. 2004-34 generally allows an accrual basis taxpayer using the deferral method to include advance payments in income in the earlier of the tax year it is included in the taxpayer's applicable financial statement, or the tax year following the year of receipt.

Rev. Proc. 2004-34 includes the following as advance payments eligible for deferral:

a. Payments for services.

b. Payments for the sale of goods.

c. Payments for the use of intellectual property.

d. Payments for the occupancy or use of property if the occupancy or use is ancillary to the provision of services (for example, hotels, banquet facilities, etc.).

e. Payments for the sale, lease or license of computer software.

f. Payments for guaranty or warranty contracts ancillary to any other permitted payment.

g. Payments for subscriptions (other than those for which an election under IRC Sec. 455 is in effect), whether or not provided in a tangible or intangible format.

h. Payments for membership in an organization.

Specifically excluded from the definition of advance payments eligible for deferral are:

a. Rent (except as described in item d. of the previous paragraph).

b. Insurance premiums.

c. Payments for financial instruments, including purported prepayments of interest.

d. Payments for service warranty contracts under the accounting method provided in Rev. Proc. 97-38.

e. Payments for warranty and guaranty contracts under which a third party is the primary obligor.

f. Payments to foreign individuals or corporations subject to IRC Sec. 871(a), 881, 1441, or 1442.

g. Payments in property to which IRC Sec. 83 applies.

Advance payments are eligible for deferral only if they are includable in gross income for the year of receipt under the taxpayer's permissible method of accounting and the payments are recognized (in whole or in part) in revenues in the taxpayer's applicable financial statement for a subsequent tax year (or, for taxpayers without an applicable financial statement, the payment is earned by the taxpayer in whole or in part in a subsequent tax year). An applicable financial statement is a financial statement required to be filed with the Securities and Exchange Commission; a certified audited financial statement used for credit purposes, reporting to shareholders, or any other substantial nontax purpose; or a financial statement (other than a tax return) required to be provided to the federal or a state government or agency.

Advance Payments for Services. Generally, advance payments for services to be performed in a later tax year must be reported in the year payments are received. But an accrual basis S corporation can elect to defer income until it is earned if the payments are for services that will be performed by the end of the next tax year. No deferral is allowed beyond the tax year after the year in which the advance payments are received. Any prepayment reported in income for tax purposes must at least equal the amount reported on the applicable financial statements.

S corporations wanting to change their method of accounting to defer advance payments must have IRS consent to do so.

Example 2-4: Deferring prepaid income for dance lessons to be provided in the future.

On November 2, 2010, The Dance Studio, a calendar-year, accrual method S corporation, receives payment for a one-year contract for 48 one-hour lessons beginning on that date. Eight lessons are given that year. The Dance Studio recognizes one-sixth ($^{8}/_{48}$) of the payment in revenues for 2010, and five-sixths ($^{40}/_{48}$) of the payment in revenues for 2011 in its applicable financial statements. It must include one-sixth of the payment in income for 2010, and five-sixths of the payment in 2011.

Variation: Assume the payment is for a two-year contract for 96 one-hour lessons. The Dance Studio provides eight lessons in 2010, 48 lessons in 2011, and 40 lessons in 2012. It recognizes one-twelfth ($^{8}/_{96}$) of the payment in revenues for 2010, six-twelfths ($^{48}/_{96}$) of the payment in revenues for 2011, and five-twelfths ($^{40}/_{96}$) of the payment in revenues for 2012 in its applicable financial statements. Nevertheless, the Dance Studio must include one-twelfth of the payment in gross income for 2010, and the remaining eleven-twelfths of the payment in gross income for 2011.

Advance Payments for Service Agreements. Advance payments received for service agreements are generally reported in the year the payments are received. However, an accrual basis S corporation that receives advance payments for service agreements on property that it sells, leases, builds, installs, or constructs can elect to postpone including prepayments in income until earned, if, in its applicable financial statements, it recognizes income as it is earned.

Example 2-5: Deferring income under a prepaid service agreement.

Ace Computers, a calendar-year, accrual method S corporation, receives payment in 2010 for a one-year contingent service contract on a computer it sold. Income can be postponed for the part of the payment not earned in 2010 if, in its applicable financial statements, Ace recognizes revenue in the same amount.

Recognizing Income from Prepaid Inventory Sales

Generally, prepaid inventory sales are reported in the year payment is received if the income is subject to the S corporation's free and unrestricted use. However, an S corporation can elect an alternative method to report prepaid inventory sales in the earlier of the year in which the payment would be reported for income tax accounting purposes, or for financial accounting reports.

Example 2-6: Reporting prepaid inventory sales.

Burn-em-up, Inc. manufactures and sells stoves. Under Burn-em-up's tax accounting method, sales are reported once a stove has been delivered to the customer and the delivery is accepted. For financial reporting purposes, income is recognized at the time the stove is shipped from the factory to the customer. Burn-em-up elects to report prepaid inventory sales in the earlier of the year in which the payment would be reported for income tax accounting purposes or on its financial statements.

In 2010, a retailer named Stoves-R-Us contracted to purchase 100 stoves and made a $17,500 advance payment to Burn-em-up against the total contract price of $50,000. The stoves were shipped on December 28, 2010. However, Stoves-R-Us did not accept delivery of the stoves until January 11, 2011. Since Burn-em-up elected the alternative method and its financial statements recognize income upon shipment of the stoves in 2010, the advance payment must be included in income in 2010.

Recognizing Income from Warranty Costs

Advance payments under guaranty or warranty contracts generally must be reported when received. However, an accrual-method manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods may elect to defer reporting some of the advance payments until later years. Income is recognized over the period of the service warranty contracts in a series of equal payments, the present value of which equals the portion of the

advance payment that qualifies for deferral. To qualify, the S corporation must sell multiyear service warranty contracts separately on those items and must have purchased insurance from an unrelated third party to insure its obligation under the contracts.

Deducting Expenses under the Accrual Method

Generally, an accrual-basis S corporation can deduct an expense only when (a) all events that determine the fact of the liability have occurred and the amount is determinable with reasonable accuracy (i.e., the all-events test); and (b) economic performance has taken place. The second, tax-only requirement that economic performance must occur in essence means that the S corporation must complete the transaction before it can accrue its cost.

Meeting the Economic Performance Requirement

Economic performance is deemed to occur when the S corporation has, from an economic perspective, completed the transaction. Generally, this is when the property or services are provided by (or to) another party or the property is used. IRC Sec. 461(h)(2) establishes the following general guidelines for meeting this requirement:

a. *Provided to the S Corporation.* If a liability arises from property or services provided to the S corporation by another person, economic performance occurs as the property or services are provided. Property can be treated as provided to the S corporation when it is delivered or accepted, or when title to the property passes.

b. *Provided by the S Corporation.* If a liability arises from services or property provided by the S corporation, economic performance occurs as the S corporation provides the property or services. For this purpose, property or services are deemed to be provided as the S corporation incurs costs in connection with satisfying the liability.

There is a safe harbor exception to the general economic performance rule for property or services provided to the S corporation. Economic performance is deemed to occur when payment is made if property or services can reasonably be expected to be provided to the S corporation within 3 1/2 months of payment. This means that an accrual method S corporation can take a deduction (or add a cost to its basis in property) in the year of payment if it reasonably expects the property or services to be provided within 3 1/2 months of payment. Otherwise, economic performance does not occur until the property or services are provided to the S corporation.

Example 2-7: Meeting the economic performance test.

R&B, Inc., a calendar year, accrual-basis S corporation, plans to upgrade its computers and Internet services the following year. On December 21, 2010, it enters into an agreement to receive Internet access beginning May 1, 2011. However, the Internet company requires payment of the first two months of service when the agreement is signed.

On December 21, 2010, R&B orders stationery and office supplies. It receives the stationery and related bill on December 31, but does not pay the bill until January 11, 2011. R&B pays for the office supplies on December 31 and receives them on January 15, 2011.

Economic performance by the Internet provider has not occurred by the end of the year. Therefore, R&B cannot deduct the Internet expense in 2010 even though paid. However, the stationary bill can be deducted in 2009 because all events necessary to fix the liability have occurred and economic performance (receipt of the supplies) has also occurred. Furthermore, the cost of the office supplies is also deductible when paid in 2010 because the supplies will be received within 3 1/2 months of payment.

Note that payment must actually be made in 2010 for the 3 1/2-month rule to apply. If R&B had paid for the office supplies in January, the 3 1/2-month safe harbor would not be available and the cost would normally be deductible the following year when payment was made and the office supplies were received. However, costs such as these may be deductible in the current year under the recurring item exception discussed later in this lesson.

Identifying Liabilities Subject to the Payment Equals Performance Rule

However, certain types of liabilities must be paid for economic performance to occur. (That is, the 3½-month safe harbor rule illustrated in the preceding example does not apply to these liabilities.) The payment equals performance rule affects the following types of liabilities:

a. Liabilities arising under a workers' compensation act, or out of any tort, breach of contract, or violation of law.

b. Rebates and refunds.

c. Awards, prizes, and jackpots.

d. Liabilities for insurance and warranty or service contracts provided for the taxpayer.

e. Taxes [other than foreign taxes eligible for the foreign tax credit and real property taxes for which a valid election under IRC Sec. 461(c) has been made].

f. Other liabilities specifically included in this category by future tax law.

Accrued Bonuses Paid after Year End

S corporations with deferred bonus plans that require workers to be employed on the bonus payment date may want to reconsider this requirement. In CCA 200949040, the IRS concluded that an accrual method corporation could not deduct bonuses accrued at the end of Year 1 that were payable to employees within the first 2½ months of the following year (Year 2) if payment was contingent on the employees still working for the company on the bonus payment date.

According to the IRS, the liability did not become fixed until Year 2 when the contingency was satisfied. Therefore, the first prong of the all-events test was not passed by the end of Year 1. The second (economic performance) prong was not satisfied as of the end of Year 1 either. Under the economic performance rules for liabilities arising from services provided to a taxpayer, economic performance occurs as the services are provided. In this case, the deferred bonus plan required employees to continue to provide services until the Year 2 date when the deferred bonuses were actually paid.

Using the Recurring Item Exception to the Economic Performance Rules

An accrual method S corporation can adopt the recurring item exception to the economic performance rules. The recurring item exception allows an S corporation using the accrual method to elect to treat certain recurring liabilities as being incurred during the current year if the all-events test is met even if economic performance has not occurred before the end of the year. This exception is important because the payment equals performance rule effectively takes away the accrual method for many expenses unless the S corporation qualifies for the recurring item exception.

Under the recurring item exception, an item can be deducted in the year it becomes fixed and determinable (when the all-events test is met) if economic performance occurs on or before the earlier of (a) the 15th day of the ninth calendar month following the close of the tax year, or (b) the date the S corporation files a timely (including extensions) tax return for the year. If economic performance occurs within 8½ months after the year-end but after the return has been filed, an amended return can be filed to deduct the item.

A liability can qualify as a recurring item if it is reasonable to expect the same item will be incurred on a recurring basis in the future. To qualify for the recurring item exception, the recurring item must also meet one of the following tests:

- *It Is Immaterial in Amount.* Generally, an item is immaterial if it is immaterial in absolute terms and in comparison with other items of income and expense, or it is immaterial for financial statement purposes under GAAP.

- *It Is Better Matched to Income in the Earlier Year.* GAAP is an important factor in determining whether this requirement is met, but is not conclusive. The matching standard is automatically deemed to be met for rebates and refunds; awards, prizes, and jackpots; insurance, warranty, and service contracts; and taxes (items b. through e. of the list of liabilities to which the payment equals performance rule applies).

Example 2-8: Using the recurring item exception and 8 1/2-month rule.

We-Sell-Em, Inc., is a calendar-year, accrual-method retailer that has adopted the recurring item exception. It has a refund policy authorizing the refund of the full purchase price to any customer who is dissatisfied with a purchase. As of December 31, 2010, We-Sell-Em owes 100 customers refunds totaling $30,000. It will pay the $30,000 liability during the first 2 1/2 months of 2011.

Since the payment-equals-performance rule applies to refunds, economic performance with respect to this $30,000 liability will not occur until 2011, and under the general rules, We-Sell-Em will be unable to deduct any of the $30,000 customer refund liability on its 2010 return. But since the item involves the payment of a refund or rebate, it automatically meets the better matching standard. So, We-Sell-Em can use the recurring item exception to accrue its liability for customer refunds.

The recurring item exception is not limited to the items subject to the payment equals performance rule, but is available to all items generally expected to be incurred from year to year. However, the following items are ineligible for the exception:

a. Interest.

b. Payments pursuant to workers' compensation act liabilities, tort, breach of contract, or violation of law claims (liability item a. of the list of liabilities).

c. Other liabilities referred to in item f. of the list of liabilities.

d. Liabilities incurred by a tax shelter, which is broadly defined to include (1) a company if interests in such enterprise have been offered for sale in an offering required to be registered with any federal or state agency, or (2) a syndicate as defined in IRC Sec. 1256(e)(3)(B).

An S corporation that has not incurred an item eligible for the recurring item exception before the current tax year can adopt the exception in the first year such expenses are incurred by deducting the expense on the return. (Although not required, it is helpful to attach a statement to the return for the first year the item is incurred.) S corporations incurring these liabilities before the current tax year must request approval from the IRS for the change in the year they elect to use the recurring item exception method. As would be expected, the normal accounting change rules of IRC Sec. 446 apply.

Deducting Prepaid Expenses

Regulations clarify when a taxpayer must capitalize amounts prepaid for benefits to be received in the future. The regulations apply to prepaid expenses, including prepaid insurance premiums and prepaid rent expense. However, they contain a special 12-month rule providing that taxpayers are not required to capitalize prepaid expenses if the benefit of the prepaid expenses does not extend beyond the earlier of (a) 12 months after the first date on which the taxpayer realizes a benefit from the expenses; or (b) the end of the tax year following the tax year in which the payment is made.

In the case of an accrual basis taxpayer, the regulations do not affect the determination of economic performance. This generally means that items cannot be deducted before the goods or services giving rise to the expense are furnished even if the benefit derived from those expenses does not extend beyond 12 months (or, if earlier, beyond the close of the following tax year).

Example 2-9: Coordinating the 12-month rule with the economic performance rules.

Marshall, Inc. is an accrual method taxpayer that leases office space from Bobcat Properties for a monthly rental rate of $3,000. On September 1, 2010, Marshall prepays its rent for the first six months of 2011 in the amount of $18,000.

Economic performance occurs ratably over the period of time that Marshall is entitled to use the property. Because economic performance does not occur until 2011, Marshall's prepaid rent is not incurred when it is paid, and therefore is not properly taken into account through capitalization, deduction, or otherwise until 2011. Because the economic performance rules take priority, the 12-month rule does not apply.

Placing S Corporation on Cash Basis for Certain Expenses Paid to Shareholder

A special rule applies to expenses paid by an accrual-method S corporation to a cash-method shareholder if the expenses are paid after the end of the corporation's tax year. These expenses cannot be deducted by the corporation until they are includable in the shareholder's income. In other words, the corporation is placed on the cash basis for these expenses. This rule applies to an expense paid to a person who owns directly or indirectly any of the corporation's stock.

Example 2-10: Placing S corporation on cash basis for certain expenses paid to shareholder.

Jancorp is an accrual-method S corporation that uses a calendar year. On December 31, 2010, it owes $1,500 equipment rent to Janet, its sole shareholder. It pays the $1,500 on January 1, 2011.

Even though the rent is properly accruable on December 31, Jancorp cannot take the deduction until the rent is paid. Thus, the corporation shows the expense on its tax return for the year ended December 31, 2011, and Janet reports the income on her 2011 income tax return.

Example 2-11: Mismatching of income and expense can occur when S corporation and shareholder use different years.

Assume the same facts as in Example 2-10, except Jancorp uses a September 30 year-end and Janet uses a calendar year. The corporation owes the rent to Janet on September 30, 2010, and makes the payment to her on the next day, October 1. The corporation shows the expense on its tax return for the year ended September 30, 2011, and Janet reports the income on her 2010 income tax return.

In this case, Janet must report the income in the year before the year in which Jancorp is allowed the deduction. To prevent this mismatching, Jancorp could have paid the expense on September 30, 2010. Then, Jancorp would show the deduction on its tax return for the year ending on that date, and Janet would show the income on her 2010 return. Alternatively, Jancorp could have waited until January 1, 2011, to make the payment, and both the corporation's expense and Janet's income would be reported in 2011.

Timing Payments to Accelerate the Shareholder's Income

The following example points out that it is sometimes favorable to have an item included in income, even though the S corporation's expense is not deducted until the next tax year.

Example 2-12: Timing payments to accelerate the shareholder's income.

Assume Janet (in Example 2-11) has a net operating loss (NOL) carryforward she will apply against her 2010 income. In 2011, she will have a significant amount of taxable income. If the corporation pays the rent on October 1, 2010, Janet can use the NOL against her income (that includes the rental payment) in 2010. The corporation will deduct the expense in the year ending September 30, 2011. The expense will reduce Jancorp's pass-through income to Janet, and will effectively lower her 2011 taxable income.

SELF-STUDY QUIZ

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

23. Each of the answer choices below describes an S corporation. Which one must use the accrual method of accounting?

    a. Fine Seed Corporation is in the farming business.

    b. The shareholders of Boxot use the accrual method of accounting.

    c. Super Shelter Corp. is a tax shelter.

    d. Always at Attention is a personal service corporation.

24. Tulyn Corporation uses the cash method of accounting. The transaction history for a recent sale follows:

Transaction Date	Transaction Description
August 1st	Sam, a regular customer, purchases an item from Tulyn corporation using in-store credit.
August 20th	Sam receives a bill from Tulyn Corporation, with the notation "past due after September 10th."
September 1st	Sam drops the check for payment in full into the mail. The check is later paid by the bank.
September 3rd	Tulyn Corporation receives Sam's payment check.
September 4th	Tulyn Corporation deposits Sam's payment check into their bank.
September 5th	The bank pays Sam's check and the funds are transferred from Sam's bank account to Tulyn's bank account.

What is the date the check is constructively received by Tulyn Corporation?

    a. September 1st.

    b. September 3rd.

    c. September 4th.

    d. September 5th.

25. Select the disadvantage to using the cash method of accounting.

    a. Income and expenses for the year are readily determinable.

    b. Income can be accelerated or expenses deferred.

    c. The inventory accounting rules can be avoided.

    d. The cash method is rarely used for financial accounting purposes.

26. Deducting expenses under the accrual method for purposes of GAAP differs from deducting expenses under the accrual method for purposes of the tax law in that the tax law adds the requirement of economic performance to the GAAP requirements for accruing expenses. Which of the following S corporations has met the economic performance requirement and should accrue a receivable?

    a. Ali-Opp Corporation has delivered one ton of steel I-beams to a job site in accordance with the terms of the contract. Ali-Opp has not been paid for the delivery.

    b. OpSteele has manufactured one ton of steel I-beams and placed them in inventory. OpSteele has not paid the supplier for all the raw materials used to manufacture the steel I-beams.

    c. Ore-Indy has mined one ton of iron ore. Ore-Indy has not yet prepared payroll checks for the miners.

27. Sonnier Company wants to use the gross receipts test to prove eligibility to use the cash method of accounting. Assuming Sonnier Company has no sales of capital assets or Section 1231 assets, what elements are included in the definition of gross receipts?

    a. All sales, all service income, and income from incidental or outside sources.

    b. All sales, all service income, interest, dividends, rents, royalties and income from incidental or outside sources.

    c. All sales (net of returns and allowances), all service income, interest, dividends, rents, royalties and income from incidental or outside sources.

    d. All sales (net of returns and allowances), interest, dividends, rents, royalties, income from incidental or outside sources and sales tax imposed on the buyer and collected by the seller.

28. Expandito, Inc., an accrual basis calendar year S corporation, started business on January 1, 200W. Expandito has gross receipts of $200,000 in 200W; $600,000 in 200X; $900,000 in 200Y; and $950,000 in 200Z. Can Expandito convert to the cash method of accounting?

    a. No, because average gross receipts is more than $500,000.

    b. Yes, because total gross receipts for the last three years is less than $5 million.

    c. No, because total gross receipts for the last three years is more than $1 million.

    d. Yes, because the average annual gross receipts for each tax year ending after December 16, 1998 is $1 million or less.

29. A qualifying taxpayer under Rev. Proc. 2002-28 may elect the cash method of accounting even though average gross receipts exceed $1 million. Name one industry that can benefit from the cash basis rules.

    a. Construction.

    b. Oil and gas extraction.

    c. Manufacturing.

    d. Sound recording.

30. Los Palabras, Inc., an accrual basis calendar year S corporation, started business on January 1, 200W. Los Palabras has gross receipts of $1,200,000 in 200W; $2,600,000 in 200X; $2,900,000 in 200Y; and $2,950,000 in 200Z. Can Los Palabras convert to the cash method of accounting under Rev. Proc. 2002-28?

    a. No, because average gross receipts is more than $2 million.

    b. Yes, because total gross receipts for the last three years is less than $10 million.

    c. No, because total gross receipts for the last three years is more than $5 million.

    d. Yes, because the average annual gross receipts for each tax year ending after December 31, 2000 is $10 million or less.

31. Which of the following S corporations using accrual basis accounting is **not** eligible to defer the taxability of advance payments received (Hint: See Rev. Proc. 2004-34)?

    a. Flurry Group, an S corporation providing consulting services, receives an advance payment on a contract.

    b. KRK, an S corporation providing factoring services receives prepayments of interest.

    c. Crowmagnum Computing receives payment for the license of computer software.

    d. Colby Hall, a banquet facility, receives advance payments to reserve the use of the facility.

32. All of the following liabilities must be paid for economic performance to occur **except for** which one?

    a. Liabilities arising under a violation of law.

    b. Foreign taxes.

    c. Liabilities due to rebates.

    d. Taxes.

33. What is the recurring item exception and why is it important?

    a. The recurring item exception allows an S corporation using the accrual method to elect to treat certain recurring liabilities as being incurred during the current year if the all-events test is met even if economic performance has not occurred before the end of the year. This is important because the recurring item exception will allow an S corporation to accrue more expenses.

    b. The recurring item exception allows an S corporation using the cash method to elect to treat certain recurring liabilities as being incurred during the current year if the all-events test is met as long as economic performance has occurred before the end of the year. This is important because the recurring item exception will allow an S corporation to deduct more expenses from taxable income.

    c. The recurring item exception allows an S corporation to accrue a liability if services can reasonably be expected to be provided to the S corporation within 3 ½ months of payment. This is important because the S corporation can take a deduction for the payment made.

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. Each of the answer choices below describes an S corporation. Which one must use the accrual method of accounting? **(Page 311)**

    a. Fine Seed Corporation is in the farming business. [This answer is incorrect. The rule applicable to C corporations that they must use the accrual method unless the corporation is in the farming business, does not apply to S corporations. Therefore, Fine Seed Corporation may use the cash or accrual method of accounting.]

    b. The shareholders of Boxot use the accrual method of accounting. [This answer is incorrect. An S corporation may use an accounting method that differs from the shareholders.]

    c. Super Shelter Corp. is a tax shelter. [This answer is correct. An S corporation must use the accrual method of accounting if it is a tax shelter. The "small taxpayer exemption" in Rev. Proc. 2001-10 does not apply to tax shelters.]

    d. Always at Attention is a personal service corporation. [This answer is incorrect. The rule applicable to C corporations that they must use the accrual method unless the corporation is in the personal service business, does not apply to S corporations. Therefore, Always at Attention may use the cash or accrual method of accounting.]

24. Tulyn Corporation uses the cash method of accounting. The transaction history for a recent sale follows:

Transaction Date	Transaction Description
August 1st	Sam, a regular customer, purchases an item from Tulyn corporation using in-store credit.
August 20th	Sam receives a bill from Tulyn Corporation, with the notation "past due after September 10th."
September 1st	Sam drops the check for payment in full into the mail. The check is later paid by the bank.
September 3rd	Tulyn Corporation receives Sam's payment check.
September 4th	Tulyn Corporation deposits Sam's payment check into their bank.
September 5th	The bank pays Sam's check and the funds are transferred from Sam's bank account to Tulyn's bank account.

What is the date the check is constructively received by Tulyn Corporation? **(Page 311)**

    a. September 1st. [This answer is incorrect. As a cash basis tax payer, Sam could deduct the item purchased as an expense (if the purchase meets all the qualifications) once the check is in the mail. The mail date of Sam's check is not relevant to the Tulyn Corporation for purposes of determining constructive receipt.]

    b. September 3rd. [This answer is correct. The receipt of a check is constructive receipt, even if the check is not deposited.]

c. September 4th. [This answer is incorrect. For purposes of establishing constructive receipt, the deposit of a check occurs after constructive receipt.]

d. September 5th. [This answer is incorrect. For purposes of establishing constructive receipt, the transfer of funds from the payor to the payee occurs after constructive receipt.]

25. Select the disadvantage to using the cash method of accounting. **(Page 312)**

a. Income and expenses for the year are readily determinable. [This answer is incorrect. Readily determinable income and expenses is an advantage of the cash method of accounting.]

b. Income can be accelerated or expenses deferred. [This answer is incorrect. The ability to accelerate income or defer expenses is an advantage of the cash method of accounting.]

c. The inventory accounting rules can be avoided. [This answer is incorrect. The ability to avoid the inventory accounting rules is an advantage of the cash method of accounting.]

d. The cash method is rarely used for financial accounting purposes. [This answer is correct. The cash method relies on actual payment or receipt rather than economic accrual. A business may need to use financial accounting methods to prepare financial statements for submission to third party users such as a bank. The cash method of accounting produces more unverifiable income which is a disadvantage when applying for a loan.]

26. Deducting expenses under the accrual method for purposes of GAAP differs from deducting expenses under the accrual method for purposes of the tax law in that the tax law adds the requirement of economic performance to the GAAP requirements for accruing expenses. Which of the following S corporations has met the economic performance requirement and should accrue a receivable? **(Page 313)**

a. Ali-Opp Corporation has delivered one ton of steel I-beams to a job site in accordance with the terms of the contract. Ali-Opp has not been paid for the delivery. [This answer is correct. Ali-Opp has provided property to others and has met the economic performance requirement. Ali-Opp should accrue a receivable for the value of the I-beams.]

b. OpSteele has manufactured one ton of steel I-beams and placed them in inventory. OpSteele has not paid the supplier for all the raw materials used to manufacture the steel I-beams. [This answer is incorrect. OpSteele would not accrue a receivable for the manufacture of inventory.]

c. Ore-Indy has mined one ton of iron ore. Ore-Indy has not yet prepared payroll checks for the miners. [This answer is incorrect. Ore-Indy would not accrue a receivable for the payment of their employees.]

27. Sonnier Company wants to use the gross receipts test to prove eligibility to use the cash method of accounting. Assuming Sonnier Company has no sales of capital assets or Section 1231 assets, what elements are included in the definition of gross receipts? **(Page 315)**

a. All sales, all service income, and income from incidental or outside sources. [This answer is incorrect. One item normally subtracted when making a determination of gross receipts is missing as well as several elements normally included in the calculation of gross receipts per Rev. Proc 2001-10.]

b. All sales, all service income, interest, dividends, rents, royalties and income from incidental or outside sources. [This answer is incorrect. One item normally subtracted when making a determination of gross receipts is missing per Rev. Proc 2001-10.]

c. All sales (net of returns and allowances), all service income, interest, dividends, rents, royalties and income from incidental or outside sources. [This answer is correct. All elements of the definition of gross receipts are included.]

d. All sales (net of returns and allowances), interest, dividends, rents, royalties, income from incidental or outside sources and sales tax imposed on the buyer and collected by the seller. [This answer is incorrect.

Sales tax collections are not included in gross receipts and one element of gross receipts is missing per Rev. Proc 2001-10.]

28. Expandito, Inc., an accrual basis calendar year S corporation, started business on January 1, 200W. Expandito has gross receipts of $200,000 in 200W; $600,000 in 200X; $900,000 in 200Y; and $950,000 in 200Z. Can Expandito convert to the cash method of accounting? **(Page 316)**

a. No, because average gross receipts is more than $500,000. [This answer is incorrect. According to Rev. Proc. 2001-10, the amount used in meeting the gross receipts test is not $500,000.]

b. Yes, because total gross receipts for the last three years is less than $5 million. [This answer is incorrect. According to Rev. Proc. 2001-10, the amount used in meeting the gross receipts test is not $5 million.]

c. No, because total gross receipts for the last three years is more than $1 million. [This answer is incorrect. The gross receipts test is not based on total gross receipts.]

d. Yes, because the average annual gross receipts for each tax year ending after December 16, 1998 is $1 million or less. [This answer is correct. The average annual gross receipts for each tax year ending after December 16, 1998 are $1 million or less.]

29. A qualifying taxpayer under Rev. Proc. 2002-28 may elect the cash method of accounting even though average gross receipts exceed $1 million. Name one industry that can benefit from the cash basis rules. **(Page 317)**

a. Construction. [This answer is correct. Construction is one of several industries benefiting under the cash basis rules.]

b. Oil and gas extraction. [This answer is incorrect. Mining activities including oil and gas extraction do not qualify for the cash basis rules per to Rev. Proc. 2002-28.]

c. Manufacturing. [This answer is incorrect. All types of manufacturing activities are excluded from the cash basis rules per to Rev. Proc. 2002-28.]

d. Sound recording. [This answer is incorrect. Information industries as well as sound recording industries are specifically excluded from the cash basis rules per to Rev. Proc. 2002-28.]

30. Los Palabras, Inc., an accrual basis calendar year S corporation, started business on January 1, 200W. Los Palabras has gross receipts of $1,200,000 in 200W; $2,600,000 in 200X; $2,900,000 in 200Y; and $2,950,000 in 200Z. Can Los Palabras convert to the cash method of accounting under Rev. Proc. 2002-28? **(Page 318)**

a. No, because average gross receipts is more than $2 million. [This answer is incorrect. The amount used in meeting the gross receipts test under Rev. Proc. 2002-28 is not $2 million.]

b. Yes, because total gross receipts for the last three years is less than $10 million. [This answer is incorrect. The amount used in meeting the gross receipts test is not total gross receipts per to Rev. Proc. 2002-28.]

c. No, because total gross receipts for the last three years is more than $5 million. [This answer is incorrect. The amount used in meeting the gross receipts test under Rev. Proc. 2002-28 is not $5 million.]

d. Yes, because the average annual gross receipts for each tax year ending after December 31, 2000 is $10 million or less. [This answer is correct. To qualify for cash basis accounting under Rev. Proc. 2002-28, the average annual gross receipts for each tax year ending after December 31, 2000 must be $10 million or less.]

31. Which of the following S corporations using accrual basis accounting is **not** eligible to defer the taxability of advance payments received (Hint: See Rev. Proc. 2004-34)? **(Page 320)**

    a. Flurry Group, an S corporation providing consulting services, receives an advance payment on a contract. [This answer is incorrect. Advanced payments for services such as consulting, are eligible for deferral.]

    b. KRK, an S corporation providing factoring services receives prepayments of interest. [This answer is correct. Rev. Proc. specifically excludes payments for financial instruments from the definition of advance payments eligible for deferral.]

    c. Crowmagnum Computing receives payment for the license of computer software. [This answer is incorrect. Payments for the sale, lease or license of computer software meets the definition of advance payments eligible for deferral under Rev. Proc. 2004-34.]

    d. Colby Hall, a banquet facility, receives advance payments to reserve the use of the facility. [This answer is incorrect. Payments for the use of property ancillary to the provision of services such as hotel facilities are included in the definition of advance payments eligible for deferral.]

32. All of the following liabilities must be paid for economic performance to occur **except for** which one? **(Page 323)**

    a. Liabilities arising under a violation of law. [This answer is incorrect. Liabilities arising out of any tort, breach of contract or violation of law must be paid for economic performance to occur.]

    b. Foreign taxes. [This answer is correct. Generally foreign taxes are eligible for a foreign tax credit and therefore foreign taxes are not affected by the payment equals performance rule.]

    c. Liabilities due to rebates. [This answer is incorrect. Liabilities due to rebates or refunds must be paid for economic performance to occur.]

    d. Taxes. [This answer is incorrect. Taxes must be paid to taxing authorities for economic performance to occur.]

33. What is the recurring item exception and why is it important? **(Page 323)**

    a. The recurring item exception allows an S corporation using the accrual method to elect to treat certain recurring liabilities as being incurred during the current year if the all-events test is met even if economic performance has not occurred before the end of the year. This is important because the recurring item exception will allow an S corporation to accrue more expenses. [This answer is correct. This is the correct definition of the recurring item exception and explains why an S corporation may benefit from meeting the exception.]

    b. The recurring item exception allows an S corporation using the cash method to elect to treat certain recurring liabilities as being incurred during the current year if the all-events test is met as long as economic performance has occurred before the end of the year. This is important because the recurring item exception will allow an S corporation to deduct more expenses from taxable income. [This answer is incorrect. This answer choice does not disclose the correct method of accounting applicable to the recurring item exception and it does not give the correct reason why an S corporation may benefit from the recurring item exception rule.]

    c. The recurring item exception allows an S corporation to accrue a liability if services can reasonably be expected to be provided to the S corporation within 3 ½ months of payment. This is important because the S corporation can take a deduction for the payment made. [This answer is incorrect. This answer choice describes the safe harbor exception to the general economic performance rule.]

CAPITALIZING BUSINESS EXPENSES

Whether particular costs should be capitalized or expensed is one of the most common tax questions encountered. Certainly, an expenditure that results in the acquisition or enhancement of a separate and distinct asset with a useful life of more than a year should be capitalized. However, in *INDOPCO*, the Supreme Court ruled that the creation of a separate and distinct asset was not a prerequisite to capitalization. If the expenditure gave rise to a significant future benefit (i.e., beyond the year in which the expenditure was incurred), it must be capitalized. Court decisions and IRS rulings since *INDOPCO* provided guidance on capitalization for expenditures that did not create a separate and distinct asset but that resulted in significant future benefits. Generally, significant future benefit resulted when the expenditure was nonrecurring and primarily benefited future income, and the benefit was significant rather than incidental.

Capitalizing Intangible Assets

Subsequent to the *INDOPCO* decision, Regs. 1.263(a)-4 and 1.263(a)-5 were issued. Capitalization under Reg. 1.263(a)-4 is required for amounts paid to:

a. Acquire certain intangible assets, including but not limited to, an ownership interest in another entity such as a corporation or partnership.

b. Create an intangible, limited to those assets described in the regulations (i.e., if the asset is not described in the regulations, it does not have to be capitalized).

c. Create or enhance a separate and distinct intangible asset, defined as a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal, or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged separate and apart from a trade or business.

d. Create or enhance future benefits to be identified in yet-to-be published IRS guidance.

e. Facilitate the acquisition or creation of intangible assets previously described.

Capitalization is required under Reg. 1.263(a)-5 for amounts paid to facilitate the acquisition of assets constituting a trade or business; the acquisition of an ownership interest in a business when the taxpayer and the target entity are considered related parties after the transaction; the acquisition of an ownership interest in the taxpayer; certain business entity restructuring, reorganization, capitalization and recapitalization transactions; the formation or organization of a disregarded entity; the acquisition of capital, including stock issuances or borrowing transactions; or the writing of an option.

Amounts capitalized under these provisions are generally added to the tax basis of the intangible asset being acquired or created. Capitalized amounts for acquired Section 197 intangibles are amortized over 15 years. Generally capitalized amounts for created intangibles should be amortized under the 15-year rule (25-year rule in the case of certain amounts paid for real estate) of Reg. 1.167(a)-3.

However, employee compensation (including bonuses and commissions) and overhead are excluded from amounts that facilitate the acquisition or creation of an intangible asset and are not required to be capitalized. Capitalization also is not required for costs paid to investigate or pursue a transaction that, in the aggregate, do not exceed $5,000 (so-called *de minimis* costs). However, commissions paid to facilitate the acquisition of an intangible are not *de minimis* costs.

Example 2-13: Capitalization is not required for *de minimis* costs.

Dogco is an S corporation that agreed to lease property to Catco. Dogco pays $7,000 to its outside legal counsel to negotiate and draft the lease agreement. Dogco must capitalize the $7,000 expenditure incurred to facilitate the lease transaction under Reg. 1.263(a)-4.

Variation: If the facilitative expenditures total $4,700 instead of $7,000, they qualify for the *de minimis* exception. Because the regulations exclude payments aggregating $5,000 or less, Dogco would not be

required to capitalize the $4,700 of investigative expenditures under IRC Sec. 263. Presumably, these expenditures would be deductible under IRC Sec. 162.

Taxpayers who have established an accounting method for capitalized expenses (including existing taxpayers who have never properly capitalized expenses) generally must request permission to change their accounting method to apply the final regulations. Rev. Proc. 2006-12, as modified and amplified by Rev. Proc. 2006-37, must be followed for taxpayers seeking to obtain automatic consent to change the accounting method for tax years ending on or after December 31, 2005. Taxpayers must complete Form 3115 and compute any Section 481 adjustment.

Capitalizing Tangible Assets

In March 2008, the IRS withdrew proposed regulations that were issued in 2006 and reissued proposed regulations under IRC Sec. 263(a) specifying when amounts paid to acquire, produce, or improve tangible real and personal property must be capitalized. The regulations will be effective for tax years beginning on or after the date published in final form. The new proposed regulations will revise Reg. 1.162-3 and 1.263(a)-2 to provide clear and consistent treatment for those items that traditionally have been considered to be materials and supplies and to provide distinct, but coordinated, treatment for those items that should be addressed under IRC Sec. 263(a).

The proposed regulations provide (a) rules for capitalizing costs paid to facilitate the acquisition or production of real or personal property; (b) new rules establishing a *de minimis* exception; and (c) procedures for electing out of the *de minimis* exception.

Transaction Costs. Generally, costs would be capitalized if they are paid to facilitate the acquisition or production of real or personal property. Inherently facilitative costs (including costs of shipping, moving or appraising property, application fees, sales and transfer taxes, finder's fees, and architectural, engineering, environmental or inspection services related to specific properties) would be capitalized regardless of whether they relate to real or personal property, or whether or not the property is actually acquired or produced.

Amounts paid for employee compensation or overhead would be treated as amounts that do not facilitate the acquisition of real or personal property; however, the taxpayer could elect to capitalize employee compensation or overhead expenses related to an acquisition.

***De Minimis* Exception.** Taxpayers would be able to deduct the cost (including facilitative costs) of acquiring or producing a unit of property if the following conditions are met:

a. The taxpayer has an applicable financial statement or a certified audited financial statement.

b. The taxpayer has, at the beginning of the tax year, written accounting procedures treating as an expense, for nontax purposes, the amounts paid for property costing less than a certain amount.

c. The taxpayer treats the amounts paid during the tax year as an expense on its applicable financial statement in accordance with its written accounting procedures.

d. The total of amounts paid and not capitalized under the *de minimis* rules do not distort the taxpayer's income for the tax year. (The regulations include a safe harbor for when amounts would not be treated as distorting income.)

The *de minimis* exception would not apply to amounts paid to improve property, acquire property for resale, or for land. Taxpayers would be allowed to elect out of the *de minimis* exception for any unit of property during the tax year to which the exception would otherwise apply.

Improvements. The following categories of costs would result in an improvement to property and would have to be capitalized:

a. Amounts that result in a betterment to a unit of property;

b. Amounts that restore a unit of property; or

c. Amounts that adapt a unit of property to a new or different use.

The proposed regulations specifically provide that repairs that are made at the same time as an improvement, but that do not directly benefit or are not incurred by reason of the improvement, are not required to be capitalized under IRC Sec. 263(a).

According to Prop. Reg. 1.263(a)-3(f), betterment to a unit of property results only if it:

a. ameliorates a condition or defect that existed before the acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect when the property was acquired or produced;

b. results in a material addition (including an enlargement, expansion, or extension) to the unit of property; or

c. results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, or quality of output of the unit of property.

Routine Maintenance Safe Harbor. The proposed regulations provide a routine maintenance safe harbor under which qualifying activities would be deemed to not improve the unit of property. Routine maintenance activities include recurring activities that a taxpayer expects to perform more than once over the class life of the unit of property to keep the property in efficient operating condition. The replacement of minor parts with improved but comparable parts generally would not result in a betterment.

Instead of determining whether an expense is deductible or capitalizable, the proposed regulations would permit a taxpayer to elect to use a repair allowance method (RAM) that is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin. The RAM would treat most amounts paid for repairing, maintaining, or improving tangible property as deductible to the extent they do not exceed the repair allowance for the MACRS class of the property, and capitalizable to the extent the costs exceed the repair allowance for that class of the property.

USING A NONACCRUAL EXPERIENCE METHOD OF ACCOUNTING

Taxpayers using the nonaccrual experience (NAE) method of accounting are not required to accrue any portion of their service-related income that, on the basis of their experience, will not be collected. The NAE method of accounting is available for amounts to be received for the performance of qualified services and for services provided by certain small businesses. Amounts to be received for all other services are subject to the general rule regarding inclusion in income. Qualified services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Under a special rule, the NAE method of accounting continues to be available for the performance of nonqualified services if the average annual gross receipts [as defined in IRC Sec. 448(c)] of the taxpayer (or any predecessor) does not exceed $5 million. The rules of paragraphs two and three of IRC Sec. 448(c) (i.e., the rules regarding the aggregation of related taxpayers, taxpayers not in existence for the entire three-year period, short tax years, definition of gross receipts, and treatment of predecessors) apply for purposes of determining the average annual gross receipts test.

Taxpayers eligible to use the NAE method can use one of the following safe harbor methods of accounting or an alternative method that meets certain requirements. For this purpose, taxpayers can choose an applicable period of at least three but not more than six years.

a. *Revenue-Based Moving Average Method.* The income amount not accrued is determined by a formula based on the taxpayer's experience over the applicable period. When the receivable is collected, any amount that was not expected to be collected (i.e., the amount not accrued) must be taken into income.

b. *Actual Experience Method.* The two options under this method are the (1) single determination date option, and (2) the multiple determination date option. Under both of these methods, the accounts receivable at

the beginning of a year are tracked to determine what percentage of those accounts was actually never collected.

c. *Modified Black Motor Co. Method.* The uncollectible amount is computed by first determining the ratio of bad debts charged off (adjusted for recoveries) for the applicable period relative to the total accounts receivable at the end of those years. This ratio is applied to the outstanding receivables at the end of the current tax year. The resulting amount is then reduced by the receivables generated and written off during the current tax year to arrive at the current year uncollectible amount.

d. *Modified Moving Average Method.* The taxpayer determines the uncollectible amount by multiplying its ending accounts receivable by the modified moving average percentage. That percentage is computed by dividing the sum of net bad debts for the applicable period (except that bad debts charged off in the same year the receivable was generated are not counted) by the sum of the receivables at the end beginning of each tax year during the applicable period.

e. *Alternative Nonaccrual-experience Method.* A taxpayer may use an alternative nonaccrual-experience method that clearly reflects the taxpayer's actual nonaccrual-experience, provided the taxpayer's alternative nonaccrual-experience method meets the self-test requirements.

Under the regulations, a change from an NAE method by a taxpayer no longer qualified to use such a method, a change to an NAE method, a change from one NAE method to another NAE method, or a change from using one safe harbor method to another safe harbor method, is a change in method of accounting. In most instances, such a change will receive automatic consent.

Example 2-14: Using the nonaccrual experience method.

Dr. Bob practices via a calendar year S corporation that is eligible to use the NAE method. For 2005 through 2010, Net Bad Debts totaled $649,000 while Total Year-end Receivables equaled $3,200,000. In addition, he generated and wrote off $10,000 of receivables during 2010.

The ratio of net bad debts to total receivables generated during the six-year testing period was 20.28% ($649,000 P $3,200,000). Dr. Bob's Modified Black Motor amount for 2010 is $152,240 [($800,000 y 20.28%) – $10,000]. Therefore, he accrues $647,760 of taxable income related to his year-end receivables ($152,240 subtracted from $800,000 of year-end receivables for 2010).

Variation: Now assume that Dr. Bob uses the Modified Moving Average Method. For 2005 through 2010, his Net Receivables Charged off in the Year Generated totaled $46,700. The modified moving average percentage is 18.82% [($649,000 – $46,700) ÷ $3,200,000], and the nonaccrual amount is $150,560 (18.82% × $800,000). Therefore, Dr. Bob accrues $649,440 ($800,000 – $150,560) of taxable income related to his year-end receivables.

SELF-STUDY QUIZ

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

34. When published in final form, proposed regulations specifying when amounts paid to produce, acquire, or improve tangible real and personal property must be capitalized, will revise which of the following regulations?

    a. Reg. 1.167(a)-3.

    b. Reg. 1.162-3.

35. What is the significance of the *INDOPCO* case?

    a. The *INDOPCO* case allowed expenditures that give rise to the acquisition or enhancement of a separate and distinct intangible asset with a useful life of more than one year to be capitalized.

    b. The *INDOPCO* case allowed expenditures that give rise to the acquisition or enhancement of a separate and distinct tangible asset with a useful life of more than one year to be capitalized.

    c. The INDOPCO case allowed expenditures that give rise to future significant benefits to be capitalized without creating a separate and distinct asset.

36. The nonaccrual experience method has several safe harbor methods of accounting. Which of the following definitions below is the six-year moving average method?

    a. The income amount not accrued is determined by a formula based on the taxpayer's experience over the current and preceding five tax years. When the receivable is collected, any amount that was not expected to be collected must be taken into income.

    b. The accounts receivable at the beginning of a year are tracked to determine what percentage of those accounts was actually never collected.

    c. The uncollectible amount is computed by first determining the ratio of bad debts charged off for the current year and the five preceding tax years relative to the total accounts receivable at the end of those years. This ratio is applied to the outstanding receivables at the end of the current tax year. The resulting amount is then reduced by the receivables generated and written off during the current tax year to arrive at the current year uncollectible amount.

    d. The taxpayer determines the uncollectible amount by multiplying its ending accounts receivable by the modified six-year moving average percentage which is computed by dividing the sum of net bad debts for the current and five preceding years by the sum of the receivables at the end of the current and five preceding years.

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.)**

34. When published in final form, proposed regulations specifying when amounts paid to produce, acquire, or improve tangible real and personal property must be capitalized, will revise which of the following regulations? **(Page 335)**

    a. Reg. 1.167(a)-3. [This answer is incorrect. Reg. 1.167(a)-3 addresses how capitalized amounts for created intangibles should be amortized under the 15-year and 25-year rules.]

    b. Reg. 1.162-3. [This answer is correct. Proposed regulations specifying when amounts paid to produce, acquire, or improve tangible real and personal property must be capitalized will revise Reg. 1.162-3 and 1.263(a)-2 to clarify treatment for items that traditionally have been considered to be materials and supplies and to provide distinct, but coordinated treatment for items that should be addressed under IRC Sec. 263(a).]

35. What is the significance of the *INDOPCO* case? **(Page 336)**

    a. The *INDOPCO* case allowed expenditures that give rise to the acquisition or enhancement of a separate and distinct intangible asset with a useful life of more than one year to be capitalized. [This answer is incorrect. The expenses incurred in the creation of an intangible asset with a useful life of more than one year would have been capitalized prior to the *INDOPCO* case.]

    b. The *INDOPCO* case allowed expenditures that give rise to the acquisition or enhancement of a separate and distinct tangible asset with a useful life of more than one year to be capitalized. [This answer is incorrect. The *INDOPCO* case is directed more towards intangible assets than tangible assets.]

    c. The *INDOPCO* case allowed expenditures that give rise to future significant benefits to be capitalized without creating a separate and distinct asset. [This answer is correct. The keys to the *INDOPCO* case are that the expenditures result in significant, future benefits that are not necessarily related to a distinct asset.]

36. The nonaccrual experience method has several safe harbor methods of accounting. Which of the following definitions below is the six-year moving average method? **(Page 336)**

    a. The income amount not accrued is determined by a formula based on the taxpayer's experience over the current and preceding five tax years. When the receivable is collected, any amount that was not expected to be collected must be taken into income. [This answer is correct. This is the correct definition of the six-year moving average method.]

    b. The accounts receivable at the beginning of a year are tracked to determine what percentage of those accounts was actually never collected. [This answer is incorrect. This is the definition of the actual experience method.]

    c. The uncollectible amount is computed by first determining the ratio of bad debts charged off for the current year and the five preceding tax years relative to the total accounts receivable at the end of those years. This ratio is applied to the outstanding receivables at the end of the current tax year. The resulting amount is then reduced by the receivables generated and written off during the current tax year to arrive at the current year uncollectible amount. [This answer is incorrect. This is the definition of the modified Black Motor Co. method.]

    d. The taxpayer determines the uncollectible amount by multiplying its ending accounts receivable by the modified six-year moving average percentage which is computed by dividing the sum of net bad debts for the current and five preceding years by the sum of the receivables at the end of the current and five preceding years. [This answer is incorrect. This is the definition of the modified six-year moving average method.]

THE U.S. DOMESTIC PRODUCER DEDUCTION

Background

The domestic production activities deduction under (DPAD) IRC Sec. 199 is available to any qualified taxpayer, including S corporations. The appropriate percentage (6% in 2007–2009 and 9% thereafter) is applied to the lesser of the taxpayer's (a) qualified production activities income (QPAI) for the year, or (b) taxable income for the year, determined without regard to the deduction. However, the allowable deduction cannot exceed 50% of the taxpayer's Form W-2 wages for the year that are properly allocable to domestic production gross receipts (DPGR). Furthermore, the allowable deduction for taxpayers with oil-related QPAI is reduced for tax years beginning after 2009.

Generally, the DPAD rules are applied at the shareholder level, requiring each S corporation shareholder to compute his or her deduction separately based on the S corporation items allocated to that shareholder. However, the IRS has issued guidance permitting certain S corporations to calculate a shareholder's share of QPAI and W-2 wages at the entity level.

Concerned about the application of IRC Sec. 199 in practice, and to better understand how taxpayers are computing the Section 199 deduction, the Large & Mid-Size Business (LMSB) Division of the IRS has classified the Section 199 deduction a Tier I issue. A Tier I issue is one the IRS believes represents a high compliance risk, not one that is necessarily an abusive or bad transaction. Accordingly, clients under audit by the LMSB can expect scrutiny of the IRC Section 199 computations and deduction.

Identifying Activities Eligible for the Deduction.

While the DPAD is intended for manufacturers, it is actually 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.
- 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 [North American Industry Classification System (NAICS) code 23], including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities.
- Engineering and architectural services performed in the U.S. by a taxpayer engaged in the business of performing engineering (e.g., NAICS code 541330) or architectural (e.g., NAICS code 541310) services, and relating to the construction of real property.

Identifying MPGE Activities

MPGE qualifying activities include manufacturing, producing, growing, extracting, installing, building, developing, improving, and creating qualified production property (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 agricultural activities include cultivating soil, raising livestock, fishing, and mining minerals.

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.

An S corporation that conducts MPGE activities is also subject to the uniform capitalization rules and must make the requisite Section 263A adjustments. In other words, if an S Corporation wants to take the DPAD, it is going to be a producer subject to the uniform capitalization rules, unless it qualifies for an exception. If an S corporation is not properly applying IRC Sec. 263A, and needs to change its accounting method, it must follow the appropriate rules.

Identifying Qualified Production Property (QPP). The term QPP includes tangible personal property, computer software, and sound recordings. The fact that property is personal property or tangible property under local law is not controlling. Conversely, property may be tangible personal property for Section 199 purposes even if local law considers it a fixture and, thus, real property. Tangible personal property does not include land, buildings, or inherently permanent structures.

Meeting the *In Significant Part* Requirement To claim the deduction, the S corporation must manufacture, produce, grow, or extract QPP in whole or in significant part within the U.S. An S corporation manufactures QPP *in significant part* if it meets one of two tests:

- *Substantial in Nature Test.* Based on all of the taxpayer's facts and circumstances, the manufacturing, production, growth, or extraction 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. 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 considered 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. Overhead includes all costs required to be capitalized under IRC Sec. 263A, except for direct materials and direct labor.

Packaging, repackaging, labeling, and minor assembly operations are not considered to be MPGE activities.

Example 2-15 Determining when property has been manufactured *in significant part*.

Fast Car, Inc. operates a classic kit car assembly plant in the U.S. It purchases engines, transmissions, and certain other components from AutoSupply, Inc., an unrelated party, and assembles the component parts into finished 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 AutoSupply	$ 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 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 in significant part by Fast Car within the U.S.

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.

Handling Specific Activities

The following are some of the special rules that apply in certain situations.

Identifying Construction Activities. S corporations are frequently used in the construction business due to the pass-through taxation and liability shield the S corporation form provides to the shareholders. Domestic production gross receipts (DPGR) from the construction of real property performed in the U.S. includes proceeds from the sale or other disposition of real property constructed by the S corporation, including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and sewers. DPGR also includes compensation for performing construction services in the U.S.

To construct real property means to erect or substantially renovate the property. Land improvements and painting qualify as construction only if connected with other activities that constitute the erection or substantial renovation of real property. A substantial renovation increases the value of the property, prolongs the property's useful life, or adapts the property to a new or different use.

Gross receipts from the sale or other disposition of land do not qualify as DPGR. However, the S corporation can treat 100% of the proceeds from a construction project that includes the sale of land as DPGR if the S corporation derives less than 5% of total gross receipts from the project from the sale of the land. A similar *de minimis* rule treats all gross receipts as non-DPGR if less than 5% of gross receipts are DPGR.

An S corporation engaged in construction activities may qualify for the deduction even if it does not have the benefits and burdens of ownership of the property being constructed. For example, a general contractor and a subcontractor may both be engaged in construction activities when installing a roof on a new building. Each one's benefit will be a percentage of its profit on the work.

Identifying Engineering or Architectural Services. DPGR includes gross receipts from engineering or architectural services performed in the U.S. for construction projects in the U.S. The S corporation 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. A small amount of income (less than 5% of gross receipts for the project) for services performed outside the U.S. or services related to property other than real property will not disqualify the receipts as DPGR. The reverse is also true—a small amount (less than 5%) of income qualifying as DPGR will not prevent the taxpayer from treating the receipts as non-DPGR.

Handling Food or Beverage Sales. Food and beverages prepared at a retail establishment do not qualify for the deduction. However, an S corporation 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. Even if an S corporation's facility is a retail establishment, food or beverages prepared at the facility and sold at wholesale are not treated as prepared at a retail establishment. In that case, gross receipts related to wholesale transactions are eligible for the deduction.

DETERMINING QUALIFIED PRODUCTION ACTIVITIES INCOME FOR SECTION 199 PURPOSES

The appropriate deduction percentage (9% after 2009) is applied to the lesser of the S corporation's qualified production activities income (QPAI) for the year, or taxable income (determined without regard to the [domestic production activities deduction (DPAD)] for the year. QPAI equals the S corporation's domestic production gross receipts (DPGR) for the year, reduced by (a) the cost of goods sold allocable to those receipts; and (b) other expenses, losses, or deductions (other than the DPAD itself) that are properly allocable to those receipts.

Determining Domestic Production Gross Receipts

DPGR is the S corporation'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 (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.

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

Computing and Allocating Gross Receipts

Gross receipts are computed using the S corporation's normal method of accounting, and 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 DPAD 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.

S corporations that have DPGR and non-DPGR must use a specific identification method to identify gross receipts that constitute DPGR if they use that method for other purposes (such as for financial statements or internal management documents). But if specific identification causes the S corporation 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, S corporations can include qualified warranty, delivery, operating manual, installation, and 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 (i.e., is not separately stated), and the S corporation does not sell the embedded service without the product.

Example 2-16: Handling receipts from embedded services.

Lenox Corp. manufactures air conditioning units at facilities within the U.S., which it sells to retailers. Lenox charges a delivery fee for delivering the units to the retailers, and 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, Lenox must allocate its gross receipts between DPGR and non-DPGR. But, if Lenox 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 would not be required.

If less than 5% of total gross receipts are non-DPGR, the S corporations with less than 5% of gross receipts from embedded services may include the embedded service income as DPGR.

Allocating Costs to Gross Receipts

Classifying receipts as DPGR is only the first step. The next step is to allocate the appropriate costs against the DPGR to determine the QPAI. According to Reg. 1.199-4(a), 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 final regulations provide three methods for allocating and apportioning deductions (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 while Reg. 1.199-4(c) provides rules for determining deductions properly allocable to DPGR. Reg. 1.199-4(d) authorizes certain taxpayers to apportion deductions to DPGR using the Section 861 method, while Reg. 1.199-4(e) enables eligible 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 to DPGR

When determining its QPAI, an S corporation must reduce DPGR by the cost of goods sold (COGS) allocable to the DPGR. COGS includes 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 sub-normal goods must also be taken into account in computing COGS for the Section 199 deduction. COGS also includes the basis of any noninventory property if the sales proceeds are included in DPGR.

When allocating COGS, S corporations must specifically identify and trace costs from the books and records to DPGR. S corporations that cannot specifically identify costs without undue burden can use any reasonable method to allocate costs, which can include methods based on gross receipts, number of units sold, number of units produced, or total production costs.

Small Business Method. Eligible small S corporations can use the small business simplified overall method (small business method) to allocate COGS and other deductions between DPGR and non-DPGR. To qualify, 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 who are allowed to use the cash method under Rev. Proc. 2002-28 also qualify for the small business method. Under the small business method, cost of goods sold allocable to DPGR equals: COGS × (DPGR ÷ total gross receipts).

Example 2-17: Using the small business simplified overall method.

GC Pianos, Inc., is an S corporation that builds custom pianos at its U.S. location. In addition, GC provides piano tuning and repair services, which account for about 10% of its gross receipts. GC must allocate its income and deductions between its DPGR (piano manufacturing) and non-DPGR (piano service). GC's books and records show the following 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

Under the small business method, GC would allocate $2,065,722 of its COGS to its qualifying manufacturing activity ($3,500,000 ÷ $3,880,000 × $2,290,000). GC's QPAI would be $1,434,278 ($3,500,000 − $2,065,722). By way of comparison, GC's QPAI using the specific identification method would have been only $1,400,000 ($3,500,000 − $2,100,000).

Allocating Other Expenses or Losses to DPGR

After allocating COGS to DPGR, the S corporation should subtract other expenses, losses, or deductions (other than the DPAD itself) that are properly allocable to DPGR. The S corporation generally must allocate and apportion these deductions using the Section 861 method described in the following paragraph. However, eligible S corporations can use one of two simplified methods—the small business method previously discussed below—to make the allocation.

Section 861 Method. The Section 861 method requires allocations under different methods for different types of expenses. The S corporation has to allocate its deductions to the relevant class of gross income (such as gross income derived from a business or derived from services) and then apportion the deductions within the class of gross income between DPGR (the statutory grouping) and non-DPGR (the residual grouping). If a deduction is not definitely related to any gross income, the taxpayer must apportion the deduction ratably between the statutory grouping and the residual grouping based on total gross receipts.

Small Business Method. S corporations qualifying to use the small business method previously discussed can use that method instead of the Section 861 rules to allocate indirect costs to DPGR. If the S corporation chooses to use the small business method, it must use that method for all costs, including COGS. S corporations eligible to use the small business method can choose to use that method, the simplified deduction method (explained in the following paragraph), or the Section 861 method for a particular tax year.

Simplified Deduction Method. S corporations 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 apportion other expenses and deductions (but not cost of goods sold) using the simplified deduction method. This method allows taxpayers to allocate other costs prorata (based on gross receipts) between DPGR and non-DPGR, just like the small business method. Taxpayers using the simplified deduction method must use this method for all other deductions, expenses, and losses allocable to DPGR. S corporations eligible to use the simplified deduction method can use that method or the Section 861 method for a particular tax year.

Determining whether a shareholder can use the simplified deduction method is made at the shareholder level. The method is applied at the shareholder level, taking into account the shareholder's DPGR, non-DPGR, and other items from all sources, including the shareholder's distributive share of those items from the S corporation.

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, Rev. Proc. 2007-35 permits the use of statistical sampling to, in part: (a) allocate gross receipts between DPGR and non-DPGR sources, (b) allocate COGS between DPGR and non-DPGR, and (c) allocate various deductions between DPGR and non-DPGR.

Statistical sampling will be considered a reasonable method that is satisfactory to the IRS to the extent the taxpayer's methodology (a) satisfies the appropriateness requirements described in the following paragraph; (b) meets the sampling plan standards in Appendix A of the revenue procedure, which provides rules for the methodology that must be followed for the statistical sampling; (c) meets the documentation standards in Appendix B; and (d) uses the technical formulas set forth in Appendix C.

Whether statistical sampling is appropriate is based on the facts and circumstances. Factors in determining the appropriateness include 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. Rev. Proc. 2007-35 makes it clear that statistical sampling will generally be allowed only when the taxpayer can show a "compelling need" to use it.

DETERMINING W-2 WAGES

The domestic production activities deduction is (DPAD) driven by domestic production gross receipts (DPGR) but is limited to 50% of the W-2 wages paid by the S corporation during the year that are allocable to the DPGR. This means that S corporations need to design and implement recordkeeping systems to capture the portion of employees' time and pay devoted to qualifying activities (such as by establishing separate general ledger accounts for DPGR-related wages and for other wages).

According to Reg. 1.199-2(e)(1), 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 in computing the domestic production activities deduction, while any decrease in W-2 wages will reduce the 50% of wages limitation for purposes of computing the deduction.

S corporations can count wages paid to employees or former employees, which include common law employees. However, they cannot count wages paid as an agent of another entity to persons who are not employees of the taxpayer.

There are three available options for computing the appropriate W-2 wages:

a. *Unmodified Box Method.* W-2 wages are the wages computed by taking the lesser of Box 1 or Box 5 (Medicare wages).

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

c. *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 Box 12 of Form W-2 that are coded D, E, F, G, or S.

Computing the Deduction

The domestic production activities deduction is applicable for both regular and alternative minimum tax (AMT) purposes. Thus, alternative minimum taxable income (AMTI) is reduced by the domestic production activities deduction. For the domestic production activities deduction, AMTI is computed without making any of the adjustments required by IRC Sec. 56 through 59. Further, the domestic production activities deduction is not taken into consideration when computing any AMT NOL.

To compute the domestic production activities deduction:

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 the correct percent for the applicable year.

Step 3 Compute the 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

The domestic production activities deduction (DPAD) is claimed at the shareholder level. As a result, each shareholder computes the deduction separately. Each shareholder is allocated, under the regular Section 1366 pass-

through rules, the shareholder's pro-rata share of items (including items of income, gain, loss, and deduction), cost of goods sold (COGS) allocated to these income items, and gross receipts included in the income items. This allocation applies even if the shareholder's share of COGS and other deductions and losses exceeds domestic production gross receipts (DPGR).

Each S corporation shareholder aggregates his or her pro rata share of S corporation items, to the extent they are not otherwise disallowed by the Code, with items incurred outside the S corporation (whether directly or indirectly) for purposes of allocating and apportioning deductions to DPGR and computing qualified production activities income (QPAI).

Determination at the Entity Level. Under. Reg. 1.199-5(c)(1)(ii), the IRS can permit a pass-through entity 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 an:

a. 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 Temp. Reg. 1.199-2T(e)(2)(ii) or some other reasonable method.

b. 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.

An S corporation that qualifies as both an eligible widely-held pass-thru entity and an eligible small pass-through entity for the year can choose to use either the simplified deduction method or the small business simplified overall method 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 for certain disallowed losses or deductions, and for the allowance of suspended losses or deductions).

An S corporation 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 S corporation then allocates its W-2 wages among the shareholders in the same manner as it allocates wage expense for that tax year.

Example 2-18 Calculating QPAI and W-2 wages under Rev. Proc. 2007-34.

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, and under Rev. Proc. 2007-34 uses the small business simplified overall method to allocate costs. 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 Temp. Reg. 1.199-2T(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 Allison engages in no other activities generating DPGR, her tentative deduction is $6,000 ($100,000 share of QPAI from JSP × 6%), subject to the Section 199(b)(1) wage limitation (50% of her $100,000 share of W-2 wages from JSP).

Jack engages in other production activities generating DPGR, he must combine his $100,000 share of QPAI and $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.

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.

Effect of Section 199 Deduction on Basis. The domestic production activities deduction has no effect on a shareholder's basis in the S corporation.

Disallowed Deductions

S corporation deductions that otherwise would be taken into account in computing the shareholder's deduction are only taken into account if and to the extent that the shareholder's pro rata share of the losses or deductions from all of the S corporation's activities are not disallowed by (a) the Section 465 at-risk rules, (b) the Section 469 passive activity loss rules, (c) the Section 1366 basis rules, or (d) any other provision of the Code.

If any of the disallowed losses or deductions are allowed in a later tax year, the shareholder takes into account a proportionate share of those losses or deductions in computing QPAI for that later tax year.

Shareholder's Share of W-2 Wages

The S corporation must allocate the amount of W-2 wages among the shareholders in the same manner it allocates wage expense among the shareholders. 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) limitation for the year.

Reporting the Deduction

There is no line item on the front page of Form 1120S for the U.S. producer deduction. 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 QPAI and W-2 wages for the year is reported on the shareholder's Schedule K-1. From there, it flows to the shareholder's Form 8903.

CLAIMING BONUS DEPRECIATION

The Economic Stimulus Act of 2008 authorized a temporary 50% first-year bonus depreciation break for "qualified property" acquired and placed in service during 2008. Then the American Recovery and Reinvestment Act of 2009 extended the bonus depreciation break to cover qualifying new (not used) assets that are both acquired and placed in service during 2009 (although an extended deadline applies to certain longer-lived assets, transportation equipment, and aircraft).

Since this provision has appeared, been extended, and disappeared within the past 10 years, the following paragraphs summarize some of the major concepts in case Congress decides to reinstate the Section 168(k) bonus deprecation deduction once again.

Determining What Is Qualified Property

To be eligible for bonus depreciation (i.e., be "qualified property"), the asset must fit within one of the following definitions:

a. Section 168 recovery property with an MACRS recovery period of 20 years or less. This definition would encompass most tangible personal property. Most real estate assets would fail to meet the definition. In addition, qualified property would not include any asset subject to the alternative depreciation system (ADS) under IRC Sec. 168(g), unless the taxpayer voluntarily elected to use ADS for the asset.

b. Depreciable computer software that is not amortizable over 15 years under IRC Sec. 197. Most purchased software is depreciable using the straight-line method over 36 months and so is would not fit into this category. Software is amortizable under IRC Sec. 197 only when it is acquired as part of an overall business acquisition transaction and is not readily available for purchase by the general public.

c. Water utility property, as defined in IRC Sec. 168(e)(5).

d. Qualified leasehold improvement property. Under the 2008 and 2009 legislation, the (1) improvement must have been to the interior portion of a building, (2) building must have been nonresidential real property, (3) improvement must be made pursuant to or under a lease by either the lessee (or sublessee) or the lessor to property that would be occupied exclusively by the lessee (or sublessee), and (4) improvement must have been placed in service more than three years after the date the building was first placed in service. Some improvements were ineligible by definition, including expenditures to enlarge a building, and improvements made under a lease between related parties.

Determining What Is a New Asset

An asset is eligible for first-year bonus depreciation under the 2008 and 2009 legislation if its original use commenced with the taxpayer. While the cost of a used asset itself generally did not satisfy the requirement, the additional cost incurred to recondition or rebuild a used asset apparently did satisfy the original-use requirement.

The old Section 168(k) regulations provided a safe-harbor rule to determine when an asset can be considered entirely new after substantial reconditioning or rebuilding. According to the safe harbor, an asset that contains used parts would be considered a new asset if the cost of the used parts was 20% or less of the total cost. In addition, new property initially used by a taxpayer for personal use and subsequently converted to business use would apparently meet the original-use requirement.

Example 2-19: Reconditioning cost qualifying for bonus depreciation.

During 2009, CheapCo bought a used machine for $20,000 and spent $5,000 to recondition it. The $20,000 purchase price was not eligible for bonus depreciation, but the $5,000 additional cost to recondition the machine is, assuming that the other requirements are also met for the $5,000 expenditure.

CheapCo bought another machine for $25,000. Of the total cost, $20,000 (80%) was attributable to new parts while $5,000 (20%) was attributable to used parts. Under the safe harbor rule, the machine was deemed to be

new. Therefore, the entire $25,000 cost is apparently eligible for bonus depreciation, assuming that the other bonus depreciation requirements were met.

Planning Considerations in Non-bonus Depreciation Year

The recently enacted Hiring Incentives to Restore Employment (HIRE) Act extended the enhanced Section 179 depreciation limits (e.g., business can expense up to $250,000) for tax years beginning in 2010, but did not extend bonus depreciation. Therefore, the Section 168(k) 50% first-year bonus depreciation break is generally dead for assets placed in service in 2010. But since bonus depreciation was available for assets placed in service in 2008 and 2009, practitioners need to keep a number of considerations in mind:

a. Bonus depreciation applies for both regular tax and AMT purposes. In addition, there is no AMT adjustment for the remaining 50% of the cost of the qualified asset. This means that the depreciation rules are the same for regular tax and AMT when bonus depreciation is claimed for an asset.

b. An S corporation that wanted to forgo claiming bonus depreciation in a prior tax year must have followed the appropriate procedures for electing out; otherwise, the depreciation was deemed allowed, regardless of whether the corporation actually claimed the deduction on the return.

c. An S corporation could elect to forgo bonus depreciation and, instead, claim additional minimum tax credits or research credits. This provision was added by the 2008 Economic Stimulus Act and extended by the 2009 Recovery Act to include assets placed in service in 2009 (2010 for certain assets).

CLAIMING BUSINESS BAD DEBT DEDUCTIONS

A deduction is allowed for business debts owed to an S corporation that become totally or partly worthless during the tax year. Business bad debts are (a) debts created or acquired in connection with a trade or business of the S corporation, such as accounts receivable, or (b) debts the losses from which are incurred in the S corporation's trade or business.

Accounts or trade receivables of an accrual method S corporation are deemed to be an enforceable obligation provided the related income has been recognized in the current or a prior tax year. However, a cash method S corporation must incur an actual cash loss to deduct a bad debt. This means that money or other property must have been transferred to another party.

Establishing a Bona Fide Debt Exists

To claim a bad debt deduction, the S corporation must establish that a bona fide debt actually exists. A bona fide debt is one arising from a debtor/creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable amount of money. A formal loan agreement is not necessary to create a bona fide debt. However, the S corporation must be able to show it was the intent of the parties at the time of the transfer to create a debtor/creditor relationship (i.e., there was a real expectation of repayment and an intent to enforce the debt).

The fact the debtor is a shareholder (or other related party) does not preclude a business bad debt deduction by the company. If an owner or related party loan made for legitimate business purposes becomes worthless, it is treated the same as a business debt to an unrelated party, assuming the loan meets the bona fide standard (that is, a debtor/creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable amount of money). Some of the factors for determining if a bona fide debt exists are whether there is a written note, a fair market rate of interest, a fixed repayment schedule, or a demand for repayment. The financial condition of the debtor at the time of the loan is also important so the S corporation can establish an expectation of repayment.

Proving Debt Is Worthless

The worthlessness of a debt is a question of fact. All pertinent evidence should be considered, including the value of any collateral and the financial condition of the debtor. Proof of worthlessness is best established by an identifiable event demonstrating the loss of value for the debt. While worthlessness can be established by suing the

debtor and obtaining an uncollectible judgment, when the facts indicate that legal action would in all probability not result in collection, proof of these facts is sufficient to justify the deduction.

Evidence that a debtor is experiencing financial difficulties does not, by itself, support an argument for worthlessness. However, the debtor's bankruptcy generally does indicate that a receivable or other unsecured business debt is at least partially worthless.

Deducting a Partially Worthless Debt

Before an S corporation can deduct a partly worthless business debt, it must be able to show that partial worthlessness has occurred and the amount of partial worthlessness has been charged off on the books of the business. The business may choose from among the following options.

- Claim a deduction for any portion of the debt up to the amount actually written off its books during the year. For example, if EasyCredit wrote off $10,000 of a $30,000 receivable due from Spendthrift for book purposes, it may claim a current year bad debt deduction related to the Spendthrift receivable for any amount up to $10,000. The requirement to record a book charge-off apparently means the portion charged off must no longer appear as an asset.

- Delay the tax write-off until a year later than the year it becomes clear the debt is partly worthless, if the applicable financial accounting rules permit. In the later year, the tax deduction is normally limited to an amount no greater than the amount charged off for book purposes during the year.

- Forgo a current year tax deduction for a partly worthless debt in favor of waiting until the balance of the debt is either collected or determined to be worthless. The business can claim a bad debt deduction for the entire uncollected amount at that time.

Deducting a Totally Worthless Debt

A totally worthless debt is deductible only in the tax year it becomes totally worthless. The deduction for the debt does not include any amount deducted in an earlier year when the debt was only partly worthless. While the S corporation apparently is not required to make an actual charge-off on its books to claim a bad debt deduction for a wholly worthless debt, it may want to do so in case the IRS later asserts the debt was only partly worthless and disallows even a partial deduction since no charge-off occurred.

If any doubt exists as to the proper tax year to claim a bad debt deduction, the authors recommend claiming the deduction in the earliest year it could possibly be allowed. The claim should be reviewed in a subsequent year (and an amended return filed for the original year) if facts indicate a later year is the proper one for claiming the deduction.

SELF-STUDY QUIZ

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

37. The domestic production activities deduction under IRC Sec. 199 for any qualifying taxpayer is what percent in 2010?

    a. 6%.

    b. 8%.

    c. 9%.

38. Which one of the S corporations in the scenarios below does not have DPGR from construction activities?

    a. Tower Realty has built a commercial building that was sold to a commercial real estate company and is currently in the leasing phase.

    b. Santos Corporation drills gas wells.

    c. Parc Realty has built a high rise residential condominium building. The condominium units are for sale rather than lease. The building was 80% pre-sold before construction started.

    d. Agather Company hauls debris from construction sites.

39. The S corporation can treat 100% of the proceeds from a construction project which includes the sale of land as domestic production gross receipts (DPGR) in which of the following circumstances?

    a. The S corporation derives 3% of total gross receipts from the project from the sale of the land.

    b. The S corporation derives 10% of total gross receipts from the project from the sale of the land.

40. Select from the S corporations described below, the one with domestic production gross receipts (DPGR).

    a. Sumtoca manufactures luggage in Mexico and sells the product outside the United States.

    b. Salty Nomore has a reverse osmosis operation that produces potable water off the coast of Thailand.

    c. Pro Agri produces rice in Japan.

    d. SHK prepares architectural drawings for construction projects within the borders of Washington State.

41. The accountant for Conglomerate 'R Us, a diverse corporation located in the United States with operations strictly within the U.S. borders, is calculating the total DPGR for Conglomerate 'R Us. The accountant has a worksheet with the following amounts, all represent gross receipts from the activity (,000 omitted):

Activity	Income	
Leasing	$	1,000
Product Sales	$	200,000
Intra-company license fees	$	30,000
Rentals from affiliated service group	$	5,000
Proceeds from film production	$	900,000

Calculate the total DPGR for Conglomerate 'R Us.

a. $245,000.

b. $1,101,000.

c. $1,106,000.

d. $1,136,000.

42. Gust Sails makes high tech sails for luxury sail boats and provides sail repair services which account for about 10% of its gross receipts. Gust Sails must allocate its income and deductions between its DPGR (sail making) and non-DPGR (sail repair services). Gust's gross receipts for the year are less than $5 million, so Gust qualifies to use the small business method to allocate cost of goods sold to its qualifying manufacturing activity. Using the small business method, calculate Gust's COGS allocation.

	Sail Making	Sail Repair	Total
Gross receipts	$3,500,000	$380,000	$3,880,000
Cost of Goods Sold	$2,100,000	$190,000	$2,290,000

a. $224,278.

b. $1,894,329.

c. $2,065,722.

d. $25,310,526.

43. Listed below are some definitions of wages. Which one applies for purposes of Section 199?

a. Wages up to the Social Security Tax Wage Base.

b. Wages subject to income tax withholding less employee elective deferrals and employee designated Roth IRA contributions.

c. Wages subject to income tax withholding plus employee elective deferrals and employee designated Roth IRA contributions.

d. Wages subject to income tax withholding plus employee elective deferrals, less employee designated Roth IRA contributions.

Use the following information to answer questions 44 and 45:

Art Patience and Alice Sanders are equal shareholders in Patience Sanders Manufacturing (PSM), a calendar year S corporation that generates DPGR and non-DPGR. While Alice has other manufacturing activities that generate DPGR and W-2 wages, Art does not.

In 200X, PSM has total costs of no more than $5 million, and so qualifies as an eligible small pass-through entity. It chooses to calculate QPAI and W-2 wages at the entity level, and under Rev. Proc. 2007-34 uses the small business simplified overall method to allocate costs. For 200X, 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. PSM uses the safe harbor under Temp. Reg. 1.199-2T(e)(2)(iii) to calculate W-2 wages. Accordingly, PSM's W-2 wages equal $200,000 [$400,000 of wages described in Reg. 1.199-2(e)(1) $\times$ ($1 million DPGR $\div$ $2 million total gross receipts)].

Under the small business simplified overall method, PSM's COGS and deductions apportioned to DPGR equal $800,000. So, JSP's QPAI is $200,000.

44. Calculate the amount of QPAI allocation to Art.

    a. $100,000.

    b. $200,000.

    c. $800,000.

45. What is the amount of Art's tentative domestic activities deduction?

    a. $6,000.

    b. $ 50,000.

    c. $100,000.

    d. $200,000.

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.)**

37. The domestic production activities deduction under IRC Sec. 199 for any qualifying taxpayer is what percent in 2010? **(Page 341)**

    a. 6%. [This answer is incorrect. 6% is the domestic production activities deduction percent applicable in 2007 through 2009 for any qualifying taxpayer.]

    b. 8%. [This answer is incorrect. The domestic production activities deduction under IRC Sec. 199 is not 8% in any year.]

    c. 9%. [This answer is correct. 9% is the appropriate domestic production activities deduction percent in year 2010 and years thereafter.]

38. Which one of the S corporations in the scenarios below does not have DPGR from construction activities? **(Page 343)**

    a. Tower Realty has built a commercial building that was sold to a commercial real estate company and is currently in the leasing phase. [This answer is incorrect. Tower Realty has DPGR from the construction business because it builds and sells real property.]

    b. Santos Corporation drills gas wells. [This answer is incorrect. Drilling gas wells constitutes DPGR construction activities for real property.]

    c. Parc Realty has built a high rise residential condominium building. The condominium units are for sale rather than lease. The building was 80% pre-sold before construction started. [This answer is incorrect. Parc Realty derives DPGR from construction activities because it sells constructed real property within 60 months from the date of the certificate of occupancy.]

    d. Agather Company hauls debris from construction sites. [This answer is correct. Since Agather Company merely hauls debris and does not actually construct any buildings, Agather Company does not derive DPGR from construction activities.]

39. The S corporation can treat 100% of the proceeds from a construction project which includes the sale of land as domestic production gross receipts (DPGR) in which of the following circumstances? **(Page 343)**

    a. The S corporation derives 3% of total gross receipts from the project from the sale of the land. [This answer is correct. Since the S corporation only derives 3% of total gross receipts from the project from the sale of the land (below the 5% threshold), it can treat 100% of the proceeds as DPGR.]

    b. The S corporation derives 10% of total gross receipts from the project from the sale of the land. [This answer is incorrect. The S corporation can treat 100% of the proceeds from a construction project that includes the sale of the land as DPGR if the S corporation derives *less than 5*% of total gross receipts from the project from the sale of the land.]

40. Select from the S corporations described below, the one with domestic production gross receipts (DPGR). **(Page 344)**

    a. Sumtoca manufactures luggage in Mexico and sells the product outside the United States. [This answer is incorrect. To have DPGR, Sumtoca would need to manufacture the product within the United States.]

    b. Salty Nomore has a reverse osmosis operation that produces potable water off the coast of Thailand. [This answer is incorrect. The production of potable water would need to occur in the U.S.]

c. Pro Agri produces rice in Japan. [This answer is incorrect. Crops grown outside the United States would not result in DPGR.]

d. SHK prepares architectural drawings for construction projects within the borders of Washington State. [This answer is correct. Architectural or engineering services performed in the U.S. for construction projects also in the U.S. will result in DPGR.]

41. The accountant for Conglomerate 'R Us, a diverse corporation located in the United States with operations strictly within the U.S. borders, is calculating the total DPGR for Conglomerate 'R Us. The accountant has a worksheet with the following amounts, all represent gross receipts from the activity **(Page 344)**

Activity	Income
Leasing	$ 1,000
Product Sales	$ 200,000
Intra-company license fees	$ 30,000
Rentals from affiliated service group	$ 5,000
Proceeds from film production	$ 900,000

Calculate the total DPGR for Conglomerate 'R Us.

a. $245,000. [This answer is incorrect. Omitting film production would not result in a correct calculation of DPGR. Income from film production is included in the list or additional activities which qualify for DPGR.]

b. $1,101,000. [This answer is correct. This answer properly omits the income from related party transactions. The income from intra-company license fees and rentals from affiliated service groups should not be included in the DPGR calculation.]

c. $1,106,000. [This answer is incorrect. The proper calculation of DPGR, in this example, would not include rentals from a related party per IRC Sec. 199(c)(7).]

d. $1,136,000. [This answer is incorrect. Not all of the income from the activities listed should be included in the DPGR calculation per IRC Sec. 199(c)(7).]

42. Gust Sails makes high tech sails for luxury sail boats and provides sail repair services which account for about 10% of its gross receipts. Gust Sails must allocate its income and deductions between its DPGR (sail making) and non-DPGR (sail repair services). Gust's gross receipts for the year are less than $5 million, so Gust qualifies to use the small business method to allocate cost of goods sold to its qualifying manufacturing activity. Using the small business method, calculate Gust's COGS allocation. **(Page 344)**

	Sail Making	Sail Repair	Total
Gross receipts	$3,500,000	$380,000	$3,880,000
Cost of Goods Sold	$2,100,000	$190,000	$2,290,000

a. $224,278. [This answer is incorrect. According to Reg. 1.199-4(f), the proper formula is not [($380,000 / $3,880,000) × $2,290,000.]

b. $1,894,329. [This answer is incorrect. According to Reg. 1.199-4(f), the proper formula is not [($3,500,000 / $3,880,000) × $2,100,000.]

c. $2,065,722. [This answer is correct. The proper formula is [($3,500,000 / $3,880,000) × $2,290,000.]

d. $25,310,526. [This answer is incorrect. According to Reg. 1.199-4(f), the proper formula is not [($2,100,000 / $190,000) × $2,290,000.]

43. Listed below are some definitions of wages. Which one applies for purposes of Section 199? **(Page 347)**

a. Wages up to the Social Security Tax Wage Base. [This answer is incorrect. For purposes of applying Section 199, the definition of wages includes more than the Social Security Tax Wage Base.]

b. Wages subject to income tax withholding less employee elective deferrals and employee designated Roth IRA contributions. [This answer is incorrect. This answer choice does not give proper treatment to employee elective deferrals and employee designated Roth IRA contributions.]

c. Wages subject to income tax withholding plus employee elective deferrals and employee designated Roth IRA contributions. [This answer is correct. This answer choice properly includes all wage categories necessary to apply Section 199. The wages must be actually reported on form W-2 and filed with the Social Security Administration.]

d. Wages subject to income tax withholding plus employee elective deferrals, less employee designated Roth IRA contributions. [This answer is incorrect. This answer choice does not give proper treatment to both employee elective deferrals and employee designated Roth IRA contributions.]

Use the following information to answer questions 44 and 45:

Art Patience and Alice Sanders are equal shareholders in Patience Sanders Manufacturing (PSM), a calendar year S corporation that generates DPGR and non-DPGR. While Alice has other manufacturing activities that generate DPGR and W-2 wages, Art does not.

In 200X, PSM has total costs of no more than $5 million, and so qualifies as an eligible small pass-through entity. It chooses to calculate QPAI and W-2 wages at the entity level, and under Rev. Proc. 2007-34 uses the small business simplified overall method to allocate costs. For 200X, PSM 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. PSM uses the safe harbor under Temp. Reg. 1.199-2T(e)(2)(iii) to calculate W-2 wages. Accordingly, PSM'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, PSM's COGS and deductions apportioned to DPGR equal $800,000. So, PSM's QPAI is $200,000.

44. Calculate the amount of QPAI allocation to Art. **(Page 348)**

a. $100,000. [This answer is correct. The total QPAI is allocated 50% to Allison as an equal partner in PSM.]

b. $200,000. [This answer is incorrect. This answer does not allocate the QPAI properly.]

c. $800,000. [This answer is incorrect. This is the amount of GOGS and deductions apportioned to DPGR.]

45. What is the amount of Art's tentative domestic activities deduction? **(Page 348)**

a. $6,000. [This answer is correct. Art's share of QPAI is multiplied by 6% to arrive at the amount of his tentative deduction.]

b. $50,000. [This answer is incorrect. This amount represents the 50% wage limitation under Section 199.]

c. $100,000. [This answer is incorrect. This is the total allocation to Art as an equal shareholder. However, the amount of Art's tentative deduction would be less than $100,000.]

d. $200,000. [This answer is incorrect. This is the total amount of the QPAI prior to allocation to the equal partners.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TSCTG103)

Determine the best answer for each question below. Then mark your answer choice on the **Examination for CPE Credit Answer Sheet** located in the back of this workbook or by logging onto the Online Grading System.

23. The S corporations in the following scenarios are using the cash basis of accounting. Which one will be able to fully deduct the expense in the year paid?

    a. Treading Water, Inc. issues a note to their supplier in payment of merchandise delivered.

    b. Underwater, Inc. makes payments for additional inventory using borrowed funds.

    c. Lack of Water, Inc. pays the supplier with a check that is subsequently denied by the bank.

    d. Too Much Water, Inc. pays two years of rent in advance.

24. Big Bands, an S corporation using the accrual method of accounting has delivered the biggest order in their short business history. The accountant knows the transaction must meet two tests to report the income under the accrual method. The first test is that the events that fix the company's right to receive income has occurred (which it has). What is the second test?

    a. The amount of income can be determined with reasonable accuracy.

    b. The amount of income can be determined with precise accuracy.

    c. The funds have been transferred to Big Bands bank account.

    d. Big Bands confirms the customer has mailed the payment check.

25. Listed below are some attributes of the accrual method of accounting. Which one is an advantage?

    a. The accrual method of accounting requires more recordkeeping than the cash method.

    b. The accrual method of accounting is complex.

    c. The accrual method of accounting matches income and expense in the appropriate year.

    d. The accrual method of accounting produces a less certain result.

26. All of the following companies can elect to report gross profit from the sale of inventories under the installment method **except:**

    a. The Expensive Appliance Store, which maintains an inventory of very large refrigerators, sold their top of the line model on March 1, 200X.

    b. Countryside Lots has residential timeshares available.

    c. Rio Ropo raises cattle.

    d. Do not select this answer choice.

27. Teo, the accountant for Bon 2 Bon Corporation, is reading Rev. Proc. 2001-10 to try and determine what steps to take to meet the owner's request to convert the current accrual method S corporation to the cash method. Listed below are some steps Teo will take. Help Teo with his job by placing the steps in order.

    i. Decide whether to claim the positive Section 481(a) adjustment over four years or report the entire amount in the year of change.

    ii. File a copy of Form 3115 (Change in Accounting Method) with the IRS National Office.

    iii. File Form 3115 with the first tax return for which the cash method is used.

    iv. Write "Filed under Rev. Proc. 2001-10" at the top of the page.

    v. Complete Form 3115.

    a. i, iv, v, ii and iii.

    b. i, iii, ii, iv and v.

    c. i. v, iv, ii, and iii.

    d. i, ii, iii, iv and v.

28. Elasticorp, an S corporation using the cash method of accounting has failed the gross receipts test and must convert back to the accrual method of accounting. Calculate the average annual gross receipts for 2009 for Elasticorp.

Year	**Amount of Gross Receipts**
2005	$600,000
2006	$900,000
2007	$1.1 million
2008	$1.5 million

    a. $866,669.

    b. $1.167 million.

    c. $2.6 million.

    d. $4.1 million.

29. When calculating average gross receipts under Rev. Proc. 2002-28, which statement is most accurate?

    a. A taxpayer may qualify for the cash method of accounting under Rev. Proc. 2002-28 if the taxpayer has annual average gross receipts of $20 million or less.

    b. Taxpayers treated as a single employer under IRC Secs. 52(a) or (b) or 414(m) or (o) are treated as multiple employers for purposes of the gross receipts test under Rev. Proc. 2002-28.

    c. If a taxpayer has been in existence less than three years, it cannot use Rev. Proc. 2002-28.

    d. If a taxpayer has been in existence less than three years, it determines its average annual gross receipts for the number of years it has been in existence and annualizes gross receipts for the short tax year.

30. Select the inventory method prohibited under Rev. Proc. 2002-28.

    a. Average cost.

    b. FIFO.

    c. LIFO.

    d. Specific identification.

31. Rev. Proc. 2004-34 specifically excludes all of the following from the definition of advance payments eligible for deferral **except**:

    a. Rent.

    b. Insurance Premiums.

    c. Prepayments of interest on financial instruments.

    d. Payments for services.

32. Name the two tests a liability must meet to qualify as a recurring item.

    a. It is immaterial in amount. –Or– It is better matched to income in the earlier year.

    b. Provided to the S corporation. –Or– Provided by the S corporation.

    c. All events that fix the obligation have occurred. –Or– The amount can be determined with reasonable accuracy.

    d. It occurs in a fiscal year after July 1, 1974. –Or– The deferral period was more than 3 months.

33. Salcorp, a calendar year, accrual-method S corporation pays $1,500 of equipment rental to its sole shareholder, Salmon, on the first day of the new tax year. The equipment rental payment had been properly accrued but Salcorp cannot take the deduction until the rent is paid. This scenario describes which of the following?

    a. Placing the S corporation on cash basis for certain expense paid to shareholder.

    b. Mismatching of income and expense when S corporation and shareholder use different years.

    c. Timing payments to accelerate the shareholder's income.

    d. Timing payments to accelerate the S corporation's income.

34. Capitalized amounts for created intangible assets should be amortized for how long?

    a. 10 years.

    b. 15 years.

    c. 20 years.

    d. 25 years.

35. Under IRC Sec. 263(a) and the related proposed regulations, three categories of cost are identified that result in an improvement to property that must be capitalized. In which of the following scenarios does the activity result in a betterment to the unit of property?

    a. Samintosh, Inc. routinely performs maintenance to the machines that produce wire rope.

    b. Infortum, Inc. purchased materials and supplies necessary to perform procedures which when completed, will cause the Widgit machine to improve output to the levels attained when the machine was new.

    c. Boaston Corporation purchased an apparatus which when applied to the postage handling machine will increase the size of the machine by three cubic feet.

    d. Kelton Corporation converted their architectural rendering machine from producing two dimensional drawings to producing three dimensional designs.

36. The nonaccrual experience method has several safe harbor methods of accounting. Which of the following definitions below is the modified six-year moving average method?

    a. The income amount not accrued is determined by a formula based on the taxpayer's experience over the current and preceding five tax years. When the receivable is collected, any amount that was not expected to be collected must be taken into income.

    b. The accounts receivable at the beginning of a year are tracked to determine what percentage of those accounts was actually never collected.

    c. The uncollectible amount is computed by first determining the ratio of bad debts charged off for the current year and the five preceding tax years relative to the total accounts receivable at the end of those years. This ratio is applied to the outstanding receivables at the end of the current tax year. The resulting amount is then reduced by the receivables generated and written off during the current tax year to arrive at the current year uncollectible amount.

    d. The taxpayer determines the uncollectible amount by multiplying its ending accounts receivable by a percentage which is computed by dividing the sum of net bad debts for the current and five preceding years by the sum of the receivables at the end of the current and five preceding years.

37. Newby Tax Accountant is attempting to discern which of the firm's clients will be eligible for the DPAD. Help Newby with this determination by sorting the clients into the correct classification. For purposes of this question, assume all client activities occur in the United States.

    I. Slowsilver Corporation is involved with the extraction of natural gas.

    II. Greenbelt Development Corporation builds roads and water systems.

    III. Cottin' Pickin' Company hauls cotton bails to the cotton gin.

    IV. ABC Packaging Corporation repackages music CDs into multi-units for sale by a warehouse wholesale club.

    a. Only Slowsilver Corporation is eligible for the domestic activities deduction.

    b. Both Slowsilver and Greenbelt Development Corporation are eligible for the domestic activities deduction.

    c. Both Greenbelt Development Corporation and Cottin' Pickin' Company are eligible for the domestic activities deduction.

    d. Both Cottin' Pickin' Company and ABC Packaging Corporation are eligible for the domestic activities deduction.

38. Camden–Lucas Architectural Services provides designs for job sites across the globe. What percent of Camden–Lucas' gross receipts from services performed outside the U.S. will be disqualified as DPGR?

    a. 1%.

    b. 2%.

    c. 3%.

    d. 5%.

39. Which of the following sources of gross receipts is **excluded** from DPGR?

    a. The S corporation's gross receipts from the exchange of QPP manufactured in the U.S.

    b. Income from qualified film produced by the taxpayer.

    c. Gross receipts from a related party rental, lease, or license.

    d. Engineering services performed in the U.S. for U.S. construction projects.

40. The final Section 199 regulations provide three methods for allocating and apportioning deductions. Which of the following is **not** one of those three methods provided?

    a. The Section 861 method.

    b. The simplified deduction method.

    c. The small business simplified overall method.

    d. The domestic production activities deduction method.

41. Gust Sails makes high tech sails for luxury sail boats and provides sail repair services which account for about 10% of its gross receipts. Gust Sails must allocate its income and deductions between its DPGR (sail making) and non-DPGR (sail repair services). Gust's gross receipts for the year are less than $5 million, so Gust qualifies to use the small business method to allocate cost of goods sold to its qualifying manufacturing activity. Using the small business method, calculate Gust's QPAI.

	Sail Making	Sail Repair	Total
Gross receipts	$1,750,000	$190,000	$1,940,000
Cost of Goods Sold	$1,050,000	$95,000	$1,145,000

    a. $700,000.

    b. $717,139.

    c. $1,032,860.

    d. $1,578,608.

42. Rev. Proc. 2007-35 makes it clear that statistical sampling will generally be allowed to make allocations when the taxpayer can show _____.

    a. The cost of the analysis of data.

    b. The availability of more accurate information.

    c. A compelling need.

    d. The time required to analyze large volumes of data.

43. Which of the following methods for computing the W-2 wages for purposes of the domestic production activities deduction is the most complex?

    a. Check the Box Method.

    b. Unmodified Box Method.

    c. Modified Box 1 Method.

    d. Tracking Wages Method.

44. Listed below are the steps necessary to compute the domestic production activities deduction. Put them in sequence.

    I. Compute the wages limitation.

    II. Compute the tentative deduction.

    III. Compare QPAI to taxable income and select the lower amount.

    IV. Compare the results from the steps above and deduct the lesser amount.

    a. I, II, III, IV.

    b. II, III, IV, I.

    c. III, II, I, IV.

    d. IV, III, II, I.

45. Select the statement which best describes the Section 199 pass-through rules.

    a. An S corporation shareholder who engages in other production activities generating DPGR must combine the share of QPAI and W-2 wages from all sources.

    b. An S corporation that qualifies as both an eligible widely-held pass-thru entity and an eligible small pass-through entity for the year must use the simplified deduction method of Reg. 1.199-4(f) to calculate QPAI.

    c. S corporation shareholders receiving an allocation of QPAI and W-2 wages are eligible to recalculate their share of either QPAI or W-2 wages.

    d. The domestic production activities deduction will reduce a shareholder's basis in an S corporation.

GLOSSARY

25% test: The test requires that the company receive 25% or more of its annual gross income within a two-month period for three consecutive years. If this condition is met, the company can choose the fiscal year that corresponds with the end of the two-month period.

Accrual basis of accounting: An accrual-basis S corporation can deduct an expense only when (a) all events that determine the fact of the liability have occurred and the amount is determinable with reasonable accuracy (i.e., the all-events test); and (b) economic performance has taken place. Under the accrual method of accounting, income is reported in the tax year earned. This is the tax year in which both of the following tests are satisfied:

a. All events that fix the company's right to receive the income have occurred.

b. The amount of income can be determined with reasonable accuracy.

Advance payments: Advance payments eligible for deferral:

a. Payments for services.

b. Payments for the sale of goods.

c. Payments for the use of intellectual property.

d. Payments for the occupancy or use of property if the occupancy or use is ancillary to the provision of services (for example, hotels, banquet facilities, etc.).

e. Payments for the sale, lease or license of computer software.

f. Payments for guaranty or warranty contracts ancillary to any other permitted payment.

g. Payments for subscriptions (other than those for which an election under IRC Sec. 455 is in effect), whether or not provided in a tangible or intangible format.

h. Payments for membership in an organization.

Architectural services: DPGR includes gross receipts from engineering or architectural services performed in the U.S. for construction projects in the U.S. The S corporation 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.

Automatic approval provisions: The IRS will automatically approve tax years under four sets of circumstances:

a. The S corporation is adopting, changing to, or retaining a calendar year.

b. The S corporation is adopting, retaining, or changing to a fiscal year that is considered a natural business year because it meets the objective 25% test described in Rev. Proc. 2006-46.

c. The S corporation is adopting, retaining, or changing to an ownership tax year because it is the same as the fiscal year used by shareholders who own more than half its shares.

d. The S corporation is changing to a certain 52-53 week year.

Average Gross Receipts: To satisfy the gross receipts test, the average annual gross receipts of the taxpayer must be no more than $1 million. Specifically, for each prior tax year ending after December 16, 1998, the taxpayer's average annual gross receipts must be $1 million or less for the three-tax-year period ending with the prior tax year.

Business reasons for a fiscal year: In the following situations, the taxpayer did establish a business purpose for the use of its requested tax year:

a. The taxpayer established that the tax year satisfied the 25% gross receipts test and resulted in less deferral than its other natural business year.

b. The taxpayer would have established a natural business year under the 25% gross receipts test except that a labor strike closed the taxpayer's business during a period that included its normal peak season.

c. For the past 10 years, the taxpayer had a three-month period of insignificant gross receipts during which, due to weather conditions, its business was not operational.

d. The taxpayer, who previously used the cash method of accounting but changed to the accrual method, would have established a natural business year under the 25% gross receipts test if it had calculated its gross receipts using the accrual method.

Cash method of accounting: Under the cash method, income is reported when it is actually or constructively received.

Constructive receipt: Income is constructively received when the cash is credited to an account or made available without restriction.

Deferral ratio: Ratio that the number of months in the deferral period of the applicable election year bears to 12 months.

Denied S Election: Denial results in the entity becoming a C corporation in its first year, and the corporation would then be subject to the built-in gains tax provisions when it elects S status for its second year.

Domestic production activities deduction: The deduction is available to corporations, partnerships, and limited liability companies, among other entities. The appropriate percentage (9% after 2009) is applied to the lesser of the S corporation's:

a. qualified production activities income (QPAI) for the tax year; or

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

Grandfathered fiscal year: An S corporation that used a fiscal year for the year that began in 1986 can continue using that fiscal year if the Section 444 election was made by July 26, 1988. Also, an S corporation that received IRS permission to use a fiscal year on or after July 1, 1974, can retain that fiscal year if the fiscal year did not end on September 30, October 31, or November 30. The Section 444 election does not have to be made.

Installment method: There are three situations where the company may elect to report gross profit from dealer or inventory sales under the installment method:

a. Pre-March 1986 Sales.

b. Residential Lots and Timeshares.

c. Property Used or Produced in a Farming Business.

LIFO: Last in, first out (LIFO) inventory accounting method.

Modified six-year moving average method: The taxpayer determines the uncollectible amount by multiplying its ending accounts receivable by the modified six-year moving average percentage. That percentage is computed by dividing the sum of net bad debts for the current and five preceding years (except that bad debts charged off in the same year the receivable was generated are not counted) by the sum of the receivables at the end of the current and five preceding years.

Natural business year: The natural business year ends with the two-month period that has the highest average percentage of gross receipts.

Penalties. Required payments under Section 444 are not deductible by the S corporation or by the shareholders. Instead, required payments are in the nature of deposits. The S corporation receives no interest on them, but interest is charged on underpayments. Required payments can be subject to the 10% underpayment penalty and the negligence and fraud penalties of Sections 6662–6664.

Permitted year: A permitted year is a tax year that:

a. ends on December 31, or

b. is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS.

QPAI: QPAI equals the S corporation's domestic production gross receipts (DPGR) for the year, reduced by (a) the cost of goods sold allocable to those receipts; and (b) other expenses, losses, or deductions (other than the producer deduction itself) that are properly allocable to those receipts.

Recurring Item: A liability can qualify as a recurring item if it is reasonable to expect the same item will be incurred on a recurring basis in the future.

Repair allowance method: Instead of determining whether an expense is deductible or capitalizable, the proposed regulations would permit a taxpayer to elect to use the repair allowance method (RAM), which would treat most amounts paid for repairing, maintaining, or improving tangible property as deductible to the extent they do not exceed the repair allowance for the MACRS class of the property, and capitalizable to the extent the costs exceed the repair allowance for that class of the property.

Section 199 pass through: The U.S. producer deduction is determined at the shareholder level. As a result, each shareholder computes the deduction separately.

Section 444 Election: IRC Sec. 444 allows an S corporation to elect to use a fiscal year if it meets certain criteria.

Section 861 method: The Section 861 method requires allocations under different methods for different types of expenses. The S corporation has to allocate its deductions to the relevant class of gross income (such as gross income derived from a business or derived from services) and then apportion the deductions within the class of gross income between DPGR (the statutory grouping) and non-DPGR (the residual grouping).

Short tax year: Changing to a fiscal year or changing from a fiscal year to a calendar year can create short tax years. Short tax years also are frequently involved when a C corporation elects S status or when a corporation voluntarily or involuntarily terminates its S election. Reorganization and recapitalization transactions may result in short tax years for the corporate parties involved. A sale or other disposition of stock by an S corporation shareholder to an ineligible shareholder may terminate the corporation's S status and thus cause a short tax year. Finally, a short-period return is often involved when an S corporation is liquidated.

Statistical sampling method for allocations: The calculation of allocable expenses and QPAI can be burdensome, particularly where large amounts of data are involved. To provide some relief, Rev. Proc. 2007-35 permits the use of statistical sampling 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.

Tracking wages method: This is the most complex method for determining W-2 wages for purposes of Section 199, since it requires the S corporation to track total wages subject to federal income tax withholding and then make appropriate modifications.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Tax Planning Guide—S Corporations—Course 1—Pass-through to Shareholders and Basis and Losses (TSCTG101)

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2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 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 $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **May 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **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

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The 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 each lesson, 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.

Page

CPE Examination Questions (Lesson 1) **305**

CPE Examination Questions (Lesson 2) **359**

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Tax Planning Guide—Course 3—Tax Accounting Methods for S Corporations (TSCTG103)

CTEC Course No. 3039-CE-0253
Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	13.	○	○	○	○	24.	○	○	○	○	35.	○	○	○	○
2.	○	○	○	○	14.	○	○	○	○	25.	○	○	○	○	36.	○	○	○	○
3.	○	○	○	○	15.	○	○	○	○	26.	○	○	○	○	37.	○	○	○	○
4.	○	○	○	○	16.	○	○	○	○	27.	○	○	○	○	38.	○	○	○	○
5.	○	○	○	○	17.	○	○	○	○	28.	○	○	○	○	39.	○	○	○	○
6.	○	○	○	○	18.	○	○	○	○	29.	○	○	○	○	40.	○	○	○	○
7.	○	○	○	○	19.	○	○	○	○	30.	○	○	○	○	41.	○	○	○	○
8.	○	○	○	○	20.	○	○	○	○	31.	○	○	○	○	42.	○	○	○	○
9.	○	○	○	○	21.	○	○	○	○	32.	○	○	○	○	43.	○	○	○	○
10.	○	○	○	○	22.	○	○	○	○	33.	○	○	○	○	44.	○	○	○	○
11.	○	○	○	○	23.	○	○	○	○	34.	○	○	○	○	45.	○	○	○	○
12.	○	○	○	○															

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: May 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Tax Planning Guide—Course 3—Tax Accounting Methods for S Corporations

Course Acronym: TSCTG103

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

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?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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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