

CHAPTER

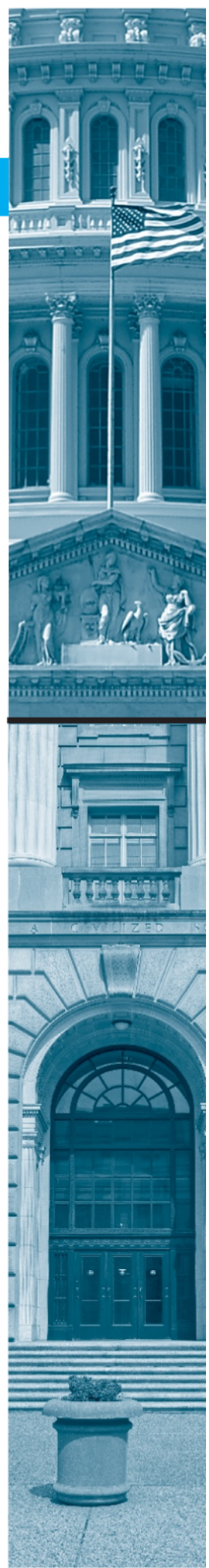
11

S CORPORATIONS

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- 1 Discuss the advantages and disadvantages of making the S election
- 2 List the requirements for being eligible to elect S corporation status
- 3 Explain how a corporation elects, revokes, or terminates S corporation status
- 4 Classify an S corporation's ordinary and separately stated items, and calculate special S corporation taxes
- 5 Allocate an S corporation's ordinary and separately stated items to its shareholders and apply loss limitation rules
- 6 Calculate a shareholder's basis in his or her S corporation stock and debt
- 7 Determine the taxability of an S corporation's distributions to its shareholders
- 8 Explain other rules that pertain to S corporations
- 9 Identify tax planning opportunities for an S corporation and its shareholders
- 10 Comply with S corporation procedural and filing requirements



CHAPTER OUTLINE

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This chapter discusses a special type of corporate entity known as an S corporation. The S corporation rules, located in Subchapter S of the Internal Revenue Code, permit small corporations to enjoy the nontax advantages of the corporate form of organization without being subject to the possible tax disadvantages of the corporate form (e.g., double taxation when the corporation pays a dividend to its shareholders). When enacting these rules, Congress stated three purposes:

- To permit businesses to select a particular form of business organization without being influenced by tax considerations
- To provide aid for small businesses by allowing the income of the business to be taxed to shareholders rather than being taxed at the corporate level
- To permit corporations realizing losses to obtain a tax benefit of offsetting the losses against income at the shareholder level¹

As discussed in Chapter C:2, S corporations are treated as corporations for legal and business purposes. For federal income tax purposes, however, they are treated much like partnerships.² As in a partnership, the profits and losses of the S corporation pass through to the owners, and the S corporation can make nontaxable distributions of earnings previously taxed to its shareholders. Although generally taxed like a partnership, the S corporation still follows many of the basic Subchapter C tax provisions (e.g., S corporations use the corporate tax rules regarding formations, liquidations, and nontaxable reorganizations instead of the partnership rules). A tabular comparison of the S corporation, partnership, and C corporation rules appears in Appendix F.

Changes over the past several years have caused many businesses to reexamine the implications of an S election. First, the restrictive nature of the S corporation requirements has caused many new businesses that were potential S corporations to look at alternative business forms. All 50 states have adopted limited liability company (LLC) legislation. LLCs offer many of the same tax advantages of S corporations because they are treated as partnerships. LLCs, however, are not subject to the same requirements that an S corporation and its shareholders must satisfy to make and retain an S election. Partially because of the S corporation restrictions, some new businesses have organized as LLCs to take advantage of the greater operational flexibility the LLC form provides the entity and its owners, as well as its liability protection. A number of small businesses, however, elected to be S corporations because of the greater certainty available within the legal system for corporate entities.

Over the last several years, tax legislation has relaxed restrictions and increased the S corporation's popularity. For example, the shareholder limit was increased to 100, and the prohibitions against certain entities and trusts becoming S corporation shareholders were lessened. Moreover, current law now treats family members as one shareholder for the 100-shareholder limit. In effect, these changes have reduced some of the differences between S corporations and LLCs and have renewed interest in the S corporation form of doing business.

For many existing C corporations, the tax cost of liquidating the corporate entity and creating an LLC may be a prohibitively expensive way to avoid the corporate level income tax (see Chapter C:6). However, many of these C corporations have taken the next best alternative, that is, making an S election.

This chapter examines the requirements for making an S election and the tax rules that apply to S corporations and their shareholders.

ADDITIONAL COMMENT

An LLC (or partnership) that wishes to be treated as an S corporation can file the S election (Form 2553) and automatically be classified as an association (corporation) under the check-the-box regulations without having to file the entity classification election (Form 8832).

¹ S. Rept. No. 1983, 85th Cong., 2d Sess., p. 87 (1958).

² Some states do not recognize an S corporation as a conduit for state income

tax purposes. Instead, they are taxed under the state income tax laws in the same manner as a C corporation.

SHOULD AN S ELECTION BE MADE?

OBJECTIVE 1

Discuss the advantages and disadvantages of making the S election

ADDITIONAL COMMENT

The applicable capital gains tax rate for net capital gains and qualified dividends of noncorporate taxpayers depends on the taxpayer's filing status and level of taxable income (see the Quick Reference section of the text). Also, 25% and 28% rates apply for gains on certain types of property. In addition, an incremental 3.8% rate applies to net investment income for taxpayers whose modified AGI exceeds \$200,000 (\$250,000 for married filing jointly). Net investment income includes, among other things, interest, dividends, annuities, royalties, rents, and net gains from the disposition of property not used in a trade or business, all reduced by deductions allocable to such income or gains.

REAL-WORLD EXAMPLE

The number of S corporations has grown from 725,000 in 1985 to 4.84 million in 2017.

KEY POINT

The structure of an S corporation can create a real hardship for a shareholder if large amounts of income pass through without any compensation payments or distributions of cash to help pay the tax on the income.

ADVANTAGES OF S CORPORATION TREATMENT

A number of advantages are available to a corporation that makes an S election.

- ▶ The corporation's income is exempt from the corporate income tax. An S corporation's income is taxed only to its shareholders, whose tax bracket may be lower than a C corporation's tax bracket.
- ▶ Shareholders may be eligible for the 20% qualified business income (QBI) deduction.
- ▶ The corporation's losses pass through to its shareholders and can be used to reduce the taxes owed on other types of income. This feature can be especially important for new businesses. The corporation can make an S election, pass through the start-up losses to the owners, and terminate the election once a C corporation becomes advantageous.
- ▶ Undistributed income taxed to the shareholder is not taxed again when subsequently distributed unless the distribution exceeds the shareholder's basis for his or her stock.
- ▶ Capital gains, dividends, and tax-exempt income are separately stated and retain their character when passed through to the shareholders. Such amounts become commingled with other corporate earnings and are taxed as dividends when distributed by a C corporation. However, the applicable capital gains tax rate on qualified dividends may alleviate the detrimental tax effect of C corporation dividends.
- ▶ Deductions, losses, and tax credits are separately stated and retain their character when passed through to the shareholders. These amounts may be subject to the various limitations at the shareholder level. This treatment can permit the shareholder to claim a tax benefit when it otherwise would be denied to the corporation (e.g., a shareholder can claim the general business credit benefit even though the S corporation reports a substantial loss for the year).
- ▶ Splitting the S corporation's income among family members is possible. However, income splitting is restricted by the requirement that reasonable compensation be provided to family members who provide capital and services to the S corporation.
- ▶ An S corporation's earnings that pass through to the individual shareholders are not subject to the self-employment tax. In contrast, a partnership must determine what portion of each general partner's net earnings constitutes self-employment income.
- ▶ An S corporation is not subject to the personal holding company tax or the accumulated earnings tax (although, as discussed later, passive income can trigger a corporate-level tax in special circumstances).

DISADVANTAGES OF S CORPORATION TREATMENT

A number of tax disadvantages also exist for a corporation that makes an S election.

- ▶ An S corporation shareholder's marginal tax rate on pass-through income may be higher than the 21% tax rate that would apply if the entity were a C corporation.
- ▶ The S corporation's earnings are taxed to the shareholders even though they are not distributed. This treatment may require the corporation to make distributions or salary payments so the shareholder can pay taxes owed on the S corporation's earnings.
- ▶ S corporations are subject to an excess net passive income tax and a built-in gains tax. Partnerships are not subject to either of these taxes.
- ▶ Dividends received by the S corporation are not eligible for the dividends-received deduction, as is the case for a C corporation.
- ▶ Allocation of ordinary income or loss and the separately stated items is based on the stock owned on each day of the tax year. Special allocations of particular items are not permitted, as they are in a partnership.

TAX STRATEGY TIP

With the top 37 % individual marginal tax rate now significantly above the 21% corporate marginal tax rate, S corporations with positive income may be less attractive to high-bracket individuals than would C corporations, but S corporations with losses may be more attractive than would C corporations. Assuming an S corporation shareholder has sufficient offsetting income (and loss limitations do not apply), he or she could use the loss pass-through immediately at a high tax savings whereas a C corporation might have to carry over the loss to offset income in later years at a low tax savings.

- ▶ The loss limitation for an S corporation shareholder is smaller than for a partner in a partnership because of the treatment of liabilities. Shareholders can increase their loss limitations by the basis of any debt they loan to the S corporation. Partners, on the other hand, can increase their loss limitation by their ratable share of all partnership liabilities.
- ▶ S corporation shareholders are subject to the at-risk, passive activity, and excess business loss limitations. C corporations generally are not subject to these rules.
- ▶ An S corporation is somewhat restricted in the type and number of shareholders it can have and the capital structure it can use. Partnerships and C corporations are not so restricted.
- ▶ S corporations must use a calendar year as their tax year unless they can establish a business purpose for a fiscal year or unless they make a special election to use an otherwise nonpermitted tax year. Similar restrictions also apply to partnerships.

Once the owners decide to incorporate, no general rule determines whether the corporation should make an S election. Before making a decision, management and the shareholders should examine the long- and short-run tax and nontax advantages and disadvantages of filing as a C corporation versus filing as an S corporation.

S CORPORATION REQUIREMENTS

OBJECTIVE 2

List the requirements for being eligible to elect S corporation status

The S corporation requirements are divided into two categories: shareholder-related and corporation-related requirements. A corporation that satisfies all the requirements is known as a small business corporation. Only small business corporations can make an S election. Each set of requirements is outlined below.

SHAREHOLDER-RELATED REQUIREMENTS

Three shareholder-related requirements must be satisfied on each day of the tax year.³

- ▶ The corporation must not have more than 100 shareholders.
- ▶ All shareholders must be individuals, estates, certain tax-exempt organizations, or certain kinds of trusts.
- ▶ None of the individual shareholders can be classified as a nonresident alien.

100-Shareholder Rule. For purposes of applying the 100-shareholder limit, members of a family (and their estates) count as one shareholder. Members of a family include the common ancestor, lineal descendants of the common ancestor, spouses (or former spouses) of the common ancestor or lineal descendants, and estates of family members. An individual will not be considered a common ancestor if he or she is more than six generations removed from the youngest generation of family member shareholders. When two unmarried or nonfamily individuals own stock jointly (e.g., as tenants in common or as joint tenants), each owner is considered a separate shareholder.

Eligible Shareholders. C corporations and partnerships cannot own S corporation stock. This restriction prevents a corporation or a partnership having a large number of owners from avoiding the 100-shareholder limitation by purchasing S corporation stock and being treated as a single shareholder. Organizations exempt from the federal income tax under Sec. 501(a) (e.g., a tax-exempt public charity or private foundation) can hold S corporation stock, and each such organization counts as one shareholder when calculating the 100-shareholder limit.

ADDITIONAL COMMENT

The Sec. 1244 stock rules (Chapter C:2) and the S corporation rules both use the term *small business corporations*. The definitions have different requirements, although most S corporation stock can qualify as Sec. 1244 stock.

REAL-WORLD EXAMPLE

Most S corporations have only one or several shareholders. Very few S corporations have large numbers of shareholders, with less than 0.2% in recent years having more than 30 owners.

³ Sec. 1361.



ETHICAL POINT

Tax professionals must assist their clients in monitoring that the S corporation requirements are met on each day of the tax year. Failing to meet one of the requirements for even one day terminates the election. Ignoring a terminating event until the IRS discovers it upon an audit probably will cause the corporation to be taxed as a C corporation and prevent it from having the termination treated as being inadvertent.

Seven types of trusts can own S corporation stock: grantor trusts, voting trusts,⁴ testamentary trusts, qualified Subchapter S trusts (QSSTs),⁵ qualified retirement plan trusts, small business trusts, and beneficiary-controlled trusts (i.e., trusts that distribute all their income to a single income beneficiary who is treated as the owner of the trust). Grantor trusts, QSSTs, and beneficiary-controlled trusts can own S corporation stock only if the grantor or the beneficiary is a qualified shareholder. Each beneficiary of a voting trust also must be an eligible shareholder. A qualified retirement plan trust is one formed as part of a qualified stock bonus, pension, or profit sharing plan or employee stock ownership plan (ESOP) that is exempt from the federal income tax under Sec. 501(a).

Small business trusts can own S corporation stock. These trusts can be complex trusts and primarily are used as estate planning devices. No interest in a small business trust can be acquired in a purchase transaction, that is, a transaction where the holder's interest takes a cost basis under Sec. 1012. Interests in small business trusts generally are acquired as a result of a gift or bequest. All current beneficiaries of a small business trust must be individuals (including nonresident aliens), estates, or charitable organizations. Current beneficiaries are parties that can receive an income distribution for the period in question. Each beneficiary counts separately for purposes of the 100-shareholder limit. QSSTs and tax-exempt trusts are ineligible to elect to be a small business trust. The trustee must make an election to obtain small business trust status.

A testamentary trust (i.e., a trust created under the terms of a will) that receives S corporation stock can hold the stock and continue to be an eligible shareholder for a two-year period, beginning on the date the stock transfers to the trust. A grantor trust that held S corporation stock immediately before the death of the deemed owner, and which continues in existence after the death of the deemed owner, can continue to hold the stock and be an eligible shareholder for the two-year period beginning on the date of the deemed owner's death. Charitable remainder unitrusts and charitable remainder annuity trusts do not qualify as small business trusts.

EXAMPLE C:11-1 ▶ Joan, a U.S. citizen, owns 25% of Walden Corporation's stock. Walden is an S corporation. At the time of Joan's death in the current year, the Walden stock passes to her estate. The estate is a qualifying shareholder, and the transfer does not affect the S election. If the stock subsequently transfers to a trust provided for in Joan's will, the testamentary trust can hold the Walden stock for a two-year period before the S election terminates. ◀

The trust in Example C:11-1 can hold the S corporation stock for an indefinite period only if the trust's income beneficiary makes an election to have it treated as a QSST or small business trust. Otherwise, the S election terminates at the end of the two-year period.

Alien Individuals. Individuals who are not U.S. citizens (i.e., alien individuals) can own S corporation stock only if they are U.S. residents or are married to a U.S. citizen or resident alien and make an election to be taxed as a resident alien. The S election terminates if an alien individual purchases S corporation stock and does not reside in the United States or has not made the appropriate election.

CORPORATION-RELATED REQUIREMENTS

The corporation must satisfy the following three requirements on each day of the tax year:

⁴ A voting trust is an arrangement whereby the stock owned by a number of shareholders is placed under the control of a trustee, who exercises the voting rights possessed by the stock. One reason for creating a voting trust is to increase the voting power of a group of minority shareholders in the selection of corporate directors or the establishment of corporate policies.

⁵ A QSST is a domestic trust that owns stock in one or more S corporations

and distributes (or is required to distribute) all its income to its sole income beneficiary. The income beneficiary must make an irrevocable election to have the QSST rules of Sec. 1361(d) apply. The beneficiary is treated as the owner (and, therefore, the shareholder) of the portion of the trust consisting of the S corporation stock. A separate election is made for each S corporation's stock owned by the trust.

ADDITIONAL COMMENT

An unincorporated eligible entity that makes a valid S election is automatically treated as making an election to be treated as a corporation under the check-the-box regulations. Thus, the entity does not have to make two separate elections.

- The corporation must be a domestic corporation or an unincorporated entity that elects to be treated as a corporation under the check-the-box regulations.
- The corporation must not be an “ineligible” corporation.
- The corporation must have only one class of stock.⁶

The first requirement precludes a foreign corporation from making an S election.

A corporation may be an ineligible corporation and thereby violate the second requirement in one of two ways:

- Corporations that maintain a special federal income tax status are not eligible to make an S election. For example, financial institutions (e.g., banks) that use the reserve method to account for bad debts and insurance companies are not eligible.
- Corporations that have elected the special Puerto Rico and U.S. possessions tax credit (Sec. 936) or that had elected the special Domestic International Sales Corporation tax exemption are ineligible to make the S election.

ADDITIONAL COMMENT

Current S corporation stock ownership rules and the approval of the check-the-box regulations permit great flexibility in creating groups of entities that fit the business needs of their owners.

S corporations can own the stock of a C corporation without any limitation on the percentage of voting power or value held. However, as mentioned earlier, a C corporation cannot own the stock of an S corporation. An S corporation that owns the stock of a C corporation cannot participate in the filing of a consolidated tax return. An S corporation also can own the stock of a Qualified Subchapter S Subsidiary (QSub). A QSub is a domestic corporation that qualifies as an S corporation, is 100% owned by an S corporation, and for which the parent S corporation elects to treat the subsidiary as a QSub. The assets, liabilities, income, deductions, losses, etc. of the QSub are treated as those of its S corporation parent and reported on the parent’s tax return.⁷

A corporation that has two classes of stock issued and outstanding has violated the third requirement and cannot be an S corporation. The single class of stock determination is more difficult than it appears at first glance because of the many different financial arrangements that are possible between an S corporation and its shareholders. A corporation is treated as having only one class of stock if all of its outstanding shares of stock possess identical rights to distribution and liquidation proceeds and the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock.⁸ A second class of stock is not created if the only difference between the two classes of stock pertains to voting rights.⁹

EXAMPLE C:11-2 ►

Kelly Corporation has two classes of common stock outstanding. The Class A and Class B common stock give the shareholders identical rights and interests in the profits and assets of the corporation. Class A stock has one vote per share. Class B stock is nonvoting. Kelly Corporation is treated as having only one class of stock outstanding and can make an S election. ◀

General Rules. The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (i.e., the governing agreements).¹⁰ Treasury Regulations permit certain types of state laws, agreements, distributions, etc., to be disregarded in determining whether all of a corporation’s outstanding shares confer identical rights to distribution and liquidation proceeds. These include

- Agreements to purchase stock at the time of death, divorce, disability, or termination of employment
- Distributions made on the basis of the shareholder’s varying stock interests during the year
- Distributions that differ in timing (e.g., one shareholder receives a distribution in the current year and a second shareholder receives a similar dollar amount distribution shortly after the beginning of the next tax year)

⁶ Sec. 1361(b)(1).

⁷ Sec. 1361(b)(3).

⁸ Reg. Sec. 1.1361-1(l).

⁹ Sec. 1361(c)(4).

¹⁰ Reg. Sec. 1.1361-1(l)(2).

Agreements to increase cash or property distributions to shareholders who bear heavier state income tax burdens so as to provide equal after-tax distributions provide unequal distribution and liquidation rights. The unequal distributions probably will cause a second class of stock to be created. However, state laws that require a corporation to pay or withhold state income taxes on behalf of some or all of a corporation's shareholders are disregarded.

Debt Instruments. Debt instruments, corporate obligations, and deferred compensation arrangements, in general, are not treated as a second class of stock. A number of safe harbors exist for characterizing corporate obligations as debt (and not as a second class of stock):¹¹

- ▶ Unwritten advances from a shareholder that do not exceed \$10,000 during the tax year, are treated as debt by the two parties, and are expected to be repaid within a reasonable time
- ▶ Obligations that are considered equity under the general tax laws but are owned solely by the shareholders in the same proportion as the corporations's outstanding stock

In addition, Sec. 1361(c)(5) provides a safe harbor for straight debt instruments so that the debt is not treated as a second class of stock. For debt to qualify under the safe harbor, it must meet the following requirements if issued while an S election is in effect:

- ▶ The debt must represent an unconditional promise to pay a certain sum of money on a specified date or on demand.
- ▶ The interest rate and interest payment dates must not be contingent on profits, the borrower's discretion, or similar factors.¹²
- ▶ The debt must not be convertible directly or indirectly into stock.
- ▶ The creditor must be an individual, estate, or trust eligible to be an S corporation shareholder, or a nonindividual creditor actively and regularly engaged in the business of lending money.¹³

The safe harbor rules can apply to debt even if the debt otherwise would be considered a second class of stock under case law or other IRC provisions. An obligation that originally qualifies as straight debt may no longer qualify if it is materially modified so that it no longer satisfies the safe harbor or is transferred to a third party who is not an eligible shareholder.¹⁴

KEY POINT

If debt instruments satisfy the safe harbor rules, such instruments cannot be construed as equity. However, such debt must have been issued in an S corporation tax year.

ELECTION OF S CORPORATION STATUS

OBJECTIVE 3

Explain how a corporation elects, revokes, or terminates S corporation status

The S election exempts a corporation from all taxes imposed by Chapter 1 of the Internal Revenue Code (Secs. 1-1399) except for the following:

- ▶ Sec. 1374 built-in gains tax
- ▶ Sec. 1375 excess net passive income tax
- ▶ Sec. 1363(d) LIFO recapture tax

This rule exempts the S corporation from the regular income tax, accumulated earnings tax, the personal holding company tax, and the corporate alternative minimum tax for all tax years the election remains in effect.

¹¹ Reg. Sec. 1.1361-1(l)(4). An exception applies to debt instruments, corporate obligations, and deferred compensation arrangements that are treated as stock under the general principles of the federal tax law where the principal purpose for the debt instrument, etc., is to circumvent the distribution or liquidation proceeds rights provided for by the outstanding stock or to circumvent the 100-shareholder limit.

¹² That the interest rate depends on the prime rate or a similar factor not related to the debtor corporation will not disqualify the instrument from coming under the safe harbor rules. If the interest being paid is unreasonably high, an appropriate portion may be treated as a payment of something other than interest.

¹³ Sec. 1361(c)(5).

¹⁴ Reg. Sec. 1.1361-1(l)(5)(ii) and (iii).

The S election affects the shareholders in three ways:

- Shareholders report their pro rata share of the S corporation's ordinary income or loss as well as any separately stated items.
- Shareholders treat most distributions as a nontaxable recovery of their stock investments.
- Shareholders' stock bases are adjusted for the shareholders' ratable share of ordinary income or loss and any separately stated items.

MAKING THE ELECTION

Only small business corporations can make the S election.¹⁵ For a small business corporation to make a valid S election, the corporation must file a timely election (Form 2553), and all the corporation's shareholders must consent to the election. Existing corporations can make a timely S election at any time during the tax year preceding the year for which the election is to be effective or on or before the fifteenth day of the third month of the year for which the election is to be effective.

For a new corporation, the S election can be made at any time on or before the fifteenth day of the third month of its initial tax year. A new corporation's initial tax year begins with the first day the corporation has shareholders, acquires assets, or begins business.

If the corporation makes the S election during the first 2½ months of the tax year for which the election is first to be effective, the corporation also must meet all the small business corporation requirements on each day of the tax year preceding and including the election date. If the corporation fails to satisfy this requirement, the election becomes effective in the corporation's next tax year.

The tax law, however, provides some relief for improper elections. First, if the corporation misses the deadline for making the S corporation election, the IRS can treat the election as timely made if the IRS determines that the corporation had reasonable cause for making the late election. Second, if the election was ineffective because the corporation inadvertently failed to qualify as a small business corporation or because it inadvertently failed to obtain shareholder consents (see below), the IRS nevertheless can honor the election if the corporation and shareholders take steps to correct the deficiency within a reasonable period of time.¹⁶

EXAMPLE C:11-3 ►

Wilco Corporation, a calendar year taxpayer, has been in existence for several years. Wilco wants to be treated as an S corporation for 2020 and subsequent years. The corporation can make the election any time during 2019 or from January 1 through March 16, 2020 (March 15 falls on a Sunday). If the corporation makes the election after March 16, 2020, it becomes effective in 2021. However, if Wilco can show reasonable cause for making the late election, the IRS may allow the election to be effective for 2020. ◀

SELF-STUDY QUESTION

Would the answer to Example C:11-3 change if Wilco is a member of an affiliated group through January 15, 2020?

ANSWER

Yes. Because Wilco is an ineligible corporation for a portion of the 2½-month period of 2020, an S election would not be effective until January 1, 2021.

Consent of Shareholders. Each person who is a shareholder on the election date must consent to the election. The consent is binding on the current tax year and all future tax years. No additional consents are required of shareholders who acquire the stock between the election date and its effective date or at any subsequent date.

Section 1362(b)(2) imposes a special rule on the shareholders when the corporation makes an election after the beginning of the tax year for which it is to be effective. Each shareholder who owned stock during any portion of the year preceding the election date, and who is not a shareholder on the election date, also must consent to the election.

EXAMPLE C:11-4 ►

Sara and Harry own all of Kraft Corporation's stock. Sara sells all her Kraft stock to Lisa on February 10. The next day Kraft makes an S election. For the election to apply in the current year, Sara, Harry, and Lisa must consent to the election. If Sara refuses to consent, the election will not be effective until next year. ◀

¹⁵ Election rules are in Sec. 1362.

¹⁶ IRS spells out detailed procedures for relief in Rev. Proc. 97-48, 1997-2 C.B. 521, Rev. Proc. 2003-43, 2003-23 C.B. 998, Rev. Proc. 2004-48, 2004-2

C.B. 172, Rev. Proc. 2007-62, 2007-41, C.B. 786, and Rev. Proc. 2013-30, 2013-36 I.R.B. 173.

Each tenant (whether or not husband and wife) must consent to the S election if the shareholders own the stock as tenants in common, joint tenants, or tenants in the entirety. If the shareholders own the S corporation stock as community property, each person having a community property interest must consent to the election. If the shareholder is a minor, either the minor or the minor's legal representative (e.g., a natural parent or legal guardian) can make the consent.

Topic Review C:11-1 summarizes the S corporation requirements and procedures for making the S election.

TERMINATION OF THE ELECTION

Once made, the S election remains in effect until the corporation either revokes the election or terminates the election because it ceases to meet the small business corporation requirements. The following discussion examines each action and outlines the requirements for making a new S election following a termination.¹⁷

Revocation of the Election. A corporation can revoke its S election in any tax year as long as it meets the requirements regarding shareholder consent and timeliness. Shareholders owning more than one-half the corporation's stock (including nonvoting stock) on the day the corporation makes the revocation must consent to the revocation. A revocation made on or before the fifteenth day of the third month of the tax year is effective on the first day of that tax year. A revocation made after the first 2½ months of the tax year takes effect on the first day of the next tax year. An exception permits the S corporation to select a prospective date for the revocation to be effective. The prospective date can be the date the corporation makes the revocation or any subsequent date.

TOPIC REVIEW C:11-1

S Corporation Requirements and Election Procedures

REQUIREMENTS

Shareholder-related:

1. The corporation may have no more than 100 shareholders. Family members and their estates count as one shareholder.
2. All shareholders must be individuals, estates, certain kinds of trusts, or certain kinds of tax-exempt organizations. Eligible trusts include grantor trusts, voting trusts, testamentary trusts, beneficiary-controlled trusts, qualified Subchapter S trusts, qualified retirement plan trusts, and small business trusts.
3. All the individual shareholders must be U.S. citizens or resident aliens.

Corporation-related:

1. The corporation must be a domestic corporation or an unincorporated entity. An unincorporated entity that makes an S election is automatically treated as having elected to be taxed as a domestic corporation under the check-the-box regulations.
2. The corporation must not be an ineligible corporation (e.g., an ineligible bank or other financial institution, an insurance company, or a foreign corporation).
3. The corporation must have only one class of stock issued and outstanding. Differences in voting rights are ignored.

MAKING THE ELECTION

1. The corporation can make the S election any time during the tax year preceding the year for which the election is effective or on or before the fifteenth day of the third month of the tax year for which the election is effective. Late elections are effective with the next tax year unless the corporation obtains IRS relief for reasonable cause.
2. Each shareholder who owns stock on the date the corporation makes the election must consent to the election. If the corporation makes the election after the beginning of the tax year, each person who was a shareholder during the portion of the tax year preceding the election also must consent to the election.

¹⁷ Termination and revocation rules are in Sec. 1362.

EXAMPLE C:11-5 ► Adobe Corporation, a calendar year taxpayer, has been an S corporation for several years. However, the corporation has become quite profitable, and management feels that it would be advantageous to make a public stock offering to obtain additional capital during 2020. Adobe can revoke its S election any time on or before March 16, 2020 (March 15 falls on a Sunday), making the revocation effective on January 1, 2020. If the corporation revokes the election after March 16, 2020, it takes effect January 1, 2021. In either case, the corporation may specify a prospective 2020 effective date as long as the date occurs on or after the date it makes the revocation. ◀

TAX STRATEGY TIP

When it is difficult to obtain the majority shareholder vote necessary for revocation, consideration should be given to purposely triggering a termination event.

Termination of the Election. The S election terminates if the corporation fails one or more of the small business corporation requirements any time after the election's effective date. The termination generally occurs on the day of the terminating event. Events that can terminate the election include

- Exceeding the 100-shareholder limit
- Having an ineligible shareholder own some of the stock
- Creating a second class of stock
- Attaining a prohibited tax status
- Selecting an improper tax year
- Failing the passive investment income test for three consecutive years

The passive investment income test applies annually. It terminates the S election if more than 25% of the corporation's gross receipts are passive investment income for each of three consecutive tax years *and* the corporation has Subchapter C earnings and profits (E&P) at the end of each of the three consecutive tax years. If the corporation meets these conditions for three consecutive tax years, the election terminates on the first day of the next (fourth) tax year.

Passive investment income includes royalties, rents,¹⁸ dividends, interest, annuities, and gains from the sale or exchange of stocks and securities. Treasury Regulations hold that passive investment income excludes income derived from the active conduct of a trade or business. Subchapter C E&P includes only earnings that accrued in tax years in which an S election was not in effect (i.e., the corporation was taxed under the C corporation rules).

EXAMPLE C:11-6 ► Shareholders formed Silver Corporation in the current year, and the corporation promptly made an S election. Silver can earn an unlimited amount of passive income during a tax year without any fear of losing its S corporation status or being subject to the Sec. 1375 tax on excess net passive income because it has never been a C corporation and thus has no Subchapter C E&P. However, if a C corporation containing E&P merged into Silver, Silver would then have potential exposure to the passive income rules. (See pages C:11-15 and C:11-16 for a discussion of the Sec. 1375 tax.) ◀

HISTORICAL NOTE

Previously, a termination was deemed effective on the first day of the tax year in which the terminating event occurred. To stop potential abuse, Congress changed the rule so that an S election terminates on the day of the terminating event.

Allocation of Income. A terminating event occurring at some time other than the first day of the tax year creates an S termination year. The S termination year is divided into an S short year and C short year. The S short year begins on the first day of the tax year and ends on the day preceding the termination date. The C short year begins on the termination date and continues through the last day of the corporation's tax year.

EXAMPLE C:11-7 ► Dixon Corporation has been an S corporation for several years. Paula and Frank each own one-half of Dixon's stock. Paula sells one-half of her Dixon stock to Eagle Corporation on July 1. The sale terminates the S election on July 1 because Eagle is an ineligible shareholder. Assuming Dixon is a calendar year taxpayer, the S short year runs from January 1 through June 30. The C short year runs from July 1 through December 31. ◀

¹⁸ Regulation Sec. 1.1362-2(c)(5)(ii)(B)(2) excludes from rents payments received for the use or occupancy of property if the corporation provides significant services or incurs substantial costs in the rental business. See

page C:11-38 for additional explanations of the significant services and substantial costs definitions.

TAX STRATEGY TIP

Income or loss can be allocated in the termination year under either of two methods. Careful consideration should be given to the possible tax advantages of a daily allocation versus an actual closing of the books. See Tax Planning Considerations for further details.

ADDITIONAL COMMENT

To use an actual closing of the books to allocate Dixon's income or loss in Example C:11-7, Eagle must consent. Due to the consequences of such an election, the method of allocation should be considered in negotiating the Dixon stock sale.

The S corporation's shareholders report the S short year income according to the normal reporting rules described below. The C corporation reports the income earned during the C short year and calculates its C short year income tax liability on an annualized basis (see Chapter C:3). The S short year and C short year returns are due on the due date for the corporation's tax return for the tax year had the termination not occurred (including any extensions).

An S corporation can use either of two rules to allocate the termination year's income between the S short year and the C short year. The general rule of Sec. 1362(e)(2) allocates the ordinary income or loss and the separately stated items between the S short year and C short year based on the number of days in each year. A special election under Sec. 1362(e)(3) permits an allocation that accords with the corporation's normal tax accounting rules if all persons who were shareholders at any time during the S short year and all persons who are shareholders on the first day of the C short year consent to the election. The corporation cannot use a daily allocation when an S termination year occurs and, during such year, sales or exchanges of 50% or more of the corporation's outstanding stock occur. In such a case, the corporation must use its normal accounting rules to make the allocation.

Inadvertent Termination. Special rules permit the corporation to continue its S election if an inadvertent termination occurs by its ceasing to be a small business corporation or by its failing the passive investment income test for three consecutive years. If such a termination occurs, the S corporation or its shareholders must take the necessary steps, within a reasonable time period after discovering the event creating the termination, to restore the corporation's small business status. If the IRS determines that the termination was inadvertent, the corporation and all persons owning stock during the termination period must agree to make the adjustments necessary to report the income for this period as if the S election had been in effect continuously.¹⁹

EXAMPLE C:11-8

▶ Shareholders formed Frye Corporation in 2016 and operated it as a C corporation during that year. Frye made an S election in 2017. During 2016, the corporation incorrectly computed its E&P and believed that no Subchapter C E&P existed for its only pre-S corporation tax year. From 2017 through 2019, Frye earned large amounts of passive income but did not pay the Sec. 1375 excess net passive income tax or worry about terminating its election because it thought it had no accumulated E&P from 2016. Upon auditing Frye's tax returns, the IRS finds that Subchapter C E&P, in fact, did exist from 2016 and terminates the S election effective on January 1, 2020. If the corporation distributes the E&P and the shareholders report the dividend income, the IRS probably will treat the occurrence as an inadvertent termination and not revoke the election. ◀

The IRS also can grant relief for inadvertent terminations of the election to treat a subsidiary as a Qualified Subchapter S Subsidiary (QSub). For example, a parent S corporation might inadvertently transfer shares of a QSub to another person, thereby violating the 100% ownership requirement. If the S corporation takes the necessary steps to correct the inadvertent transfer, the IRS can grant relief, thereby allowing the election to remain in effect.

Other IRS Waivers. The IRS not only can waive a termination it deems to be inadvertent, it also can validate certain invalid elections. Validation of an invalid election can occur when the election failed to meet the basic S corporation requirements of Sec. 1361 or failed to provide the necessary shareholder consents. The IRS also can exercise this authority in situations where a corporation never filed an election. In addition, the IRS can treat a late S election as being timely filed if the IRS determines that reasonable cause

¹⁹ Regulation Sec. 1.1362-4(b) holds that a termination will be inadvertent if the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election or if it took place

without the corporation's knowledge and reasonable safeguards were in place to prevent the event from occurring.

existed for failing to make a timely election and the corporation meets certain other requirements.²⁰

New Election Following a Termination. A corporation that revokes or terminates its S election must wait five tax years before making a new election.²¹ This delay applies unless the IRS consents to an earlier reelection. Regulation Sec. 1.1362-5(a) indicates that permission for an early reelection can occur (1) when more than 50% of the corporation's stock is owned by persons who did not own stock on the termination date or (2) when the event causing the termination was not reasonably within the control of the corporation or the shareholders having a substantial interest in the corporation *and* was not part of a plan to terminate the election involving the corporation or such shareholders.

EXAMPLE C:11-9 ► Terri owned Vector Corporation, a calendar year taxpayer that has been an S corporation for ten years. In January of last year, Terri sold all the Vector stock to Michelle with payments to be made over a five-year period. Two years after the sale, Michelle fails to make the necessary payments, and Terri repossesses the stock. During the time Michelle held the stock, Vector revoked its S election. Vector should immediately apply for reelection of S status because a more than 50% ownership change occurred since the revocation date. ◀

Avoiding Termination of an S Election. Termination of an S election potentially can increase corporate or shareholder taxes. The S corporation's owners, management, and tax advisor need to understand the various events that can cause the termination of the S election. Some steps shareholders can take to prevent an untimely termination include the following:

- Monitor all transfers of S corporation stock. Make certain the purchaser or transferee of the stock is not an ineligible shareholder (e.g., corporation, partnership, or non-resident alien) or that the total number of shareholders does not exceed 100 (e.g., an excess shareholder resulting from creation of a joint interest).
- Establish procedures for the S corporation to purchase the stock of deceased shareholders to avoid the stock being acquired by a trust that is ineligible to be a shareholder.
- Establish restrictions on the transferability of the S corporation stock by having shareholders enter into a stock purchase agreement. Such an agreement could provide that the stock cannot be transferred without the prior consent of all other shareholders

WHAT WOULD YOU DO IN THIS SITUATION?



Harry Baker formed Xeno Corporation on January 4, 2017. The corporation filed a valid S corporation election on January 19, 2017, to be in effect for 2017. Harry, the corporation's sole shareholder, consented to the election. The corporation had business ties to Mexico, and to strengthen these ties, Harry sold 25% of his Xeno shares to Pedro Gonzales on February 10, 2018. Pedro is one of Harry's business associates and is a citizen and resident of Mexico. Harry continued to operate Xeno as an S corporation throughout 2018. Early in March 2019, Harry became

aware that, by selling stock to an ineligible shareholder, he may have jeopardized the corporation's S election. Thus, Harry immediately contacted Pedro and persuaded Pedro to sell his Xeno shares back to him (Harry). Harry hires you as his tax advisor on December 17, 2019, at which time you learn about the sale and repurchase of the Xeno shares. However, Harry tells you not to worry because, by buying back the shares, he already has rectified the situation, and thus the IRS need not be told about the transfers. How do you advise Harry on this matter?

²⁰ See footnote 16.

²¹ *Termination* includes both revocation of the S election and loss of the election because one or more of the small business corporation requirements were not met.

and, if the necessary consent cannot be obtained, the corporation will repurchase the stock at a specified price (e.g., at book value).

- ▶ Monitor the passive income earned by an S corporation that previously had been a C corporation for one or more years. Make certain the passive income requirement is not failed for three consecutive years by reducing the level of passive income or by distributing the Subchapter C E&P.

S CORPORATION OPERATIONS

OBJECTIVE 4

Classify an S corporation's ordinary and separately stated items, and calculate special S corporation taxes

S corporations make the same accounting period and accounting method elections that a C corporation makes. Each year, the S corporation must compute and report to the IRS and to its shareholders its ordinary income or loss and its separately stated items. The special S corporation rules are explained below.

TAXABLE YEAR

Section 1378(a) requires that the S corporation's taxable year be a permitted year, defined as

- ▶ A tax year ending on December 31 (including a 52–53 week year)
- ▶ Any fiscal year for which the corporation establishes a business purpose²²

Section 1378(b) specifically notes that income deferral for the shareholders is not a necessary business purpose. An S corporation that adopts a fiscal year coinciding with its natural business year has satisfied the business purpose requirement. The natural business year for an S corporation depends on the type of business conducted. When a trade or business has nonpeak and peak periods of business, the natural business year is considered to end at, or soon after, the close of the peak business period. A business whose income is steady throughout the year, does not have a natural business year.²³

EXAMPLE C:11-10

▶ Sable Corporation, an S corporation, operates a ski resort and reports \$1 million of gross receipts for each of its last three tax years. If at least \$250,000 (25% of gross receipts) of the receipts occurred in February and March for each of the three consecutive years, Sable can adopt, or change to, or continue to use a natural business year ending March 31.²⁴ ◀

An S corporation's adoption of, or a change to, a fiscal year that is an ownership tax year also is permitted. An ownership tax year is the same tax year used by shareholders owning more than 50% of the corporation's outstanding stock. The 50% requirement must be met on the first day of the tax year to which the change relates. Failure to meet the 50% ownership requirement on the first day of any later tax year requires a change to a calendar year or other approved fiscal year. S corporations also can adopt or change to a fiscal year for which it obtains IRS approval, based on the facts and circumstances of the situation.²⁵

Section 444 permits an S corporation to elect a fiscal year other than a permitted year. The fiscal year elected under Sec. 444 must have a deferral period of three months or less (e.g., a September 30 or later fiscal year-end for an S corporation otherwise required to use a calendar year). An S corporation that changes its tax year can elect to use a new fiscal year under Sec. 444 only if the deferral period is no longer than the shorter of three months or the deferral period of the tax year being changed.²⁶ A Sec. 444 election is not required of an S corporation that satisfies the business purpose exception.

ADDITIONAL COMMENT

The requirement that all S corporations adopt calendar years (with March 15 return due dates) caused a hardship for tax return preparers. Section 444 is a compromise provision that allows a fiscal year for filing purposes, but it mandates a special payment of the deferred taxes.

²² Some S corporations use a "grandfathered" fiscal year, which is a fiscal year for which IRS approval was obtained after June 30, 1974. Excluded are fiscal years that result in an income deferral of three months or less.

²³ Rev. Procs. 2002-39, 2002-1 C.B. 1046, and 2006-46, 2006-2 C.B. 859.

²⁴ See Rev. Proc. 2006-46, 2006-2 C.B. 859, for an explanation of the 25% test.

²⁵ Regulation Sec. 1.1378-1 and Rev. Proc. 2006-46, 2006-2 C.B. 859, explain

the procedures for an S corporation adopting a fiscal year or changing the tax year of a new or existing S corporation. Rev. Rul. 87-57, 1987-2 C.B. 117, examines eight situations concerning whether the tax year is a permitted year.

²⁶ Special Sec. 444 transitional rules for 1986 permitted many S corporations to retain a previously adopted fiscal year (e.g., January 31) even though the deferral period is longer than three months.

S corporations that elect a fiscal year under Sec. 444 must make required payments under Sec. 7519, which approximate the deferral benefit of the fiscal year. Revocation or termination of the S election also terminates the Sec. 444 election unless the corporation becomes a personal service corporation. Termination of the Sec. 444 election permits the S corporation to obtain a refund of prior Sec. 7519 payments.

Topic Review C:11-2 summarizes the alternative tax years available to an S corporation.

ACCOUNTING METHOD ELECTIONS

As with a partnership, an S corporation makes accounting method elections independent of accounting method elections made by its shareholders. Three elections generally reserved for the S corporation's shareholders are as follows:

- ▶ Section 617 election relating to deduction and recapture of mining exploration expenditures
- ▶ Section 901 election to take a credit for foreign income taxes²⁷

ORDINARY INCOME OR LOSS AND SEPARATELY STATED ITEMS

S corporations are treated much like partnerships and thus report both an ordinary income or loss amount and a series of separately stated items. Ordinary income or loss is the net of income and deductions other than the separately stated items described in the next paragraph.

The S corporation's separately stated items are the same ones that apply in partnership taxation under Sec. 702(a), related Treasury Regulations, and tax return instructions.²⁸ For example, the following items must be separately stated:

- ▶ Net short-term capital gains and losses
- ▶ Net long-term capital gains and losses
- ▶ Net Sec. 1231 gains and losses
- ▶ Unrecaptured Sec. 1250 gains
- ▶ Sec. 179 expense
- ▶ Charitable contributions

KEY POINT

S corporations are much like partnerships in their method of reporting income and losses. Both are pass-through entities that provide K-1s to their owners with their respective shares of income and loss items.

TOPIC REVIEW C:11-2

Alternative S Corporation Tax Years

TAX YEAR

Calendar year (including certain 52–53 week years)

Permitted fiscal year:

a. Ownership year

b. Natural business year

c. Facts and circumstances year

Nonpermitted fiscal year

REQUIREMENTS

The permitted tax year unless an exception applies.

IRS will grant approval if:

The tax year requested is the same as that used by shareholders owning more than 50% of the corporation's outstanding stock. This test must be met on the first day of the year for which approval is requested as well as for each succeeding year.

25% or more of the gross receipts for each of the three most recent 12-month periods are in the last two months of the requested tax year.

The corporation establishes a business purpose (other than an ownership year or natural business year) using the facts and circumstances of the situation.

A Sec. 444 election permits the S corporation to use an otherwise nonpermitted tax year if the deferral period is three months or less and the corporation makes the necessary required payments.

²⁷ Secs. 1363(c).

²⁸ Sec. 1366(a).

- ▶ Dividends and interest income²⁹
- ▶ Taxes paid or accrued to a foreign country or to a U.S. possession
- ▶ Tax-exempt or partially tax-exempt interest
- ▶ Investment income and expenses
- ▶ Any other item provided by Treasury Regulations and tax form instructions

For a comprehensive list of separately stated items, see Form 1120S, Schedule K included in Appendix B.

Section 1366(b) requires that the character of any separately stated item be determined as if the item were (1) realized directly by the shareholder from the same source from which it was realized by the corporation or (2) incurred by the shareholder in the same manner as it was incurred by the corporation. Thus, the character of an income, gain, deduction, loss, or credit item does not change merely because the item passes through to the shareholders.

Deductions That Cannot Be Claimed. S corporations also have several deductions that it cannot claim, including

- ▶ The 50%, 65%, or 100% dividends-received deduction (because dividends pass through to the S corporation's shareholders)
- ▶ The same deductions disallowed to a partnership under Sec. 703(a)(2) (e.g., additional itemized deductions for individuals, taxes paid or accrued to a foreign country or to a U.S. possession, charitable contributions, oil and gas depletion, and NOL carryovers).³⁰

Similarity to C Corporation Treatment. S corporations are treated as corporations for certain tax matters. For example, an S corporation can elect to amortize its organizational expenditures under Sec. 248 (after deducting up to \$5,000). Also, the 20% reduction in certain tax preference benefits under Sec. 291 applies to an S corporation if the corporation was a C corporation in any of its three preceding tax years.³¹

ADDITIONAL COMMENT

The 20-year carryover period continues to run on pre-2018 C corporation NOLs even during subsequent S corporation years.

Carryovers When Status Changes. Some S corporations may operate as C corporations during a period of years that either precede the making of an S election or follow the termination of an S election. No carryovers that originate in a C corporation tax year can carry to an S corporation tax year other than carryovers that can be used to offset the built-in gains tax (see pages C:11-16 through C:11-18). Similarly, no carryovers created in an S corporation tax year can carry to a C corporation tax year.³² Losses from an S corporation tax year pass through to the shareholder and, if greater than the shareholder's income for the year, can create an NOL carryover for the shareholder.

SPECIAL S CORPORATION TAXES

The S corporation is subject to three special taxes: the excess net passive income tax, the built-in gains tax, and the LIFO recapture tax. Each of these taxes is explained below.

Excess Net Passive Income Tax. The excess net passive income (or Sec. 1375) tax applies when an S corporation has passive investment income for the tax year that exceeds 25% of its gross receipts and, at the close of the tax year, the S corporation has Subchapter C E&P. The excess net passive income tax equals the S corporation's excess net passive income times the highest corporate tax rate (21% in 2019).³³

²⁹ Partnerships are permitted to have C corporations as owners of partnership interests. Thus, dividends eligible for the dividends-received deduction also are separately stated. Such is not the case with an S corporation, which cannot have a corporate shareholder.

³⁰ Sec. 1363(b)(2).

³¹ Secs. 1363(b)(3) and (4).

³² Sec. 1371(b).

³³ Passive investment income and Subchapter C E&P for this purpose have the same definition here as given on page C:11-10.

The excess net passive income is determined as follows:

$$\begin{array}{l} \text{Excess} \\ \text{net} \\ \text{passive} \\ \text{income} \end{array} = \begin{array}{l} \text{Net} \\ \text{passive} \\ \text{income} \end{array} \times \frac{\text{Passive investment income} - 25\% \text{ of gross receipts}}{\text{Passive investment income}}$$

KEY POINT

The excess net passive income tax is of concern to a former C corporation that has accumulated E&P. A corporation that always has been an S corporation will not have a passive income problem.

The excess net passive income is limited to the corporation's taxable income, which is defined as a C corporation's taxable income except with no reduction for the NOL deduction or the dividends-received deduction. Net passive income equals passive investment income minus any deductions directly related to its production. Passive investment income excludes income derived from the active conduct of a trade or business.³⁴

EXAMPLE C:11-11 ► Paoli Corporation, an S corporation, reports the following results for the current year:

Service (nonpassive) income	\$35,000
Dividend income	37,000
Interest income	28,000
Passive income-related expenses	10,000
Other expenses	25,000

At the end of this year, Paoli's E&P from its prior C corporation tax years amounts to \$60,000. Paoli's excess net passive income is determined as follows:

$$\$33,846 = (\$65,000 - \$10,000) \times \frac{\$65,000 - (0.25 \times \$100,000)}{\$65,000}$$

The excess net passive income tax is \$7,108 (\$33,846 × 0.21). The special tax reduces (on a pro rata basis) the dividend income and interest income items that pass through to the shareholders. The S election is not terminated at the end of the current year unless Paoli also was subject to the tax in the prior two tax years. ◀

TAX STRATEGY TIP

A former C corporation can avoid the Sec. 1375 tax (and the possibility of having its S election terminated) by electing to distribute its Subchapter C E&P. See Tax Planning Considerations for further details.

Built-in Gains Tax. A second corporate level tax may apply to gains recognized by an S corporation that formerly was a C corporation. This tax, called the **built-in gains** (or Sec. 1374) tax, applies to any income or gain the corporation would have included in gross income while a C corporation had the corporation used the accrual method of accounting (known as a **built-in gain**) and that the corporation reports during the five-year period beginning on the date the S election took effect (known as the recognition period). **Built-in losses** are any deductions or losses the corporation would have deducted while a C corporation had the corporation used the accrual method of accounting and that the corporation reports during the five-year period beginning on the date the S election took effect. Built-in gains and losses also include the differences between the FMVs and adjusted bases of assets held at the time the S election takes effect. Built-in losses reduce the amount of recognized built-in gains in determining the built-in gains tax liability. Congress enacted this tax to prevent taxpayers from avoiding the corporate level tax by making an S election before distributing or selling its assets.

EXAMPLE C:11-12 ► Theta Corporation, a calendar year taxpayer, incorporated 12 years ago and operated as a C corporation through the end of last year. On February 4 of the current year, Theta filed an S election that was effective for the current year and later tax years. Theta is subject to the built-in gains tax for five years starting with January 1 of the current year. ◀

The Sec. 1374 tax is determined by using the following four-step calculation:

STEP 1: Determine the corporation's net recognized built-in gain for the tax year.

STEP 2: Reduce the net recognized built-in gain from Step 1 (but not below zero) by any NOL or capital loss carryovers from prior C corporation tax years.

³⁴ Reg. Sec. 1.1362-2(c)(5). Also, Reg. Sec. 1.1375-1(f), Ex. (2) indicates that passive income subject to the Sec. 1375 tax includes municipal bond interest that otherwise is exempt from the federal income tax.

TAX STRATEGY TIP

An S corporation with NOL, capital loss, and general business credit carryovers from C corporation years can use these carryovers to reduce the effect of the built-in gains tax. Both NOL and capital loss carryovers reduce the amount of recognized built-in gain taxed under Sec. 1374. The general business carryover reduces the actual built-in gains tax.

PRACTICAL APPLICATION

The application of the Sec. 1374 tax requires detailed records, which enable the taxpayer to track the built-in gain assets and determine when the corporation recognizes these gains.

STEP 3: Compute a tentative tax by multiplying the amount determined in Step 2 by the highest corporate tax rate (21% in 2019).

STEP 4: Reduce the tax determined in Step 3 (but not below zero) by the general business credit and minimum tax credit carryovers from any prior C corporation tax years and by the nonhighway use of gasoline and other fuels credit.

A recognized built-in gain or loss is any gain or loss recognized on an asset disposition during the five-year recognition period unless the S corporation can establish that it did not hold the asset on the first day of the first tax year to which the S election applies. A recognized built-in gain cannot exceed the excess of a property's FMV over its adjusted basis on the first day of the five-year recognition period. Dispositions include sales or exchanges and other events, including the collection of accounts receivable by a cash basis taxpayer, collection of an installment sale obligation, and the completion of a long-term contract by a taxpayer using the completed contract method.³⁵

Built-in losses include not only losses originating from a disposition of property, but also any deductions claimed during the five-year recognition period that are attributable to periods before the first S corporation tax year. A recognized built-in loss cannot exceed the excess of a property's adjusted basis over its FMV on the first day of the five-year recognition period. Built-in losses, however, do not include any loss, deduction, or carryover originating from the disposition of an asset acquired before or during the recognition period where the principal purpose of such acquisition was avoiding the Sec. 1374 tax.

The net recognized built-in gain for a tax year is limited to the smaller of:

- ▶ The excess of (1) the net unrealized built-in gain (i.e., excess of the FMV of the S corporation's assets at the beginning of its first tax year for which the S election is in effect over their total adjusted basis on such date) over (2) the total net recognized built-in gain for prior tax years beginning in the five-year recognition period.³⁶
- ▶ The S corporation's taxable income as if it were a C corporation but with no dividends-received deduction or NOL deduction allowed.

If the net of the recognized built-in gains and losses exceeds the corporation's taxable income, the excess built-in gain carries over to the next tax year, where it may be subject to the Sec. 1374 built-in gains tax in the carryover year. The built-in gain carryover consists of a ratable share of each of the income categories (e.g., ordinary income or capital gains) making up the net recognized built-in gain for the tax year.

The built-in gains tax passes through to the shareholders as if it were a loss. The loss must be allocated proportionately among the net recognized built-in gains that resulted in the tax being imposed.

EXAMPLE C:11-13

▶ Assume the same facts as in Example C:11-12 and that Theta Corporation uses the accrual method of accounting. Theta owns the following assets on January 1 of the current year:

**ETHICAL POINT**

A C corporation that has substantially appreciated assets and wants to make an S election should obtain an appraisal of its assets on or about the first day of the S election period. The S corporation's tax accountant must make sure the appraiser does not assign an artificially low value to these assets to minimize the potential built-in gains tax burden.

<u>Assets</u>	<u>Adjusted Basis</u>	<u>FMV</u>
Cash	\$ 10,000	\$ 10,000
Marketable securities	39,000	45,000
Accounts receivable	60,000	60,000
Inventory (FIFO)	60,000	75,000
Building	27,000	44,000
Land	10,000	26,000
Machinery and equipment ^a	74,000	140,000
Total	<u>\$280,000</u>	<u>\$400,000</u>

^a \$50,000 of the gain is subject to recapture under Sec. 1245.

³⁵ Income and gains potentially can be taxed under both the excess net passive income (Sec. 1375) and built-in gains (Sec. 1374) taxes. Any such income or gain is fully taxed under the Sec. 1374 rules. The portion of the income or gain taxed under the Sec. 1374 tax is exempt from the Sec. 1375 tax.

³⁶ The recognition period can be extended beyond five years if property having a carryover basis is acquired in a tax-free transaction (e.g., a tax-free reorganization) from a C corporation. For such property, the five-year recognition period begins on the date the S corporation acquired the property.

During the current year, Theta collects \$58,000 of accounts receivable and declares \$2,000 uncollectible. It sells the FIFO inventory at a \$25,000 profit in the first quarter, replacing the sold inventory with new inventory. It also sells two machines during the current year. One machine, having an \$18,000 FMV and an \$11,000 adjusted basis on January 1, produced a \$7,000 gain (Sec. 1245 recapture income) on September 2. A second machine, having a \$15,000 FMV and a \$19,000 adjusted basis on January 1, produced a \$4,000 loss on March 16.

- Theta recognizes no built-in gain or loss on collecting the receivables because it is an accrual method taxpayer. The \$2,000 uncollectible debt is not a built-in loss because the loss arose after January 1. It is deductible as part of the ordinary income or loss calculation.
- Of the \$25,000 inventory profit, \$15,000 ($\$75,000 - \$60,000$) is a built-in gain taxed under Sec. 1374. Theta includes the entire \$25,000 profit in ordinary income or loss.
- Theta recognizes a \$7,000 built-in gain ($\$18,000 - \$11,000$) and a \$4,000 ($\$15,000 - \$19,000$) built-in loss on the sale of the two machines. The \$7,000 gain is ordinary income due to Sec. 1245 recapture and becomes part of Theta's S corporation ordinary income or loss. The \$4,000 Sec. 1231 loss passes through separately to the shareholders.

In total, an \$18,000 ($\$15,000 + \$7,000 - \$4,000$) net recognized built-in gain is taxed under Sec. 1374, subject to the taxable income ceiling. Assuming C corporation taxable income (with no NOL deduction or dividends-received deduction) is at least \$18,000, the built-in gains tax is \$3,780 ($\$18,000 \times 0.21$). The entire tax amount reduces the shareholder's ordinary income from the inventory and machinery sales. ◀

LIFO Recapture Tax. If a C corporation using the LIFO inventory method makes an S election, Sec. 1363(d)(3) requires the corporation to include its LIFO recapture amount in gross income for its last C corporation tax year. The LIFO recapture amount is the excess of the inventory's basis for tax purposes under the FIFO method over its basis under the LIFO method at the close of the final C corporation tax year. Any tax increase incurred in the final C corporation tax year is payable in four annual installments, on or before the due date for the final C corporation tax return and on or before the due date for the first three S corporation tax returns. The S corporation's inventory basis is increased by the LIFO recapture amount included in gross income.

EXAMPLE C:11-14

- Taylor Corporation, a calendar year C corporation since its inception in 2007, made an S election on December 21, 2019, effective for its 2020 tax year. Taylor has used the LIFO inventory method for a number of years. Its LIFO inventory has a \$400,000 adjusted basis, a \$650,000 FIFO inventory value, and an \$800,000 FMV. Taylor's LIFO recapture amount is \$250,000 ($\$650,000 - \$400,000$). Taylor includes this amount in gross income reported on its 2019 C corporation tax return. Given a 21% corporate tax, Taylor's increased tax liability is \$52,500 ($0.21 \times \$250,000$), of which \$13,125 ($0.25 \times \$52,500$) is due with Taylor's 2019 C corporation tax return. An additional \$13,125 is due with the 2020 through 2022 S corporation tax returns. Taylor increases the basis of its inventory by the \$250,000 LIFO recapture amount. ◀

STOP & THINK

Question: Former C corporations that are now treated as S corporations are subject to three corporate level taxes—the LIFO recapture tax, the built-in gains tax, and the excess net passive income tax. Why did Congress enact these three taxes?

Solution: Prior to enacting the LIFO recapture tax, Congress debated making the conversion of a C corporation into an S corporation a taxable event subject to the corporate liquidation rules. The corporation would have recognized all gains and losses at the time of conversion. As a compromise, only LIFO users are subject to an “automatic” tax when conversion occurs, and this tax applies only to the LIFO recapture amount and not all inventory appreciation. The built-in gains tax applies only when the corporation sells or exchanges assets during its first ten years after the S election. Assets not sold or exchanged during this time period escape the tax. The excess net passive income tax encourages S corporations to distribute their accumulated E&P. No tax is imposed, however, if the corporation keeps its passive income below the 25% of gross receipts threshold. Thus, former C corporations and their shareholders generally are better off under the current system than had Congress mandated corporate liquidation treatment.

REAL-WORLD EXAMPLE

The special S corporation taxes account for only a small amount of federal revenues. For example, collections on the built-in gains and excess net passive income taxes usually are less than 1% of total C corporation tax revenues.

TAXATION OF THE SHAREHOLDER

OBJECTIVE 5

Allocate an S corporation's ordinary and separately stated items to its shareholders and apply loss limitation rules

INCOME ALLOCATION PROCEDURES

An S corporation's shareholders must report their pro rata share of the ordinary income or loss and separately stated items for the S corporation's tax year that ends with or within the shareholder's tax year.³⁷ Each shareholder's pro rata share of these items is determined by

1. Allocating an equal portion to each day in the tax year (by dividing the amount of the item by the number of days in the S corporation's tax year)
2. Allocating an equal portion of the daily amount to each share of stock outstanding on each day (by dividing the daily amount for the item by the number of shares of stock outstanding on a particular day)
3. Totalling the daily allocations for each share of stock
4. Totalling the amounts allocated for each share of stock held by the shareholder

TYPICAL MISCONCEPTION

An S corporation's income or loss is allocated basically the same as a partnership's except that a partnership may have the added flexibility of making certain special allocations under Sec. 704(b).

These allocation rules are known as the "per day/per share" method. Special allocations (such as those possible under the partnership tax rules) of the ordinary income or loss and separately stated items are not permitted.

If a sale of the S corporation stock occurs during the year, the transferor reports the earnings allocated to the transferred shares through the day of the transfer.³⁸ The transferee reports his or her share of the earnings from the day after the transfer date through the end of the tax year.

EXAMPLE C:11-15 ▶ Fox Corporation is an S corporation owned equally by Arnie and Bonnie during all of the current year (assume not a leap year). During this year, Fox reports ordinary income of \$146,000 and a long-term capital gain of \$36,500. Arnie and Bonnie each report \$73,000 ($0.50 \times \$146,000$) of ordinary income and \$18,250 ($0.50 \times \$36,500$) of long-term capital gain. ◀

EXAMPLE C:11-16 ▶ Assume the same facts as in Example C:11-15, except Bonnie sells one-half of her shares to Clay on March 31 of the current year (the 90th day of Fox's tax year). Arnie reports the same ordinary income and long-term capital gain from his investment. Bonnie and Clay report ordinary income and long-term capital gain as follows:

		<u>Ordinary Income</u>	
Bonnie:	$\left(\$146,000 \times \frac{1}{2} \times \frac{90}{365} \right) + \left(\$146,000 \times \frac{1}{4} \times \frac{275}{365} \right)$		= \$45,500
Clay:	$\$146,000 \times \frac{1}{4} \times \frac{275}{365}$		= <u>27,500</u>
	Total		= <u><u>\$73,000</u></u>

		<u>Long-Term Capital Gain</u>	
Bonnie:	$\left(\$36,500 \times \frac{1}{2} \times \frac{90}{365} \right) + \left(\$36,500 \times \frac{1}{4} \times \frac{275}{365} \right)$		= \$11,375
Clay:	$\$36,500 \times \frac{1}{4} \times \frac{275}{365}$		= <u>6,875</u>
	Total		= <u><u>\$18,250</u></u> ◀

³⁷ Sec. 1366(a). If the shareholder dies during the S corporation's tax year, the income earned during the portion of the tax year preceding death is reported on the shareholder's tax return. Income for the period the estate holds the S corporation stock is reported on the estate's fiduciary tax return.

³⁸ Reg. Sec. 1.1377-1(a)(2)(ii). Also see examples under Reg. Sec. 1.1377-1(c).

KEY POINT

Shareholders of an S corporation need to be aware that when they dispose of their stock, they have the option of having income or loss determined by an actual closing of the books rather than an allocation on a daily basis.

A special election is available for allocating the ordinary income or loss and separately stated items when the shareholder's interest in the S corporation terminates or is substantially reduced during the tax year. Under this election, the income is allocated according to the accounting methods used by the S corporation (instead of on a daily basis). The election divides the S corporation's tax year into two parts ending on

- The day the shareholder's interest in the corporation terminates
- The last day of the S corporation's tax year

The corporation can make this election only if all affected shareholders agree to the election.³⁹ Affected shareholders include the shareholder whose interest terminated and all shareholders who received S corporation shares during the year. The Tax Planning Considerations section of this chapter explores this election in greater detail.

ADDITIONAL COMMENT

The limitation on net business interest also could apply in S corporation situations similar to its application to partnerships. Chapter C:9 covers this topic in some detail.

INCOME PASS-THROUGH TO SHAREHOLDERS

The S corporation's ordinary income and separately stated items pass through to the shareholders at the end of the corporation's tax year with all items retaining the same character as at the corporation level. In addition the shareholders may be eligible for the qualified business income (QBI) deduction. Chapter C:9 covers this topic in detail, and the QBI deduction rules apply to S corporation shareholders in a similar manner.

EXAMPLE C:11-17

► Beta Corporation is a calendar year S corporation with one shareholder, William. The corporation incurs the following items in the current year:

Gross profit from operations	\$250,000
Long-term capital gain	5,000
Tax-exempt interest income	1,000
Short-term capital loss	2,000
Salary paid William	80,000
Depreciation deduction	20,000
Other business deductions	50,000

Assume that William's salary is reasonable and that any employment taxes on William's salary are included in other business deductions.

The S corporation items are classified as follows:

S corporation ordinary income:	
Gross profit from operations	\$250,000
Minus: Salary to William	(80,000)
Depreciation	(20,000)
Other business deductions	(50,000)
S corporation ordinary income	<u>\$100,000</u>
Separately stated items:	
Long-term capital gain	\$ 54,000
Short-term capital loss	(2,000)
Tax-exempt income	1,000

The S corporation reports ordinary income or loss items on page 1 of Form 1120S. It reports the separately stated items (as well as the \$100,000 S corporation ordinary income) on Schedule K of Form 1120S. It also prepares a separate Schedule K-1 that reports to William his share of S corporation items. William uses the Schedule K-1 information to prepare his individual tax return. ◀

³⁹ Sec. 1377(a)(2).

EXAMPLE C:11-18 ▶ Assume the same facts as in Example C:11-17. In addition, William is married and files a joint tax return, claiming the standard deduction. William's spouse earns a \$90,000 salary for the year. Taxable income on the joint tax return is calculated as follows:

Share of S corporation ordinary income	\$100,000
Share of S corporation net capital gain (\$5,000 – \$2,000)	3,000
William's salary	80,000
Spouse's salary	90,000
Adjusted gross income	<u>\$273,000</u>
Minus: Standard deduction	(24,400)
QBI deduction	(20,000)
Taxable income	<u>\$228,600</u>

Excess taxable income without regard to the net capital gain and QBI deduction is \$245,600 (\$273,000 AGI – 3,000 NCG – \$24,400 SD). Thus, the QBI deduction is the lesser of:

Combined QBI (\$100,000 × 0.20)	\$20,000 or
20% of excess taxable income (\$245,600 × 0.20)	\$49,120

The W-2 and service business restrictions do not apply in this example because the taxpayers' taxable income is less than \$321,400 (in 2019). Only William's S corporation ordinary income (and not his salary) is qualified business income. Note that, if William reduced his salary, his QBI deduction would increase, and the corporation's employment taxes would decrease. Thus, the reasonableness of the salary is important. An unreasonably low salary would invite IRS scrutiny and possibly an adjustment. ▶

LOSS AND DEDUCTION PASS-THROUGH TO SHAREHOLDERS

The S corporation's ordinary loss and separately stated loss and deduction items pass through to the shareholders at the end of the corporation's tax year. The shareholders report these items in their tax year in which the S corporation's tax year ends.

Allocation of the Loss. Under the rules outlined above, allocation of the loss also occurs on a daily basis. Thus, shareholders receive an allocation of ordinary loss and separately stated items even if they own the stock for only a portion of the year. If ordinary loss and other separately stated loss and deduction pass-through items exceed the shareholder's income, the excess may create an NOL for the shareholder and result in a carryover at the shareholder level.

EXAMPLE C:11-19 ▶ Kauai Corporation, an S corporation, reports a \$73,000 ordinary loss during the current year (not a leap year). At the beginning of the current year, Edward and Frank own equally all of Kauai's stock. On June 30 of the current year (the 181st day of Kauai's tax year), Frank gives one-fourth of his stock to his son George. Edward is allocated \$36,500 ($\$73,000 \times 0.50$) of ordinary loss. Frank and George are allocated ordinary losses as follows:

$$\begin{array}{rcl} \text{Frank:} & \left(\$73,000 \times \frac{1}{2} \times \frac{181}{365} \right) + \left(\$73,000 \times \frac{3}{8} \times \frac{184}{365} \right) & = \$31,900 \\ \text{George:} & \$73,000 \times \frac{1}{8} \times \frac{184}{365} & = \underline{4,600} \\ \text{Total} & & \underline{\underline{\$36,500}} \end{array}$$

All three shareholders can deduct these losses on their individual tax returns subject to the loss limitations described below. ▶

Shareholder Loss Limitations. Each shareholder's deduction for his or her share of the ordinary loss and the separately stated loss and deduction items is limited to the sum

REAL-WORLD EXAMPLE

A U.S. Supreme Court case held that discharge of indebtedness income excluded from gross income under Sec. 108 nevertheless is a pass-through item that increases the shareholders' stock bases, thereby allowing loss pass-through items to be deducted by the shareholders. *Gitlitz et al. v. Comm.* 87 AFTR 2d 2001-417, 2001-1 USTC ¶50,147 (USSC, 2001). A subsequent tax act, however, disallowed the pass-through and stock basis increase for debt cancellations. This situation is a good example of Congress "overruling" the Supreme Court with its legislative power.

of the adjusted basis for his or her S corporation stock plus the adjusted basis of any indebtedness owed *directly* by the S corporation to the shareholder. Thus, a shareholder must account for stock basis and debt basis. Unlike the partnership taxation rules, however, a shareholder cannot increase his or her stock basis by a ratable share of the general S corporation liabilities.⁴⁰

In determining the stock basis limitation for losses, the shareholder makes the following positive and negative adjustments:⁴¹

- Increase stock basis for any capital contributions during the year
- Increase stock basis for ordinary income and separately stated income or gain items
- Decrease stock basis for distributions not included in the shareholder's income
- Decrease stock basis for nondeductible, noncapital expenditures (unless the shareholder elects to determine the loss limitation without this decrease)

Sequencing the basis reduction for distributions ahead of losses means that distributions reduce the deductibility of S corporation loss and deduction pass-throughs, but losses do not affect the treatment of S corporation distributions.

Many S corporations are nothing more than incorporated forms of sole proprietorships or partnerships. As a result, banks and other lending institutions often require one or more shareholders to personally guarantee loans the institutions make to the S corporation. The IRS and courts, however, have held that these guaranteed loans do not create corporate indebtedness to the shareholder. As a result, the shareholder's loss limitation does not increase until the shareholder pays part or all of the corporation's liability or the shareholder executes a note at the bank in full satisfaction of the corporation's liability. Such action by the shareholder converts the guarantee into an indebtedness of the corporation to the shareholder, which increases the shareholder's debt basis and loss limitation.⁴²

The adjusted basis of S corporation stock and debt generally is determined as of the last day of the S corporation's tax year. If the shareholder disposes of the S corporation stock before that date, the stock and debt bases are instead determined immediately prior to the disposition.

Loss and deduction pass-through items are allocated to each share of stock and reduce each share's basis. Once the losses and deductions have reduced stock basis to zero, they then reduce the basis of any debt owed by the S corporation to the shareholder.

TAX STRATEGY TIP

Rather than having the corporation borrow money, an S corporation shareholder might consider borrowing money directly from the bank and then lending the loan proceeds to the corporation with the corporation guaranteeing the bank loan. In this way, the shareholder obtains debt basis.

EXAMPLE C:11-20 ►

Pat and Bill equally own Tillis Corporation, an S corporation. During the current year, Tillis reports an ordinary loss of \$104,000. Tillis's liabilities at the end of the current year include \$110,000 of accounts payable, \$150,000 of mortgage payable, and a \$20,000 note owed to Bill. Thus, Bill has a \$20,000 debt basis for the amount he loaned to the corporation. Pat and Bill each had a \$40,000 adjusted basis in their Tillis stock on January 1. The ordinary loss is allocated equally to Pat and Bill. Pat's \$52,000 loss allocation is only partially deductible this year (i.e., up to \$40,000) because the loss exceeds his \$40,000 stock basis. Bill's \$52,000 loss allocation is fully deductible this year because his loss limitation is \$60,000 (\$40,000 stock basis + \$20,000 debt basis). After the loss pass-through, Pat and Bill each have a zero stock basis and Bill has an \$8,000 debt basis.⁴³ ◀

⁴⁰ Sec. 1366(d)(1). Amounts owed by an S corporation to a conduit entity that has the shareholder as an owner or beneficiary will not increase the shareholder's loss limitation.

⁴¹ Sec. 1366(d) and Reg. Sec. 1.1366-2(a)(3). Special basis adjustment rules apply to oil and gas depletion.

⁴² Rev. Ruls. 70-50, 1970-1 C.B. 178; 71-288, 1971-2 C.B. 319; and 75-144, 1975-1 C.B. 277. See also *Estate of Daniel Leavitt v. CIR*, 63 AFTR 2d 89-1437, 89-1 USTC ¶9332 (4th Cir., 1989) among a series of decisions that

uphold the IRS's position. However, see *Edward M. Selfe v. U.S.*, 57 AFTR 2d 86-464, 86-1 USTC ¶9115 (11th Cir., 1986) for a transaction where a guarantee was held to increase the shareholder's loss limitation because the transaction was structured so the bank looked primarily to the shareholder instead of the corporation for repayment.

⁴³ See pages C:11-25 through C:11-28 for a detailed discussion of basis adjustments.

Any loss or deduction pass-through not currently deductible is suspended until the shareholder regains basis in his stock or debt. The carryover period for the loss or deduction item is unlimited.⁴⁴ The additional adjusted basis amount can originate from a number of sources, including subsequent profits earned by the S corporation, additional capital contributions or loans made by the shareholder to the corporation, or purchases of additional stock from other shareholders.

EXAMPLE C:11-21 ▶ Assume the same facts as in Example C:11-20 and that Tillis Corporation reports ordinary income of \$24,000 next year. Pat and Bill each are allocated \$12,000 of ordinary income. This income provides Pat with the necessary \$12,000 stock basis to deduct the \$12,000 loss carryover. The \$12,000 income allocated to Bill restores his debt basis to \$20,000 (see footnote 43). ◀

If a limited loss is made up of more than one type of income, the loss limitation is prorated between the different types of losses. For example, if a shareholder has a \$6,000 stock basis, a \$9,000 ordinary loss pass-through, and a \$3,000 long-term capital loss pass-through, \$4,500 ($\$6,000 \times \$9,000/\$12,000$) of the allowed loss is ordinary, and \$1,500 ($\$6,000 \times \$3,000/\$12,000$) of the allowed loss is a long-term capital loss.

If a shareholder sells his or her S corporation stock still having unused losses due to lack of stock or debt basis, these losses do not transfer to the new shareholder. Instead, the unused losses lapse when the shareholder sells the stock. If the shareholder transfers the S corporation stock to a spouse or former spouse incident to a divorce, however, the suspended losses transfer to the spouse or former spouse. Thus, the spouse or former spouse can deduct the losses when he or she obtains sufficient basis.

Special Shareholder Loss and Deduction Limitations. S corporation shareholders are subject to three special loss and deduction limitations. These limitations may prevent an S corporation's shareholder from using losses or deductions even though the general loss limitation described above does not otherwise apply. Application of the special loss limitations occurs as follows:

KEY POINT

An advantage of an S election is that losses pass through to the shareholders. This advantage, however, is significantly limited by the at-risk and passive activity rules.

- ▶ **At-Risk Rules:** The Sec. 465 at-risk rules apply at the shareholder level. Thus, a shareholder can deduct a loss from a particular S corporation activity only to the extent the shareholder is at risk in the S corporation's activity at year-end.
- ▶ **Passive Activity Limitation Rules:** Losses and credits from a passive activity offset income earned from that passive activity or other passive activities in the same or subsequent tax year. An S corporation shareholder personally must meet the material participation standard for an activity to avoid the passive activity limitation. The S corporation's material participation in an activity does not allow a passive investor to deduct S corporation losses against his or her salary and other "active" income.
- ▶ **Excess Business Losses:** S corporation shareholders are subject to the limitation on excess business losses. This topic is covered in Chapter C:9 and applies to S corporation shareholders in a manner similar to that for partners in a partnership.

In addition, various separately stated loss and deduction items are subject to shareholder limitations (e.g., charitable contributions, capital losses, and investment interest expenses), but they are not subject to corporate limitations. Conversely, some separately stated items are subject to corporate limitations but not shareholder limitations (e.g., the 50% nondeductible portion of meal and entertainment expenses).

Post-Termination Loss Carryovers. Loss and deduction carryovers incurred in S corporation tax years can carry over at the shareholder level even though the S election has terminated. Shareholders can deduct these carryovers only in the post-termination transition period.⁴⁵

⁴⁴ Sec. 1366(d)(2). If more than one type of loss or deduction item passes through to the shareholder, the carryover amount is allocated to each of the pass-through items based on their relative amounts.

⁴⁵ Sec. 1366(d)(3). The loss carryovers that carry over include those disallowed by the at-risk rules.

SELF-STUDY QUESTION

If losses are suspended due to the lack of basis in S corporation stock, do the losses expire when the S election terminates?

ANSWER

No. These loss carryovers may be deducted in the post-termination transition period (usually one year) if the shareholder creates additional stock basis in that period of time.

The length of the post-termination transition period depends on the event causing the termination. In general, the period begins on the day after the last day of the corporation's final S corporation tax year and ends on the later of one year after the last day or the due date for the final S corporation tax return (including any extensions).

If the S election terminates for a prior tax year as a result of a determination, the period runs for 120 days beginning on the determination date. Section 1377(b)(2) defines a determination as a court decision that becomes final, a closing agreement entered into, a final disposition of a refund claim by the IRS, or an agreement between the corporation and the IRS that the corporation failed to qualify as an S corporation.

The shareholder can deduct the loss carryovers only up to his or her adjusted basis of the stock at the end of the post-termination transition period.⁴⁶ Losses that cannot be deducted because of the basis limitation are lost forever. Deducted losses reduce the shareholder's stock basis.

EXAMPLE C:11-22 ►

Sigma Corporation has been a calendar year S corporation for several years. Helen's stock basis is \$45,000. On July 1, 2019, its S election terminates when an ineligible shareholder acquires part of its stock. For the period ended June 30, 2019, Helen is allocated \$60,000 of Sigma's ordinary loss. Helen can deduct only \$45,000 of this loss because of her Sigma stock basis, which the loss reduces to zero. The \$15,000 unused loss carries over to the post-termination transition period, which ends on June 30, 2020, assuming Sigma does not extend the March 16, 2020 (March 15 falls on a Sunday), due date for the S short-year tax return. Helen must have an adjusted basis for the Sigma stock of at least \$15,000 at the close of business on June 30, 2020, to use the loss. Helen should consider making additional capital contributions of at least \$15,000 between July 1, 2019, and June 30, 2020, to use the loss. ◀

Topic Review C:11-3 summarizes the rules governing deductibility of S corporation losses and deductions that pass through to the shareholders.

TOPIC REVIEW C:11-3**Deductibility of S Corporation Losses and Deductions****ALLOCATION PROCESS**

1. Losses and deductions are allocated based on the number of shares of stock owned by each shareholder on each day of the tax year. Special allocations of losses and deductions are not permitted.
2. Termination of the S election requires the tax year to be divided into two parts. The corporation can elect (with the shareholders' consent) to allocate the loss or deduction according to the corporation's accounting methods. This election also is available when a shareholder's interest in the S corporation terminates.

LOSS LIMITATIONS

1. Losses and deductions pass through on a per-share basis and are limited to the shareholder's basis in stock and debt. Once the basis for all the shareholder's stock is reduced to zero, the losses reduce the basis of any S corporation indebtedness to the shareholder.
2. Losses and deductions that are not deducted carry over to a tax year in which the shareholder regains stock or debt basis. The time period for the carryover is unlimited. The unused losses lapse if the shareholder transfers the stock to anyone other than a spouse or former spouse incident to a divorce.
3. S corporation shareholders are subject to three special loss limitations:

- At-risk rules
- Passive activity limitations
- Limitation on excess business losses

Some separately stated loss and deduction items also are subject to shareholder limitations (e.g., investment interest expense). Other separately stated items are subject to corporate limitations but not shareholder limitations (e.g., the 50% nondeductible portion of business meals expenses).

⁴⁶ Sec. 1366(d)(3)(B).

FAMILY S CORPORATIONS

Family S corporations have been an important tax planning device. This type of tax planning often involves a high-tax-bracket taxpayer gifting stock to a minor child who generally has little other income. The transfer results in income splitting among family members. The IRS has enjoyed success in litigating cases dealing with intrafamily transfers of S corporation stock when the transferor (usually a parent) retains the economic benefits and control over the stock transferred to the transferee (usually a child).⁴⁷ The IRS has attained less success when one family member purchases the stock from another family member at its market value.

ADDITIONAL COMMENT

The advantages of family S corporations have been somewhat curtailed. For example, income from stock of an S corporation gifted to a child under age 18 (and, in some cases, age 18 through 23) is subject to the “kiddie tax,” where unearned income exceeding \$2,200 (in 2019) is taxed at special rates based on the estate and trust income tax rates.

The IRS also has the statutory authority to adjust the income, loss, deduction, or credit items allocated to a family member to reflect the value of services rendered or capital provided to the corporation. Section 1366(e) defines family as including spouse, ancestors, lineal descendants, and trusts created for such individuals. This provision permits the reallocation of income to provide for full compensation of a shareholder or nonshareholder for services and capital provided to the corporation. It also reduces the residual income reported by the S corporation and allocated to the shareholders according to their stock ownership. Such a reallocation prevents not only the shifting of income from the family member providing the services or capital to other family members, but also the avoidance of employment taxes. Alternatively, the IRS can determine that the corporation paid too much compensation to a shareholder and reduce that shareholder’s salary and increase the residual income allocated based on stock ownership.

EXAMPLE C:11-23 ▶

Harvest Corporation, an S corporation, reports ordinary income of \$200,000 after it claims a \$20,000 deduction for Sid’s salary. Sid and his three children own the Harvest stock equally. Harvest employs none of Sid’s three children. The IRS subsequently determines that reasonable compensation for Sid is \$80,000. This adjustment increases Sid’s salary income and Harvest’s compensation deduction by \$60,000 (\$80,000 – \$20,000) and reduces Harvest’s ordinary income to \$140,000 (\$200,000 – \$60,000). Each shareholder’s ratable share of ordinary income is reduced from \$50,000 (\$200,000 ÷ 4) to \$35,000 (\$140,000 ÷ 4). These adjustments have a threefold effect. First, they increase the amount of income allocable to Sid (\$80,000 + \$35,000 vs. \$20,000 + \$50,000), where Sid may be in a higher tax bracket than his children. Second, the increased salary increases Sid’s employment taxes. Third, the increased salary decreases Sid’s qualified business income for the QBI deduction. Alternatively, if the IRS can prove that the stock transfer to the three children is not a bona fide transfer, all \$220,000 of Harvest’s income is taxed to Sid—\$80,000 as salary and \$140,000 as an allocation of ordinary income. ◀

BASIS ADJUSTMENTS

OBJECTIVE 6

Calculate a shareholder’s basis in his or her S corporation stock and debt

Shareholder’s must adjust their S corporation stock basis annually. In addition, if the S corporation is indebted to the shareholder, he or she may have to adjust the debt basis downward for loss or deduction pass-throughs and upward to reflect restoration of the debt basis when the corporation earns subsequent profits. Each of these adjustments is described below.

BASIS ADJUSTMENTS TO S CORPORATION STOCK

Basis adjustments to the shareholder’s stock are made in the following order:⁴⁸

- Initial investment (or basis at beginning of tax year)
- Plus: Additional capital contributions made during the year
- Allocable share of ordinary income
- Allocable share of separately stated income and gain items

⁴⁷ See, for example, *Gino A. Specca v. CIR*, 47 AFTR 2d 81-468, 80-2 USTC ¶9692 (7th Cir., 1980) and *Henry D. Duarte*, 44 T.C. 193 (1965), where the IRS’s position prevailed. See also *Gavin S. Millar*, 1975 PH T.C. Memo

¶75,113, 34 TCM 554, and *Donald O. Kirkpatrick*, 1977 PH T.C. Memo ¶77, 281, 36 TCM 1122, where the taxpayers prevailed.

⁴⁸ Sec. 1367(a) and Reg. Sec. 1.1367-1(f).

SELF-STUDY QUESTION

Why is the determination of stock basis in an S corporation important?

ANSWER

To determine gain or loss on the sale of the stock, to determine the amount of losses that can be deducted, and to determine the amount of distributions to shareholders that are nontaxable.

Minus: Distributions excluded from the shareholder's gross income
Allocable share of any expense not deductible in determining ordinary income (loss) and not chargeable to the capital account (A shareholder, however, can elect to make this adjustment <i>after</i> the two following adjustments.)
Allocable share of ordinary loss and separately stated loss and deduction items (prorated among such losses if limited)
Adjusted basis for stock (but not less than zero)

A shareholder's initial basis for S corporation stock depends on how he or she acquires it. Stock purchased from the corporation or another shareholder takes a cost basis. Stock received as part of a corporate formation takes a substituted basis from the assets transferred. Stock acquired by gift takes the donor's basis (adjusted for gift taxes paid) or FMV (if lower). Stock acquired at death takes its FMV on the decedent's date of death or the alternate valuation date (if elected). The basis of S corporation stock inherited from a deceased shareholder is its FMV minus any corporate income that would have been income in respect of a decedent (see Chapter C:14) if the income had been acquired from the decedent. No basis adjustment occurs when the corporation makes the initial S election.

The basis adjustments to the S corporation stock parallel those made to a partnership interest. The ordinary income and separately stated income and gain items increase the shareholder's basis whether they are taxable, tax-exempt, or receive preferential tax treatment.

EXAMPLE C:11-24 ► Cathy owns Marlo Corporation, an S corporation. At the beginning of the current year, Cathy's adjusted basis in her Marlo stock is \$105,000. Marlo reports the following operating results this year:

Ordinary income	\$70,000
Municipal bond interest income	15,000
Dividends from domestic corporations	6,000
Long-term capital gain	8,000
Short-term capital loss	17,000

Cathy's adjusted basis in her Marlo stock at year-end is \$187,000 (\$105,000 + \$70,000 + \$15,000 + \$6,000 + \$8,000 - \$17,000). ◀

Cathy makes the basis adjustment at the end of the S corporation's tax year, when the results for the entire period are known. Because profits and losses are allocated ratably on a daily basis to all shares held on each day of the tax year, a shareholder's gain or loss realized on the sale of S corporation stock during the tax year is not determinable until the ordinary income or loss and separately stated items allocable to the shares sold are known. Similarly, when S corporation stock becomes worthless during a tax year, the shareholder must make the necessary positive and negative basis adjustments before determining the amount of the worthless security loss.

EXAMPLE C:11-25 ► Mike, Carlos, and Juan equally own Diaz Corporation, an S corporation. Mike's 100 shares of Diaz stock have a \$25,000 adjusted basis at the beginning of the current year (not a leap year). Diaz reports ordinary income of \$36,500 and municipal bond interest income of \$14,600 in the current year. On February 14 of the current year (the 45th day of Diaz's tax year), Mike sells all his Diaz stock for \$30,000. Assuming the corporation uses the daily method to allocate the income items, Mike's basis for the Diaz stock is \$27,100, determined as follows:

$$\$27,100 = \$25,000 + \left(\$36,500 \times \frac{45}{365} \times \frac{1}{3} \right) + \left(\$14,600 \times \frac{45}{365} \times \frac{1}{3} \right)$$

Mike reports a \$2,900 (\$30,000 - \$27,100) gain on the sale. ◀

KEY POINT

Losses first reduce basis in stock and then any amount of debt owed to the shareholder by the S corporation. Subsequent net increases in basis are added first to debt and then to stock.

BASIS ADJUSTMENTS TO SHAREHOLDER DEBT

After the shareholder's basis in S corporation stock is reduced to zero, basis in any S corporation indebtedness to the shareholder is reduced (but not below zero) by the remainder of the available loss and deduction items.⁴⁹ If a shareholder has more than one loan outstanding at year-end, the basis reduction applies to all the indebtednesses based on the relative adjusted basis of each loan. Ordinary income and separately stated gain or income items allocated to the shareholder in subsequent tax years (net of distributions and losses to the shareholders) first restore debt basis. Once all previous decreases to debt basis are restored, any additional positive basis adjustments increase the shareholder's stock basis.⁵⁰

Repayment of a shareholder indebtedness results in gain recognition to the shareholder if the payment amount exceeds the debt's adjusted basis. If the indebtedness is secured by a note, the difference is a capital gain. If the indebtedness is not secured by a note or other evidence of the indebtedness, the repayment is ordinary income.⁵¹

EXAMPLE C:11-26 ▶

At the beginning of Year 1, Betty owns one-half the stock of Trailer Corporation, an S corporation. Betty's basis in the Trailer stock is \$40,000. Trailer owes Betty \$20,000 on January 1, Year 1, evidenced by a note. Thus, Betty has a \$20,000 debt basis. During Year 1, Trailer reports an ordinary loss of \$100,000 and during Year 2 reports ordinary income of \$10,000. Betty's \$50,000 loss pass-through from Year 1 first reduces her stock basis from \$40,000 to zero. Next, the \$10,000 remainder of the loss pass-through reduces Betty's debt basis from \$20,000 to \$10,000. Betty's \$5,000 allocation of Year 2's ordinary income increases her debt basis from \$10,000 to \$15,000. If the corporation repays the note before the end of Year 2, Betty reports a \$5,000 (\$20,000 – \$15,000) long-term capital gain resulting from the repayment plus \$5,000 of ordinary income from Trailer's Year 2 operations. If the debt instead were unsecured (i.e., an advance from the shareholder not secured by a note), the gain would be ordinary income. ▶

**STOP & THINK**

Question: The text preceding Example C:11-26 says that ordinary income and separately stated gain or income items (net of losses and distributions) restore debt basis before increasing stock basis; that is, debt is restored first by any net increase. The following rule also applies: total basis for the loss limitation equals (1) stock basis *after* all current year adjustments other than for losses plus (2) debt basis *before* any current year adjustments.

Consider the following situation: Omega Corporation is an S corporation with one shareholder. At the beginning of last year, the shareholder's stock basis was \$15,000, and her debt basis was \$20,000. Last year, Omega incurred a \$45,000 ordinary loss, \$35,000 of which the shareholder could deduct and \$10,000 of which carries over. The loss affected basis as follows:

	<u>Stock Basis</u>	<u>Debt Basis</u>
Basis at beginning of last year	\$15,000	\$20,000
Ordinary loss last year (\$45,000)	(15,000)	(20,000)
Basis at beginning of current year	<u>\$ -0-</u>	<u>\$ -0-</u>

In the current year, Omega earns \$18,000 of ordinary income. What does the shareholder recognize in the current year, and what is the effect on her stock and debt bases? Why is the net increase rule for debt basis restoration beneficial to the shareholder?

Solution: The shareholder recognizes \$18,000 of ordinary income and deducts the entire \$10,000 loss carryover. Current year basis adjustments are as follows:

	<u>Stock Basis</u>	<u>Debt Basis</u>
Balance at beginning of current year	\$ -0-	\$ -0-
Ordinary income	10,000	8,000
Loss carryover allowed	(10,000)	-0-
Basis at end of current year	<u>\$ -0-</u>	<u>\$8,000</u>

The net increase approach benefits the shareholder because it allows her to deduct the \$10,000 loss carryover in the current year rather than next year. The net increase for

⁴⁹ The shareholder makes no basis reductions to debt repaid before the end of the tax year. Regulation Sec. 1.1367-2(d)(1) holds that restoration occurs immediately before a shareholder repays or disposes of indebtedness during the tax year.

⁵⁰ Sec. 1367(b)(2)(B).

⁵¹ Rev. Ruls. 64-162, 1964-1 (Part I) C.B. 304 and 68-537, 1968-2 C.B. 372.

debt restoration is \$8,000 (\$18,000 – \$10,000), which leaves \$10,000 of the \$18,000 ordinary income to increase stock basis. This net increase approach to debt restoration allows a stock basis increase sufficient to use the loss carryover. Alternatively, if debt were restored by ordinary income without netting, the debt basis would increase by the entire \$18,000, leaving no positive adjustment to the stock basis. This increase to debt basis would not help the shareholder in the current year because debt basis for the loss limitation is the balance before any current year adjustments. Under this hypothetical alternative approach, the shareholder could deduct the loss next year because next year's beginning debt basis would be \$18,000. However, the net increase approach is better than the alternative because it allows the shareholder to deduct the loss in the current year.

S CORPORATION DISTRIBUTIONS

OBJECTIVE 7

Determine the taxability of an S corporation's distributions to its shareholders

Two sets of rules apply to S corporation distributions. One applies to S corporations having accumulated E&P. Accumulated E&P may exist if an S corporation was a C corporation in a pre-S election tax year. Another set of distribution rules applies to S corporations that do not have E&P (e.g., a corporation formed after 1982 that makes a timely S election in its initial tax year). These rules are explained below.

CORPORATIONS HAVING NO EARNINGS AND PROFITS

For S corporations with no accumulated E&P, a two-tier rule applies. Distributions are initially nontaxable and reduce the shareholder's stock basis (but not below zero). If the distribution exceeds the shareholder's stock basis, the shareholder treats the excess as a gain from the sale or exchange of the stock. Stock basis for determining excess distributions is that after positive adjustments for ordinary income and separately stated income and gain items but before negative adjustments.⁵²

EXAMPLE C:11-27 ►

Sandy owns 100% of Liberty Corporation, an S corporation. At the beginning of the current year, Sandy's adjusted basis in her Liberty stock (a capital asset) is \$20,000, and she has no debt basis. In the current year, Liberty reports ordinary income of \$30,000 and a long-term capital loss of \$7,000. Liberty makes a \$35,000 cash distribution to Sandy on June 15. Sandy's basis for the stock must be adjusted for the ordinary income before determining the taxability of the distribution. Because Sandy's \$50,000 (\$20,000 + \$30,000) adjusted stock basis exceeds the \$35,000 distribution, she excludes the entire distribution from her gross income. The distribution reduces her stock basis to \$15,000 (\$50,000 – \$35,000). Because Sandy still has sufficient stock basis, she can deduct the \$7,000 capital loss, which further reduces her stock basis to \$8,000.

If Liberty instead reports only \$5,000 of ordinary income and a \$7,000 capital loss, \$10,000 of the distribution is taxable. The ordinary income increases the stock's basis to \$25,000 (\$20,000 + \$5,000). Because the distribution exceeds the stock's adjusted basis by \$10,000 (\$35,000 – \$25,000), Sandy recognizes a capital gain on the excess distribution. The distribution not included in Sandy's income (\$25,000) reduces her stock basis to zero at year-end. Because the stock basis after the distribution is zero, Sandy cannot deduct the \$7,000 capital loss in the current year. She must wait until she regains a positive stock basis (or obtains debt basis by lending money to the corporation). ◀

SELF-STUDY QUESTION

Can distributions that exceed stock basis be nontaxable to the extent of shareholder loans?

ANSWER

No. Although the amount of deductible losses can be increased by the amount of shareholder loans, nontaxable distributions are strictly limited to stock basis. Also, distributions never reduce debt basis.

If an S corporation distributes appreciated property to its shareholders, the S corporation recognizes gain as if it sold the property.⁵³ The corporation recognizes no loss, however, when it distributes property that has declined in value. The gain recognized on the distribution may be taxed at the corporate level as part of the S corporation's built-in gains or excess net passive income. The gain also becomes part of the S corporation's ordinary income or loss, or is passed through as a separately stated item, depending on the

⁵² Secs. 1368(b) and (d).

⁵³ Sec. 311(b).

type of property distributed and the character of the gain recognized. After this recognition occurs, the distributed property causes no further taxation provided the sum of the money plus the FMV of the noncash property distributed does not exceed the shareholder's stock basis. The shareholder's stock basis is reduced by the FMV of the distribution, and the shareholder takes a FMV basis in the distributed property.

EXAMPLE C:11-28 ▶

Tad owns 100% of Echo Corporation, which always has been an S corporation. Tad's stock basis at the beginning of the current year is \$50,000. Echo reports \$30,000 of ordinary income for this year (exclusive of the effects of a property distribution to Tad). On December 1, Echo distributes some Cable Corporation stock to Tad. The stock cost \$40,000 and has a \$100,000 FMV, and Echo has held it as an investment for three years. Echo reports \$60,000 (\$100,000 – \$40,000) of capital gain from distributing the stock. Tad reports \$30,000 of ordinary income and \$60,000 of long-term capital gain from Echo's current year activities. Tad's stock basis increases to \$140,000 (\$50,000 + \$30,000 + \$60,000). The distribution is free of further taxation because the \$140,000 stock basis exceeds the \$100,000 distribution. The stock basis is \$40,000 (\$140,000 – \$100,000) at year-end. Tad takes a \$100,000 FMV basis in the Cable stock. ◀

ADDITIONAL COMMENT

The distribution of appreciated stock in Example C:11-28 produced income to Echo, which passed through to Tad. A similar distribution by a C corporation would result in a double tax by causing income recognition to both Echo and Tad.

CORPORATIONS HAVING ACCUMULATED EARNINGS AND PROFITS

Prior Rules. Under pre-1983 rules, a corporation's undistributed taxable income was taxed to its shareholders as a deemed distribution at year-end. This income accumulated in a previously taxed income (PTI) account, which can be a source of S corporation distributions. For simplicity in this text, however, the following discussion assumes that S corporation status occurs after 1982 and thus ignores the implications of PTI.

KEY POINT

The AAA represents the cumulative income and loss recognized in post-1982 S corporation years. To the extent the AAA is positive and sufficient basis exists in the stock, distributions from an S corporation are nontaxable and reduce stock basis.

Current Rules. Under current (post-1982) rules, some S corporations have a post-1982 accumulated E&P balance earned while a C corporation. Part or all of a distribution may be treated as made from this balance. The current rules, however, also require S corporations that have accumulated E&P balances to maintain an accumulated adjustments account (AAA) from which they make most of their distributions. The existence of accumulated E&P and AAA balances makes the tax treatment of cash and property distributions somewhat more complicated than do the rules explained in the preceding section.

Money Distributions. For corporations making a post-1982 S election and having an accumulated E&P balance, money distributions come from the two tiers of earnings illustrated in Table C:11-1. The corporation makes distributions from the first tier until it is exhausted. The corporation then makes distributions from the second tier until that tier is used up. Amounts distributed after the two tiers of earnings are exhausted reduce the shareholder's remaining basis in his or her S corporation stock. Any additional amounts distributed once stock basis has been reduced to zero are taxed to the shareholder as a capital gain. The corporation usually maintains these tiers as working paper accounts and not as general ledger accounts.

The AAA is the cumulative total of the ordinary income or loss and separately stated items accumulated for the S period but excluding tax-exempt income and expenses related to its production. The S period is the most recent continuous period during which the corporation has been an S corporation. No tax years beginning before 1983 are included in this period.⁵⁴

⁵⁴ Sec. 1368(e). An S corporation without accumulated E&P need not maintain the AAA to determine the tax effect of its distributions. If an S corporation having no E&P subsequently acquires E&P in a transaction where it assumes tax attributes under Sec. 381(a) (e.g., a merger), the corporation must calculate its AAA at the merger date to determine the tax effects of

post-merger distributions. To accomplish this calculation, a firm may need to make calculations back to the original S election date. To reduce this hardship, the IRS, in the Form 1120S instructions, recommends that all S corporations maintain AAA information.

▼ **TABLE C:11-1**
Source of Money or Property Distributions Made by S Corporations Having Accumulated Earnings and Profits

Tier	Classification	Treatment of Distributions
1	Accumulated adjustments account	Nontaxable ^a
2	Accumulated E&P	Taxable (dividend)
3	Basis of S corporation stock	Nontaxable ^a
4	Excess over stock basis	Taxable (capital gain)

^a These distributions reduce the basis of the S corporation stock. Although generally nontaxable, gain can be recognized if the amount of money plus the FMV of the noncash property distributed exceeds the shareholder's adjusted basis in the S corporation stock as indicated in Tier 4.

The year-end AAA balance is determined as follows:

AAA balance at the beginning of the year

Plus: Ordinary income

Separately stated income and gain items (except for tax-exempt income)

Minus: Distributions made from AAA (see first bullet item below)

Ordinary loss

Separately stated loss and deduction items (except for expenses or losses related to the production of tax-exempt income)

Expenses not deductible in determining ordinary income (loss) and not chargeable to the capital account

AAA balance at the end of the year

Four differences exist between the positive and negative adjustments required for the AAA and the basis calculation for S corporation stock:

- Distributions not included in gross income reduce *stock basis before* other negative adjustments. Distributions reduce the AAA *after* other negative adjustments unless the other negative adjustments, when netted against positive adjustments, produce a “net negative adjustment.” In this case, positive adjustments increase the AAA and negative adjustments other than distributions reduce the AAA to the extent of the positive adjustments. Then, distributions reduce the AAA before the net negative adjustment, and the net negative adjustment reduces the AAA after the distribution.⁵⁵
- Tax-exempt income does not increase the AAA but increases the basis of S corporation stock.
- Nondeductible expenses that reduce stock basis also reduce the AAA except for expenses related to the production of tax-exempt income and federal income taxes related to a C corporation tax year.
- The AAA balance can be negative (e.g., when the cumulative losses exceed the cumulative profits), but a shareholder's stock basis cannot be less than zero.

Allocation of the AAA balance to individual distributions occurs at year-end after taking into account current year income and loss items. In general, the AAA balance is allocated ratably to individual distributions within a tax year (other than distributions coming from E&P) based on the amount of money or FMV of noncash property distributed.

TYPICAL MISCONCEPTION

Even though stock basis cannot be less than zero, the AAA can be negative if cumulative losses exceed cumulative profits.

⁵⁵ Reg. Secs. 1.1367-1(f) and 1.1368-2(a)(5). This ordering for AAA preserves nontaxable treatment for S corporation earnings from prior years distributed in the loss year.

Corporations also maintain an Other Adjustments Account (OAA) if they have accumulated E&P at year-end. The corporation increases this account for tax-exempt income earned and decreases it by expenses incurred in earning the tax-exempt income, distributions out of the OAA, and federal taxes paid by the S corporation that are attributable to C corporation tax years. The effect of creating a separate account for tax-exempt income earned by companies having accumulated E&P is that the AAA is determined by taking into account only the taxable portion of the S corporation's income and any expenses and losses other than those related to the production of the tax-exempt income. Although the corporation reports the OAA balance on page 4 of the Form 1120S, it is not an accumulated earnings account. Municipal bond interest and other forms of tax-exempt income (net of related deductions) become part of the stock basis and thus appear after accumulated E&P in the distribution order. A corporation having an accumulated E&P balance might consider having the tax-exempt income-producing property owned at the shareholder level rather than at the corporate level.

EXAMPLE C:11-29 ▶ Omega Corporation is an S corporation with one shareholder, George. George's stock basis at the beginning of the current year is \$22,000. Omega reports the following results for the current year:

Ordinary loss	\$10,000
Dividend income	2,000

In addition, at the beginning of the current year, the corporation has a \$12,000 AAA balance and a \$4,000 accumulated E&P balance. In December of the current year, Omega distributes \$7,500 cash to George. Because the ordinary loss and dividend income produce an \$8,000 (\$2,000 – \$10,000) net negative adjustment, the predistribution AAA remains at \$12,000 while the \$2,000 dividend increases predistribution stock basis. Accordingly, the predistribution balances are as follows:

	<u>Stock Basis</u>	<u>AAA</u>	<u>E&P</u>
Beginning balances	\$22,000	\$12,000	\$4,000
Dividend income	2,000	2,000	
Partial ordinary loss		(2,000)	
Predistribution balance	<u>\$24,000</u>	<u>\$12,000</u>	<u>\$4,000</u>

Given these predistribution balances, the distribution has the following effects:

	<u>Stock Basis</u>	<u>AAA</u>	<u>E&P</u>
Predistribution balance	\$24,000	\$12,000	\$4,000
AAA distribution	(7,500)	(7,500)	
Ordinary loss	(10,000)		
Net negative adjustment		(8,000)	
Ending balance	<u>\$ 6,500</u>	<u>(\$3,500)</u>	<u>\$4,000</u>

Because the net negative adjustment to the AAA occurs after the distribution, the entire distribution comes out of the AAA, and none comes out of accumulated E&P. Also, the distribution does not exceed the predistribution stock basis. Thus, the entire distribution is nontaxable. ▶

EXAMPLE C:11-30 ▶ Sigma Corporation, an S corporation, reports the following results during the current year:

Ordinary income	\$30,000
Long-term capital gain	15,000
Municipal bond interest income	5,000
Dividend from domestic corporation	3,000
Charitable contribution	8,000

Sigma's sole shareholder, Silvia, has a \$60,000 stock basis on January 1. On January 1, Sigma has a \$40,000 AAA balance, a \$27,000 accumulated E&P balance, and a zero OAA balance. Sigma makes \$50,000 cash distributions to Silvia, its sole shareholder, on June 1 and December 1. The stock basis, AAA, OAA, and accumulated E&P activity for the year (before any distributions) is summarized as follows:

TYPICAL MISCONCEPTION

If shareholders sell their S corporation stock, the AAA account remains with the S corporation. But if an S election terminates, other than for the post-termination transition period, the AAA disappears.

	<u>Stock Basis</u>	<u>AAA</u>	<u>E&P</u>	<u>OAA</u>
Beginning balance	\$ 60,000	\$40,000	\$27,000	\$ -0-
Ordinary income	30,000	30,000		
Long-term capital gain	15,000	15,000		
Municipal bond interest	5,000			5,000
Dividend income	3,000	3,000		
Charitable contribution		(8,000)		
Predistribution balance	<u>\$113,000</u>	<u>\$80,000</u>	<u>\$27,000</u>	<u>\$5,000</u>

The \$80,000 AAA balance is allocated ratably to each of the distributions as follows:

$$\$40,000 = \$50,000 \times \frac{\$80,000}{\$50,000 + \$50,000}$$

The charitable contribution does not reduce the predistribution stock basis but does reduce the predistribution AAA because the reduction does not produce a net negative adjustment. Accordingly, \$40,000 of each distribution comes out of AAA. This portion of the distribution is nontaxable because the AAA distributions in total are less than the stock's \$113,000 predistribution basis. The remaining \$10,000 (\$50,000 - \$40,000) of each distribution comes out of accumulated E&P and is taxable as dividend income. Accumulated E&P is reduced to \$7,000 (\$27,000 - \$20,000) at year-end. The OAA balance reported on Form 1120S is not affected by the distribution because the accumulated E&P has not been exhausted. The stock's basis is \$25,000 (\$113,000 - \$80,000 - \$8,000) at year-end because a dividend distribution from accumulated E&P does not reduce its basis, but the charitable contribution does. After adjustment for the distribution, the AAA is zero. The effects of the distribution are summarized below:

	<u>Stock Basis</u>	<u>AAA</u>	<u>E&P</u>	<u>OAA</u>
Predistribution balance	\$113,000	\$80,000	\$27,000	\$5,000
AAA distribution	(80,000)	(80,000)		
E&P distribution			(20,000)	
Charitable contribution	(8,000)			
Ending balance	<u>\$ 25,000</u>	<u>\$ -0-</u>	<u>\$ 7,000</u>	<u>\$5,000</u>

Property Distributions. Property distributions (other than money) made by an S corporation having accumulated E&P trigger gain recognition according to the general rules described on pages C:11-28 and C:11-29. The FMV of the noncash property distributed reduces AAA.

TAX STRATEGY TIP

If a shareholder has NOL carryovers that are about to expire, the election to treat distributions as dividend income to the extent of E&P (as opposed to AAA distributions) may make sense.

Distribution Ordering Elections. An S corporation can elect to change the distribution order of E&P and the AAA. Specifically, the S corporation can elect to skip over the AAA in determining the source of a cash or property distribution, in which case distributions will come from accumulated E&P and then AAA. This election permits the S corporation to distribute Subchapter C E&P so as to avoid the excess net passive income tax and termination of the S election. The Tax Planning Considerations section of this chapter contains further discussion of this election.

Post-Termination Transition Period. Nontaxable distributions of money made during the S corporation's post-termination transition period can be made to those shareholders who owned S corporation stock on the termination date. These distributions come first from the former S corporation's AAA balance and then from current and accumulated E&P. The amounts from the AAA are nontaxable and reduce the shareholder's stock basis.⁵⁶ The AAA balance disappears when the post-termination period ends. Even though the profits earned during the S election period no longer can be distributed tax-free from the AAA after the post-termination period ends, they still can be distributed tax-free to the extent of the shareholder's stock basis once the corporation distributes its current

⁵⁶ Sec. 1371(e).

TOPIC REVIEW C:11-4

Taxation of S Corporation Income and Distributions

TAXATION OF INCOME TO THE CORPORATION

1. Unlike with a partnership, special entity level taxes apply to an S corporation.
 - a. Built-in gains tax: applicable to the net recognized built-in gain of an S corporation that formerly was a C corporation and that made its S election after December 31, 1986.
 - b. Excess net passive income tax: applicable to S corporations that have Subchapter C E&P at year-end and that earn passive investment income exceeding 25% of gross receipts during the tax year.
 - c. LIFO recapture tax: imposed when a C corporation that uses the LIFO inventory method in its final C corporation tax year makes an S election.

ALLOCATION OF INCOME TO THE SHAREHOLDERS

1. Income and gains are allocated based on the number of shares of stock owned by each shareholder on each day of the tax year.
2. Termination of the S election or termination of the shareholder's interest in the S corporation during the tax year requires the tax year to be divided into two parts. The S corporation can elect to allocate the income or gain according to the general rule in (1) or the accounting methods used by the corporation.

SHAREHOLDER DISTRIBUTIONS

1. Income and gain allocated to the shareholder increase the basis of the S corporation stock. For any S corporation that does not have an E&P balance, the amount of money plus the FMV of any noncash property distributed is nontaxable provided it does not exceed the shareholder's stock basis, determined before negative adjustments. The corporation recognizes gain (but not loss) when it distributes noncash property. The gain passes through to the shareholders.
2. If the S corporation made the S election after 1982 and has accumulated E&P, two earnings tiers must be maintained: the AAA and accumulated E&P. Distributions come from each tier in succeeding order until the tier is exhausted. Distributions out of accumulated E&P are taxable to the shareholder as dividends. Other distributions are nontaxable unless stock basis is reduced to zero, in which case the shareholder recognizes capital gain on the excess distribution.

and accumulated E&P. Any distributions made from current or accumulated E&P and noncash distributions made during the post-termination transition period are taxable.

Topic Review C:11-4 summarizes the taxation of S corporation income and gains that pass through to the shareholders and the treatment of S corporation distributions.

 STOP & THINK

Question: Special earnings tracking rules apply to S corporations that formerly were C corporations. Why do we need to have these special rules, which add complexity to the distribution topic?

Solution: Former C corporations that were profitable usually have an accumulated E&P balance when they become an S corporation. These earnings have never been taxed as a dividend to the corporation's shareholders. If separate tracking of the S corporation earnings (AAA) and C corporation earnings (accumulated E&P) did not occur, it would be impossible to determine which cash and property distributions came from S corporation earnings and which ones came from C corporation earnings, thereby frustrating the government's ability to collect taxes on distributed E&P.

OTHER RULES

OBJECTIVE 8

Explain other rules that pertain to S corporations

In addition to the differences discussed above, S corporations differ from C corporations in a number of other ways. As discussed below, these differences include tax preference items and other alternative minimum tax (AMT) adjustments, expenses owed by the S corporation to a shareholder, related party sales and exchanges, and fringe benefits paid by the S corporation to a shareholder-employee.

TAX PREFERENCE ITEMS AND OTHER AMT ADJUSTMENTS

The S corporation is not subject to the AMT, but the AMT does apply to individuals. Accordingly, the S corporation computes and passes through tax preference items to its shareholders. The shareholders then include these tax preference items in their individual AMT calculations. Allocation of the tax preference items occurs on a daily basis unless the corporation makes one of the two special elections to allocate the items based on the corporation's tax accounting methods.

The individual AMT rules also prescribe a number of adjustments to the tax reporting of certain transactions and occurrences for AMT purposes from that used for income tax purposes. As with tax preference items, these special AMT adjustments pass through to the S corporation's shareholders to be included in their individual AMT calculations.⁵⁷

TRANSACTIONS INVOLVING SHAREHOLDERS AND OTHER RELATED PARTIES

The Sec. 267(a)(2) related party transaction rules deny a payor a deduction for an expense paid to a related payee when a mismatching of the expense and income items occurs because of differences in accounting methods. A number of related party situations directly involve S corporations. Some of these transactions involve two S corporations or an S corporation and a C corporation where the same shareholders directly or indirectly own more than 50% of the value of each corporation's stock. Section 267(a)(2), for example, prevents an S corporation using the accrual method from currently deducting a year-end expense accrued for an item owed to a second S corporation that uses the cash method when the same shareholders own both corporations. The first S corporation can deduct the expense on the day the second S corporation includes the income in its gross income.

The S corporation, being a pass-through entity, is subject to Sec. 267(e), which extends the Sec. 267(a)(2) related party transaction rules described above to any payment made by the S corporation to *any* person who directly or indirectly owns S corporation stock. This rule prevents the S corporation from deducting a payment to be made to one of its shareholders or to someone who indirectly owns such stock until the payee reports the income. Payments made to the S corporation by a person who directly or indirectly owns S corporation stock are similarly restricted.

EXAMPLE C:11-31 ► Vassar Corporation, an S corporation, uses the accrual method of accounting and a calendar tax year. On September 1, Year 1, Vassar borrows \$50,000 from Joan, a cash basis taxpayer who owns 10% of the Vassar stock. Joan charges interest at a 5% annual rate. At year-end, Vassar accrues \$625 of interest expense on the loan. The corporation pays six months of interest (including the \$625 of accrued interest) to Joan on April 1, Year 2. Vassar cannot deduct the Year 1 accrued interest until it pays the interest in Year 2. ◀

Section 267(a)(1) denies a deduction for losses incurred on the sale or exchange of property directly or indirectly between related parties. The same definition of a related party applies for this purpose as in applying Sec. 267(a)(2) to expense transactions involving an S corporation. Any loss disallowed to the seller on the related party sale or exchange can offset gains realized by the purchaser on a subsequent sale or exchange.

FRINGE BENEFITS PAID TO A SHAREHOLDER-EMPLOYEE

The S corporation is not treated as a corporate taxpayer with respect to many fringe benefits paid to 2% shareholders.⁵⁸ Instead, the S corporation is treated the same as a partnership, and a 2% shareholder is treated as a partner of such partnership.⁵⁹ Because of this restriction, many fringe benefits paid to a 2% shareholder-employee of an S corporation are

⁵⁷ Adjustments and preferences are listed in Secs. 56 and 57.

⁵⁸ Section 1372(b) defines a 2% shareholder as any person who directly or indirectly owns on any day of the S corporation's tax year more than 2% of its outstanding stock or stock possessing more than 2% of its voting power.

The Sec. 318 stock attribution rules apply to determine whether the 2% threshold has been exceeded.

⁵⁹ Sec. 1372(a).

TYPICAL MISCONCEPTION

Most fringe benefits provided by a C corporation are deductible to the corporation and nontaxable to the employee. However, fringe benefits paid to a more-than-2% shareholder-employee of an S corporation are in many cases nondeductible unless taxable to the shareholder-employee as compensation.

deductible by the corporation and taxable to the shareholder unless the benefit is specifically excludible from the shareholder's gross income under the particular fringe benefit provision. Shareholders owning 2% or less of the S corporation stock are treated as ordinary employees.

The special fringe benefit rules apply only to statutory fringe benefits. They do not apply to stock options, qualified retirement plans, and nonqualified deferred compensation. The fringe benefits limited by the more-than-2%-shareholder rule include group term life insurance premiums (Sec. 79), accident and health benefit plan insurance premiums and payments (Secs. 105 and 106), meals and lodging furnished by the employer (Sec. 119), and cafeteria plan benefits (Sec. 125). Fringe benefits that may be excluded by more-than-2%-shareholders include compensation for injuries and sickness (Sec. 104), educational assistance program benefits (Sec. 127), dependent care assistance program benefits (Sec. 129), and certain other fringe benefits (Sec. 132). For purposes of the Sec. 162(l) above-the-line deduction for self-employed taxpayer's health insurance premiums, a more-than-2%-shareholder is deemed to be self-employed.

EXAMPLE C:11-32

▶ Bill and his wife Cathy each own 50% of Edison Corporation, an S corporation. Edison employs Bill and ten other individuals. All employees receive group term life insurance benefits based on their annual salaries. All employees except Bill can qualify for the Sec. 79 group term life insurance premium exclusion. Bill is treated as a partner and, therefore, does not qualify as an employee. Bill's premiums are taxable to Bill. Nevertheless, Edison can deduct the premiums paid to all its employees, including Bill. Because Bill is treated as self-employed under the 2% shareholder rules, he can deduct a portion of the premiums paid on the health insurance as a "for" AGI deduction under the Sec. 162(l) rules applicable to health insurance payments made by all self-employed individuals. ◀

TAX PLANNING CONSIDERATIONS

OBJECTIVE 9

Identify tax planning opportunities for an S corporation and its shareholders

ELECTION TO ALLOCATE INCOME BASED ON THE S CORPORATION'S ACCOUNTING METHODS

As a general rule, the S corporation's ordinary income or loss and separately stated items are allocated based on the amount of stock owned by each shareholder on each day of the S corporation's tax year. A special "closing of books" election allows the income to be allocated based on the S corporation's accounting methods when the S election terminates or when a shareholder terminates or substantially reduces his or her entire interest in the S corporation.⁶⁰ The use of the S corporation's tax accounting method to allocate the year's profit or loss can permit income shifting among shareholders.

EXAMPLE C:11-33

▶ At the beginning of the current year (assume not a leap year), Rod and Dana equally own Apex Corporation, an S corporation. During the current year, Apex reports ordinary income of \$146,000. On March 31 of the current year (the 90th day of Apex's tax year), Dana sells all his Apex stock to Randy. Apex earns \$125,000 of its ordinary income after March 31 of the current year. Rod is allocated \$73,000 ($\$146,000 \times 0.50$) of ordinary income. His income allocation is the same whether the corporation uses the daily allocation method or the special allocation election. In total, Dana and Randy are allocated \$73,000 of ordinary income. Dana and Randy can allocate the ordinary income amount in the following ways:

<i>Daily Allocation</i>	<i>Closing of Books Election</i>
Dana: $\$146,000 \times \frac{1}{2} \times \frac{90}{365} = \$18,000$	$(\$146,000 - \$125,000) \times \frac{1}{2} = \$10,500$
Randy: $\$146,000 \times \frac{1}{2} \times \frac{275}{365} = \$55,000$	$\$125,000 \times \frac{1}{2} = \$62,500$

⁶⁰ The shareholder, however, still can be a creditor, director, or employee of the corporation. Sections 1362(e) and 1377(a) prevent the daily allocation method from applying to any items resulting from a sale or exchange of 50% or more of the S corporation's stock during an S termination year.

The shifting of the \$7,500 in income from Dana (\$18,000 – \$10,500) to Randy (\$62,500 – \$55,000) under the special election also reduces Dana's adjusted basis for his Apex stock when determining his gain or loss on the sale. The \$7,500 difference between the income allocations under the two methods may be a point for negotiation between Dana and Randy, particularly if their marginal tax rates differ. ◀

By electing to use the S corporation's tax accounting method to allocate profits or losses between the C short year and S short year in the termination year, the corporation can shift losses into an S short year where the shareholders obtain an immediate benefit at a marginal tax rate of up to 37%, or it can shift profits into a C short year to take advantage of the 21% corporate tax rate.

EXAMPLE C:11-34 ► Delta Corporation has been an S corporation for several years using a calendar year as its tax year. The corporation has one shareholder whose marginal tax rate is 32%. Delta's S election terminates on July 1. The S short year includes January 1 through June 30, and the C short year includes July 1 through December 31. Total ordinary income this year is \$10,000. If the corporation closes its books on June 30, \$40,000 of ordinary loss is allocable to the S short year, and \$50,000 of ordinary income is allocable to the C short year. Assuming each month has 30 days, the following income allocations are possible:

<i>Period</i>	<i>Daily Allocation</i>	<i>Closing of Books Election</i>
S short year	\$ 5,000	(\$40,000)
C short year	5,000	50,000
Total	<u>\$10,000</u>	<u>\$10,000</u>

With the daily allocation, one-half the income is taxed to the shareholder, and the other half is taxed to the C corporation.⁶¹ The daily allocation method causes the shareholder's tax to be \$1,600 ($\$5,000 \times 0.32$) on the pass-through income and the C corporation's tax to be \$1,050 ($\$5,000 \times 0.21$), for a total tax of \$2,650. By closing the books, the corporation passes the \$40,000 S short year loss through to its shareholder and is taxed on the \$50,000 C short year income as a C corporation. This method provides the shareholder with a \$12,800 ($\$40,000$ pass-through loss $\times 0.32$) tax savings and causes the C corporation's tax to be \$10,500 ($\$50,000 \times 0.21$), for a net tax savings of \$2,300 ($\$12,800 - \$10,500$). Thus, in this situation, the closing of books method provides the greater overall tax advantage (\$2,300 tax savings vs. \$2,650 tax). ◀

INCREASING THE BENEFITS FROM S CORPORATION LOSSES

At the shareholder level, the deduction for S corporation pass-through losses is limited to the S corporation stock basis plus the basis of debt owed by the S corporation to the shareholder. Pass-through losses exceeding this limitation carry over to a subsequent tax year when the shareholder regains stock or debt basis. If the shareholder expects his or her marginal tax rate to be the same or lower in a carryover tax year, the shareholder should consider either increasing his or her stock basis or loaning additional funds to the corporation before the end of the current tax year. Conversely, if the shareholder never expects the loans to be repaid, he or she should not lend the S corporation additional amounts just to secure an additional tax deduction, which is worth at most 37 cents (at 2019 rates) for each dollar loaned. If the shareholder expects his or her marginal tax rate to be higher in future tax years, the shareholder should consider deferring additional capital contributions or loans until after the end of the current tax year.

EXAMPLE C:11-35 ► Nancy owns 100% of Bailey Corporation, an S corporation. Bailey expects a \$100,000 ordinary loss in the current year. Nancy's stock basis (before adjustment for the current loss) is \$35,000. Bailey also owes Nancy \$25,000. Nancy's current marginal tax rate is 37%, but she expects her marginal tax rate to decline to 22% next year. Nancy should consider making \$40,000

⁶¹ Section 1362(e)(5)(A) requires calculation of the tax liability for the C short year to be based on the annualized income of the former S corporation.

Given the current flat 21% corporate tax rate, however, annualization will result in the same tax as simply multiplying the short period income by 21%.

KEY POINT

If an S corporation shareholder has losses that have been suspended due to lack of basis, either contributions to capital or bona fide loans to the corporation will create the necessary basis to use the losses.

[\$100,000 loss – (\$35,000 stock basis + \$25,000 debt basis)] of additional capital contributions or loans before the end of the current year to obtain an additional \$6,000 $[(0.37 - 0.22) \times \$40,000]$ of tax benefits from deducting the loss in the current year rather than next year. If Nancy instead expects her marginal tax rates to be 22% in the current year and 37% next year, she can defer \$6,000 $[(0.37 - 0.22) \times \$40,000]$ of tax benefits (less the time value of money for one year) by postponing her capital contributions or loans until next year. Alternatively, Nancy could use the loss carryover to offset profits reported next year. These profits would restore part or all of her debt basis (and possibly increase her stock basis). The stock basis then would be partially or fully offset by the \$40,000 loss carryover. ◀

The S corporation loss carryover is available only to the shareholder who held the stock when the loss occurred. A shareholder should consider increasing the stock basis to take advantage of the carryover before selling the stock. The purchasing shareholder does not acquire the carryover.

SALARY LEVELS

An S corporation shareholder who is also an employee can pay himself or herself a salary. The salary is subject to employment taxes and is not qualified business income for the QBI deduction. Thus, the shareholder/employee can reduce employment taxes and increase the QBI deduction by reducing the salary level and taking distributions instead. Compensation, however, must be reasonable under the tax law. In a C corporation, unreasonable salary issues usually arise for excessively high salaries intended to avoid the double taxation inherent in dividend distributions. Conversely, in an S corporation situation, salaries tend to be unreasonable if too low. Prior to the enactment of the QBI deduction, the low salary strategy mainly focused on reducing employment taxes. With the advent of the QBI deduction, the low salary strategy also increases the QBI deduction by increasing S corporation ordinary income. This double benefit of low salaries may have the effect of drawing increased IRS scrutiny. Therefore, S corporation shareholder/employees will need to be increasingly diligent in having substantiation to support the reasonableness of their salaries. See Part d of Problem C:11-28 for a comparison that entails these issues.

PASSIVE INCOME REQUIREMENTS

The S corporation can earn an unlimited amount of passive income each year without incurring any penalty provided it has no E&P accumulated in a C corporation tax year (known as Subchapter C E&P) at the end of its tax year. Thus, a corporation can make an S election to avoid the personal holding company tax that otherwise might apply to a C corporation's passive income.

S corporations that have operated as C corporations and have accumulated Subchapter C E&P are potentially liable for the excess net passive income tax. In addition, their S election may terminate if the passive investment income exceeds 25% of gross receipts for three consecutive tax years. The S corporation can avoid both of these possible problems by making a special election under Sec. 1368(e)(3) to distribute its entire Subchapter C E&P balance to its shareholders. A corporation that elects to distribute Subchapter C E&P before distributing from its accumulated adjustments account (AAA) can make a second special election to treat part or all of this "distribution" as a deemed dividend, which is deemed distributed to the shareholders and immediately contributed by the shareholders to the corporation on the last day of the corporation's tax year.⁶² Such an election requires no cash outlay. The distribution, however, results in a tax cost for the shareholders who pay tax on the resulting deemed dividend income. To the shareholders, the cost of the election can be small if the accumulated E&P balance is insignificant or if the shareholder has a current year NOL (excluding the distribution) or an NOL carryover. The tax cost also could be low given the shareholder's applicable tax rate on dividends. The ultimate long-run benefit, however, may be great because it permits the S corporation to earn an unlimited amount of passive investment income free from corporate taxes in subsequent tax years.

⁶² Reg. Sec. 1.1368-1(f)(3).

EXAMPLE C:11-36 ► Hawaii Corporation incorporated 12 years ago and operated for a number of years as a C corporation, during which time it accumulated \$30,000 of E&P. Most of Hawaii's gross income now comes from rentals and interest, constituting passive investment income. Hawaii makes an S election starting in the current year. The excess net passive income tax will apply in the current year if Hawaii's rentals and interest exceed 25% of its gross receipts for the year unless the corporation elects to distribute the accumulated E&P and then distributes the earnings by the end of the current year. ◀

S corporations that earn rental income also can avoid the passive income tax and the possibility of having its election terminated if the corporation renders significant services to the occupant of the space or if the corporation incurs significant costs in the rental business.⁶³ Whether the corporation performs significant services or incurs substantial costs in the rental business depends on the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

EXAMPLE C:11-37 ► Assume the same facts as in Example C:11-36 except Hawaii Corporation provides significant services to its tenants in connection with its rental activities. Because the services are significant, Hawaii has a passive income problem only if its interest income exceeds 25% of its gross receipts. If the 25% threshold is not exceeded, Hawaii can avoid having to distribute its Subchapter C E&P in the current year. ◀

S corporations that experience a passive income problem in two consecutive tax years should carefully monitor their passive income in the next year. If they see that their passive income for the third year will exceed the 25% threshold, they should elect to distribute their accumulated Subchapter C E&P before year-end. This strategy not only will prevent loss of the S election but also will avoid having to pay the Sec. 1375 tax.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 10

Comply with S corporation procedural and filing requirements

MAKING THE ELECTION

A corporation makes the S election by filing Form 2553 (Election by a Small Business Corporation). Any person authorized to sign the S corporation's tax return under Sec. 6037 can sign the election form. The corporation files Form 2553 with the IRS Service Center designated in the instructions. The IRS can treat a late election as timely made if the corporation can show reasonable cause.⁶⁴

A shareholder can consent to the S election either on Form 2553 or on a separate consent statement signed by the shareholder and attached to the corporation's election form. Regulation Sec. 1.1362-6(b) outlines other information that must be provided with a separate consent. The IRS can grant extensions of time for filing shareholder consents to the S election.⁶⁵

A corporation makes a Sec. 444 election to use a fiscal year on Form 8716, which the corporation must file by the earlier of (1) the fifteenth day of the fifth month following the month that includes the first day of the tax year for which the election will first be effective or (2) the due date for the income tax return resulting from the election.⁶⁶ The corporation must attach a copy of Form 8716 to Form 1120S for the first tax year for which the Sec. 444 election is effective. A corporation desiring to make a Sec. 444 election also must state its intention in a statement attached to its S election form (Form 2553).⁶⁷

⁶³ According to Reg. Sec. 1.1362-2(c)(5)(ii)(B)(2), however, significant services are not rendered and substantial costs are not incurred in connection with net leases.

⁶⁴ Sec. 1362(b)(5). Also see footnote 16.

⁶⁵ Reg. Sec. 1.1362-6(b)(3)(iii).

⁶⁶ Temp. Reg. Sec. 1.444-3T(b)(1).

⁶⁷ Temp. Reg. Sec. 1.444-3T(b)(3).

FILING THE CORPORATE TAX RETURN

All S corporations, whether or not they owe taxes under Secs. 1374 or 1375, must file a tax return if they exist for part or all of the tax year. An S corporation must file its corporate tax return not later than the fifteenth day of the third month following the end of the tax year.⁶⁸ The S corporation reports its results on Form 1120S (U.S. Income Tax Return for an S Corporation). A completed S corporation tax return and the facts supporting the return appear in Appendix B. An S corporation is allowed an automatic six-month extension of time for filing its tax return by filing Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns), also illustrated in Appendix B.⁶⁹

EXAMPLE C:11-38 ▶ Simpson Corporation, an S corporation, uses the calendar year as its tax year. Its tax return generally is due on March 15. Simpson can file Form 7004 and obtain an automatic six-month extension for the return, thereby extending its due date until September 15. ◀

All S corporations that file a tax return must furnish each person who is a shareholder at any time during the tax year with pertinent information from the tax return, usually via Form 1120S, Schedule K-1. The corporation must make the Schedule K-1 available to the shareholder not later than the day on which it files its tax return.⁷⁰ An individual shareholder reports the S corporation's pass-through ordinary income or loss and certain passive income or loss items on his or her Form 1040, Schedule E. The shareholder reports most separately stated items on other supporting schedules to Form 1040, as illustrated on the Form 1120S, Schedule K-1 presented in Appendix B.

An S corporation is subject to the same basic three-year statute of limitations that applies to other taxpayers. This three-year limitations period applies for purposes of determining the time period during which

- ▶ The corporation remains liable for assessments of the excess net passive income and built-in gains taxes
- ▶ The IRS can question the correctness of an S election made for a particular tax year

The limitation period for assessing the income tax liability of an S corporation shareholder (e.g., for an erroneous S corporation loss deduction claimed), however, runs from the date on which the shareholder files his or her return and not from the date the S corporation files its tax return.⁷¹

If the corporation elects a fiscal year under Sec. 444, it determines the Sec. 7519 required payment on a computation worksheet provided in the instructions for the Form 1120S. The corporation need not make a required payment if the total of such payments for the current year and all preceding years is \$500 or less. Amounts equal to or less than the \$500 threshold carry over to succeeding years. The required payment is due on or before May 15 regardless of the fiscal year used. The required payment and the computation worksheet must accompany a Form 8752, which also is used to secure a refund of prior Sec. 7519 payments.⁷²

ESTIMATED TAX PAYMENTS

S corporations must make estimated tax payments if their estimated tax liability is reasonably expected to be \$500 or more.⁷³ Estimated tax payments are required for the corporate liability attributable to the built-in gains tax (Sec. 1374) and the excess net passive income tax (Sec. 1375). In addition, the S corporation's shareholders must include their income, gain, loss, deduction, and credit pass-through items in their own estimated tax calculations.

⁶⁸ Sec. 6072(b).

⁶⁹ Reg. Sec. 1.6081-3.

⁷⁰ Sec. 6037(b).

⁷¹ *Sheldon B. Bufferd v. CIR*, 71 AFTR 2d 93-573, 93-1 USTC ¶50,038 (USSC, 1993).

⁷² Temp. Reg. Sec. 1.7519-2T.

⁷³ Estimate tax rules appear in Sec. 6655.

SELF-STUDY QUESTION

Is an S corporation required to make estimated tax payments?

ANSWER

Yes. An S corporation is required to pay estimated taxes if the corporation is subject to built-in gains or excess net passive income taxes. Also, shareholders are required to include their S corporation income, loss, and credit pass-through items in determining their estimated tax payments.

ADDITIONAL COMMENT

When examining an S corporation, the IRS conducts the audit in a unified proceeding at the corporate level rather than in separate audits of each S corporation shareholder.

REAL-WORLD EXAMPLE

In 2017, of the 6.9 million corporate tax returns filed, 70.2% were S corporations.

The corporate estimated tax payment requirements described for a C corporation in Chapter C:3 also apply to an S corporation's tax liabilities. The required quarterly installment is 25% of the lesser of (1) 100% of the tax shown on the return for the tax year or (2) the sum of 100% of the built-in gains tax shown on the return for the tax year plus 100% of the excess net passive income tax shown on the return for the preceding tax year.

An S corporation cannot use the prior year tax liability exception when determining the required payment to be made with respect to the built-in gains tax. This exception, however, is available with respect to the excess net passive income tax portion of the required payment without regard to whether the corporation owed any tax in the prior year. All corporations can use the prior year tax liability exception for the excess net passive income tax whether or not they are "large" corporations under Sec. 6655(d)(2). The annualization election of Sec. 6655(e) also is available when determining the quarterly estimated tax payment amounts. An S corporation's failure to make timely estimated tax payments, or a timely final payment when it files the tax return, will trigger interest and penalties.

The S corporation's shareholders must include their ratable share of ordinary income or loss and separately stated items in determining their estimated tax liability. Such amounts are treated as having been received concurrently by the shareholders throughout the S corporation's tax year. Thus, ordinary income or loss and separately stated items for an S corporation tax year that ends with or within the shareholder's tax year are included in the estimated tax calculation to the extent they are attributable to months in the S corporation tax year that precede the month in which the installment is due.⁷⁴

CONSISTENCY RULES

Section 6037(c) requires an S corporation shareholder to report on his or her return a Subchapter S item in a manner consistent with the treatment accorded the item on the S corporation's return. A Subchapter S item is any item (e.g., income, gain, deduction, loss, credit, accounting method, or tax year) of an S corporation where the reporting of the item is more appropriately determined at the corporation level than at the shareholder level. A shareholder must notify the IRS of any inconsistency when the corporation has filed a return but the shareholder's treatment on his return is (or may be) inconsistent with the treatment of the item on the corporation return. Failure to do so may result in the imposition of a negligence penalty under Sec. 6662. Any adjustment required to produce consistency with the corporate return is treated as a mathematical or clerical error for penalty calculation purposes. A similar notification also is required when the corporation has not filed a return. If a shareholder receives incorrect information from the S corporation regarding a Subchapter S item, the shareholder's consistent reporting of the item consistently with the information provided by the corporation generally will eliminate the imposition of any penalty.

SAMPLE S CORPORATION TAX RETURN

A sample S corporation Form 1120S and supporting Schedule K-1 appear in Appendix B, along with the facts supporting the return. Two differences should be noted between the S corporation tax return and a partnership tax return. First, the S corporation tax return provides for the determination of a corporate tax liability and the payment of the special taxes that can be levied on the S corporation. No such items appear in the partnership return. Second, the S corporation return does not require a reconciliation of the shareholders' basis adjustments as occurs on a partnership tax return. Schedule M-1, M-2, and M-3 reconciliations similar to those required of a C corporation are required of an S corporation. Schedule M-1 requires a reconciliation of book income with the income or loss reported on line 23 of Schedule K, which includes not only the ordinary income (loss) amount but also separately stated income and deduction items. Alternatively, an S corporation must file Schedule M-3 in lieu of Schedule M-1 if the amount of total assets reported in Schedule L of Form 1120S (Balance Sheet per Books) equals or exceeds \$10 million.

⁷⁴ For example, see Ltr. Rul. 8639008 (June 23, 1986).

The S corporation also may file Schedule M-3 voluntarily even if not required to do so. If the corporation files Schedule M-3, in either case, it checks the appropriate box on page 1 of Form 1120S and does not file Schedule M-1. (The sample tax return in Appendix B does not include Schedule M-3.) Schedule M-2 requires a reconciliation of the AAA, OAA, and PTI accounts. (The PTI account pertains to pre-1983 S corporations.) Only S corporations that have an accumulated E&P balance must provide the AAA reconciliation and OAA balance although the IRS recommends that all S corporations maintain AAA and OAA balances.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

- C:11-1** List five advantages and five disadvantages of making an S election. Briefly explain each item.
- C:11-2** Julio, age 50, is a U.S. citizen who has a 22% marginal tax rate. He has operated the A&B Automotive Parts Company for a number of years as a C corporation. Last year, A&B reported \$200,000 of pre-tax profits, from which it paid \$50,000 in salary and \$25,000 in dividends to Julio. The corporation expects this year's pre-tax profits to be \$300,000. To date, the corporation has created no fringe benefits or pension plans for Julio. Julio asks you to explain whether an S corporation election would reduce his taxes. How do you respond to Julio's inquiry?
- C:11-3** Celia, age 30, is leaving a major systems development firm to establish her own firm. She will design computer-based systems for small- and medium-sized businesses. Celia will invest \$100,000 in the business. She hopes to operate near her breakeven point during her first year, although a small loss is possible. Profits will build up slowly over the next four years until she is earning \$150,000 a year in her fifth year. Celia has heard about S corporations and asks you whether the S corporation form would be advisable for her new business. How do you respond to Celia's inquiry?
- C:11-4** Lance and Rodney are contemplating starting a new business to manufacture computer software games. They expect to encounter losses in the initial years. Lance's CPA has talked to them about using an S corporation. Rodney, while reading a business publication, encounters a discussion on limited liability companies (LLCs). The article talks about the advantages of using an LLC instead of an S corporation. How would you respond to their inquiry?
- C:11-5** Which of the following classifications make a shareholder ineligible to own stock in an S corporation?
- U.S. citizen
 - Domestic corporation
 - Partnership where all the partners are U.S. citizens
 - Estate of a deceased U.S. citizen
 - Grantor trust created by a U.S. citizen
 - Nonresident alien individual
- C:11-6** Will the following events cause an S election to terminate?
- The S corporation earning 100% of its gross receipts in its first tax year from passive sources
 - The S corporation issuing nonvoting stock that has a dividend preference
 - The S corporation purchasing 100% of the single class of stock of a second domestic corporation that has conducted business activities for four years
 - An individual shareholder donating 100 shares of S corporation stock to a charity that is exempt from tax under Sec. 501(c)(3)
 - The S corporation earning tax-exempt interest income
- C:11-7** What is an inadvertent termination? What actions must the S corporation and its shareholders take to correct an inadvertent termination?
- C:11-8** After an S corporation revokes or terminates its S election, how long must the corporation wait to make a new election? What circumstances permit an early reelection?
- C:11-9** What tax years can a newly created corporation that makes an S election adopt for its first tax year? If a fiscal year is permitted, does it require IRS approval?
- C:11-10** At the time Cable Corporation makes its S election, it elects to use a fiscal year based on a Sec. 444 election. What other requirements must Cable satisfy to continue to use its fiscal year election for future tax years?
- C:11-11** What are Subchapter C earnings and profits (E&P)? How does the existence of such E&P affect the S corporation's ability to earn passive income?
- C:11-12** Explain the procedures for allocating an S corporation's ordinary income or loss to each of the shareholders. What special allocation elections are available?

- C:11-13** What limitations apply to the amount of loss pass-through an S corporation shareholder can deduct? What happens to any losses exceeding this limitation? What happens to losses if the shareholder transfers his or her stock?
- C:11-14** What actions can an S corporation shareholder take before year-end to increase the amount of the S corporation's losses he or she can deduct in the year they are incurred?
- C:11-15** What is a post-termination transition period? What loss carryovers can an S corporation shareholder deduct during this period?
- C:11-16** Explain the positive and negative adjustments to the basis of an S corporation shareholder's stock investment and the basis of an S corporation debt owed to the shareholder.
- C:11-17** Explain the differences between the tax treatment accorded nonliquidating property distributions made by S corporations and partnerships.
- C:11-18** What nonliquidating distributions made by an S corporation are taxable to its shareholders? Tax-free to its shareholders?
- C:11-19** What is an accumulated adjustments account (AAA)? What income, gain, loss, and deduction items *do not* affect this account assuming the S corporation has an accumulated E&P balance?
- C:11-20** Explain the differences between the way the following items are reported by a C corporation and an S corporation:
- Ordinary income or loss
 - Dividend income
 - Capital gains and losses
 - Tax-exempt interest income
 - Charitable contributions
 - Nonliquidating property distributions
 - Fringe benefits paid to a shareholder-employee
- C:11-21** When is the S corporation's tax return due? What extensions are available for filing the return?
- C:11-22** What taxes must an S corporation prepay by making quarterly estimated tax payments? Can a shareholder owning S corporation stock use the corporation's estimated tax payments to reduce the amount of his or her individual estimated tax payments? Explain.
- C:11-23** Review the completed C corporation, partnership, and S corporation tax returns presented in Appendix B. List three major tax reporting similarities and three major tax reporting differences in either content or format among the three tax returns.

ISSUE IDENTIFICATION QUESTIONS

- C:11-24** Jennelle and Paula are equal partners in the J&P Manufacturing Partnership. The partnership will form J&P Corporation by exchanging the assets and liabilities of the J&P Manufacturing Partnership for all the corporation's stock on September 1 of the current year. The partnership then will liquidate by distributing the J&P Corporation stock equally to Jennelle and Paula. Both shareholders use the calendar year as their tax year and desire that the corporation make an S election. What tax issues should Jennelle and Paula consider with respect to the incorporation?
- C:11-25** Williams Corporation has operated as a C corporation for the last seven years. The corporation has assets with a \$450,000 adjusted basis and an \$800,000 FMV. Liabilities amount to \$100,000. Dan Williams, who uses a calendar year as his tax year, owns all the Williams Corporation stock. The corporation uses the accrual method of accounting and a June 30 year-end. Dan's CPA has suggested that he convert the corporation to S corporation status to reduce his total corporate/personal federal income tax liability. Dan would like to complete the conversion on the last day of the corporation's tax year. What tax issues should Dan and his CPA consider with respect to the S election?
- C:11-26** Peter owns 50% of Air South Corporation, an air charter service. His S corporation stock basis at beginning of the year is \$100,000. Air South has not done well this year and will report an ordinary loss of \$375,000. What tax issues should Peter consider with respect to the loss?
- C:11-27** Glacier Smokeries has been an S corporation since its inception six years ago. On January 1 of the current year, the corporation's two equal shareholders, Adam and Rodney, had adjusted bases of \$175,000 and \$225,000, respectively, for their S corporation's stock. The shareholders plan to have the corporation distribute land with a \$75,000 adjusted basis and a \$300,000 FMV in the current year. The shareholders also expect ordinary income to be \$125,000 in the current year. What tax issues should Adam and Rodney consider with respect to the distribution?

PROBLEMS

- C:11-28** *Comparison of Entity Forms and QBI Deduction.* Carl Carson, a single taxpayer, owns 100% of Delta Corporation. During 2019, Delta reports \$150,000 of taxable income. Carl reports no income other than that earned from Delta, and Carl claims the standard deduction.
- What is Delta's income tax liability assuming Carl withdraws none of the earnings from the C corporation? What is Carl's income tax liability? What is the total tax liability for the corporation and its shareholder?
 - Assume that Delta instead distributes \$80,000 of its after-tax earnings to Carl as a dividend in the current year. What is the total income tax liability for the C corporation and its shareholder?
 - How would your answer to Part a change if Carl withdrew \$80,000 from the business in salary? Assume the corporation pays \$6,120 of Social Security taxes on the salary, which it can deduct from the \$150,000 taxable income amount in Part a. Carl also pays \$6,120 of Social Security taxes on the salary, which he cannot deduct.
 - How would your answers to Parts a–c change if Delta were instead an S corporation, and the qualified business income (QBI) deduction applied?
- C:11-29** *Making the Election.* Voyles Corporation, a calendar year taxpayer formed five years ago, desires to make an S election beginning in 2020. Sue and Andrea each own one-half of the Voyles stock.
- How does Voyles make the S election?
 - When can Voyles file its election form?
 - If in Part b the corporation does not file the election in a timely manner, when will the election take effect?
- C:11-30** *Termination of the Election.* Orlando Corporation, a calendar year taxpayer, has been an S corporation for several years. On July 9, 2019, Orlando authorizes a second class of nonvoting preferred stock that pays a 10% annual dividend. The corporation issues the stock to Sid on September 11, 2019, to raise additional equity capital. Sid owns no other Orlando stock.
- Does Orlando's S election terminate? If so, when is the termination effective?
 - What tax returns must Orlando file for 2019? When are they due?
 - How would your answer to Parts a and b change if instead the second class of stock were nonvoting Class B common stock?
- C:11-31** *Revocation of the Election.* Tango Corporation, a calendar year taxpayer, has been an S corporation for several years. Tango's business activities have become very profitable in recent years. On June 16, 2019, its sole shareholder desires to revoke the S election.
- How does Tango revoke its S election? When does the revocation take effect?
 - Assume Tango files a prospective revocation effective July 1, 2019. What tax returns are required of Tango for 2019? For 2020? When are these returns due?
 - If the corporation makes a new S election after the revocation, when does it take effect?
- C:11-32** *Sale of S Corporation Interest.* Peter and his wife, Alice, own all the stock of Galleon Corporation. Galleon made its S election 12 years ago. Peter and Alice sold one-half their Galleon stock to a partnership owned by Rob and Susan (not husband and wife) at the close of business on December 31 of the current year for a \$75,000 profit. What are the tax consequences of the sale transaction for Peter and Alice? For the corporation? As Peter and Alice's CPA, do you have any advice for them if all parties would like the S election to continue?
- C:11-33** *Selecting a Tax Year.* Indicate in each of the following independent situations whether the taxpayer can accomplish what is proposed. Provide adequate authority for your answer including any special elections that are needed or requirements that must be satisfied. Assume all individuals use the calendar year as their tax year unless otherwise indicated.
- Will and Carol form Classic Corporation. They want the corporation to adopt a fiscal year ending January 31 as its tax year to provide a maximum deferral for their income. The corporation makes an S election for its initial tax year ending January 31, 2020.
 - Mark and Dennis have owned and operated the Plastic Corporation for several years. Plastic has used a fiscal year ending June 30 since its organization as a C corporation because it conforms to the corporation's natural business year. The corporation makes an S election for its tax year beginning July 1, 2019.

C:11-34 *Passive Income Tax.* Oliver organized North Corporation 15 years ago. The corporation made an S election last year after it accumulated \$60,000 of E&P as a C corporation. As of December 31 of the current year, the corporation has distributed none of its accumulated E&P. In the current year, North reports the following results:

Dividends from domestic corporations	\$ 60,000
Rental income	100,000
Services income	50,000
Expenses related to rental income	30,000
Expenses related to services income	15,000
Other expenses	5,000

The corporation has not provided significant services nor incurred substantial costs in connection with earning the rental income. The services income is derived from the active conduct of a trade or business.

- Is North subject to the excess net passive income tax? If so, what is its tax liability?
- What is the effect of the excess net passive income tax liability on North's pass-throughs of ordinary income and separately stated items?
- What advice would you give North regarding its activities?

C:11-35 *Built-in Gains Tax.* Theta Corporation formed 15 years ago. In its first year, it elected to use the cash method of accounting and adopted a calendar year as its tax year. It made an S election on August 15 of last year, effective for Theta's current tax year. At the beginning of the current year, Theta had assets with a \$600,000 FMV and a \$180,000 adjusted basis. During the current year, Theta reports taxable income of \$400,000.

- In the current year, Theta collects all \$200,000 of accounts receivables outstanding on January 1 of the current year. The receivables had a zero adjusted basis.
- On February 1, Theta sells an automobile for \$3,500. The automobile had a \$2,000 adjusted basis and a \$3,000 FMV on January 1 of the current year. Theta claimed \$800 of MACRS depreciation on the automobile in the current year.
- On March 1, Theta sells land (a Sec. 1231 asset) that it held three years in anticipation of building its own office building for a \$35,000 gain. The land had a \$45,000 FMV and a \$25,000 adjusted basis on January 1 of the current year.
- In the current year, Theta paid \$125,000 of accounts payable outstanding on January 1 of the current year. All the payables are deductible expenses.

What is the amount of Theta's built-in gains tax liability?

C:11-36 *Determination of Pass-Throughs and Stock Basis Adjustments.* Mike and Nancy are equal shareholders in MN Corporation, an S corporation. The corporation, Mike, and Nancy are calendar year taxpayers. The corporation has been an S corporation during its entire existence and thus has no accumulated E&P. The shareholders have no loans to the corporation. The corporation incurred the following items in the current year:

Sales	\$300,000
Cost of goods sold	140,000
Dividends on corporate investments	10,000
Tax-exempt interest income	3,000
Sec. 1245 gain (recapture) on equipment sale	22,000
Sec. 1231 gain on equipment sale	12,000
Long-term capital gain on stock sale	8,000
Long-term capital loss on stock sale	7,000
Short-term capital loss on stock sale	6,000
Depreciation	18,000
Salary to Nancy	20,000
Business meals expenses	2,200
Interest expense on loans allocable to:	
Business debt	32,000
Stock investments	6,400
Tax-exempt bonds	1,800
Principal payment on business loan	9,000
Charitable contributions	2,000
Distributions to shareholders (\$15,000 each)	30,000

- a. Compute the S corporation's ordinary income and separately stated items. See Problem C:11-63 for related Form 1120S, Schedule K.
- b. Show Mike's and Nancy's shares of the items in Part a.
- c. Compute Mike's and Nancy's ending stock bases assuming their beginning balances are \$100,000 each. When making basis adjustments, apply the adjustments in the order outlined on pages C:11-25 and C:11-26 of the text.

C:11-37 *Allocation of Income to Shareholders.* John owns all the stock of Lucas Corporation, an S corporation. John's basis for the 1,000 shares is \$130,000. On June 11 of the current year (assume a non-leap year), John gifts 100 shares of stock to his younger brother Michael, who has been working in the business for one year. Lucas Corporation reports \$125,000 of ordinary income for the current year. What amount of income is allocated to John? To Michael?

C:11-38 *Sale of S Corporation Interest.* Al and Ruth each own one-half the stock of Chemical Corporation, an S corporation. During the current year (assume a non-leap year), Chemical earns \$15,000 per month of ordinary income. On April 5, Ruth sells her entire stock interest to Patty. The corporation sells a business asset on August 18 and realizes a \$75,000 Sec. 1231 gain. What alternatives (if any) exist for allocating Chemical's current year income?

C:11-39 *Allocation of Income to Shareholders.* Toyland Corporation, an S corporation, uses the calendar year as its tax year. Bob, Alice, and Carter own 60, 30, and 10 shares, respectively, of the Toyland stock. Carter's basis for his stock is \$26,000 on January 1 of the current year (assume a non-leap year). On June 30, Alice gifted one-half of her stock to Mike. On November 30, Carter sold his stock to Mike for \$45,000. Toyland reports the following results for the current year:

Ordinary income	\$120,000
Long-term capital loss	10,000
Charitable contributions	6,000

- a. What amount of income, loss, or deduction do the four shareholders report (assuming the corporation makes no special allocation election)?
- b. What gain or loss does Carter recognize when he sells the Toyland stock?

C:11-40 *Allocation of Income to Shareholders.* Redfern Corporation, a calendar year taxpayer, has been an S corporation for several years. Rod and Kurt each own 50% of Redfern's stock. On July 1 of the current year (assume a non-leap year), Redfern issues additional common stock to Blackfoot Corporation for cash. Rod, Kurt, and Blackfoot each end up owning one-third of Redfern's stock. Redfern reports ordinary income of \$125,000 and a short-term capital loss of \$15,000 in the current year. Eighty percent of the ordinary income and all the capital loss accrue after Blackfoot purchases its stock. Redfern makes no distributions to its shareholders in the current year. What income and losses do Redfern, Blackfoot, Rod, and Kurt report as a result of the current year's activities?

C:11-41 *Allocation of Income Between Family Members.* Bright Corporation, an S corporation, has been 100% owned by Betty since its creation 12 years ago. The corporation has been profitable in recent years and, in the current year (assume a non-leap year), reports ordinary income of \$240,000 after paying Betty a \$60,000 salary. On January 1, Betty gifts 15% of her Bright stock to each of her three sons, John, Andrew, and Stephen, hoping they will work in the family business. Betty pays gift taxes on the transfers. The sons are ages 24, 17, and 15 at present and are not currently active in the business. Bright distributes \$7,500 in cash to each son and \$27,500 in cash to Betty in the current year.

- a. What income does Betty, John, Andrew, and Stephen report for the current year as a result of Bright's activities assuming the sons are considered bona fide owners of the stock? How will the income be taxed to the children?
- b. Assuming the IRS determines a reasonable salary for Betty to be \$120,000, how would your answer to Part a change?
- c. How would your answer to Part a change if the sons were not considered bona fide owners of the stock?

C:11-42 *Use of Losses by Shareholders.* Monte and Allie each own 50% of Raider Corporation, an S corporation. Both individuals actively participate in Raider's business. On January 1, Monte and Allie have adjusted bases for their Raider stock of \$80,000 and \$90,000, respectively. During the current year, Raider reports the following results:

Ordinary loss	\$175,000
Tax-exempt interest income	20,000
Long-term capital loss	32,000

Raider's balance sheet at year-end shows the following liabilities: accounts payable, \$90,000; mortgage payable, \$30,000; and note payable to Allie, \$10,000.

- What income and deductions will Monte and Allie report from Raider's current year activities?
- What is Monte's stock basis on December 31?
- What are Allie's stock basis and debt basis on December 31?
- What loss carryovers are available for Monte and Allie?
- Explain how the use of the losses in Part a would change if instead Raider were a partnership and Monte and Allie were partners who shared profits, losses, and liabilities equally.

C:11-43 *Use of Loss Carryovers.* Assume the same facts as in Problem C:11-42. Assume further that Raider Corporation reports \$75,000 of ordinary income, \$20,000 of tax-exempt income, and a \$25,000 long-term capital gain in the next year.

- What income and deductions will Monte and Allie report from next year's activities?
- What is Monte's stock basis on December 31 of next year?
- What are Allie's stock basis and note basis on December 31 of next year?
- What loss carryovers (if any) are available to Monte and Allie?

C:11-44 *Use of Losses by Shareholders.* Tom owns 100% of Hammer Corporation, an S corporation. Tom has a \$100,000 stock basis on January 1. Tom actively participates in Hammer's business. Hammer's operating results were not good in the current year, with the corporation reporting an ordinary loss of \$175,000. The size of the loss required Tom to lend Hammer \$50,000 on August 10 of the current year to provide funds needed for operations. The loan is secured by a Hammer Corporation note. Hammer rebounds during the next year and reports ordinary income of \$60,000. Hammer repays the \$50,000 note on December 15.

- What amount of Hammer's current year loss can Tom deduct on his income tax return?
- What is Tom's basis for the Hammer stock and note at the end of the loss year?
- What income and deductions will Tom report next year from Hammer's activities and the loan repayment?

C:11-45 *S Corporation and Partnership Losses.* In the current year, Harold and Faye form Entity Company by each contributing \$50,000 to the company in exchange for a 50% ownership interest. In addition, the company borrows \$40,000 from First Bank. In the current year, the company incurs a \$110,000 loss from operations.

- How much of the loss can each shareholder deduct in the current year if Entity is an S Corporation, and what is each shareholder's basis in his or her stock at the end of the year?
- How much of the loss can each partner deduct in the current year if Entity is a partnership, and what is each partner's basis in his or her partnership interest at the end of the year?

C:11-46 *Allocation of Losses to Shareholders.* Harry and Rita formed Alpha Corporation as an S corporation, with each shareholder contributing \$10,000 in exchange for stock. In addition, Rita loaned the corporation \$7,000, and the corporation borrowed another \$8,000 from the bank. In the current year, the corporation incurred a \$26,000 operating loss. In the next year, the corporation will earn \$16,000 of operating income.

- For the current year and next year, determine the pass-through items for each shareholder and each shareholder's stock basis at the end of each year. Also, determine Rita's debt basis at the end of each year.
- Same as Part a except the corporation also distributes \$6,000 cash to each shareholder at the end of next year.

- c. Assume the same facts as in Part b and that Alpha is a partnership instead of an S corporation. For the current year and next year, determine the pass-through items for each partner and each partner's basis in his or her partnership interest at the end of each year.

C:11-47 *Post-Termination Loss Use.* Stein Corporation, an S corporation, has 400 shares of stock outstanding. Chuck and Linda own an equal number of these shares, and both actively participate in Stein's business. Chuck and Linda each contributed \$60,000 when they organized Stein on September 9 of Year 1. Start-up losses during Year 1 resulted in Stein reporting a \$210,000 ordinary loss. Stein's activities have since become profitable, and the corporation voluntarily revokes the S election on March 1 of Year 2, with no prospective revocation date being specified. In Year 2, Stein reports \$360,000 of taxable income (\$30,000 per month). Stein makes no distributions to its shareholders in either year.

- What amount of loss can Chuck and Linda deduct in Year 1?
- What amount of loss do Chuck and Linda carry over to Year 2?
- If Chuck reported only \$5,000 of other business income in Year 1, what happens to the "excess" deductible S corporation losses?
- What portion of the loss carryover from Part b can Chuck and Linda deduct in Year 2? What happens to any unused portion of the loss?
- What advice can you offer to Chuck and Linda to enhance their use of the Stein loss?

C:11-48 *Use of Losses by Shareholders.* Tina, a single taxpayer, owns 100% of Rocket Corporation, an S corporation. She has an \$80,000 stock basis for her investment on January 1 of the current year (Year 1). During the first 11 months of Year 1, Rocket reports an ordinary loss of \$100,000. The corporation expects an additional \$20,000 loss for December. Tina earns \$325,000 of ordinary income from her other activities in Year 1. She expects her other income to decline to \$125,000 in Year 2 and continue at that level in future years. The corporation expects Year 2 losses to be only \$20,000. Rocket projects a \$35,000 profit for Year 3 and each of the subsequent four years. What advice can you offer Tina about using her Rocket losses and retaining S corporation status in future years? How would your answer change if Tina expected her income from other activities to be \$75,000 in Year 1 and \$325,000 in Year 2?

C:11-49 *Stock Basis Adjustment.* For each of the following items, indicate whether the item will increase, decrease, or cause no change in the S corporation's ordinary income (loss), AAA, and in the shareholder's stock basis. The corporation was formed four years ago and made its S election two years ago. During the time it was a C corporation, it accumulated \$30,000 of E&P. The corporation has not distributed any of this accumulated E&P.

- Operating profit
- Dividend income received from domestic corporation
- Interest income earned on corporate bond held as an investment
- Life insurance proceeds paid on death of corporate officer
- Long-term capital gain
- Sec. 1231 loss
- Sec. 1245 gain (depreciation recapture)
- Charitable contributions
- Fines paid for having overweight trucks
- Depreciation
- Pension plan contributions for employees
- Salary paid to owner
- Premiums paid on life insurance policy in Part d
- Distribution of money (but not exceeding current year's earnings)

C:11-50 *Taxability of Distributions.* Tammy organized Sweets Corporation in January of the current year, and the corporation immediately elected to be an S corporation. Tammy, who contributed \$40,000 in cash to start the business, owns 100% of the corporation's stock. Sweets' current year results are reported below:

Ordinary income	\$36,000
Short-term capital loss	5,000

On July 10, Sweets makes a \$10,000 cash distribution to Tammy.

- What income (if any) do Sweets and Tammy recognize as a result of the distribution?
- What is Tammy's basis for the Sweets stock on December 31?
- How would your answers to Parts a and b change if Sweets' distribution were instead \$80,000?

C:11-51 *Property Distributions.* George and Martha formed Washington Corporation as an S corporation several years ago. George and Martha each have a 50% interest in the corporation. At the beginning of the current year, their stock bases are \$45,000 each. In the current year, the corporation earns \$40,000 of ordinary income. In addition, the corporation distributes property to George having a \$26,000 FMV and a \$40,000 adjusted basis and distributes property to Martha having a \$26,000 FMV and a \$16,000 adjusted basis.

- Determine what George and Martha recognize in the current year, and determine their ending stock bases. What bases do George and Martha have in the distributed property?
- What tax planning disadvantages do you see with these property distributions?
- How would you answer to Part a change if George and Martha form the Washington Partnership instead of an S corporation?

C:11-52 *Taxability of Distributions.* Curt incorporates Vogel Corporation on January 15 of the current year. Curt makes a \$70,000 capital contribution including land having a \$12,000 FMV, and Vogel makes a timely S election for this year. Vogel reports \$60,000 of ordinary income, \$40,000 of Sec. 1231 gain, \$5,000 of tax-exempt interest income, and \$3,000 of charitable contributions this year. On December 1, Vogel distributes \$5,000 cash plus the land contributed by Curt because the corporation no longer needs it in the business. The land, which had a \$10,000 basis and a \$12,000 FMV when contributed to the corporation in January, has an \$18,000 FMV when distributed.

- What income do Vogel Corporation and Curt report as a result of the distribution?
- What is Curt's basis in the Vogel stock on December 31?
- What is Vogel's accumulated adjustments account (AAA) balance on December 31?

C:11-53 *Taxability of Distributions.* Hal organized Stable Corporation five years ago and has continued to own all its stock. The corporation made an S election one year after its incorporation. At the beginning of the current year, Stable reports the following earnings accumulations:

Accumulated adjustments account (AAA)	\$85,000
Accumulated E&P	22,000

Hal's basis in his Stable stock on January 1 of the current year is \$120,000. During the current year, Stable reports the following results from its operations:

Ordinary income	\$30,000
Tax-exempt interest income	15,000
Long-term capital loss	20,000

Stable makes a \$65,000 cash distribution to Hal on August 8.

- What income, gain, or loss (if any) do Stable and Hal recognize as a result of the distribution?
- What is Hal's basis in the Stable stock on December 31?
- What are Stable's AAA, E&P, and OAA balances on December 31?
- How would your answers to Parts a–c change if Stable instead distributed \$120,000?

C:11-54 *Taxability of Distributions.* Sigma Corporation, an S corporation with one shareholder, incurred the following items Year 1 and Year 2:

<u>Year 1</u>	
Tax-exempt income	\$ 5,000
Ordinary income	30,000
<u>Year 2</u>	
Ordinary loss	(\$40,000)
Cash distribution	15,000

At the beginning of Year 1, the corporation had AAA and OAA balances of zero and accumulated E&P of \$6,000. At the beginning of Year 1, the shareholder had a \$10,000 basis in stock and a \$12,000 basis in debt he loaned to the corporation.

- Determine items reported by the shareholder in Year 1 and Year 2.
- Determine the balances in each corporate account and the shareholder's stock and debt bases at the end of each year.
- Determine the results if the distribution in Year 2 is \$35,000 instead of \$15,000.
- How does the answer to Part c change if, in Year 2, the corporation has an \$18,000 long-term capital gain in addition to the \$40,000 ordinary loss?

C:11-55 *Taxability of Distributions.* Beta Corporation, an S corporation with one shareholder, incurred the following items:

<u>Year 1</u>	
Ordinary loss	(\$40,000)
<u>Year 2</u>	
Ordinary income	\$27,000
Cash distribution	10,000
<u>Year 3</u>	
Ordinary income	\$22,000
Cash distribution	17,000

At the beginning of Year 1, the shareholder's stock basis was \$20,000, and her debt basis was \$16,000.

- Assuming the corporation has no accumulated E&P, show items reported by the shareholder in each year, show all basis adjustments to stock and debt, and show the stock and debt bases at the end of each year.
- Redo Part a for Year 2 and Year 3 assuming ordinary income in Year 2 is \$8,000 instead of \$27,000.
- Go back to the original facts and again redo Part a for all years assuming that, at the beginning of Year 1, the corporation had a AAA balance of zero and accumulated E&P of \$12,000.

COMPREHENSIVE PROBLEMS

C:11-56 *Comparison of Entity Formations.* Cara, Bob, and Steve want to begin a business on January 1, 2020. The individuals are considering three business forms—C corporation, partnership, and S corporation.

- Cara has investment land with a \$36,000 adjusted basis and a \$50,000 FMV that she is willing to contribute. The land has a rundown building on it having a \$27,000 basis and a \$15,000 FMV. Cara has never used the building nor rented it. She would like to get rid of the building. Because she needs cash, Cara will take out a \$25,000 mortgage on the property before the formation of the new business and have the new business assume the debt. Cara obtains a 40% interest in the entity.
- Bob will contribute machinery and equipment, which he purchased for his sole proprietorship in January 2014. He paid \$100,000 for the equipment and has used the MACRS rules with a half-year convention on this seven-year recovery period property. He did not make a Sec. 179 expensing election for this property, and he elected out of bonus depreciation. The FMV of the machinery and equipment is \$39,000. Bob obtains a 39% interest in the entity.
- Steve will contribute cash of \$600 and services worth \$20,400 for his interest in the business. The services he will contribute include drawing up the necessary legal documentation for the new business and setting up the initial books. Steve obtains a 21% interest in the entity.

To begin operations, the new business plans to borrow \$50,000 on a recourse basis from a local bank. Each owner will guarantee his or her ownership share of the debt.

What are the tax and nontax consequences for the new business and its owners under each alternative? Assume that any corporation will have 200 shares of common stock authorized and issued. For the partnership alternative, each partner receives a capital,

profits, and loss interest. How would your answer to the basic facts change if instead Steve contributes \$2,600 in cash and \$18,400 in services?

C:11-57 *Comparison of Operating Activities.* RST business entity reported the following items during the current year:

Dividends from 25%-owned domestic corporation	\$ 19,000
Municipal bond interest received	18,000
Corporate bond interest received	29,000
Gain on land contributed by Karen*	40,000
Operating profit (excluding depreciation)	120,000
MACRS depreciation	36,000
Sec. 1245 gain (depreciation recapture)	5,000
Sec. 1231 loss	28,000
Long-term capital losses	4,000
Short-term capital losses	5,000
Charitable contributions	23,000
Investment interest expense (related to General Electric bonds)	16,000
Salary (guaranteed payment)	37,000

* Karen held the land as an investment prior to contributing it to RST business entity three years ago in exchange for her ownership interest. When Karen contributed the land, it had a basis of \$15,000 and a FMV of \$40,000. RST sold the land in the current year for \$55,000. RST business entity held the land as an investment. Assume that Sec. 351 applied to any corporate formation transaction.

- What is the corporate taxable income and income tax liability for the current year if RST is taxed as a C corporation?
- What is the ordinary income and separately stated items for the current year if RST elects to be an S corporation? Assume that RST has never operated as a C corporation.
- What are the ordinary income and separately stated items if RST is treated as a general partnership?

C:11-58 *Comparison of Nonliquidating Distributions.* Jeff and John organized Tampa Corporation 18 years ago and have each owned 50% of the corporation since its inception. In the current year, Tampa reports ordinary income/taxable income of \$40,000. On April 5, Tampa distributes \$100,000 cash to Jeff and distributes land with a \$100,000 FMV and a \$70,000 adjusted basis to John. Tampa had purchased the land as an investment two years ago. What are the tax implications to Tampa, Jeff, and John of the land distribution in each of the four situations that follow?

- Tampa has been a C corporation since its formation. On January 1 of the current year, Jeff's basis in his stock is \$50,000, and John's stock basis is \$45,000. Tampa has accumulated E&P of \$155,000 on January 1 of the current year.
- Tampa was formed as a C corporation but made an S election three years after its formation. On January 1 of the current year, Jeff's basis in his stock is \$100,000, and John's stock basis is \$80,000. Tampa had the following earnings balances on January 1 of the current year:

Accumulated Adjustments Account	\$125,000
Accumulated E&P	30,000

- Tampa was formed as a partnership and continues to operate in that form. On January 1 of the current year, Jeff's basis in his partnership interest is \$100,000, and John's partnership basis is \$80,000. The partnership has no liabilities and no unrecognized precontribution gains.
- How would your answers to Parts a–c change if the land held as an investment and then distributed to John had been contributed to Tampa by Jeff two years ago? At the time of Jeff's contribution, the land had a FMV of \$95,000 and a \$70,000 basis.

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

C:11-59 Alice, a married taxpayer, will form Morning Corporation in the current year. Alice plans to acquire all of Morning's common stock for a \$1 million contribution to the corporation. Morning will obtain additional capital by borrowing \$200,000 from a local bank. Morning will conduct a variety of service activities with little need to retain its capital in the business. Alice expects start-up losses of \$80,000 during Morning's first year of operation. She expects the corporation to earn pre-tax operating profits of \$220,000 (before reduction for Alice's salary) starting next year. Alice plans to withdraw \$90,000 of Morning's profits as a reasonable salary. Her other income consists primarily of ordinary income (no dividends or capital gains) from other sources, including her husband's salary, and she expects these amounts to total \$115,000 annually. What advice can you provide Alice about the advisability of making an S election in the initial tax year? In the next tax year? In answering these questions, compare the following alternatives: (1) S corporation in both the current year and the next year, (2) S corporation in the current year and C corporation in the next year (i.e., by revoking the S election next year), (3) C corporation in both the current year and the next year, and (4) C corporation in the current year and S corporation in the next year. When analyzing these alternatives, consider the total income taxes associated with each alternative, specifically, at the corporate and shareholder levels and across both years. Ignore payroll taxes, however. Also, assume the following facts: (1) for both years, the standard deduction is \$24,400; (2) 2019 tax rate schedules remain the same for both years; (3) Alice claims the qualified business income (QBI) deduction where appropriate; and (4) a 7% discount rate applies for present value calculations. Although this problem asks for only a two-year analysis, discuss some shortcomings of such a short time frame.

C:11-60 One way to compare the accumulation of income by alternative business entity forms is to use mathematical models. The following models express the investment after-tax accumulation calculation for a particular entity form:

Pass-through entities (S corporations, partnerships, and LLCs): $ATA = [1 + R(1 - 0.8t_p)]^n$

C corporation: $ATA = [1 + R(1 - t_c)]^n (1 - t_g) + t_g$

where: ATA = after-tax accumulation in n years

R = before-tax rate of return;

t_p = owner's marginal tax rate on ordinary income

$0.8t_p$ = owner's marginal tax rate as adjusted to reflect the 20% QBI deduction

t_c = corporation's marginal tax rate

t_g = owner's tax rate on capital gains

n = number of periods

For each alternative business form, the owner makes an initial investment of \$1. The following operating assumptions apply:

Before-tax rate of return (R) = 0.18

Marginal tax rate for owner (t_p) = 0.37 and $0.8t_p$ = 0.296

Corporate tax rate (t_c) = 0.21

Capital gains rate (t_g) = 0.238 for regular capital gains, including the 3.8% tax on net investment income

Investment horizon (n) = 2, 5, or 30 years

A pass-through entity distributes only enough cash each year for the owner to pay his or her taxes. Also, the shareholder claims the qualified business income (QBI) deduction. The corporation pays no dividends. The shareholder sells his or her stock at the end of the investment horizon, and the shareholder's gain is taxed at capital gains rate. (See Chapter I:18 of the *Individuals* volume for a detailed explanation of these models.)

Required: What is the after-tax accumulation if each business form is operated for the investment horizon and then sold for the amount of the accumulation? Which entity form is best for each investment horizon? For the C corporation alternative, do the analysis with and without the 100% Sec. 1202 exclusion.

TAX FORM/RETURN PREPARATION PROBLEMS

C:11-61 Bottle-Up, Inc., was organized on January 8, 2009, and made its S election on January 24, 2009. The necessary consents to the election were filed in a timely manner. Its address is 1234 Hill Street, City, ST 33333. Bottle-Up uses the calendar year as its tax year,

the accrual method of accounting, and the first-in, first-out (FIFO) inventory method. Bottle-Up manufactures ornamental glass bottles. It made no changes to its inventory costing methods this year. It uses the specific identification method for bad debts for book and tax purposes. Herman Hiebert and Melvin Jones own 500 shares each. Both individuals materially participate in Bottle-Up's single activity. Herman Hiebert is the tax matters person. Financial statements for Bottle-Up for the current year are shown in Tables C:11-2 through C:11-4. Prepare a 2018 S corporation tax return for Bottle-Up, showing yourself as the paid preparer.

C:11-62 Refer to the facts in Tax Form/Return Preparation Problem C:9-58. Now assume the company is an S corporation rather than a partnership. Additional facts are as follows:

- Drs. Bailey and Firth formed the corporation on January 1, 2017, and the corporation immediately elected S corporation status effective at the beginning of 2017.
- Upon formation of the corporation, Dr. Bailey received common stock worth \$1.2 million, and Dr. Firth received common stock worth \$2.8 million.
- The balance sheet information is the same as in Table C:9-3 except the equity section is as follows:

	<u>January 1, 2018</u>	<u>December 31, 2018</u>
Common stock	\$4,000,000	\$4,000,000
Retained earnings	171,360	283,420

- The \$200,000 paid to Dr. Bailey is salary constituting W-2 wages (instead of a guaranteed payment). Ignore employment taxes (Social Security, etc.) on Dr. Bailey's salary.
- Use book numbers for Schedule L and Schedule M-1 in Form 1120S.

See page C:11-54 for additional information.

▼ **TABLE C:11-2**

Bottle-Up, Inc. Income Statement for the Year Ended December 31 of the Current Year (Problem C:11-61)

Sales		\$2,500,000
Returns and allowances		<u>(15,000)</u>
Net sales		\$2,485,000
Beginning inventory	\$ 102,000	
Purchases	900,000	
Labor	200,000	
Supplies	80,000	
Utilities	100,000	
Other manufacturing costs	<u>188,000</u>	
Goods available for sale	\$1,570,000	
Ending inventory	<u>(96,000)</u>	<u>1,474,000</u>
Gross profit		\$1,011,000
Salaries ^a	\$ 451,020	
Utilities expense	54,000	
Depreciation (MACRS depreciation is \$36,311) ^b	11,782	
Automobile and truck expense	26,000	
Office supplies expense	9,602	
Advertising expense	105,000	
Bad debts expense	620	
Rent expense	30,000	
Interest expense ^c	1,500	
Meals and entertainment expense ^d	12,500	
Selling expenses	108,500	
Repairs and maintenance expense	38,000	
Accounting and legal expense	4,500	
Charitable contributions ^e	9,000	

Insurance expense ^f	24,500	
Hourly employees' fringe benefits	11,000	
Payroll taxes	36,980	
Other taxes	2,500	
Penalties (fines for overweight trucks)	1,000	(938,004)
Operating profit		\$ 72,996
Other income and losses:		
Long-term gain on sale of capital assets	\$ 48,666 ^g	
Sec. 1231 loss	(1,100) ^h	
Interest on U.S. Treasury bills	1,200	
Interest on State of Florida bonds	600	
Dividends from domestic corporations	11,600	
Investment expenses	(600)	60,366
Net income		<u>\$ 133,362</u>

^a Officer salaries of \$120,000 are included in the total. All are employer's W-2 wages.

^b The AMT depreciation adjustment on personal property is \$9,000.

^c Investment interest expense is \$500. All other interest expense is trade- or business-related. None of the interest expense relates to the production of tax-exempt income.

^d Of \$12,500 total, \$4,000 allocated to meals and \$8,500 allocated to entertainment.

^e The corporation made all contributions in cash to qualifying charities.

^f Includes \$3,000 of premiums paid for policies on lives of corporate officers. Bottle-Up is the beneficiary for both policies.

^g The corporation acquired the capital assets on March 3, 2016 for \$100,000 and sold them on September 15, 2018, for \$148,666.

^h The corporation acquired the Sec. 1231 property on June 5, 2017 for \$10,000 and sold it on December 21, 2018, for \$8,900.

▼ TABLE C:11-3

Bottle-Up, Inc. Balance Sheet for January 1 and December 31 of the Current Year (Problem C:11-61)

	January 1	December 31
Assets:		
Cash	\$ 15,000	\$116,948
Accounts receivable	41,500	45,180
Inventories	102,000	96,000
Stocks	103,000	74,000
Treasury bills	15,000	16,000
State of Florida bonds	10,000	10,000
Building and equipment	375,434	375,000
Minus: Accumulated depreciation	(161,318)	(173,100)
Land	160,000	190,000
Total	<u>\$660,616</u>	<u>\$750,028</u>
Liabilities and equities:		
Accounts payable	\$ 36,000	\$ 10,000
Accrued salaries payable	12,000	6,000
Payroll taxes payable	3,416	7,106
Sales taxes payable	5,200	6,560
Due to Mr. Hiebert	10,000	5,000
Mortgage and notes payable (current maturities)	44,000	52,000
Long-term debt	210,000	260,000
Capital stock	10,000	10,000
Retained earnings	330,000	393,362
Total	<u>\$660,616</u>	<u>\$750,028</u>

▼ **TABLE C:11-4****Bottle-Up, Inc. Statement of Change in Retained Earnings, for the Current Year Ended December 31 (Problem C:11-61)**

Balance, January 1		\$330,000 ^a
Plus: Net income	\$133,362	
Minus: Dividends	(70,000)	63,362
Balance, December 31		\$393,362

^a The January 1 accumulated adjustments account balance is \$274,300.

Required: Prepare the 2018 S corporation tax return (Form 1120S), including the following additional schedules and forms: Schedule D, Form 4562, and Schedule K-1.

Optional: (1) Complete Schedule M-2 in Form 1120S even though the company has never been a C corporation. For this purpose, the accumulated adjustments account at the beginning of 2018 is \$171,360. (2) Prepare a schedule for each shareholder's basis in his or her S corporation stock. For this purpose, Bailey's stock basis at the beginning of 2018 is \$1,251,408 and Firth's is \$2,535,952.

C:11-63 *Short Tax Form.* Refer to the facts in Problem C:11-36, and prepare Form 1120S, Schedule K based on these facts.

CASE STUDY PROBLEM

C:11-64 Debra has operated a family counseling practice for a number of years as a sole proprietor. She owns the condominium office space that she occupies in addition to her professional library and office furniture. She has a limited amount of working capital and little need to accumulate additional business assets. Her total business assets are about \$150,000, with an \$80,000 mortgage on the office space being her only liability. Typically, she has withdrawn any unneeded assets at the end of the year. Debra has used her personal car for business travel and charged the business for the mileage at the appropriate mileage rate provided by the IRS. Over the last three years, Debra's practice has grown so that she now forecasts \$80,000 of income being earned this year. Debra has contributed small amounts to an Individual Retirement Account (IRA) each year, but her contributions have never reached the annual limits. Although she has never been sued, Debra recently has become concerned about legal liability. An attorney friend of hers has suggested that she incorporate her business to protect herself against being sued and to save taxes.

Required: You are a good friend of Debra's and a CPA; she asks your opinion on incorporating her business. You are to meet with Debra tomorrow for lunch. Prepare a draft of the points you feel should be discussed over lunch about incorporating the family counseling practice.

TAX RESEARCH PROBLEMS

C:11-65 Cato Corporation incorporated six years ago in California, with Tim and Elesa, husband and wife, owning all the Cato stock. Immediately thereafter, Cato made an S election effective for that year. Tim and Elesa filed the necessary consents to the election. On March 10 of last year, Tim and Elesa transferred 15% of the Cato stock to the Reid and Susan Trust, an irrevocable trust created three years earlier for the benefit of their two minor children. Early in the current year, Tim and Elesa's tax accountant learns about the transfer and advises the couple that the transfer of the stock to the trust may have terminated Cato's S election. Prepare a memorandum for your tax manager indicating any action Tim and Elesa can take that will permit Cato to retain its S election. Research sources suggested by the tax manager include Secs. 1361(c)(2), 1362(d)(2), and 1362(f).

C:11-66 One of your wealthy clients, Cecile, invests \$100,000 for sole ownership of an electing S corporation's stock. The corporation is in the process of developing a new food product. Cecile anticipates that the new business will need approximately \$200,000 in capital (other than trade payables) during the first two years of its operations before it starts to earn sufficient profits to pay a return on the shareholder's investment. The first \$100,000 of this total is to come from Cecile's contributed capital. The remaining \$100,000 of funds will come from one of the following three sources:

- Have the corporation borrow the \$100,000 from a local bank. Cecile is required to act as a guarantor for the loan.
- Have the corporation borrow \$100,000 from the estate of Cecile's late husband. Cecile is the sole beneficiary of the estate.
- Have Cecile lend \$100,000 to the corporation from her personal funds.

The S corporation will pay interest at a rate acceptable to the IRS. During the first two years of operations, the corporation anticipates losing \$125,000 before it begins to earn a profit. Your tax manager has asked you to evaluate the tax ramifications of each of the three financing alternatives. Prepare a memorandum to the tax manager outlining the information you found in your research.

C:11-67 Joe Stephens formed Sigma Corporation on January 4 of Year 1, and the corporation immediately made an S election effective for that year. In forming the corporation, Joe contributed \$50,000 cash in exchange for 100% of Sigma's stock. Shortly thereafter, the corporation obtained a \$75,000 bank loan to assist with operations. Sigma's first two years did not go as well as expected, with Sigma incurring a \$60,000 ordinary loss in Year 1 and a \$12,000 ordinary loss in Year 2. Moreover, in Year 2, Joe and his wife Marsha divorced. As part of the divorce settlement, on March 31 of Year 2, Joe gave Marsha 50% of the Sigma stock. In Year 3, Sigma's performance improved, with the corporation earning \$40,000 of ordinary income. Joe asks your help in determining the tax consequences of these events, particularly the usage of the S corporation losses. At a minimum, you should consider the following resources:

- IRC Sec. 1366
- Reg. Sec. 1.1366-2