Chapter 4: S CORPORATION TAX ISSUES
In the 2019 fiscal year there were 5,186,557 S corporation returns filed.

S corporation returns constituted 45.98% of the total returns filed by all C corporations, S corporations, and partnerships.
This section reviews the classification of business entities and how an entity makes the S corporation election.
Unincorporated domestic entity with more than one owner is, by default, a partnership. However, it can elect to be treated as an association (a corporation) for federal tax purposes.

A single-member LLC (SMLLC) is, by default, a disregarded entity. It too can elect to be taxed as a corporation for federal tax purposes.
CHECK-THE-BOX REGULATIONS (CONTINUED) P. 102

- Tax Status v. Organization @ State Level
- How to elect S Corp Status:
  - Form 8832, Entity Classification Election, to be taxed as a C corporation
  - Form 2553, Election by a Small Business Corporation, to be taxed as an S corporation
FIGURE 4.1
CLASSIFICATION OF BUSINESS ENTITIES
P. 103
Form 2553 is the form used to elect to be classified as an S Corporation?

True or False
I.R.C. § 1361 and file the I.R.C. § 1362 election – eligibility requirements
It does not have more than 100 shareholders.

All its owners are US citizens or resident alien individuals, estates, certain trusts, or certain tax-exempt organizations.

It does not have more than one class of stock.
Family Attribution Rules (pp. 103-104)

- Husband & Wife = 1 shareholder
- All Family members = 1 shareholder
- Six-Generation Rule:
  - Begins with the common ancestor (shareholder)
- Six-Generation applied on the latest of
  - The effective date of the S election,
  - The earliest day that a member of the family acquires stock, or
- October 22, 2004
ELIGIBLE SHAREHOLDERS
PP. 104-105

- Individuals who are US citizens or residents
  - If a spouse is a nonresident alien who has a current ownership interest (e.g., community property law), the corporation does not qualify
- Decedent and bankruptcy estates
- Certain trusts (described later)
- I.R.C. § 501(c)(3) tax-exempt entities
- I.R.C. § 401(a) qualified plans
Some trusts must make an election to qualify as an S corporation shareholder.

- Grantor Trusts (Including Deemed Grantor Trusts)
- Testamentary Trusts
- Voting Trusts
- Electing Small Business Trusts (need election)
- Qualified Subchapter S Trusts (need election)
During the life of the **Current Income Beneficiary** there is only one income beneficiary who is a US citizen or resident.

<table>
<thead>
<tr>
<th>Distributions of trust principal are made to only the income beneficiary.</th>
</tr>
</thead>
</table>

The income interest terminates on the beneficiary’s death or termination of the trust, whichever is earlier.

<table>
<thead>
<tr>
<th>If the trust terminates during the current income beneficiary’s lifetime, the trust distributes all trust assets to that beneficiary.</th>
</tr>
</thead>
</table>

The trustee makes annual distributions of income if the trust instrument does not require all trust income to be distributed annually.
The QSST election treats the trust as a grantor trust and the beneficiary as the owner of the part of the trust that consists of S corporation stock.

The QSST and ESBT election deadlines are the same (2 months + 16 days).
Relief for Late Elections (RP 2013-30)
- The taxpayer can make a late ESBT or QSST election within 3 years and 75 days after the date on which the trust election should have been effective.
- If that period has expired, the taxpayer can request a letter ruling.
An LLC is generally not eligible to be a shareholder in an S corporation

However, the owner of an SMLLC that is disregarded as an entity separate from its owner is treated as owning the LLC’s assets directly, including its shares in an S corporation.

If the LLC’s sole owner is a US citizen or resident or another eligible S corporation shareholder, the LLC can be a shareholder in an S corporation.

However, if the LLC elects to be a C corporation or an S corporation for federal income tax purposes, or if one or more additional persons acquires an interest in the LLC, it is ineligible to own shares in an S corporation.
Certain tax-exempt organizations can be S corporation shareholders.

An eligible shareholder is an organization described in

- I.R.C. § 501(c)(3) (organizations organized and operated for charitable, religious, educational, and other specified purposes)
- I.R.C. § 401(a) (qualified pension, profit sharing, and stock bonus plans)
An S corporation must have a single class of stock.

This rule applies only to outstanding shares.

Differences in voting rights do not create multiple classes of stock.
Each share of stock must confer identical rights to all current and liquidating distributions.

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on:

- the corporate charter
- articles of incorporation
- Bylaws
- applicable state law
- binding agreements relating to distribution and liquidation proceeds
If an LLC elects to be taxed as an S corporation, the operating agreement may need to be amended:

- to remove special income allocations, and
- provide for equal distributions of liquidation proceeds, per unit (share)
Buy-sell agreements, shareholder agreements that restrict the transfer of stock, and redemption agreements are disregarded unless:

- a principal purpose of the agreement is to circumvent the one class of stock requirement; and
- the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the FMV of the stock.

Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded.
If restricted stock is issued in connection with the performance of services and is substantially nonvested, the stock is generally not treated as outstanding unless the holder makes an I.R.C. § 83(b) election.

Certain call options, warrants, or similar instruments may be a second class of stock if:

- the exercise price is substantially below the FMV of the stock on the date of issue, and
- they are substantially certain to be exercised.
However, if the call option is transferred without the transfer of a corresponding portion of the loan, the option must again be tested to determine if it constitutes a second class of stock.

<table>
<thead>
<tr>
<th>Call option issued to an employee or independent contractor in connection with services is not treated as stock if:</th>
</tr>
</thead>
<tbody>
<tr>
<td>the option is nontransferable, and has no readily ascertainable FMV when it is issued.</td>
</tr>
</tbody>
</table>

Call options issued to a commercial lender in connection with a commercially reasonable loan are not treated as a second class of stock.
A company electing S corporation status must file Form 2553, Election by a Small Business Corporation, with the IRS Service Center (Kansas City or Ogden) where the company files (or will file) its tax returns.

- If an unincorporated entity is electing S corporation status as of the first day it is seeking entity classification as a corporation, the entity can file only Form 2553 and does not have to also file Form 8832.

- The corporation can file Form 2553 by mail or by fax.

- Figure 4.2 (P. 107) shows page 1 of Form 2553.
**FIGURE FORM 2553 (NO SUBSTITUTE, NO E-FILE)  P. 107**

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**Form 2553**  
Election by a Small Business Corporation  
(Under section 1362 of the Internal Revenue Code)  
(Including a late election filed pursuant to Rev. Proc. 2013-30)  
OMB No. 1545-0129

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

### Part I  
**Election Information**

<table>
<thead>
<tr>
<th>Name (see instructions)</th>
<th>A Employer Identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type or Print</strong></td>
<td><strong>Employer Identification number</strong></td>
</tr>
<tr>
<td>Number, street, and room or suite no. If a P.O. box, see instructions</td>
<td></td>
</tr>
<tr>
<td><strong>City or town, state or province, country, and ZIP or foreign postal code</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Date incorporated</strong></td>
<td>C State of incorporation</td>
</tr>
</tbody>
</table>

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

**Election is to be effective for tax year beginning (month, day, year) (see instructions)**

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

**Selected tax year:**

1. Calendar year
2. Fiscal year ending (month and day)
3. 52-53-week year ending with reference to the month of December
4. 52-53-week year ending with reference to the month of [ ]

If box (2) or (4) is checked, complete Part II.

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

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

**Telephone number of officer or legal representative**

**I** If this S corporation election is being filed late, I declare that I have examined this election, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.

---

**Sign Here**

<table>
<thead>
<tr>
<th>Signature of officer</th>
<th>Title</th>
<th>Date</th>
</tr>
</thead>
</table>

---

**For Paperwork Reduction Act Notice, see separate instructions.**

Cat. No. 1567T  
Form 2553 (Rev. 12-2017)
Evidence of Filing

- When the IRS receives and processes Form 2553, it sends CP261, Notice of Acceptance as an S corporation.
- If the corporation does not receive this notice within 60 days of filing the S corporation election, it should contact the IRS.
Form 2553 is due on or before:

- the fifteenth day of the third month of the tax year for which the election is to take effect; or

- If the company is in existence as a C corporation, it may file this election in the tax year preceding the tax year the status is to take effect.
For a new corporation, the tax year commences on the earliest of the following:
1. Issuance of shares
2. Acquisition of assets
3. Commencement of business
If the first tax year is less than 2 months and 15 days, the 2-month-and-15-day period may extend to the second tax year.
Thornton Corporation is a calendar year taxpayer.

- On November 8, 2019, it issued its first shares.
- On December 9, 2019, the assets contributed by the shareholders were titled to the corporation.

Thornton must file Form 2553 on or before January 23, 2020, (2 months + 15 days from November 8, 2019.)
Each shareholder who owns shares at the time of filing the S corporation election must consent to the election.

Shareholders consent by signing Form 2553, or they can attach a separate consent statement.

Figure 4.3 shows the Form 2553 consent.

Figure 4.4 shows who must consent to the S election (P. 109).
### Part I  Election Information

<table>
<thead>
<tr>
<th>K Shareholder’s Consent Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under penalties of perjury, I declare that I consent to the election of the above-named corporation (entity) to be an S corporation under section 1362(a) and that I have examined the consent statement, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I understand my consent is binding and may not be withdrawn after the corporation (entity) has made a valid election. If seeking relief for a late filed election, I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the S corporation election for the year for which the election should have been filed (see beginning date entered on line E) and for all subsequent years.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>L Stock owned or percentage of ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>[see instructions]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>M Social security number or employer identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td>[see instructions]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>N Shareholder’s tax year ends</th>
</tr>
</thead>
<tbody>
<tr>
<td>[month and day]</td>
</tr>
</tbody>
</table>

#### Notes:
- If you need more rows, use additional copies of page 2.
- Name and address of each shareholder or former shareholder required to consent to the election (see instructions).

<table>
<thead>
<tr>
<th>Number of shares or percentage of ownership</th>
<th>Date acquired</th>
<th>Signature</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>If shares are held by</td>
<td>Person who must sign</td>
<td>Authority</td>
<td></td>
</tr>
<tr>
<td>-----------------------</td>
<td>----------------------</td>
<td>-----------</td>
<td></td>
</tr>
<tr>
<td>Community property, tenants in common, joint tenants, tenants by the entirety</td>
<td>Each person holding an interest</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(i)</td>
<td></td>
</tr>
<tr>
<td>Minor</td>
<td>Self, parent, or legal representative</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(ii)</td>
<td></td>
</tr>
<tr>
<td>Estate</td>
<td>Executor or administrator, or other fiduciary appointed by testamentary instrument of the court</td>
<td>Treas. Reg. §1.1362-6(b)(2)(iii)</td>
<td></td>
</tr>
<tr>
<td>Trust</td>
<td>Person treated as the shareholder</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(iv)</td>
<td></td>
</tr>
<tr>
<td>QSST</td>
<td>Deemed owner (beneficiary)</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(iv)</td>
<td></td>
</tr>
<tr>
<td>ESBT</td>
<td>Trustee and, if a grantor trust, the deemed owner</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(iv)</td>
<td></td>
</tr>
</tbody>
</table>
The IRS will accept a late consent if
1. filed within a reasonable period
2. reasonable cause
3. the interests of the government would not be jeopardized
I.R.C. § 1362(b)(5) instructs the IRS to treat late S corporation elections as timely filed if:
- Reasonable cause for the delinquency.
Service centers can grant relief if

- The corporation files Form 2553 no more than 3 years and 75 days after the day the election was intended to become effective.

- The corporation must explain the reasonable cause for failure to timely file the election and its diligent actions to correct the mistake upon discovery.

- This information can be provided on line I of Form 2553 or on an attached statement.
Letter Ruling Request

If the corporation does not meet the requirements for relief from a late election from the service center, the corporation may file a request for a letter ruling from the IRS National Office and pay a user fee (currently $30,000).
A corporation can revoke its S election at any time.
- Revocation terminates the election
- **Entity becomes a C corporation (even if it is unincorporated)**

To revoke the election, the corporation files a statement with the IRS service center where the S election was filed indicating the effective date of the revocation.
- Signed by any person authorized to sign income tax returns
- A statement of consent must be attached
- Consent signed by the holders of more than 50% of the stock (including nonvoting stock) on the date that the revocation is filed
There is a general prohibition against making a new S corporation election if the corporation terminated an S election within 5 years.

Thus, if a corporation decides to terminate its S status and become a C corporation, it must remain a C corporation for at least 5 years.

If the corporation then decides to reelect S status, it may be subject to tax at the entity level (such as the built-in gains tax), discussed in Issue 6.
The IRS can reduce the reelection period to 1 year if the corporation meets the following two criteria:
1. There was a change in ownership of more than 50% of the corporation’s shares since termination of the prior election.
   and
2. The prior termination was beyond the control of the current shareholders.
This section reviews the classification of business entities and how an entity makes the S corporation election.
<table>
<thead>
<tr>
<th>Liability protection</th>
<th>Step-up in basis of appreciated property after the death of an owner or sale of an owner’s interest</th>
<th>Allowable type and number of owners</th>
</tr>
</thead>
<tbody>
<tr>
<td>New partnership audit regime</td>
<td>Tax rules that apply to entities with foreign income</td>
<td>Availability of employee benefits</td>
</tr>
</tbody>
</table>
By default, an SMLLC is classified as a disregarded entity. For tax purposes, the entity’s, assets, liabilities, income, and deductions are treated as belonging directly to the owner.

If the sole owner is an individual, ordinary income or loss on Schedule C, E, or F. An SMLLC’s income is generally SE income.
P A R T N E R S H I P  P. 111

Passes through its items of income, gain, losses, deductions, and credits to partners

- The partners are taxed on their distributive share of partnership income.
- A partner (other than a limited partner) must also pay SE tax.
- Guaranteed payments from a partnership are not wages; SE income.

Have more flexibility in allocating income and loss to owners than S corporations.

- S corporations generally must allocate all items on a per-share, per-day basis.
- Partnership allocations may differ from capital ownership if they meet the requirements of I.R.C. § 704(b).
- However, partnership must allocate built-in gains and losses on contributed property to the contributing partner.
A partner’s share of partnership loss is allowed only to the extent of the adjusted basis of the partner’s interest in the partnership at the end of the partnership year in which the loss occurred.

Basis is increased by a partner’s share of the partnership liabilities.

- The risk of economic loss is enough to give a partner debt basis.
- Only economic outlay (discussed later) gives an S corporation shareholder debt basis.
Guaranteed payments are not QBI and may reduce a partner’s QBI deduction.

A partnership can compensate its owners for their contributions of capital, labor, and/or management by:

- allocation of profits or
- guaranteed payments.

Contrast: If S corporation shareholders provide labor or management, the S corporation must pay them reasonable compensation.

Partners do not receive wages from the partnership (self-employed)
C corporations pay a flat 21% tax rate.

Distribution of earnings and profits is taxed to the shareholder.

Qualified dividends are taxed at the reduced tax rate of 0%, 15%, or 20%.

C corporation income is not eligible for the QBI deduction.

Dividends received from a C corporation are subject to the 3.8% NIIT.
C CROSS-REFERENCE P. 112

C Corporations vs. Pass Through Entities

• Corporate level tax > shareholder or partner level tax

Pass through Income, loss, deduction, and credits to the shareholders

Losses that exceed the shareholder’s basis in the S corporation stock and basis in indebtedness to the S corporation shareholder are not currently deductible.

Corporate liabilities (other than those owed to its shareholders) are not included in a shareholder’s basis.
An S corporation with C corporation history may pay tax on built-in gains and excess net passive investment income.

Distributions are not subject to the NIIT if material participation.

Distributions are not subject to employment taxes and may qualify as part of the W-2 wage base for QBI.

Reasonable Compensation Rules Apply
Figure 4.6 compares the attributes of partnerships, S corporations, C corporations, and disregarded entities.
ISSUE 5: COMPENSATION OF SHAREHOLDERS P. 135

This section explains the compensation of S corporation shareholder-employees.
A shareholder officer is required to take reasonable compensation especially if they perform services for the S Corporation?

True or False
Both S and C corporations deduct expenses for wages paid, even if those payments are made to shareholder-employees.

Because wages are deductible, but dividends paid are not, there is an incentive for a C corporation to disguise distributions to owners as wages to claim a deduction.
On the contrary, S corporation wages are subject to employment taxes, which creates an incentive to characterize payments as a share of earnings instead of wages.

To prevent the treatment of wages as earnings that are not subject to employment taxes, an S corporation must pay its shareholders reasonable compensation for services that they provide to the corporation.

If the salary paid to an S corporation shareholder is not reasonable, the IRS can recharacterize a shareholder distribution as wages that are subject to employment taxes.

For newly electing S corporations, the CP261 notice contains a statement that the corporation should compensate its shareholders, and that the IRS will be enforcing this rule.
The I.R.C. § 199A qualified business income (QBI) deduction applies to qualified business income.

Wages reduce qualified business income, which may reduce the QBI deduction.

However, for taxpayers who are above the QBI phase-in range, the deduction may be limited if the corporation does not pay enough W-2 wages.

For purposes of the QBI deduction, reasonable compensation of an S corporation shareholder includes any amounts (including distributions) paid by the S corporation to the shareholder, up to the amount that would constitute reasonable compensation.

See the “Qualified Business Income Deduction Issues” chapter in this book for a discussion of calculation of the QBI deduction, and limitations on that deduction.
Reasonable compensation is determined by facts and circumstances and the burden of proof is on the taxpayer to substantiate that the compensation is reasonable.
Reasonable Compensation of a shareholder officer is determined by:

- Whatever the taxpayer says it is
- Salary comparisons of others in the industry performing similar occupations
- Comparison of salaries paid with distributions made to shareholder officer
- Both a and c
- Both b and c
- **Mayson Manufacturing factors**:  
  - The employee’s qualifications  
  - The nature, extent, and scope of the employee’s work  
  - The size of the business  
  - The complexities of the business  
  - Comparison of the salaries paid/ER’s gross and net income  
  - The prevailing general condition of the economy  
  - Comparison of the salaries paid/distributions to the SH  
  - Salaries paid for similar positions in similar businesses  
  - Salary policy of the corporation  
  - Compensation paid to EE in previous years  
  - Approval by the board of directors
Herold Marketing factors:
- Whether the employer and the employee dealt at arm’s length
- Whether the employee guaranteed the employer’s debt
- Whether the employer offered a pension plan or profit-sharing plan to its employees
- Whether the employer reimbursed the employee for business expenses that the employee paid personally
• No single factor is decisive of the question, and courts consider and weigh the totality of the facts and circumstances in determining reasonable compensation.

• For example, prior-year compensation may not be indicative if the corporation paid the shareholder-employee a lower salary during years when the business was not profitable, or if the employee took on increased duties or responsibilities.
The IRS Reasonable Compensation Job Aid for IRS Valuation Professionals describes three valuation methods for IRS agents and field personnel to determine reasonable compensation:

1. market approach
2. income approach
3. cost approach

- Although standard appraisal practice requires the consideration of all 3 approaches, the Job Aid states that reasonable compensation will generally rest **heavily on the market approach** (comparison to compensation for similar positions in similar companies).

- The income and cost approaches are then used to refine the reasonable compensation amount.
The market approach compares the shareholder-employee’s compensation with typical compensation in the industry. It asks how much compensation would be paid for the same position, held by a non-owner in an arms-length employment relationship, at a similar company.

List of sources of information for the market approach
**Figure 4.23 2018 BLS MWE Table P. 137**

Average hourly wages for selected occupational groups and areas by job characteristic, civilian workers, 2018

<table>
<thead>
<tr>
<th>Selected occupational groups and areas</th>
<th>Union</th>
<th>Nonunion</th>
<th>Full-time</th>
<th>Part-time</th>
</tr>
</thead>
<tbody>
<tr>
<td>13-0000 Business and financial operations</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Atlanta-Sandy Springs-Roswell, GA.</td>
<td>–</td>
<td>$36.66</td>
<td>$36.85</td>
<td>–</td>
</tr>
<tr>
<td>Boston-Cambridge-Nashua, MA-NH.</td>
<td>$35.86</td>
<td>$42.83</td>
<td>$42.70</td>
<td>$28.24</td>
</tr>
<tr>
<td>Chicago-Naperville-Elgin, IL-IN-WI.</td>
<td>$33.25</td>
<td>$37.17</td>
<td>$37.78</td>
<td>–</td>
</tr>
<tr>
<td>Dallas-Fort Worth-Arlington, TX.</td>
<td>–</td>
<td>$38.12</td>
<td>$38.27</td>
<td>–</td>
</tr>
<tr>
<td>Detroit-Warren-Dearborn, MI.</td>
<td>–</td>
<td>$36.75</td>
<td>$36.90</td>
<td>–</td>
</tr>
<tr>
<td>Houston-The Woodlands-Sugar Land, TX.</td>
<td>–</td>
<td>$40.71</td>
<td>$41.08</td>
<td>–</td>
</tr>
<tr>
<td>Los Angeles-Long Beach-Anaheim, CA.</td>
<td>$35.27</td>
<td>$39.39</td>
<td>$39.35</td>
<td>–</td>
</tr>
<tr>
<td>Miami-Fort Lauderdale-West Palm Beach, FL.</td>
<td>–</td>
<td>$34.41</td>
<td>$34.82</td>
<td>–</td>
</tr>
<tr>
<td>Minneapolis-St. Paul-Bloomington, MN-WI.</td>
<td>$34.17</td>
<td>$36.78</td>
<td>$36.85</td>
<td>–</td>
</tr>
<tr>
<td>New York-Newark-Jersey City, NY-NJ-PA.</td>
<td>$37.69</td>
<td>$47.68</td>
<td>$47.37</td>
<td>$26.87</td>
</tr>
<tr>
<td>Philadelphia-Camden-Wilmington, PA-NJ-DE-MD.</td>
<td>$35.07</td>
<td>$39.42</td>
<td>$39.23</td>
<td>–</td>
</tr>
<tr>
<td>Phoenix-Mesa-Scottsdale, AZ.</td>
<td>–</td>
<td>$32.77</td>
<td>$33.05</td>
<td>–</td>
</tr>
<tr>
<td>San Jose-Sunnyvale-Santa Clara, CA.</td>
<td>$43.36</td>
<td>$47.20</td>
<td>$47.24</td>
<td>–</td>
</tr>
<tr>
<td>Seattle-Tacoma-Bellevue, WA.</td>
<td>$39.57</td>
<td>$40.95</td>
<td>$41.11</td>
<td>–</td>
</tr>
<tr>
<td>Washington-Arlington-Alexandria, DC-VA-MD-WV.</td>
<td>$34.49</td>
<td>$44.01</td>
<td>$44.00</td>
<td>–</td>
</tr>
</tbody>
</table>
The Job Aid directs agents and other IRS personnel to use the income approach only when the FMV of the company is available for each year that compensation is being examined.

The income approach is based on an independent investor test that seeks to determine whether an independent investor would be satisfied with his or her return on investment.

The independent investor test creates a rebuttable presumption that an employee’s compensation is reasonable if investors obtain a far higher return than they had any reason to expect.
A high rate of return indicates that the assets’ value increased, and that the employee provided valuable services.

Thus, if investors obtain returns above what they should reasonably expect, an employee’s salary is presumptively reasonable.

The presumption is rebutted if the high rate of return is attributable to an extraneous event rather than the employee’s efforts.
The cost approach breaks the duties of the employee into components such as company administration, accounting, finance, marketing, advertising, engineering, and purchasing.

It apportions the total hours worked by the employee to the job functions, uses salary surveys to determine the cost of each job duty that the employee performs, and compares the employee’s salary to market compensation for comparable positions.

The Job Aid notes that a weakness of the cost approach is that an employee might perform many tasks to some degree.
Are economic and debt servicing taken into consideration when determining reasonable compensation of a shareholder officer?

True or False
If an S corporation distributes profits and fails to pay its shareholder-employees reasonable compensation, the excess distributions are disguised compensation and the corporation is responsible for FICA, FUTA, and income tax withholding on that compensation.

The IRS may also assess interest and penalties.

_Radtke v. U.S._
- paid its sole shareholder dividends
- no salary for the services that he provided to the corporation.
- The court reclassified the payments as wages, which were subject to FICA and FUTA.
Lucy Granger is an interior decorator who operated her business as a sole proprietorship. In 2019, Lucy earned $120,000, and she paid approximately $17,000 SE tax on that income. In 2020, Lucy incorporated her business and elected S corporation status. She is the sole shareholder and president of the corporation.
Lucy works full-time in her decorating business.

In 2020, the corporation earned $125,000 and distributed $100,000 to Lucy.
  - The corporation did not pay Lucy a salary for the year.
  - Lucy reported her income from the S corporation on Schedule E

The IRS determined that a comparable decorator would be paid a $75,000 salary.

The IRS reclassified $75,000 of the distributions as wage income, and the corporation was responsible for FICA, FUTA, and income tax withholding on that income.
David Watson was a practicing CPA with considerable experience in business taxation.

He formed a professional corporation (PC) that elected to be taxed as an S corporation.

He was the sole shareholder in his PC and its sole employee.

In both 2002 and 2003, Mr. Watson’s salary was $24,000 per year.

The PC distributed approximately $200,000 to him in 2002 and $175,000 in 2003.
The IRS determined that the PC underpaid employment taxes, and assessed tax, penalties, and interest.

At trial, the IRS expert testified that the value of the services that Mr. Watson provided to the PC was $91,044 per year, for the years at issue.

The court ruled that $67,044 ($91,044 – $24,000 salary paid) should be recharacterized and subject to employment tax.
Compensation Study

An S corporation that is trying to establish reasonable compensation for its shareholder-employees may consider hiring a consulting firm to conduct a compensation study.
An S corporation must file Form W-2 to report the compensation of its employees, including shareholder-employees.

S corporations report the deduction for officer compensation on Form 1120-S, line 7.

A corporation determines who is an officer under the laws of the state where it is incorporated.

Figure 4.24 shows the reporting of officer compensation on Form 1120-S.
<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a</td>
<td>Gross receipts or sales</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>1b</td>
<td>Returns and allowances</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>2</td>
<td>Cost of goods sold (attach Form 1125-A)</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>3</td>
<td>Gross profit</td>
<td>Subtract line 2 from line 1c</td>
</tr>
<tr>
<td>3c</td>
<td>Cost of goods sold (attach Form 1125-A)</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>4</td>
<td>Net gain (loss) from Form 4797, line 17 (attach Form 4797)</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>5</td>
<td>Other income (loss) (see instructions—attach statement)</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>6</td>
<td>Total income (less). Add lines 2 through 5</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>7</td>
<td>Compensation of officers (see instructions—attach Form 1125-E)</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>8</td>
<td>Salaries and wages (less employment credits)</td>
<td>Subtract line 1b from line 1a</td>
</tr>
<tr>
<td>9</td>
<td>Repairs and maintenance</td>
<td>Subtract line 1b from line 1a</td>
</tr>
</tbody>
</table>
Figure 4.25 shows Form 1125-E.

In addition, if the corporation has gross receipts of $500,000 or more and deducts compensation of officers, it must list the compensation of each of its officers on Form 1125-E, Compensation of Officers.
• Total gross receipts include the following amounts:
  • Form 1120-S, page 1, line 1a, gross receipts or sales
  • Form 1120-S, page 1, line 4, net gain (loss) from Form 4797
  • Form 1120-S, page 1, line 5, other income (loss)
  • Schedule K, line 3a, gross rental income (loss)
  • Schedule K, line 4, interest income
  • Schedule K, line 5a, ordinary dividends

• Schedule K, line 6, royalties
• Schedule K, line 7, net short-term capital gain (loss)
• Schedule K, line 8a, net long-term capital gain (loss)
• Schedule K, line 9, net section 1231 gain (loss)
• Schedule K, line 10, other income (loss)
• Form 8825, line 2, gross rents
• Form 8825, line 19, net gain (loss) from the disposition of rental real estate property
• Form 8825, line 20a
### Compensation of Officers

<table>
<thead>
<tr>
<th>Name</th>
<th>Employer Identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Complete Form 1125-E only if total receipts are $500,000 or more. See instructions for definition of total receipts.

<table>
<thead>
<tr>
<th>(a) Name of officer</th>
<th>(b) Social security number (see instructions)</th>
<th>(c) Percent of time devoted to business</th>
<th>(d) Percent of stock owned</th>
<th>(e) Percent of preferred stock owned</th>
<th>(f) Amount of compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td></td>
</tr>
</tbody>
</table>

2 Total compensation of officers

3 Compensation of officers claimed on Form 1125-A or elsewhere on return

4 Subtract line 3 from line 2. Enter the result here and on Form 1120, page 1, line 12 or the appropriate line of your tax return.

For Paperwork Reduction Act Notice, see separate instructions.
Many of the cases involving undercompensation of S corporation shareholders involve compensation of officers.

In general, an officer of the corporation is an employee for FICA tax purposes unless the officer performs no more than minor services and is not entitled to any compensation.

A director of a corporation in his or her capacity as a director is not an employee of the corporation.
The IRS used which of the following as statistical comparisons in determining reasonable compensation of a shareholder officer?

a. Bureau of Labor and Statistics
b. Trade-organization, trade journals or analyst’s studies
c. Private company compensation information that has been disclosed to obtain loans, financing, grants, etc.
d. All of the above
This section explains how to determine, adjust, and report shareholder stock and debt basis.
- Properly report Basis
  - Stock Basis
  - Debt Basis
- Technical Content guide for agents
- Letter 5969: Soft-audit letter to Voluntarily self-correct
The shareholder has an initial basis in his or her stock at the time of acquisition.

The shareholder then increases basis each year for his or her share of the corporation’s income and decreases basis for the shareholder’s share of deductions and losses.

Distributions (other than dividends from accumulated earnings and profits) also reduce basis.
Recordkeeping

An S corporation shareholder must maintain adequate books and records to substantiate his or her basis.

IRS can impose penalties for a failure to maintain books and records to substantiate basis.
How Acquired
- §351 Incorporation
- Purchase
- Decedent
  - Except imputed IRD
  - Imputed IRD
- Gift
  - Before 1977
  - After 1976
  - Any if FMV < donor basis
- Compensation

Beginning Basis
- Basis in property contributed to corporation
- Cost
- FMV or zero
  - FMV on date of death or alternate valuation date
  - Zero
- Generally donor basis
  - Add gift tax (≤ FMV)
  - Add gift tax on appreciation
  - Limit to FMV for loss
- Gross income on receipt
In 2020, Jeannie Bird inherited all the stock in Jayco.

Jayco is a cash method S corporation.

FMV of the stock on the date of death was $1,000,000

Accounts receivable on the date of death $450,000

Jeannie’s initial basis in the Jayco stock is

FMV

$1,000,000

Less cash method receivable (450,000)

Basis

$ 550,000

Jeannie includes the accounts receivable in income when Jayco collects the receivables, and Jeannie’s basis increases to $1,000,000 [$550,000 + $450,000].
If there is more than one shareholder, the corporation must generally allocate each income and loss item on a per-day, per-share basis.

A shareholder’s basis is adjusted annually for the shareholder’s allocable portion of the S corporation’s income and loss, and for distributions.

An income item increases stock basis.  
A loss, deduction, or distribution decreases stock basis.

Basis Adjustments
P. 118
An exception applies if a shareholder’s entire interest in the S corporation terminates and the corporation elects to treat the tax year as two short tax years.

An election to terminate the year may also be allowed if there is a substantial disposition or issuance of stock.

The first tax year ends at the end of the day on which the shareholder’s entire interest terminates.
Adjustments to basis are made annually on the last day of the year (or immediately before the disposition of S corporation stock).

Under the general rules, adjustments are made in the following order:

1. Income items, including tax-exempt income and separately stated income, and excess depletion increase basis.
2. Distributions (other than dividends from the corporation's accumulated earnings and profits) decrease basis, but not below zero.
3. Nondeductible, noncapital expenses and depletion decrease basis, but not below zero.
4. Items of loss and deduction decrease basis, but not below zero.
EXAMPLE 4.4
ADJUSTING SHAREHOLDER BASIS
PP. 118-119

▪ Cheryl Sims is the sole shareholder of Sims Corporation.

▪ On January 1, 2020, Cheryl’s basis in the corporation was $15,000

▪ In 2020, the corporation had:

  ▪ Ordinary loss $20,000
  ▪ Net section 1231 gain $4,000
  ▪ Cash contribution to a charity $5,000
  ▪ Nondeductible expenses $1,000
  ▪ Distributed to Cheryl $12,000
## Part I: Information About the Corporation

<table>
<thead>
<tr>
<th>A</th>
<th>Corporation's employer identification number</th>
<th>00-0000000</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Corporation's name, address, city, state, and ZIP code</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sims Corporation</td>
<td>100 Pine Street</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Seattle, WA 98107</td>
</tr>
<tr>
<td>C</td>
<td>IRS Center where corporation filed return</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Orden</td>
<td></td>
</tr>
</tbody>
</table>

## Part II: Information About the Shareholder

<table>
<thead>
<tr>
<th>D</th>
<th>Shareholder's identifying number</th>
<th>000-00-0000</th>
</tr>
</thead>
<tbody>
<tr>
<td>E</td>
<td>Shareholder's name, address, city, state, and ZIP code</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cheryl Sims</td>
<td>500 Pinney Avenue</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Seattle, WA 98103</td>
</tr>
<tr>
<td>F</td>
<td>Shareholder's percentage of stock ownership for tax year</td>
<td>100%</td>
</tr>
</tbody>
</table>

## Part III: Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

<table>
<thead>
<tr>
<th></th>
<th>Ordinary business income (loss) (20,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Net rental real estate income (loss)</td>
</tr>
<tr>
<td>3</td>
<td>Other net rental income (loss)</td>
</tr>
<tr>
<td>4</td>
<td>Interest income</td>
</tr>
<tr>
<td>5a</td>
<td>Ordinary dividends</td>
</tr>
<tr>
<td>5b</td>
<td>Qualified dividends</td>
</tr>
<tr>
<td>6</td>
<td>Royalties</td>
</tr>
<tr>
<td>7</td>
<td>Net short-term capital gain (loss)</td>
</tr>
<tr>
<td>8a</td>
<td>Net long-term capital gain (loss)</td>
</tr>
<tr>
<td>8b</td>
<td>Corrected (25%) gain (loss)</td>
</tr>
<tr>
<td>8c</td>
<td>Unrecaptured section 1250 gain</td>
</tr>
<tr>
<td>9</td>
<td>Section 1231 gain (loss)</td>
</tr>
<tr>
<td>10</td>
<td>Other income (loss)</td>
</tr>
</tbody>
</table>

### Calculation of Adjustment to Book Income

<table>
<thead>
<tr>
<th>11</th>
<th>Section 179 deduction</th>
<th>12</th>
<th>Other deductions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Section 179 deduction</td>
<td>19</td>
<td>Items affecting shareholder basis</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>A</td>
<td>Other deductions</td>
<td>D</td>
<td>12,000</td>
</tr>
<tr>
<td></td>
<td>5,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Description</td>
<td>Amount</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-------------------------------------------------</td>
<td>----------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning stock basis</td>
<td>$15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase for income items</td>
<td>4,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basis before distribution</td>
<td>$19,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution</td>
<td>(12,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basis before loss items</td>
<td>$ 7,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decrease for nondeductible expenses</td>
<td>(1,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basis before loss and deduction items</td>
<td>$ 6,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowable ordinary business loss*</td>
<td>(4,800)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowable cash contributions*</td>
<td>(1,200)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ending stock basis</td>
<td>$        0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* The $6,000 allowed loss items must be allocated between the $5,000 charitable contribution deduction and the $20,000 ordinary loss.

- Of the total $25,000 loss items,
  - 80% ($20,000 ÷ $25,000) is the ordinary loss
  - 20% ($5,000 ÷ $25,000) is the charitable contribution deduction.

- $4,800 ($6,000 × 80%) of the allowed loss is ordinary
- $1,200 ($6,000 × 20%) is charitable contribution
Cheryl’s 2020 loss is limited to $4,800.

She can carry over the suspended $15,200 ($20,000 − $4,800) loss to 2021, which may again be limited by Cheryl’s basis in the corporation.

Cheryl can claim a $1,200 cash contribution on Schedule A (Form 1040), subject to the contribution limitations.

If she does not itemize deductions, she can claim a $300 above-the-line charitable contribution deduction.

She can carry over the remaining $3,800 ($5,000 − $1,200) to 2021.
Other Loss Limitations

- In addition to the basis limitations, a shareholder’s loss may be limited by the at-risk rules and the passive activity loss limitations.
Under the general ordering rule:

1. Nondeductible expense items, such as the 50% disallowed meal expense, reduce basis before other items of loss and deduction.

2. If the nondeductible items exceed available basis, the shareholder’s basis is reduced to zero.

3. There is no carryforward of excess nondeductible items.
At the beginning of 2020, Joanna's basis in her stock was $5,000.

In 2020, LTB had
- $4,500 ordinary loss,
- $1,500 disallowed meals

The corporation had no income items, and Joanna received no distributions.

Under the general rule,
- Beginning basis $5,000
- Disallowed meal expenses (1,500)
- Joanna's basis before loss $3,500
- She can deduct $3,500 of the corporation's ordinary loss.
- The $1,000 loss ($4,500 loss less $3,500 deduction) that exceeds her basis is carried forward.
A shareholder can elect to decrease basis by items of loss or deduction before the nondeductible expenses.

If a shareholder makes this election, any amount of nondeductible expenses that exceeds the shareholder’s basis in stock and indebtedness is treated, for purposes of calculating basis, as nondeductible expenses in the next tax year.
At the beginning of 2020, Joanna’s basis in her stock was $5,000.

In 2020, LTB had
- $4,500 ordinary loss,
- $1,500 disallowed meals

The corporation had no income items, and Joanna received no distributions.

Under the elective rule,
- Beginning basis $5,000
- Ordinary loss (4,500)
- Joanna’s basis before ND $ 500
- Less ND expense ( 500)
- Basis $ 0
- She can deduct all the ordinary loss.
- The remaining $1,000 nondeductible expense ($1,500 - $500) is carried forward.
The facts are the same as in Example 4.6 except that the 2020 nondeductible expense was a $50,000 fine. Fine was nondeductible and the ordinary loss was still $4,500.

Figure 4.9 compares Joanna’s basis calculations with the general rule and the elective ordering rule.
### Figure 4.9
Comparing General Rule and Elective Ordering Rule

<table>
<thead>
<tr>
<th>General Rule</th>
<th>Elective Ordering Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning basis</td>
<td>Beginning basis</td>
</tr>
<tr>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Nondeductible expense</td>
<td>Allowable ordinary business loss</td>
</tr>
<tr>
<td>$(50,000)</td>
<td>$(4,500)</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>Adjusted basis</td>
</tr>
<tr>
<td>$0</td>
<td>$500</td>
</tr>
<tr>
<td>Allowable ordinary business loss</td>
<td>Allowable nondeductible expense</td>
</tr>
<tr>
<td>$(0)</td>
<td>$(500)</td>
</tr>
<tr>
<td>Ending basis</td>
<td>Ending basis</td>
</tr>
<tr>
<td>$(0)</td>
<td>$(0)</td>
</tr>
<tr>
<td>Carryforward to next year</td>
<td>Carryforward to next year</td>
</tr>
<tr>
<td>$0</td>
<td>$49,500</td>
</tr>
<tr>
<td>Nondeductible expense</td>
<td>Nondeductible expense</td>
</tr>
<tr>
<td>$0</td>
<td>$49,500</td>
</tr>
<tr>
<td>Ordinary loss</td>
<td>Ordinary loss</td>
</tr>
<tr>
<td>$4,500</td>
<td>$(0)</td>
</tr>
</tbody>
</table>
A shareholder obtains debt basis by loaning the S corporation money or property in which the shareholder has basis. There must be *bona fide indebtedness* from the corporation to the shareholder.
A shareholder does not obtain basis of indebtedness in the S corporation merely by:

| guaranteeing a loan | acting as a surety, accommodation party | acting in a similar capacity relating to a loan |

When a shareholder makes a payment on bona fide indebtedness of the S corporation the shareholder may increase the basis of his or her indebtedness to the extent of that payment.
Claire Conrad is the sole shareholder of Glacier, Inc., an S corporation.

In 2018, Claire guaranteed a $100,000 bank loan made to Glacier.

In 2020, Glacier was unable to make the loan payments,
• Claire used her personal funds to pay $20,000 of loan principal on Glacier’s behalf.

The loan guarantee does not affect Claire’s basis in 2018.

Her $20,000 principal payment increases her basis by $20,000 in 2020.
The IRS ruled that the shareholder’s execution of a promissory and bank’s acceptance of the note caused the **indebtedness** of the corporation to accrue **to the shareholder**.

- Created a basis in the indebtedness
FIGURE 4.10
SUBSTITUTION OF PROMISSORY NOTE FOR GUARANTEE

Shareholder Guarantee Does Not Create Basis

Shareholder Guarantee Does Not Create Basis

Bank

Loan $

S Corporation

Note

Shareholder

Bank

Loan $

S Corporation

Note

Shareholder
Ltr. Rul. 8747013

**S corporation pledged its assets to the lender as security for a loan.**
- The shareholders guaranteed the loan.

The shareholders then borrowed money from the lender and loaned the funds to the corporation so that it could pay the loan.

The S corporation’s assets secured the loan to the shareholders.

The IRS ruled that the shareholders had debt basis in their loan to the corporation.
In *Gilday v. Commissioner*, the shareholders initially guaranteed a loan to an S corporation.

- The shareholders later gave the bank a promissory note in satisfaction of the corporation’s indebtedness.
- The corporation gave the shareholders a promissory note for the amount owed to the bank.

The court found that the shareholders moved from the position of guarantors to primary obligors on the loan from the bank.
Most courts have held that there is no attributed basis for loans made by related parties.

- See *Prashker v. Commissioner*
- Rev. Rul. 69-125

- Loan from a Partnership to an S Corporation where the partners and S corporation shareholders were the same persons did not constitute indebtedness of the corporation to the shareholders.
In *Culnen v. Commissioner*, a shareholder owned controlling interests in two S corporations.

One corporation advanced funds to another, so that the shareholder could claim basis in the recipient corporation. The corporation advancing the funds recorded the advances as distributions to the shareholder. The recipient corporation recorded the funds as loans from the shareholder.

Both corporations recorded and reported the transactions consistently.

The court found that the shareholder had debt basis in the recipient corporation.

See also *Yates v. Commissioner*. 
▪ Treas. Reg. § 1.1366-2(a)(2)(iii)
  ▪ Shareholder can make a loan to an S corporation through an entity that is disregarded as separate from the shareholder.

▪ Example: SLLC to the S corporation is treated as a loan from the LLC’s sole member to the S corporation
  ▪ = debt basis.
Under Treas. Reg. § 1.1366-2, back-to-back loans create basis.

In a back-to-back loan,
- shareholder borrows money (possibly from a related entity)
- shareholder lends the money to the S corporation

The arrangement must constitute bona fide indebtedness from the S corporation to the shareholder.
Andy Bennett owns all the stock of two S corporations
- Andy Co.
- Bennett Co.

Andy borrowed $50,000 from Andy Co. and loaned the $50,000 to Bennett Co.

If the loan from Andy to Bennett Co. constitutes **bona fide indebtedness** from Bennett Co. to Andy, Andy’s back-to-back loan increases his basis of indebtedness in Bennett Co. by $50,000.
Seven Sixty Ranch Co.--shareholder personally borrowed money from banks for the S corporation business operations.

- S corporation gave the shareholder promissory notes for the amounts that the shareholder borrowed from the banks.
- Court ruled bona fide debts.
- Thus the shareholder had basis.
CIRCULAR LOAN: OREN V. COMMISSIONER

Shareholder

Controlled #2 loaned funds to controlled entity #1

Borrowed from controlled entity #1

Loaned those funds to controlled entity #2
The court found that the circular lending arrangement between a shareholder and his wholly owned corporations had no actual economic outlays or amounts at risk.
Similarly, in *Kaplan v. Commissioner*, the court found that loans to the S corporation lacked economic substance.

| S corporation shareholder borrowed money from a bank. | The shareholder pledged bank accounts of two wholly owned S corporations as security for the loan. | The shareholder loaned the borrowed funds to the two S corporations and deposited the funds in the pledged bank accounts. | The corporations returned the funds to the shareholder | He repaid the bank loan 11 days after the original loan. |

The court found that the various disbursements between the taxpayer and his S corporations were the equivalent of offsetting bookkeeping entries, and the shareholder made no economic outlay.
If a shareholder’s portion of an S corporation’s losses does not exceed his or her stock basis, there will never be an adjustment to debt basis.

If, however, the shareholder’s portion of losses exceeds the stock basis, debt basis must be adjusted as follows:

- In the year of the loss, after the stock basis is reduced to zero, the shareholder reduces debt basis.
- In a subsequent year when the corporation reports income, the shareholder will restore debt basis before increasing stock basis.
Bigtime, Inc. is an S corporation.

- 2019, Bigtime $100,000 ordinary loss
  - Beginning of 2019, stock basis of $60,000 and debt basis of $50,000
  - The 2019 loss reduced Jimmy’s stock basis to $0 and his debt basis to $10,000

- In 2020, Bigtime $140,000 ordinary income
  - Restores Jimmy’s debt basis to $50,000
  - Increases Jimmy’s stock basis to $100,000

### 2019

<table>
<thead>
<tr>
<th>Stock Basis</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>$60,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>1. (60,000)</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>(40,000)</td>
</tr>
<tr>
<td>End $0</td>
<td>10,000</td>
</tr>
</tbody>
</table>

### 2020

<table>
<thead>
<tr>
<th></th>
<th>40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td></td>
</tr>
<tr>
<td>2. 100,000</td>
<td></td>
</tr>
<tr>
<td>End $100,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
The IRS LB&I Division compliance campaign is focusing on S corporation basis reporting, and S corporation shareholders may be required to file basis calculations with their tax returns.

There is a box on Schedule E (Form 1040), Supplemental Income and Loss, to indicate whether basis reporting is required.
**Income or Loss From Partnerships and S Corporations** – Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which any amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198** (see instructions).

| 27 | Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered “Yes,” see instructions before completing this section. | Yes | No |

<table>
<thead>
<tr>
<th>28</th>
<th>(a) Name</th>
<th>(b) Enter P for partnership; S for S corporation</th>
<th>(c) Check if foreign partnership</th>
<th>(d) Employer identification number</th>
<th>(e) Check if basis computation is required</th>
<th>(f) Check if any amount is not at risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Worksheet for Figuring a Shareholder's Stock and Debt Basis

**Part I—Shareholder Stock Basis**

1. Stock basis at the beginning of the corporation's tax year
2. Basis from any capital contributions made or additional stock acquired during the tax year
3a. Ordinary business income (losses go on Part III)
3b. Net rental real estate income (losses go on Part III)
3c. Other net rental income (losses go on Part III)
3d. Interest income
3e. Ordinary dividends
3f. Royalties
3g. Net capital gains (losses go on Part III)
3h. Net section 1231 gain (losses go on Part III)
3i. Other income (losses go on Part III)
3j. Excess depletion adjustment
3k. Tax-exempt income
3l. Recapture of business credits
3m. Other items that increase stock basis

4. Add lines 3a through 3m
5. Stock basis before distributions. Add lines 1, 2, and 4
6. Distributions (excluding dividend distributions)
   - Note: If line 6 is larger than line 5, subtract line 6 from line 5 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.
7. Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15
8a. Non-deductible expenses
8b. Deduction for oil and gas

9. Add lines 8a and 8b
10. Stock basis before tax loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15
11. Allowable loss and deduction items. Enter the amount from Part III, line 12, column (c)
12. Debt basis restoration (see note in instructions for Part II, line 8)
13. Other items that decrease stock basis
14. Add lines 11, 12, and 13
15. Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-
### FIGURE 4.12 WORKSHEET FOR FIGURING BASIS P. 126

#### Part II—Shareholder Debt Basis

<table>
<thead>
<tr>
<th>Amount of Debt</th>
<th>Debt 1</th>
<th>Debt 2</th>
<th>Debt 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Open account debt</td>
<td>Open account debt</td>
<td>Open account debt</td>
<td></td>
</tr>
<tr>
<td>Loan balance at the beginning of the corporation’s tax year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional loans (see instructions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan balance before repayment. Combine lines 1 and 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principal portion of debt repayment (this line doesn’t include interest)</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Loan balance at the end of the corporation’s tax year. Combine lines 3 and 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Adjustments to Debt Basis:

<table>
<thead>
<tr>
<th></th>
<th>Debt 1</th>
<th>Debt 2</th>
<th>Debt 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Open account debt</td>
<td>Open account debt</td>
<td>Open account debt</td>
<td></td>
</tr>
<tr>
<td>Debt basis at the beginning of the corporation’s tax year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enter the amount, if any, from line 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt basis restoration (see instructions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt basis before repayment. Combine lines 5, 7, and 8</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Divide line 9 by line 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonreimbursable debt repayment. Multiply line 10 by line 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt basis before nondeductible expenses and losses. Subtract line 11 from line 9</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nondeductible expenses and (or) gas depletion deductions in excess of stock basis</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt basis before losses and deductions. Subtract line 13 from line 12. If the result is zero or less, enter -0-</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowable losses in excess of stock basis. Enter the amount from Part III, line 13, column (b)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt basis at the end of the corporation’s tax year. Subtract line 15 from line 14. If the result is zero or less, enter -0-</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Gain on Loan Repayment:

<table>
<thead>
<tr>
<th></th>
<th>Debt 1</th>
<th>Debt 2</th>
<th>Debt 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Open account debt</td>
<td>Open account debt</td>
<td>Open account debt</td>
<td></td>
</tr>
<tr>
<td>Repayment. Enter the amount from line 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonreimbursable repayments. Enter the amount from line 11</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reportable gain. Subtract line 18 from line 17</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Figure 4.12
Worksheet for Figuring Basis
P. 127

<table>
<thead>
<tr>
<th>Part III—Allowable Loss and Deduction Items</th>
<th>(a) Current year losses and deductions</th>
<th>(b) Carryover amounts (column (e) from the previous year)</th>
<th>(c) Allowable loss from stock basis</th>
<th>(d) Allowable loss from debt basis</th>
<th>(e) Carryover amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Ordinary business loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Net rental real estate loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Other net rental loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Net capital loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Net section 1231 loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Other loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Section 179 deductions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Charitable contributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Investment interest expense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Section 50(e)(2) expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Other deductions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Foreign taxes paid or accrued</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

13. **Total Loss.** Combine lines 1 through 12 for each column. Enter the total loss in column (c) on line 1 of Part I and enter the total loss in column (d) on line 15 of Part II.
Dear [Taxpayer]:

Our research indicates you may have claimed pass-through loss or deduction items in excess of your basis in stock and debt in [S CORPORATION, TIN].

Section 1366(d)(1) of the Internal Revenue Code (IRC) states that the loss and deduction items taken into account by an S corporation shareholder cannot exceed the shareholder's basis in stock and debt. Generally, loss or deduction items not allowed because of the basis limitation can be carried forward and deducted in a later year, depending on the basis limitation for that later year.

Our records indicate you didn't attach an adjusted basis computation schedule to your federal income tax return. You are required to compute and maintain an adjusted basis computation schedule under IRC Section 1367 and Treasury Regulation Section 1.6041-1(b). You must attach the schedule to your return as directed in the instructions to Form 1040, Schedule K-1, Supplemental Income and Loss.

Please provide your adjusted basis computation schedule to the address above, along with a copy of this letter, by the response due date. You can refer to the Shareholder's Instructions for Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., at www.irs.gov/forms-pubs for more information.

If you claimed loss or deduction items in excess of your basis in stock and debt, file Form 1040X, Amended U.S. Individual Income Tax Return or amend Form 1041, U.S. Income Tax Returns for Estates and Trust, whichever is applicable, to correct your errors for the tax periods listed above. Mail the amended form to the address above. You can find Forms 1040X and 1041 at www.irs.gov/forms-pubs.

Please remember that after applying the basis limitation, the deduction amount of your aggregated losses and deductions may be further reduced by the at-risk rules and the passive activity loss rules. For more information, see Publication 925, Passive Activity and At-Risk Rules, at www.irs.gov/forms-pubs.

We enclosed a copy of this letter for your records. This letter is not an audit of your tax return. If you have questions, contact the person listed at the top of this letter.
This section explains the tax treatment of distributions from S corporations to their shareholders.
S corporations may distribute cash to their shareholders. The tax treatment of those distributions depends on the taxpayer’s basis in his or her S corporation stock, and whether the S corporation has accumulated earnings and profits (AE&P) from a prior year when it was a C corporation. An S corporation may also distribute noncash assets to its shareholders.
The IRS LB&I Division has undertaken a campaign to educate S corporations and their shareholders about the following distribution issues:

1. Failure to report tax on nondividend distributions that exceed stock basis
2. Failure to determine that a distribution, whether in cash or in property, is taxable as a dividend
3. Failure to report gain on the distribution of appreciated property to a shareholder
4. Computation of distributions from S corporations with accumulated earnings and profits
If the S corporation does not have AE&P, the tax treatment of cash distributions depends on the shareholder’s stock basis.

If the distributions do not exceed adjusted stock basis, the shareholder receives the distribution tax-free and reduces basis by the amount of the distribution.

The calculation is made at the end of the year, and the shareholder’s pro rata share of the corporation’s income items increases basis before basis is reduced by distributions.

• See the earlier discussion of basis adjustments, PP. 118-122.

Debt basis is not considered when determining the taxability of a distribution.
### Nondividend Distributions (Continued)

<table>
<thead>
<tr>
<th>Distributions from an S corporation that exceed the shareholder's basis are treated as a gain from a deemed sale of the stock.</th>
<th>Stock is a capital asset for most taxpayers, and the gain is a capital gain.</th>
</tr>
</thead>
<tbody>
<tr>
<td>It is a long-term capital gain if the stock has been held for longer than one year.</td>
<td></td>
</tr>
</tbody>
</table>

Nondividend distributions are reported on Schedule K-1 (Form 1120-S box 16 with code “D.”)

Dividend distributions (discussed later) are reported on Form 1099-DIV.
Deborah Burke is the sole shareholder in Medco, Inc., an S corporation.

Medco has no AE&P.

In 2020, Medco had
- $90,000 of section 1231 gains
- $50,000 ordinary loss
- $120,000 distribution to Deborah

Her stock basis was $150,000 on January 1, 2020.

Figure 4.14 shows Deborah’s 2020 basis adjustments.
The $120,000 distribution to Deborah did not exceed her $240,000 basis.

She reduces her basis by the amount of the distribution.

Deborah does not include the distribution in her income.
EXAMPLE 4.12 TAXABLE DISTRIBUTION P. 130

- Same except basis at beginning of year was $10,000

- Basis at beginning of year $ 10,000
- Current-year income 90,000
- Basis before distribution $100,000
- Distribution (100,000)
- Basis before loss $ 0
- Loss ( 0)
- Ending basis $ 0

The $120,000 distribution reduces her basis to $0.

Deborah has a $20,000 ($120,000 – $100,000) gain.

She cannot deduct any of the $50,000 loss in the current year.
An S corporation does not accumulate E&P.

If the S corporation was previously a C corporation (or acquired assets from a C corporation in a reorganization) it may have AE&P.

The distribution of AE&P creates a taxable dividend.

Thus, an S corporation that has E&P must maintain an accumulated adjustments account (AAA) and an AE&P account to determine the tax effect of distributions during years as an S corporation.
Distributions from an S corporation are generally treated as if they were made first from the S corporation's income, and then from AE&P.

The AAA tracks the income that the S corporation has earned but not yet distributed.

Distributions that do not exceed the balance in the AAA reduce a shareholder's basis (and result in capital gain if the distribution exceeds the shareholder's basis) in the same manner as a distribution from an S corporation that does not have AE&P.

The AAA is an account of the S corporation and is not apportioned among the shareholders.

The corporation reports the AAA on Schedule M-2 (Form 1120-S).

 ACCUMULATED ADJUSTMENTS ACCOUNT P. 130
A new S corporation (or a corporation that has newly elected S corporation status) starts with a zero balance in its AAA.

Each year, the corporation must adjust its AAA.

All taxable (but not tax-exempt) items of S corporation income increase AAA.

AAA is decreased by items of loss or deduction
- except for nondeductible expenses related to tax-exempt income and federal taxes attributable to any tax year in which the corporation was a C corporation.
- These items may decrease AAA below zero.

Distributions reduce AAA (but not below zero).
ORDERING RULES

Different from the ordering rules for basis adjustments

Generally,

- Income items first increase AAA
- Losses reduce AAA to the extent of income items for the year
- Distributions reduce AAA
- **Net negative adjustment** in a year that the corporation has a net loss

Net negative adjustment = excess of loss items over income items
Acme, Inc. is an S corporation that was formerly a C corporation.

Acme had $250,000 AE&P at the beginning of 2020.

In 2020, Acme had
- $90,000 section 1231 gains
- $150,000 ordinary loss
- $120,000 distribution to Diana

Diana’s basis in her S corporation stock at the beginning of 2020 was $150,000.

She has no debt basis.

Figure 4.15 shows the adjustments to Acme’s AAA.
FIGURE 4.15 Acme, Inc.'s AAA Adjustments

- AAA at beginning of year $110,000
- Income items 90,000
- Losses, limited to the income items (90,000)
- AAA before distributions $110,000
- Nondividend distribution* (110,000)
- Net negative adjustment (60,000)
- ($150,000 − $90,000)
- AAA at end of year (60,000)

* The $10,000 distribution that exceeds AAA is a dividend and does not reduce AAA.

FIGURE 4.16 Diana Miller’s Basis Adjustments

- Beginning of year $150,000
- Income items 90,000
- Basis before distributions $240,000
- Distributions from AAA (110,000)
- Basis before losses $130,000
- Losses allowable ($150,000 total) (130,000)
- Basis at end of year $0

- Diana’s loss deduction is limited by her basis.
- She must carry forward $20,000 ($150,000 − $130,000) of the loss.
- She must also report $10,000 of dividend income.
### Schedule M-2

Analysis of Accumulated Adjustments Account, Shareholders’ Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account

(see instructions)

<table>
<thead>
<tr>
<th></th>
<th>(a) Accumulated adjustments account</th>
<th>(b) Shareholders’ undistributed taxable income previously taxed</th>
<th>(c) Accumulated earnings and profits</th>
<th>(d) Other adjustments account</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Balance at beginning of tax year</td>
<td>110,000</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Ordinary income from page 1, line 21</td>
<td>90,000</td>
<td></td>
<td>150,000</td>
</tr>
<tr>
<td>3</td>
<td>Other additions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Loss from page 1, line 21</td>
<td>(150,000)</td>
<td></td>
<td>(150,000)</td>
</tr>
<tr>
<td>5</td>
<td>Other reductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Combine lines 1 through 5</td>
<td>50,000</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Distributions</td>
<td>110,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Balance at end of tax year. Subtract line 7 from line 6</td>
<td>(60,000)</td>
<td></td>
<td>240,000</td>
</tr>
</tbody>
</table>
If the corporation has AE&P and wants to distribute from this account before making distributions from the AAA, it may elect to do so with the consent of all its affected shareholders.

- Election is irrevocable
- Applies only for the tax year for which it is made

An S corporation that has AE&P and passive investment income may be subject to the corporate level tax on excess net passive investment income (discussed later) and lose its S corporation status.

That corporation may elect to make distributions first from AE&P to avoid the corporate level tax and loss of its S corporation status.
A deemed dividend is treated as if
1. it were a pro rata distribution of money to the shareholders
2. received by the shareholders
3. immediately contributed back to the corporation
4. all on the last day of the tax year

- This election is irrevocable and applies only for the tax year for which it is made.
- The corporation will be treated as also having elected to distribute AE&P first.
- The AE&P at the end of the year is first reduced by any actual distributions of AE&P made during the tax year, and the amount of the deemed dividend equals the AE&P at the end of the tax year.
- Thus, the election eliminates the AE&P.
▪ Identify the election and get shareholder consents.
▪ The statement of election must include the amount deemed distributed to each shareholder.
Previously Taxed Income

• Schedule M-2, column (b), reports shareholders’ undistributed taxable income previously taxed.
• This is the previously taxed income (PTI) of a shareholder that accumulated between 1958 and 1982.
• Distributions that exceed AAA come from PTI before AE&P.
### Figure 4.18 Summary of Distributions from S Corporations

<table>
<thead>
<tr>
<th>General Order</th>
<th>Source</th>
<th>Description</th>
<th>Taxability</th>
<th>Effect on Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>AAA (including current-year income and loss items)</td>
<td>All S corporations to the extent of AAA</td>
<td>Not taxable unless exceed shareholder's basis</td>
<td>Reduce basis to the extent thereof</td>
</tr>
<tr>
<td>2.</td>
<td>PTI</td>
<td>Shareholders with pre-1983 PTI accumulations</td>
<td>Not taxable unless exceed shareholder's basis</td>
<td>Reduce basis to the extent thereof</td>
</tr>
<tr>
<td>3.</td>
<td>AE&amp;P</td>
<td>S corporations with AE&amp;P</td>
<td>Dividends</td>
<td>No effect on basis</td>
</tr>
<tr>
<td>4.</td>
<td>OAA, then paid-in capital</td>
<td>All remaining distributions</td>
<td>Not taxable unless exceed shareholder's basis</td>
<td>Reduce basis to the extent thereof</td>
</tr>
</tbody>
</table>
An S corporation is subject to the same general rules as a C corporation and must recognize gain on distributions of appreciated property (FMV exceeds adjusted basis) as if it sold the property for its FMV.

It generally does not recognize losses on distributions of property with FMV that is less than its adjusted basis.

Gain recognized on distributions of depreciable property may be characterized as ordinary income.
If the distributed property is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, the deemed FMV is reduced by the assumed liability, but cannot be less than the liability.
Thus, for an S corporation with no C corporation history, the shareholder’s share of the gain increases basis and is not taxable to the extent that it does not exceed the shareholder’s basis in his or her shares.

Instead, any gain recognized by the S corporation is taken into account by the shareholders, in the same manner as other income from the S corporation.

The corporation does not pay tax on the gain on distributed property unless it is subject to the built-in-gains tax (discussed later).
The shareholder’s basis in distributed property is its FMV.

I.R.C. § 312 limits the reduction to the adjusted basis of the distributed property even though the FMV is included in the shareholder’s income as a dividend.

For an S corporation with AE&P, under the general ordering rules, the distribution reduces AAA (but not below zero) and then is a dividend distribution that reduces the AE&P.
In general, if the S corporation distributes property with an adjusted basis that is less than its FMV, the corporation does not recognize a loss.

The shareholder’s basis is the FMV of property less any liabilities that the shareholder assumes.

The corporation may recognize a loss on a pro rata distribution to a qualified person, *in complete liquidation* of the corporation.
Under I.R.C. § 1239, any gain recognized by a seller on the sale of distributed property must be treated as ordinary income if the property is, in the hands of a related buyer, depreciable under I.R.C. § 167.

I.R.C. § 1239 defines related persons to include a corporation and any person who actually or constructively owns more than 50% of the outstanding stock.

Constructive ownership rules apply (I.R.C. §267).
EXAMPLE 4.15
DISTRIBUTION OF NONCASH PROPERTY
P. 134

Handcraft has always been an S corporation and has no AE&P.

Sally, Will, and Tom are unrelated.
- Sally owns 40%
- Will owns 35%
- Tom owns 25%

In 2020, Handcraft had $350,000 taxable income before any distributions.

Handcraft plans to make the distributions shown in Figure 4.19 at the end of 2020.
## Figure 4.19 Handcraft, Inc. 2020 Distributions

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Asset</th>
<th>FMV</th>
<th>Adjusted Basis</th>
<th>Liabilities Assumed</th>
<th>Net Distributed Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sally</td>
<td>Cash</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$0</td>
<td>$200,000</td>
</tr>
<tr>
<td>Will</td>
<td>Building</td>
<td>$255,000</td>
<td>$85,000</td>
<td>$80,000</td>
<td>$175,000</td>
</tr>
<tr>
<td>Tom</td>
<td>Securities</td>
<td>$125,000</td>
<td>$190,000</td>
<td>$0</td>
<td>$125,000</td>
</tr>
</tbody>
</table>
**FIGURE 4.20 Handcraft, Inc.’s Gain on Distributions**

<table>
<thead>
<tr>
<th>Asset</th>
<th>Gain Recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$0</td>
</tr>
<tr>
<td>Building ($255,000 FMV – $85,000 basis)</td>
<td>$170,000</td>
</tr>
<tr>
<td>Securities ($125,000 FMV – $190,000 basis)*</td>
<td>$0</td>
</tr>
</tbody>
</table>

* S corporations do not recognize loss on distributed assets
Handcraft’s 2020 taxable income is $520,000.

It allocates
- $208,000 ($520,000 \times 40\%) to Sally
- $182,000 ($520,000 \times 35\%) to Will
- $130,000 ($520,000 \times 25\%) to Tom

Each shareholder takes his or her share of income into account as an addition to basis, and then reduces basis by the FMV (less liabilities assumed) of the distributed property.

Figure 4.21 shows the shareholders’ bases in the distributed assets.
<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Asset</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sally</td>
<td>Cash</td>
<td>$200,000</td>
</tr>
<tr>
<td>Will</td>
<td>Building</td>
<td>$255,000</td>
</tr>
<tr>
<td>Tom</td>
<td>Securities</td>
<td>$125,000</td>
</tr>
</tbody>
</table>
The distributions reduce each shareholder’s basis in his or her shares.

If a shareholder’s basis before the distribution was less than the distribution amount, the shareholder would recognize gain on the excess amount.
The built-in gains tax is a corporate-level tax on S corporations with C corporation history.
An S corporation that was formerly a C corporation may be taxed on its built-in gains (BIG).

The IRS LB&I Division has undertaken a campaign to educate S corporations and their shareholders about the need to properly calculate and document built-in gains.
The BIG tax applies to built-in gains of a former C corporation for the first 5 years following conversion to S corporation status.

This 5-year period is called the **recognition period**
- Any assets sold before or during the recognition period are subject to the BIG tax, regardless of when the proceeds are received.
- Thus, the sale of assets in an installment sale will be subject to the BIG tax, even if no sale proceeds are received during the recognition period.

Corporate level tax on sale of assets

Applies if
- Previously a C corporation
- Received assets from C in tax-free reorg, subsidiary liquidation or Qsub election

5-year recognition period
- Tax on gains accrued in C corp
- Highest Corporate Tax rate (21%)
FIGURING BUILT IN GAINS

NUBIG – Net Unrealized Build-In Gain
TIL – Taxable Income Limitation
PLA – Prelimitation Amount
C Corporation Carryforwards

• No “inherited” carryover
• NOL and net capital loss carryforwards reduce the BIG tax.
QUESTIONS?