2020 NATIONAL INCOME TAX WORKBOOK

Chapter 4: S CORPORATION TAX ISSUES



CHAPTER TOPICS P. 101



INTRODUCTION FUN FACTS

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

P 101



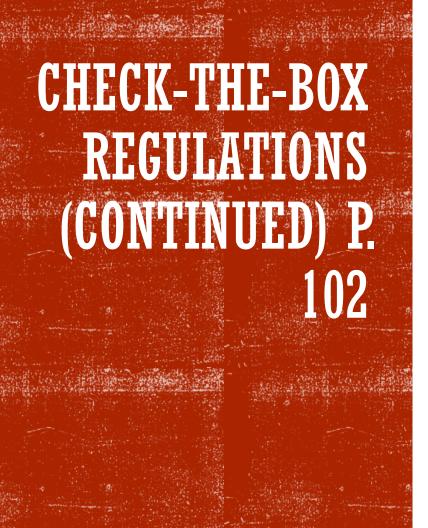
ISSUE 1: ENTITY CLASSIFICATION P. 102

 This section reviews the classification of business entities and how an entity makes the S corporation election.



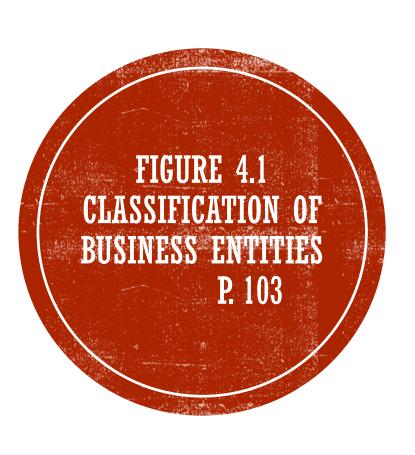
- Unincorporated domestic entity with more than one owner is, by default, a partnership.
 - However, it can elect to be treated as an association (a corporation) for federal tax purposes.
- A single-member LLC (SMLLC) is, by default, a disregarded entity.
 - It too can elect to be taxed as a corporation for federal tax purposes.

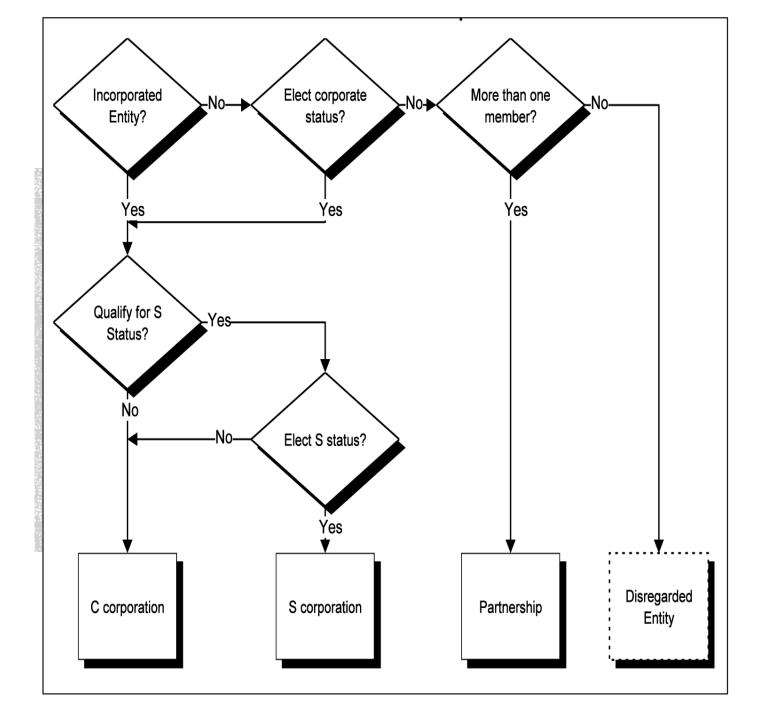




- Tax Status v. Organization @ State Level
- How to elect S Corp Status:
 - Form 8832, Entity Classification Election, to be taxed as a C corporation
 - Form 2553, Election by a Small Business Corporation, to be taxed as an S corporation

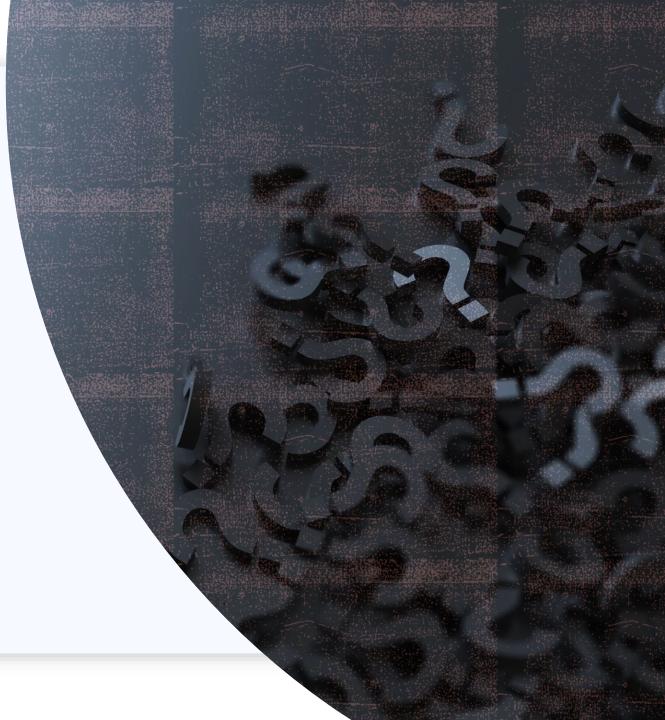






POLLING QUESTION 1

Form 2553 is the form used to elect to be classified as an S Corporation? True or False



CHECK-THE-BOX REGULATIONS (CONTINUED) P. 102

 I.R.C. § 1361 and file the I.R.C. § 1362 election – eligibility requirements



It does not have more than 100 shareholders.

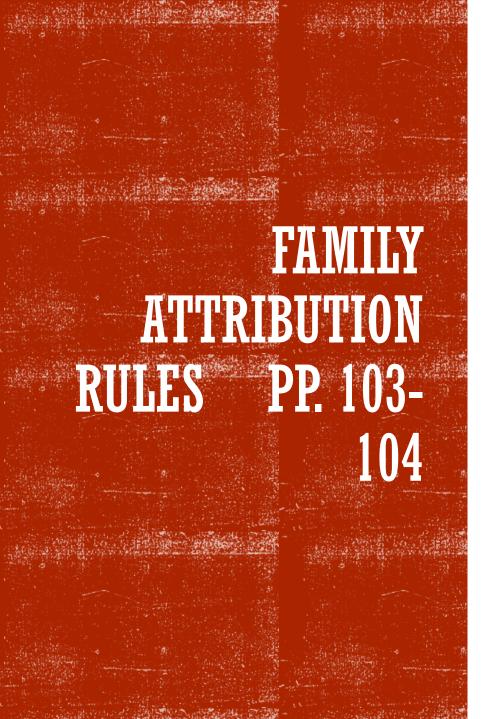


All its owners are US citizens or resident alien individuals, estates, certain trusts, or certain tax-exempt organizations. S CORPORATION ELIGIBILITY P. 103



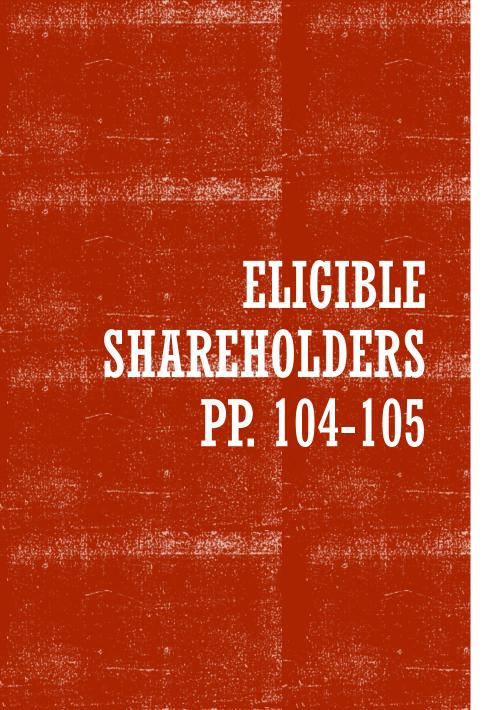
It does not have more than one class of stock.





- 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





- 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.

Distributions of trust principal are made to only the income beneficiary.

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

If the trust terminates during the current income beneficiary's lifetime, the trust distributes all trust assets to that beneficiary.

The trustee makes annual distributions of income if the trust instrument does not require all trust income to be distributed annually. QUALIFIED SUBCHAPTER S TRUSTS P. 105 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). QSST ELECTION P. 105

Relief for Late Elections (RP 2013-30)

PRACTITIONER

NOTE P. 105

- 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.



SMLLC P. 105

• 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.

TAX-EXEMPT ORGANIZATIONS P. 105

- 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)

ONE CLASS OF STOCK PP. 105-106

- 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 article charter incorpo	BVIAWS	applicable state law	binding agreements relating to distribution and liquidation proceeds
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UNIFORM RIGHTS PER SHARE P. 106



PLANNING POINTER LLC OPERATING AGREEMENT

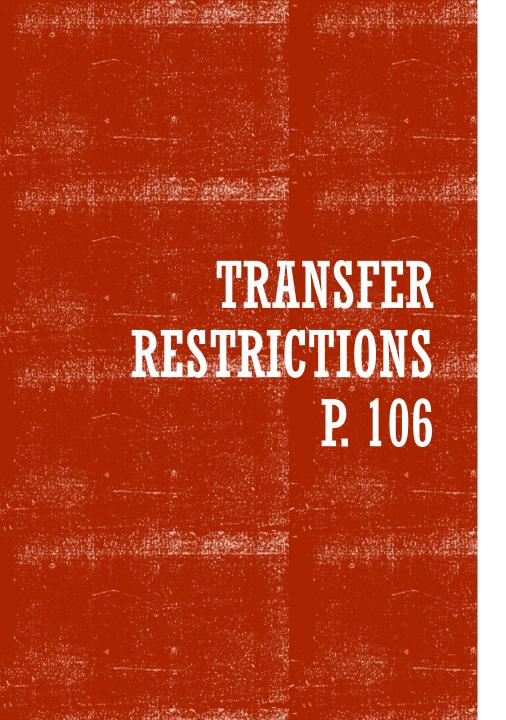
P. 106

 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

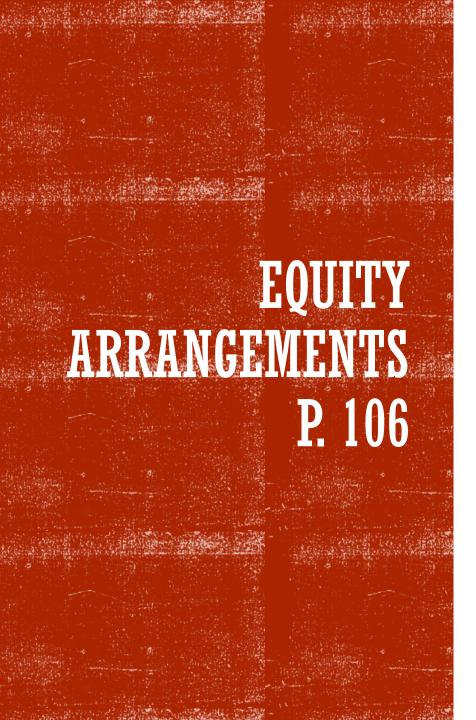
 provide for equal distributions of liquidation proceeds, per unit (share)





- 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.



Call option issued to an employee or independent contractor in connection with services is not treated as stock if :

has no readily ascertainable FMV when it is issued.

the option is nontransferable, and

Call options issued to a commercial lender in connection with a commercially reasonable loan are not treated as a second class of stock.

EQUITY ARRANGEMENTS (CONTINUED) P. 106

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.



S CORPORATION ELECTION P. 106

- 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

Form **2553** (Rev. December 2017)

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. 1545-0123

Department of the Treasury Internal Revenue Service You can fax this form to the IRS. See separate instructions.
 Go to www.irs.gov/Form2553 for instructions and the latest information.

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.

Paru						
	Name (see instructions)		A Employer identification number			
ype r	Number, street, and room or suite no. If a P.O. box, see ins	structions.	B Date incorporated			
rint						
	City or town, state or province, country, and ZIP or foreign	postal code	C State of incorporation			
	heck the applicable box(es) if the corporation (entity), after ap					
	ection is to be effective for tax year beginning (month, da					
	aution: A corporation (entity) making the election for its f eginning date of a short tax year that begins on a date oth		sually enter the			
Se	elected tax year:					
(1)) 🗌 Calendar year					
(2))					
(3)) 52-53-week year ending with reference to the month	th of December				
(4)) 52-53-week year ending with reference to the month	th of 🕨				
lf I	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 test 2 under <i>Who May Elect</i> in the instructions) ► □					
Na	ame and title of officer or legal representative whom the IRS	may call for more information	Telephone number of officer or legal representative			
fili re:	ection is being made by an entity eligible to elect to be tro- ing an entity classification election timely and the represe asons the election or elections were not made on time ar scovery. See instructions.	ntations listed in Part IV are tru	e. See below for my explanation of the			
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PRACTITIONER NOTE P. 108

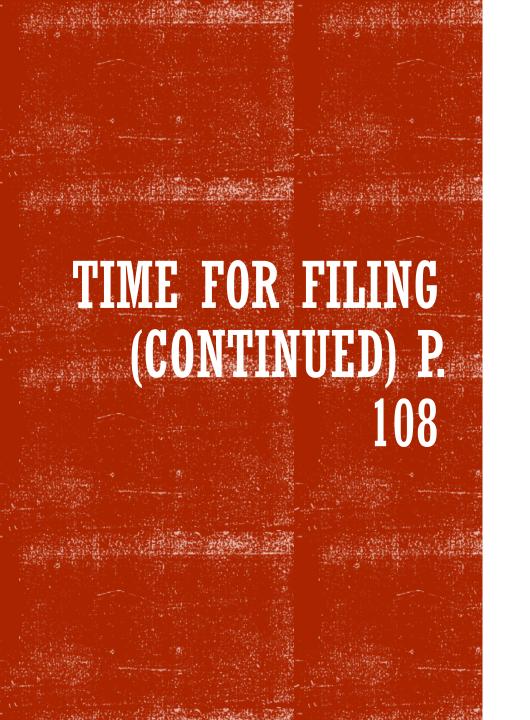
Evidence of Filing

- 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.

TIME FOR FILING P. 108

• 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



TIME FOR FILING (CONTINUED) P. 108

 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.



EXAMPLE 4.1 INITIAL SHORT TAX YEAR P. 108

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 commenced doing business on January 10, 2020.

Thornton must file Form 2553 on or before January 23, 2020, (2 months + 15 days from November 8, 2019.



SHAREHOLDER CONSENT P. 108

- 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).



FIGURE 4.3 FORM 2553 SHAREHOLDER CONSENT

Form 2553 (Rev. 12-2017) Page 2 Name Employer identification number Election Information (continued) Note: If you need more rows, use additional copies of page 2. Part I κ Shareholder's Consent Statement 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 this consent statement, including L accompanying documents, and, to the best Stock owned or of my knowledge and belief, the election percentage of ownership contains all the relevant facts relating to the (see instructions) 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 м affected returns consistent with the S Social security corporation election for the year for which Ν number or the election should have been filed (see Name and address of each Number of Shareholder's employer beginning date entered on line E) and for all shareholder or former shareholder shares or identification tax year ends subsequent years. required to consent to the election. (month and percentage Date(s) number (see Signature Date (see instructions) of ownership acquired instructions) day)

P. 108

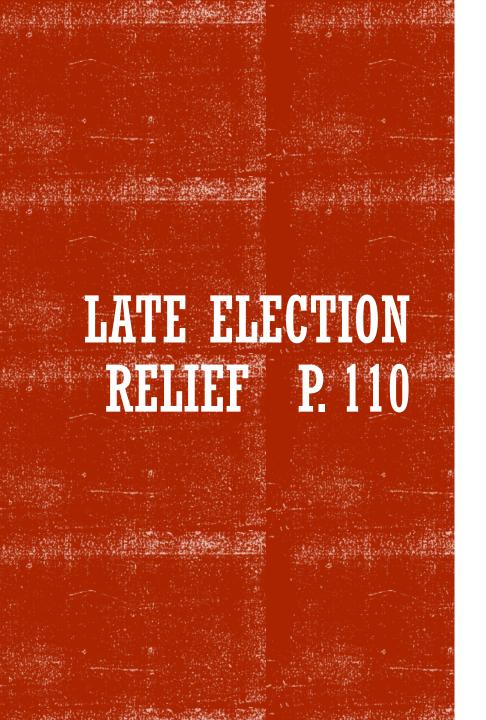
If shares are held by	Person who must sign	Authority	
Community property, tenants in common, joint tenants, tenants by the entirety	Each person holding an interest	Treas. Reg. § 1.1362-6(b)(2)(i)	FIGURE 4.4 REQUIRED
Minor	Self, parent, or legal representative	Treas. Reg. § 1.1362-6(b)(2)(ii)	CONSENTS
Estate	Executor or administrator, or other fiduciary appointed by testamentary instrument of the court	Treas. Reg. §1.1362-6(b)(2)(iii)	FOR S ELECTION
Trust	Person treated as the shareholder	Treas. Reg. § 1.1362-6(b)(2)(iv)	P. 109
QSST	Deemed owner (beneficiary)	Treas. Reg. § 1.1362-6(b)(2)(iv)	
ESBT	Trustee and, if a grantor trust, the deemed owner	Treas. Reg. § 1.1362-6(b)(2)(iv)	

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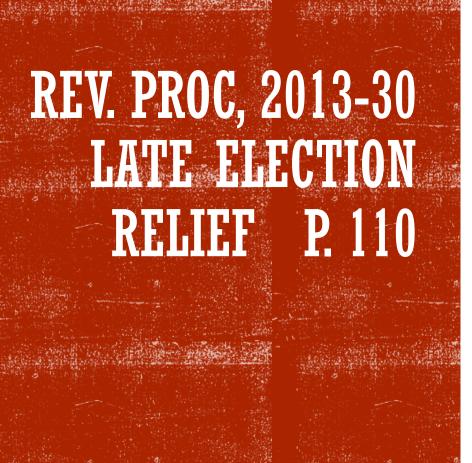
The IRS will accept a late consent if

- 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.



PRACTITIONER NOTE P. 110

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).



REVOCATION OF S ELECTION P. 110

- 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

ELECTION AFTER REVOCATION P. 110

- 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.

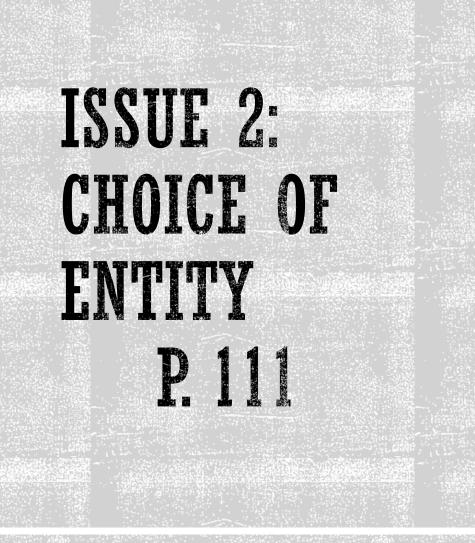


ELECTION AFTER REVOCATION (CONTINUED) P. 110

- 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.

PRACTITIONER NOTE: OTHER FACTORS TO CONSIDER P. 111

Liability protection	Step-up in basis of appreciated property after the death of an owner or sale of an owner's interest	Allowable type and number of owners
New partnership audit regime	Tax rules that apply to entities with foreign income	Availability of employee benefits





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

PARTNERSHIP 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.



PARTNERSHIP (CONTINUED)

P. 111

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.

Partners do not receive wages from the partnership (self employed)

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

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

allocation of profits or

guaranteed payments.

Guaranteed payments are not QBI and may reduce a partner's QBI deduction.

PARTNERSHIP (CONTINUED) P. 112



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%.

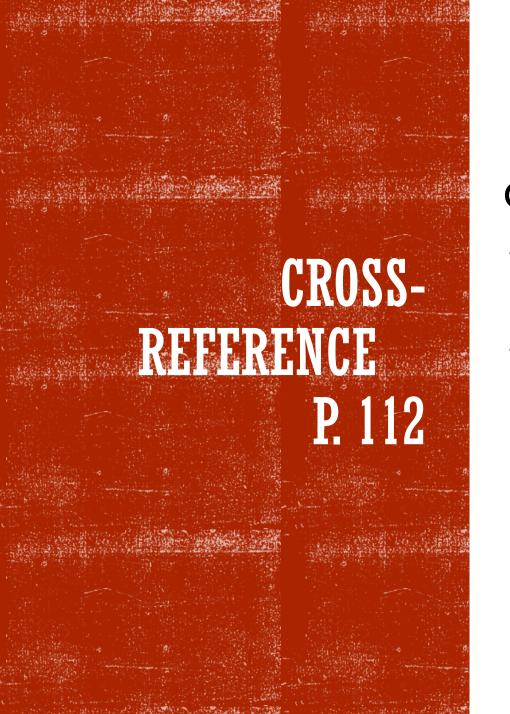


C corporation income is not eligible for the QBI deduction.



Dividends received from a C corporation are subject to the 3.8% NIIT.

C CORPORATION P. 112



C Corporations vs. Pass Through Entities

- Corporate level tax > shareholder or partner level tax
- See pages 458–480 in the 2018 National Income Tax Workbook for a comparison of C corporation taxation with the taxation of a disregarded entity, partnership, and S corporation.





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.

Reasonable Compensation Rules Apply



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

Distributions are not subject to the NIIT if material participation.

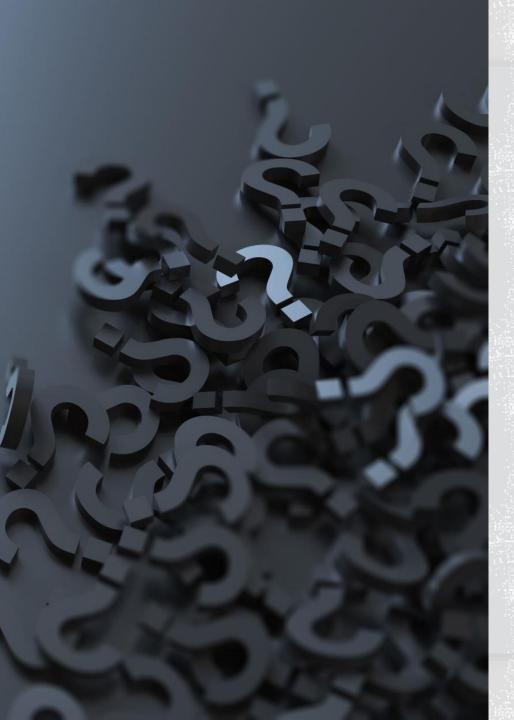
An S corporation with C corporation history may pay tax on built-in gains and excess net passive investment income.

ENTITY COMPARISON PP. 112-116

Figure 4.6 compares the attributes of partnerships, S corporations, C corporations, and disregarded entities.

ISSUE 5: COMPENSATION OF SHAREHOLDERSP. 135

This section explains the compensation of S corporation shareholder-employees.



POLLING QUESTION 2

A shareholder officer is required to take reasonable compensation especially if they perform services for the S Corporation?



COMPENSATION OF SHAREHOLDERS P. 135

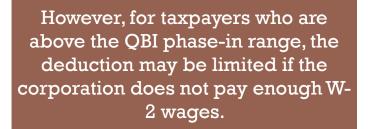
Both S and C corporations deduct expenses for wages paid, even if those payments are made to shareholderemployees. Because wages are deductible, but dividends paid are not, there is an incentive for a C corporation to disguise distributions to owners as wages to claim a deduction.

COMPENSATION OF **SHAREHOLDERS** R 135

- 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.



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.



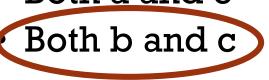
REASONABLE COMPENSATION P. 135

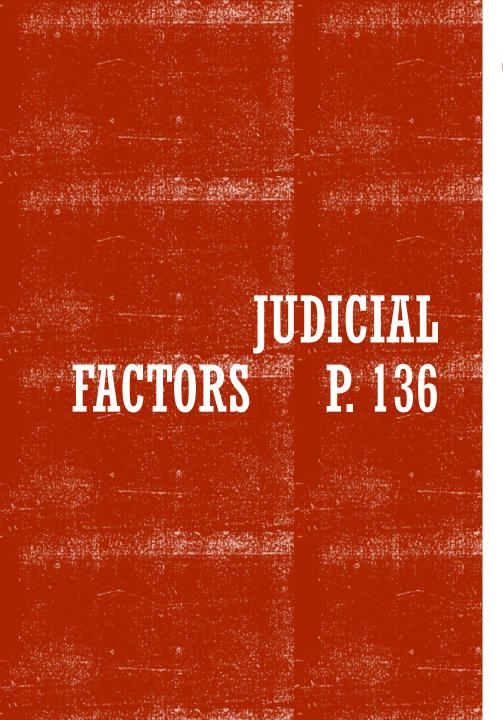
Reasonable compensation is determined by facts and circumstances and the burden of proof is on the taxpayer to substantiate that the compensation is reasonable.



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

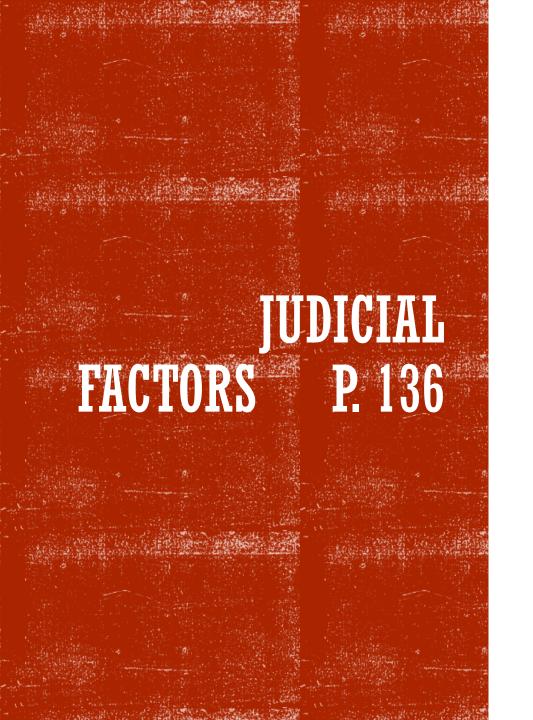




• Mayson Manufacturing factors :

- 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.

UDICIAL

FACTORS P. 136

 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.



IRS REASONABLE COMPENSATION JOB AID P. 136

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

23

02

Q3

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 nonowner 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, 2018¹

	Job characteristic			
Selected occupational groups and areas	Union	Nonunion	Full-time	Part-time
13-0000 Business and financial operations				
Atlanta-Sandy Springs-Roswell, GA	_	\$36.66	\$36.85	_
Boston-Cambridge-Nashua, MA-NH	\$35.86	\$42.83	\$42.70	\$28.24
Chicago-Naperville-Elgin, IL-IN-WI	\$33.25	\$37.17	\$37.78	-
Dallas-Fort Worth-Arlington, TX	_	\$38.12	\$38.27	_
Detroit-Warren-Dearborn, MI	-	\$36.75	\$36.90	_
Houston-The Woodlands-Sugar Land, TX	-	\$40.71	\$41.08	_
Los Angeles-Long Beach-Anaheim, CA	\$35.27	\$39.39	\$39.35	_
Miami-Fort Lauderdale-West Palm Beach, FL	-	\$34.41	\$34.82	_
Minneapolis-St. Paul-Bloomington, MN-WI	\$34.17	\$36.78	\$36.85	_
New York-Newark-Jersey City, NY-NJ-PA	\$37.69	\$47.68	\$47.37	\$26.87
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	\$35.07	\$39.42	\$39.23	_
Phoenix-Mesa-Scottsdale, AZ	-	\$32.77	\$33.05	_
San Jose-Sunnyvale-Santa Clara, CA	\$43.36	\$47.20	\$47.24	-
Seattle-Tacoma-Bellevue, WA	\$39.57	\$40.95	\$41.11	_
Washington-Arlington-Alexandria, DC-VA-MD-WV	\$34.49	\$44.01	\$44.00	_

\$

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 INCOME APPROACH P. 137



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 INCOME APPROACH P. 137



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 COST APPROACH P. 137



The Job Aid notes that a weakness of the cost approach is that an employee might perform many tasks to some degree.

POLLING QUESTION 4

Are economic and debt servicing taken into consideration when determining reasonable compensation of a shareholder officer?





RECLASSIFICATION OF PAYMENTS AS WAGES PP. 137-

138

 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.



EXAMPLE 4.16 P. 138

- 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.

EXAMPLE 4.16 (CONTINUED) P. 138

- 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 E. WATSON V. U.S. P. 138

- 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.



DAVID E. WATSON V. U.S. (CONTINUED) B. 138

- 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.



PLANNING POINTER

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.

P. 138



COMPENSATION REPORTING REQUIREMENTS

P. 138

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.

FIG	U	RE	42				120	_			P.	139
		1120-	_	ι	► Do not	file this form unl	urn for an less the corporati	on has file	ed or		OMB No. 1545-0123	
	Department of the Treasury Internal Revenue Service			► (is attaching Form 2553 to elect to be an S corporation. 2019 ► Go to www.irs.gov/Form1120S for instructions and the latest information.							
	For	calendar yea	ar 2019 o	r tax year	ax year beginning , 2019, ending					, 20		
	A Se	election effectiv	ve date		Name					D Employ	ver identification number	
	B Business activity code number (see instructions)			TYPE OR PRINT	Number, street, and room or suite no. If a P.O. box, see instructions.			E Date incorporated				
	C Ch	eck if Sch. M-3 a	ittached		City or town, state	or province, countr	ry, and ZIP or foreign	postal code	2	F Total as \$	sets (see instructions)	
	H (I E J (Check if: (1) Enter the num Check if corpo	Final re ber of sh oration: (1)	turn (2) areholder) 🗌 Aggre	Name change s who were sha egated activities fo	e (3) Address reholders during or section 465 at-ri	ss change (4) any part of the ta	Amende ax year	d return (5) d activities for se	S election ■ ection 469 p	2553 if not already filed termination or revocation cassive activity purposes	
	Income	1a Gross b Retur c Balan 2 Cost 3 Gross 4 Net g 5 Other	s receipts rns and allence. Subtration of goods s s profit. Su pain (loss) f r income (l	or sales owances act line 1t sold (attac ibtract lin from Form oss) (see	o from line 1a . ch Form 1125-A) e 2 from line 1c n 4797, line 17 (a instructions—at		· · · · · ·	. 1a . 1b 	· · · · · ·	. 1c . 2 . 3		
	itations)	7 Comp 8 Salari	pensation les and wa	of officers	s (see instruction employment cre	eans)	1125-E) · · · · · ·			. 7 . 8 . 9		J



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.

Figure 4.25 shows Form 1125-E.

REPORTING ON FORM 1125-E

P. 139

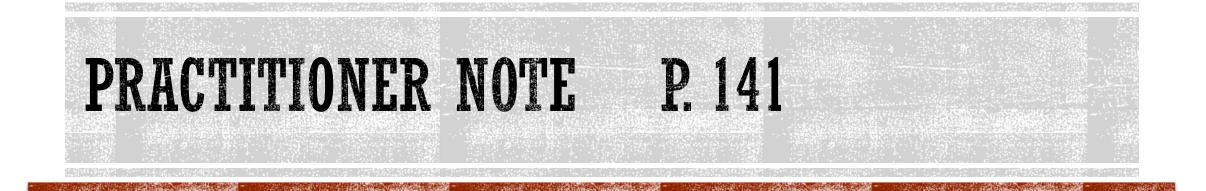
- Total gross receipts include the following amounts:
- Form 1120-S, page 1, line 1a, gross receipts or sales
- Form 1120-S, page 1, line 4, net gain (loss) from Form 4797
- Form 1120-S, page 1, line 5, other income (loss)
- Schedule K, line 3a, gross rental income (loss)
- Schedule K, line 4, interest 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

FIGURE 4.25 FORM 1125-E P. 140

Form 1125-E		Compensation o	f Officers					
(Rev. October 2016) Department of the Treasury Internal Revenue Service	form1125e.	OMB No. 1545-						
Name					Employ	ver identification nu	umber	
Note: Complete Form 1	125-E only if total receipts are	\$500,000 or more. See instr	ructions for defini	ition of total re	ceipts.	_		
(a) Na	ame of officer	(b) Social security number	(c) Percent of time devoted to	Percent of s		(f) Amount o		
		(see instructions)	business	(d) Common	(e) Preferred	compensation		
1			%	%	%			
			%	%	%			
			%	%	%			
					70		70	
	2 Total compensation	of officers					2	
	3 Compensation of off	icers claimed on Form 1	125-A or elsew	here on retur	m		3	
		n line 2. Enter the resu our tax return					4	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 55989C Form 1125-E (Rev. 10-2016)



Officers

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.







ISSUE 3: Shareholder Stock and debt Basis P.117

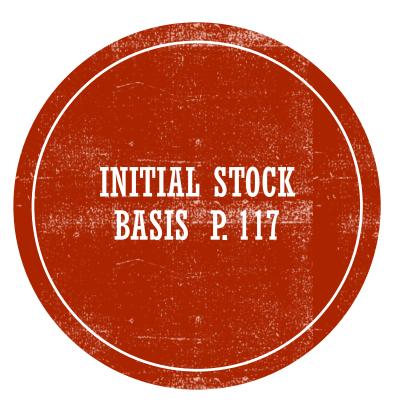
This section explains how to determine, adjust, and report shareholder stock and debt basis.





- Properly report BasisStock Basis
 - Debt Basis
- Technical Content guide for agents
- Letter 5969: Soft-audit letter to Voluntarily selfcorrect





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.

PRACTITIONER NOTE P. 117



An S corporation shareholder must maintain adequate

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.

BASIS AT TIME OF ACQUISITION

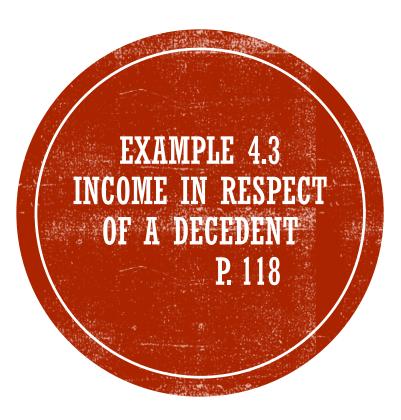
How Acquired

- §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

PP. 117-118

- Cost
- FMV or zero
 - FMV on date of death or alternate valuation date
 - Zero
- Generally donor basis
 - Add gift tax (\leq 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]. A shareholder's basis is adjusted annually for the shareholder's allocable portion of the S corporation's income and loss, and for distributions.

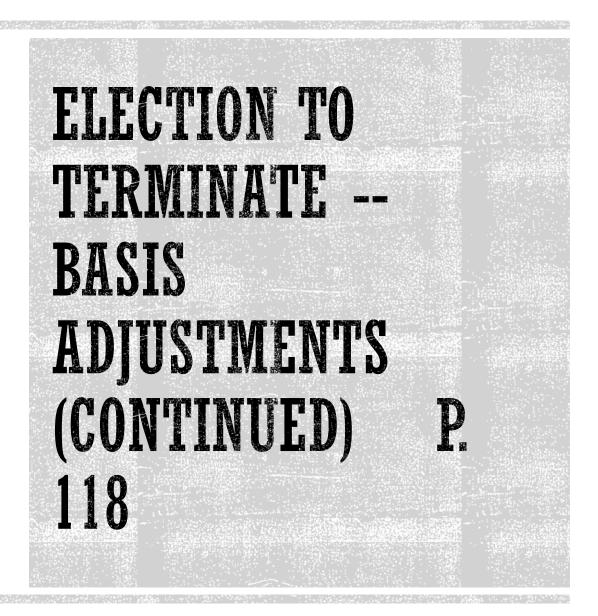
An income item increases stock basis.

A loss, deduction, or distribution decreases stock basis.

BASIS ADJUSTMENTS P. 118

If there is more than one shareholder, the corporation must generally allocate each income and loss item on a per-day, per-share basis.

- 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: Income items, including taxexempt income and separately stated income, and excess depletion increase basis.

Distributions (other than dividends from the corporation's accumulated earnings and profits) decrease basis, but not below zero.

Nondeductible, noncapital expenses and depletion decrease basis, but not below zero.

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

\$4,000

\$5,000

- Net section 1231 gain
- Cash contribution to a charity
- Nondeductible expenses

\$1,000

Distributed to Cheryl

\$12,000

					6713	119
		Final K-1	Amended	K-1	OMB No. 154	15-0123
2019	Pa		reholder's Share uctions, Credits,		urrent Year Income, Other Items	
For calendar year 2019, or tax year	1	Ordinary busir	ness income (loss)	13	Credits	
			(20,000)			
	2	Net rental real	estate income (loss)			

671119

FIGURE 4.7 SCHEDULE P. 119 K-1

Shareholder's Share of Income, Deductions,				
	3	Other net rental income (loss)		
Credits, etc. See back of form and separate instructions.				
Part I Information About the Corporation	4	Interest income		
Corporation's employer identification number 00-0000000	5a	Ordinary dividends		
B Corporation's name, address, city, state, and ZIP code	5b	Qualified dividends	14	Foreign transactions
Simo Composition	6	Royalties		
Sims Corporation	7	Net short-term capital gain (loss)		
100 Pine Street Seattle, WA 98107	'	Net short-tern capital gain (ioss)		
c IRS Center where corporation filed return Ogden	8a	Net long-term capital gain (loss)		
Part II Information About the Shareholder	8b	Collectibles (28%) gain (loss)		
D Shareholder's identifying number 000-00-0000	8c	Unrecaptured section 1250 gain		
E Shareholder's name, address, city, state, and ZIP code	9	Net section 1231 gain (loss) 4,000		
Cheryl Sims 500 Phinney Avenue Seattle, WA 98103	10	Other income (loss)	15	Alternative minimum tax (AMT) items
F Shareholder's percentage of stock ownership for tax year				
	11	Section 179 deduction	16 C	Items affecting shareholder basis
	12 A	Other deductions 5,000	D	12,000
<u>ک</u>				

Schedule K-1 (Form 1120-S)

Department of the Treasury Internal Revenue Service

beginning

/ 2019

1

ending

/ /

FIGURE 4.8 CHERYL SIMS'S STOCK BASIS P. 120

4,000

\$19,000

(1,000)

\$ 6,000

(4,800)

(1,200)

- Beginning stock basis \$15,000
- Increase for income items
- Basis before distribution
- Distribution (12,000)
- Basis before loss items
 \$7,000
- Decrease for nondeductible expenses
- Basis before loss and deduction items
- Allowable ordinary business loss*
- Allowable cash contributions*
- Ending stock basis
 <u>\$0</u>

- * 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.

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

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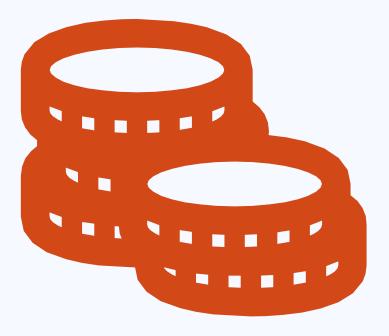
She can carry over the remaining 3,800 (5,000 - 1,200) to 2021.

EXAMPLE 4.4 ADJUSTING SHAREHOLDER BASIS P. 120

CROSS-REFERENCE P. 120

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.
- See pages 85–107 in the 2017 National Income Tax Workbook for a discussion of these rules.



NONDEDUCTIBLE EXPENSES P. 120

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.



EXAMPLE 4.5 GENERAL ORDERING RULE FOR NONDEDUCTIBLE EXPENSES P. 120

- 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 <u>\$3,500</u>
- 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.

ELECTIVE ORDERING RULE P. 120

- 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.

EXAMPLE 4.6 ELECTIVE ORDERING IS ADVANTAGEOUS

- 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 <u>(4,500)</u>	
•	Joanna's basis before ND	\$ 500
•	Less ND expense	<u>(500)</u>
•	Basis	<u>\$0</u>
•	She can deduct all the ordina	ry loss.

• The remaining \$1,000 nondeductible expense (\$1,500 - \$500) is carried forward.

P. 120

EXAMPLE 4.7 ELECTIVE ORDERING IS NOT ADVANTAGEOUS P. 121



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 RULE**

P. 121

General Rule

- Beginning basis ٠
- Nondeductible expense •
- Adjusted basis •
- Allowable ordinary business loss •
- Ending basis •
- Carryforward to next year ٠
- Nondeductible expense ٠
- **Ordinary** loss •

\$ 5,0	JUU
(50,	000)
\$	0
(0)
\$	0

0

\$ 4,500

¢ Γ 000

Elective Ordering Rule

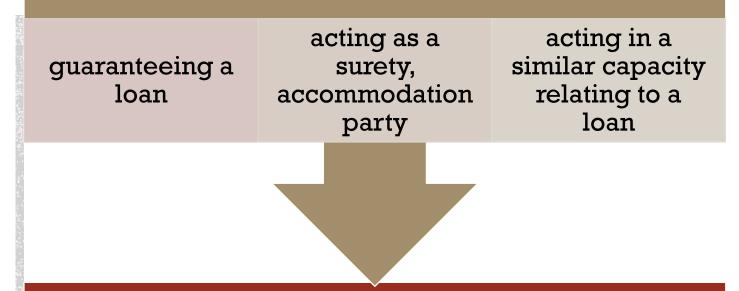
	-		
•	Beginning basis	\$5	,000,
•	Allowable ordinary business loss	(4	,500)
•	Adjusted basis	\$	500
•	Allowable nondeductible expense	(500)
•	Ending basis	<u>\$</u>	0
•	Carryforward to next year		

- Nondeductible expense \$49,500 ٠ \$ 0
- Ordinary loss ٠



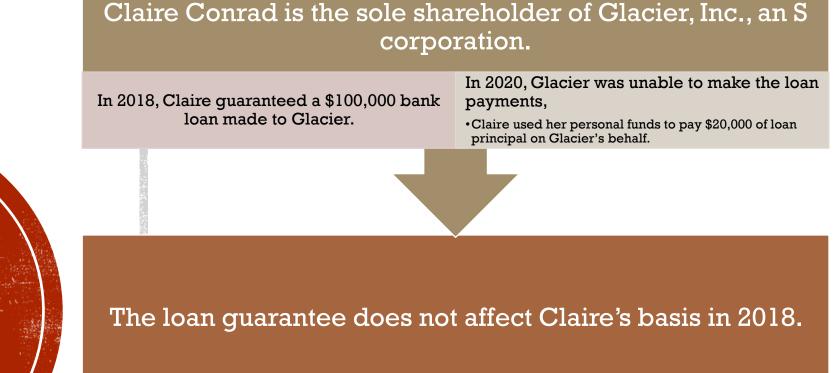
A shareholder obtains debt basis by loaning the S corporation money or property in which the shareholder has basis.

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



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.





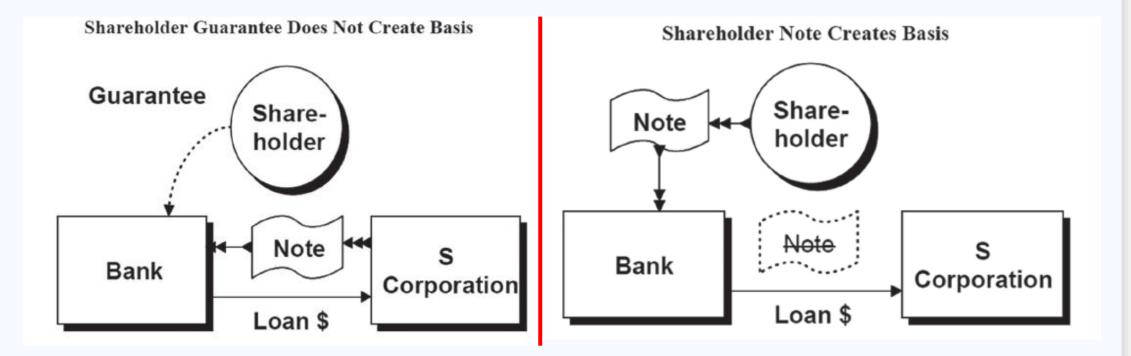
Her \$20,000 principal payment increases her basis by \$20,000 in 2020.





- 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 P. 122





S CORPORATION DEBT BASIS P. 122

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.

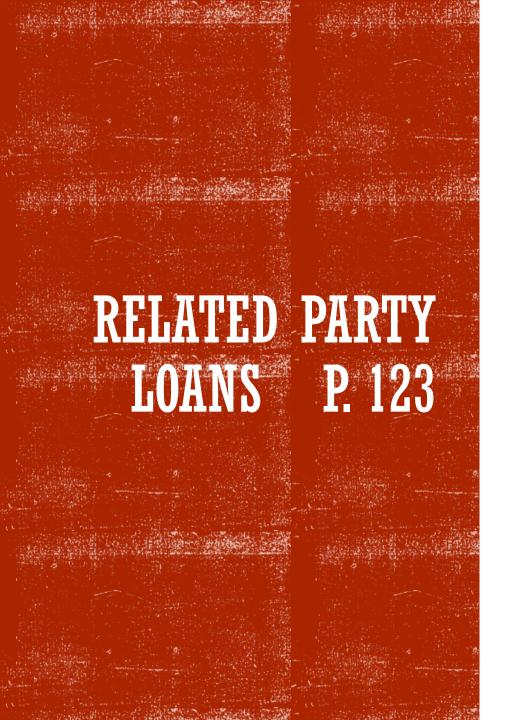
The S corporation's assets secured the loan to the shareholders.

The IRS ruled that the shareholders had debt basis in their loan to the corporation.

S CORPORATION **DEBT BASIS** (CONTINUED) P. 122

- 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 the 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.

RELATED PARTY LOANS (CONTINUED) P. 123



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.

RELATED PARTY LOANS(CONTINUED)P. 123

 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

BACK-TO-BACK LOANS P. 123

The arrangement must constitute bona fide indebtedness from the S corporation to the shareholder.

EXAMPLE 4.9 BACK-TO-BACK LOAN P. 123

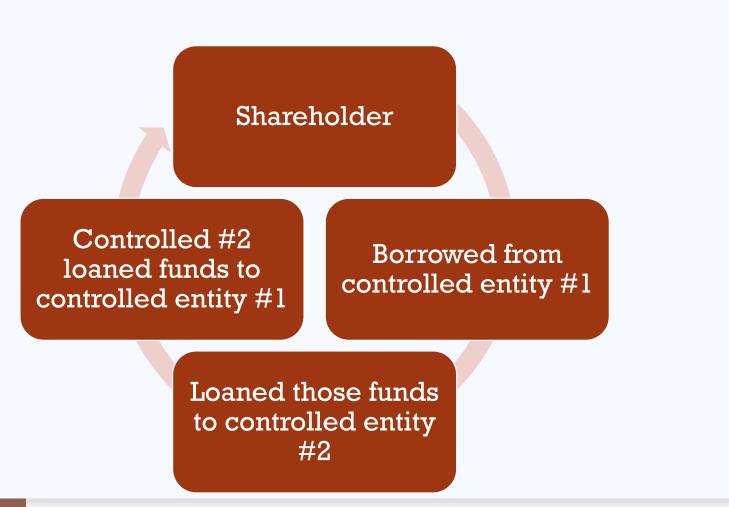
- Andy Bennett owns all the stock of two S corporations
 - Andy Co.
 - Bennett Co.
- Andy borrowed \$50,000 from Andy Co. and loaned the \$50,000 to Bennett Co.
- If the loan from Andy to Bennett Co. constitutes bona fide indebtedness from Bennett Co. to Andy, Andy's back-to-back loan increases his basis of indebtedness in Bennett Co. by \$50,000.

BACK-TO-BACK LOANS P. 123

- 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 rulled bona fide debts.
- Thus the shareholder had basis.

CIRCULAR LOAN: OREN V. COMMISSIONER

PG 123



CIRCULAR LOANS P. 123

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.

CIRCULAR LOANS P. 123

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.

ADJUSTMENTS TO S CORPORATION DEBT BASIS PP. 123-124

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.

EXAMPLE 4.10 DEBT BASIS ADJUSTMENTS P. 124

- 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						
	Stock Basis			Debt			
	Basis						
		\$60,000		\$50,000			
1.		(60,000)					
2.				<u>(40,000)</u>			
E	nd	<u>\$0</u>		10,000			
	2020						
1.				40,000			
2.		<u>100,000</u>					
E	nd	<u>\$100,000</u>		<u>\$50,000</u>			
1. 2.		<u>202</u>	<u>:0</u>	40,000			



BASIS REPORTING P. 124

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.

FIGURE 4.11SCHEDULE EBASISREPORTINGP. 124

Schedule	e E (Form 1040 or 1040-SR) 2019		Attachment Sequence	No. 13	Page 2			
Name(s)	shown on return. Do not enter name and social security n	umber if shown on a	other side.		Your social securit	y number		
Cautio	Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.							
Part	Part II 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 passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Ye see instructions before completing this section							
28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk		
Α								
В								
С								
D								

FIGURE 4.12 WORKSHEET FOR FIGURING BASIS P. 125

	ksheet for Figuring a Shareholder's Stock and Debt Basis I—Shareholder Stock Basis		
1.	Stock basis at the beginning of the corporation's tax year	1.	
2.	Basis from any capital contributions made or additional stock acquired during the tax year	2.	
a.	Ordinary business income (losses go on Part III)		
	Net rental real estate income (losses go on Part III) 3b.		
	Other net rental income (losses go on Part III)		
	Interest income		
	Ordinary dividends		
	Royalties		
	Net capital gains (losses go on Part III)		
	Net section 1231 gain (losses go on Part III)		
	Other income (losses go on Part III)		
	Excess depletion adjustment		
	Tax-exempt income		
	Recapture of business credits		
•	Other items that increase stock basis		
	Add lines 3a through 3m	4.	
	Stock basis before distributions. Add lines 1, 2, and 4	5.	
	Distributions (excluding dividend distributions)	6.	
	Note. If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.		
	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	7.	
-	Nondeductible expenses		
	Depletion for oil and gas		
	Add lines 8a and 8b	9.	
-	Stock basis before 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	10.	
•	Allowable loss and deduction items. Enter the amount from Part III, line 13, column (c)	11.	
-	Debt basis restoration (see net increase in instructions for Part II, line 8)	12.	
	Other items that decrease stock basis	13.	
-	Add lines 11, 12, and 13	14.	
-	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-	15.	
_			

Part II—Shareholder Debt Basis

FIGURE 4.12 WORKSHEFT FOR FIGURING BASIS **P**. 126

		Debt 1 Formal note Open account debt	Debt 2 Formal note Open account debt	Debt 3	Total
Amo	unt of Debt:				
1.	Loan balance at the beginning of the corporation's tax year				
2.	Additional loans (see instructions)				
3.	Loan balance before repayment. Combine lines 1 and 2				
4.	Principal portion of debt repayment (this line doesn't include interest)	()	()	()	()
5.	Loan balance at the end of the corporation's tax year. Combine lines 3 and 4				
Adjus	stments to Debt Basis:				
6.	Debt basis at the beginning of the corporation's tax year				
7.	Enter the amount, if any, from line 2				
8.	Debt basis restoration (see instructions)				
9.	Debt basis before repayment. Combine lines 6, 7, and 8				
10.	Divide line 9 by line 3				
11.	Nontaxable debt repayment. Multiply line 10 by line 4				
12.	Debt basis before nondeductible expenses and losses. Subtract line 11 from line 9				
13.	Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
14.	Debt basis before losses and deductions. Subtract line 13 from line 12. If the result is zero or less, enter -0-				
15.	Allowable losses in excess of stock basis. Enter the amount from Part III, line 13, column (d)				
16.	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-				
Gain	on Loan Repayment:				
17.	Repayment. Enter the amount from line 4				
18.	Nontaxable repayments. Enter the amount from line 11				
19.	Reportable gain. Subtract line 18 from line 17				

FIGURE 4.12 WORKSHEET FOR FIGURING BASIS P. 127

(b) Carryover (a) Current year amounts (column (d) Allowable loss (c) Allowable loss (e) Carryover losses and (e)) from the from stock basis from debt basis amounts deductions previous year 1. Ordinary business loss 2. Net rental real estate loss 3. Other net rental loss 4. Net capital loss 5. Net section 1231 loss 7. Section 179 deductions 8. Charitable contributions 9. Investment interest expense 10. Section 59(e)(2) expenditures 11. Other deductions 12. Foreign taxes paid or accrued 13. Total Loss. Combine lines 1 through 12 for each column. Enter the total loss in column (c) on line 11 of Part I and enter the total loss in column (d) on line 15 of Part II

Part III—Allowable Loss and Deduction Items



Department of the Treasury Internal Revenue Service Large Business & International

[Taxpayer Name] Address line 1 Address line 2 Address line 3 [Address line 4]

Date:

Taxpayer ID number:

Tax periods:

Person to contact:

Contact address:

Employee ID number:

Contact telephone number:

Contact fax number:

Response due by:

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 1.6001-1(a). You must attach the schedule to your return as directed in the instructions to Form 1040, Schedule E, 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.



FIGURE 4.13 LETTER 5969 P. 128



ISSUE 4: DISTRIBUTIONS TO SHAREHOLDERS P. 129

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.

DISTRIBUTIONS TO SHAREHOLDERS P. 129

DISTRIBUTIONS TO SHAREHOLDERS P. 129

- 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) P. 129

Distributions from an S corporation that exceed the shareholder's basis are treated as a gain from a deemed sale of the stock.

Stock is a capital asset for most taxpayers, and the gain is a capital gain.

It is a long-term capital gain if the stock has been held for longer than one year.

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.

EXAMPLE 4.11 NONTAXABLE DISTRIBUTION P. 129

Deborah Burke is the sole shareholder in Medco, Inc., an S corporation.



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.



FIGURE 4.14 DEBORAH BURKE'S BASIS ADJUSTMENTS P. 130

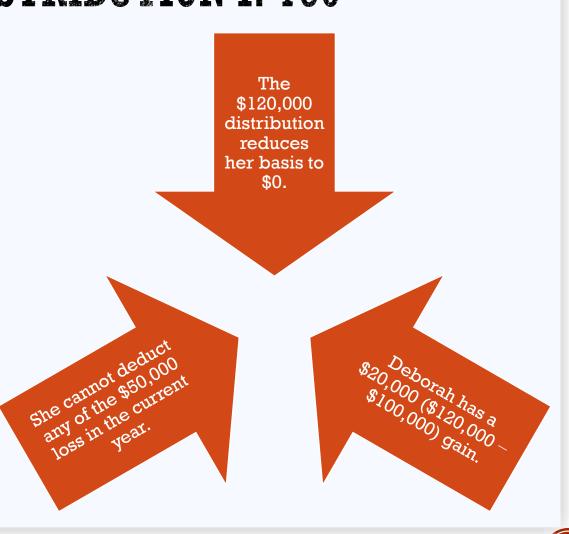


EXAMPLE 4.12 TAXABLE DISTRIBUTION P. 130

- Same except basis at beginning of year was \$10,000
- Basis at beginning of year
- Current-year income
- Basis before distribution
- Distribution (100,000)
- Basis before loss
- Loss
- Ending basis

\$ 10,000 <u>90,000</u> \$100,000

\$ 0 (0) \$ 0



DIVIDEND DISTRIBUTIONS P. 130



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



ADJUSTING THE AAA 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).



Income items first increase AAA

Losses reduce AAA to the extent of

income items for the year

Different from the ordering rules for basis adjustments



Generally,

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

EXAMPLE 4.13 AAA ADJUSTMENTS P. 130

- 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 AND FIGURE 4.16

P. 130

FIGURE 4.15 Acme, Inc.'s AAA Adjustments

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

<u>(\$60,000)</u>

\$110,000

90,000

(90,000)

\$110,000

(110,000)

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	<u>(110,000)</u>
•	Basis before losses	\$130,000
•	Losses allowable (\$150,000 total)	<u>(130,000)</u>
•	Basis at end of year	<u>\$</u> 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.

FIGURE 4.17 ACME INC'S SCHEDULE M-2 P. 131

Schedule M-2 Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account (see instructions)

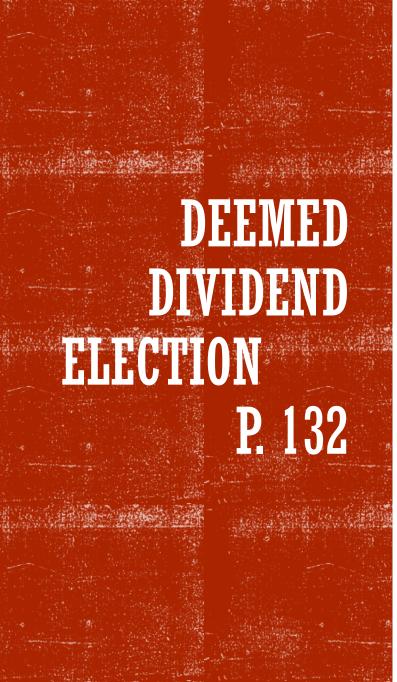
		(a) Accumulated adjustments account	(b) Shareholders' undistributed taxable income previously taxed	(c) Accumulated earnings and profits	(d) Other adjustments account
1	Balance at beginning of tax year	110,000		250,000	
2	Ordinary income from page 1, line 21				
3	Other additions	90,000			
4	Loss from page 1, line 21	(150,000)			
5	Other reductions	()			()
6	Combine lines 1 through 5	50,000		250,000	
7	Distributions	110,000		10,000	
8	Balance at end of tax year. Subtract line 7 from				
	line 6	(60,000)		240,000	

Form **1120-S** (2019)



- 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.

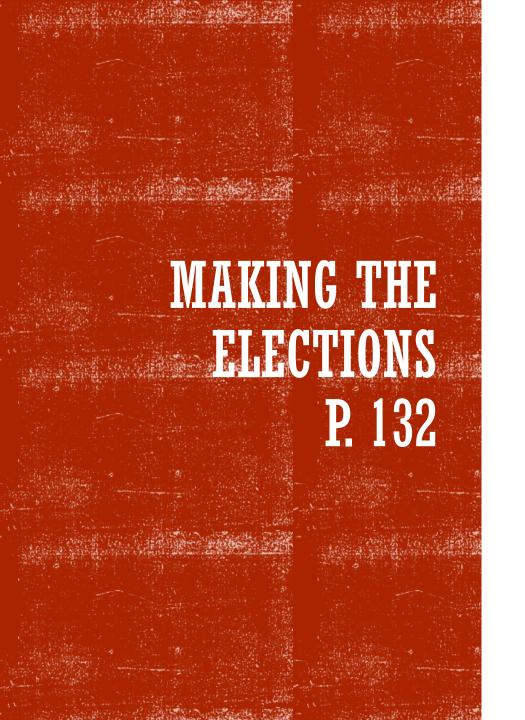




A deemed dividend is treated as if

- 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.



PRACTITIONER NOTE P. 132

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 P. 133

General Order	Source	Description	Taxability	Effect on Basis
1.	AAA (including current- year income and loss items)	All S corporations to the extent of AAA		
	Not taxable unless exceed shareholder's basis	Reduce basis to the extent thereof		
2.	PTI	Shareholders with pre-1983 PTI accumulations	Not taxable unless exceed shareholder's basis	Reduce basis to the extent thereof
3.	AE&P	S corporations with AE&P	Dividends	No effect on basis
4.	OAA, then paid-in capital	All remaining distributions	Not taxable unless exceed shareholder's basis	Reduce basis to the extent thereof

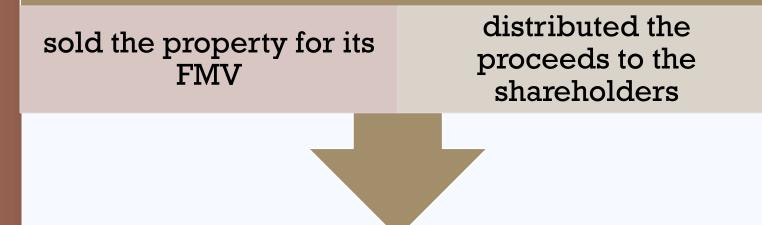
DISTRIBUTIONS OF NONCASH PROPERTY P. 133

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.

When an S corporation distributes appreciated property to its shareholders, it is treated as if it



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. DISTRIBUTION OF APPRECIATED PROPERTY P. 133 The corporation does not pay tax on the gain on distributed property unless it is subject to the built-ingains tax (discussed later).

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. DISTRIBUTION OF APPRECIATED PROPERTY P. 133

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. 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.

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.

DISTRIBUTION OF APPRECIATED PROPERTY P. 133

The shareholder's basis in distributed property is its FMV.

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.

DISTRIBUTION OF LOSS PROPERTY P. 133

The corporation may recognize a loss on a pro rata distribution to a qualified person, *in complete liquidation* of the corporation.

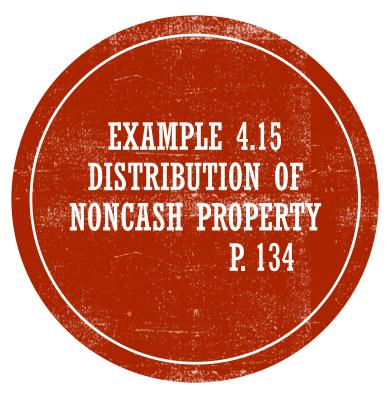


Under I.R.C. § 1239, any gain recognized by a seller on the sale of distributed property must be treated as ordinary income if the property is, in the hands of a related buyer, depreciable under I.R.C. § 167.

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).

DISTRIBUTION OF DEPRECIABLE PROPERTY P. 133



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 P. 134

Shareholder	Asset	FMV	Adjusted Basis	Liabilities Assumed	Net Distributed Value
Sally	Cash	\$200,000	\$200,000	\$ 0	\$200,000
Will	Building	\$255,000	\$ 85,000	\$ 80,000	\$175,000
Tom	Securities	\$125,000	\$190,000	\$ 0	\$125,000

FIGURE 4.20 P. 134

FIGURE 4.20 Handcraft, Inc.'s Gain on Distributions

Asset	Gain Recognized
Cash	\$0
Building (\$255,000 FMV – \$85,000 basis)	\$170,000
Securities (\$125,000 FMV – \$190,000 basis)*	\$0
* S corporations do not recognize loss on distributed assets	;



EXAMPLE 4.15 DISTRIBUTION **OF NONCASH** PROPERTY (CONTINUED) **P.** 134

- Handcraft's 2020 taxable income is \$520,000.
- It allocates
 - \$208,000 (\$520,000 × 40%) to Sally
 - \$182,000 (\$520,000 × 35%) to Will
 - \$130,000 (\$520,000 × 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.



FIGURE 4.21 SHAREHOLDERS' BASES IN DISTRIBUTED ASSETS P. 134

Shareholder	Asset	Basis
Sally	Cash	\$200,000
Will	Building	\$255,000
Tom	Securities	\$125,000



FIGURE 4.22 SHAREHOLDERS' STOCK BASIS ADJUSTMENTS P. 135

	Sally	Will	Tom
Beginning basis	\$ 40,000	\$ 35,000	\$ 25,000
Increase for current-year income	208,000	182,000	130,000
Basis before distribution	\$248,000	\$217,000	\$155,000
Distribution (see Figure 4.19)	(200,000)	(175,000)	(125,000)
Ending basis	\$ 48,000	\$ 42,000	\$ 30,000

• 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.

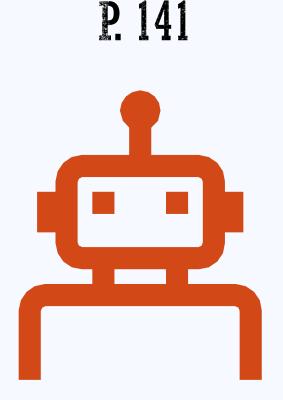


ISSUE 6: S CORPORATION BUILT-IN GAINS TAX P. 141

The built-in gains tax is a corporatelevel tax on S corporations with C corporation history.

S CORPORATION BUILT-IN GAINS TAX

- An S corporation that was formerly a C corporation may be taxed on its builtin 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%)

GENERAL RULES P. 142



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?

