2020
National Income Tax Workbook

Chapter 4: S CORPORATION TAX ISSUES

Land Grant University
Tax Education Foundation

POLLING QUESTION 1

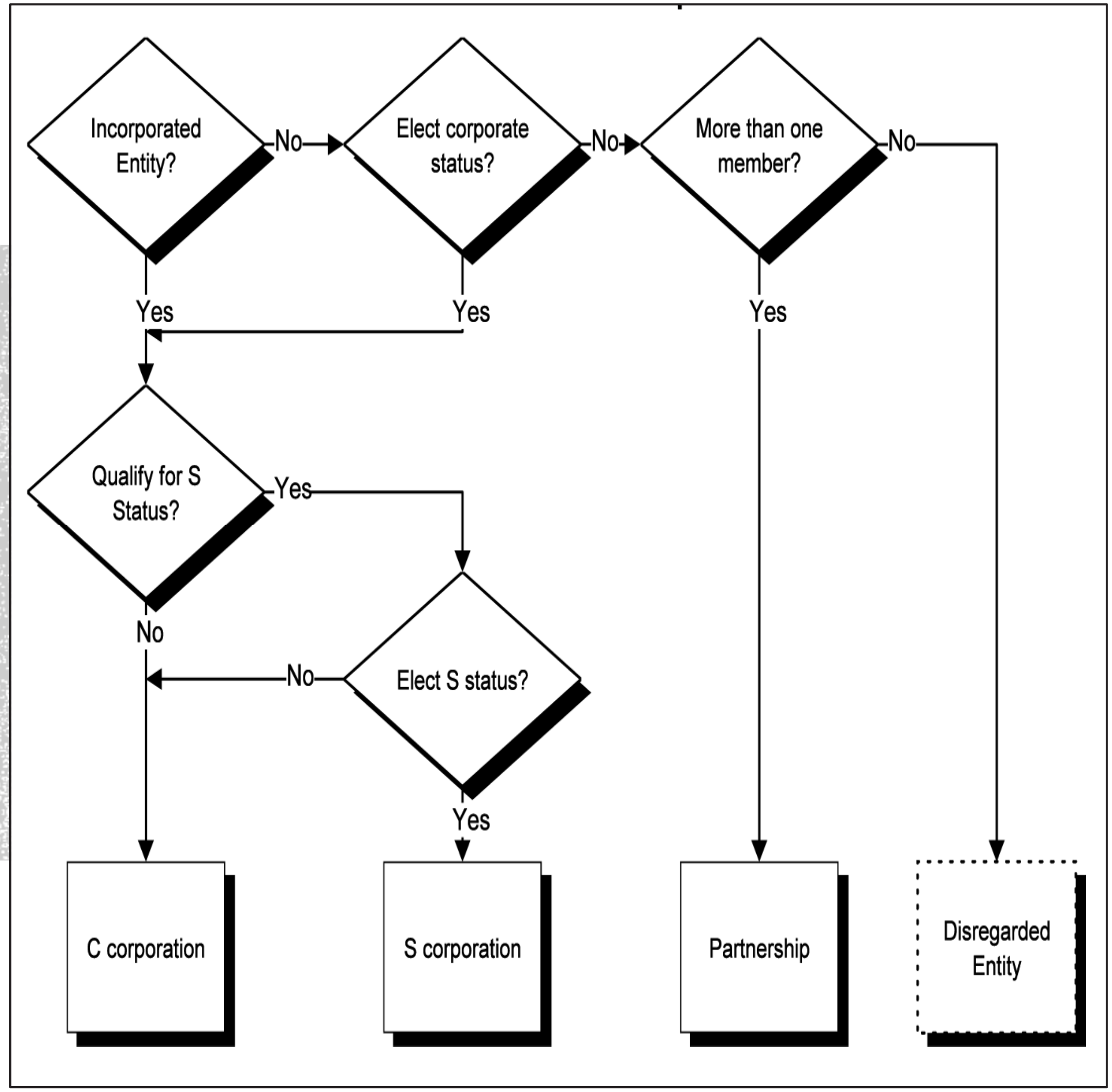
Is an Officer Shareholder of an S Corp who performs services, required to take Reasonable Compensation?

Chapter Topics P. 101

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



S CORPORATION ELIGIBILITY P. 103

- 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

TRUSTS
PP. 104-105

- 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)

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.

REV. PROC, 2013-30 LATE ELECTION RELIEF P. 110

- 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.

ISSUE 2: CHOICE OF ENTITY P. 111

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

POLLING QUESTION 2

Are you sleeping yet?

ISSUE 5: COMPENSATION OF SHAREHOLDERS P. 135

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

COMPENSATION OF SHAREHOLDERS P. 135

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.

CROSS-REFERENCE QBI DEDUCTION P. 135

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 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.

JUDICIAL FACTORS P. 136

- ***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

JUDICIAL FACTORS P. 136

- ***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

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

- 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.

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.

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) P. 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.

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.

FIGURE 4.24 FORM 1120S, LINE 7 P. 139

Form **1120-S**

Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

► Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.
► Go to www.irs.gov/Form1120S for instructions and the latest information.

OMB No. 1545-0123

2019

For calendar year 2019 or tax year beginning , 2019, ending , 20

A S election effective date

B Business activity code number (see instructions)

C Check if Sch. M-3 attached ☐

TYPE OR PRINT

Name

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state or province, country, and ZIP or foreign postal code

D Employer identification number

E Date incorporated

F Total assets (see instructions) $

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☐ No If "Yes," attach Form 2553 if not already filed

H Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year ►

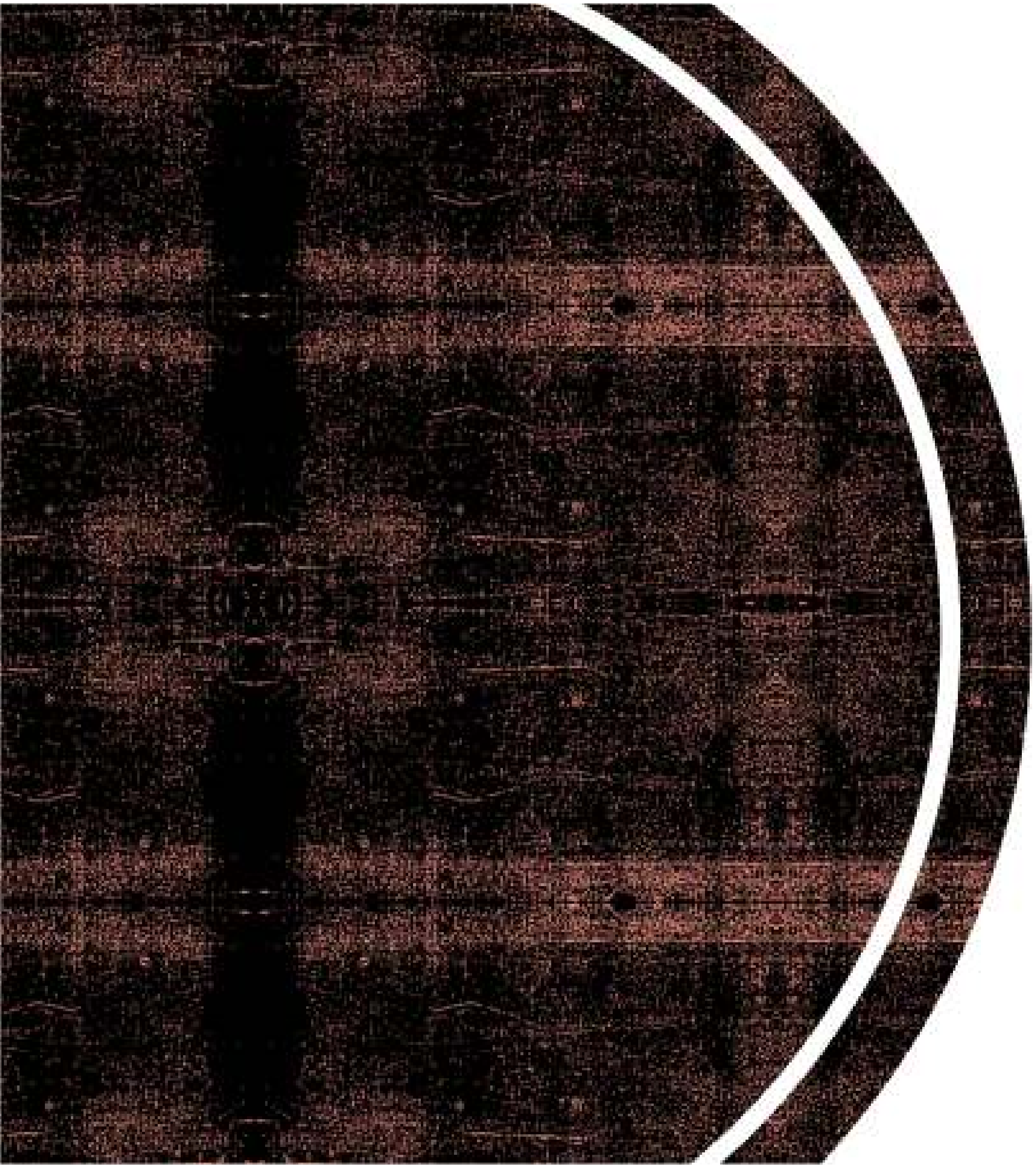
J Check if corporation: (1) ☐ Aggregated activities for section 465 at-risk purposes (2) ☐ Grouped activities for section 469 passive activity purposes

Caution: Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

Income	1a	Gross receipts or sales	1a	
	b	Returns and allowances	1b	
	c	Balance. Subtract line 1b from line 1a	1c	
	2	Cost of goods sold (attach Form 1125-A)	2	
	3	Gross profit. Subtract line 2 from line 1c	3	
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)	4	
	5	Other income (loss) (see instructions—attach statement)	5	
	6	**Total income (loss).** Add lines 3 through 5 ►	6	
itations)	7	Compensation of officers (see instructions—attach Form 1125-E)	7	
	8	Salaries and wages (less employment credits)	8	
	9	Repairs and maintenance	9	

POLLING QUESTION 3

Is the IRS focusing on Reasonable Compensation of Officer Shareholders of an S Corp?



ISSUE 3: SHAREHOLDER STOCK AND DEBT BASIS P. 117

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

IRS COMPLIANCE CAMPAIGN PG 117

- Properly report Basis
  - Stock Basis
  - Debt Basis
- Technical Content guide for agents
- Letter 5969: Soft-audit letter to Voluntarily self-correct

INITIAL STOCK BASIS P. 117

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.

BASIS AT TIME OF ACQUISITION PP. 117-118

How Acquired	Beginning Basis
§351 Incorporation	Basis in property contributed to corporation
Purchase	Cost
Decedent	FMV or zero
Except imputed IRD	FMV on date of death or alternate valuation date
Imputed IRD	Zero
Gift	Generally donor basis
Before 1977	Add gift tax (≤ FMV)
After 1976	Add gift tax on appreciation
Any if FMV < donor basis	Limit to FMV for loss
Compensation	Gross income on receipt

BASIS ADJUSTMENTS P. 118

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.

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

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

FIGURE 4.7 SCHEDULE K-1 P. 119

671119

Final K-1 ☐ Amended K-1 ☐ OMB No. 1545-0123

Schedule K-1 (Form 1120-S) **2019**

Department of the Treasury
Internal Revenue Service

For calendar year 2019, or tax year

beginning / / 2019 ending / /

Shareholder's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
00-0000000

B Corporation's name, address, city, state, and ZIP code
Sims Corporation
100 Pine Street
Seattle, WA 98107

C IRS Center where corporation filed return
Ogden

Part II Information About the Shareholder

D Shareholder's identifying number
000-00-0000

E Shareholder's name, address, city, state, and ZIP code
Cheryl Sims
500 Phinney Avenue
Seattle, WA 98103

F Shareholder's percentage of stock ownership for tax year . . . . 100 %

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

1	Ordinary business income (loss)	(20,000)	13	Credits	
2	Net rental real estate income (loss)				
3	Other net rental income (loss)				
4	Interest income				
5a	Ordinary dividends				
5b	Qualified dividends		14	Foreign transactions	
6	Royalties				
7	Net short-term capital gain (loss)				
8a	Net long-term capital gain (loss)				
8b	Collectibles (28%) gain (loss)				
8c	Unrecaptured section 1250 gain				
9	Net section 1231 gain (loss)	4,000			
10	Other income (loss)		15	Alternative minimum tax (AMT) items	
11	Section 179 deduction		16	Items affecting shareholder basis	
			C		1,000
12	Other deductions				
A		5,000	D		12,000

FIGURE 4.8 CHERYL SIMS'S STOCK BASIS P. 120

Beginning stock basis	$15,000
Increase for income items	4,000
Basis before distribution	$19,000
Distribution	(12,000)
Basis before loss items	$ 7,000
Decrease for nondeductible expenses	(1,000)
Basis before loss and deduction items	$ 6,000
Allowable ordinary business loss*	(4,800)
Allowable cash contributions*	(1,200)
Ending stock basis	$ 0

- * 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

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.

S CORPORATION DEBT BASIS P. 121

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.

LOAN GUARANTEES P. 121

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.

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.

RELATED PARTY LOANS P. 123

- 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.

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.		(40,000)
End	$ 0	10,000

2020

	Stock Basis	Debt Basis
1.		40,000
2.	100,000	
End	$100,000	$50,000

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 4.11 SCHEDULE E BASIS REPORTING P. 124

Schedule 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 number if shown on other side. | **Your social security number**

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

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 a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership exp[illegible]wered "Yes," see instructions before completing this section . . . . ☐ **Yes** ☐ **No**

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
A			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

FIGURE 4.12 WORKSHEET FOR FIGURING BASIS
P. 125

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			1.	
2.	Basis from any capital contributions made or additional stock acquired during the tax year			2.	
3a.	Ordinary business income (losses go on Part III)	3a.			
b.	Net rental real estate income (losses go on Part III)	3b.			
c.	Other net rental income (losses go on Part III)	3c.			
d.	Interest income	3d.			
e.	Ordinary dividends	3e.			
f.	Royalties	3f.			
g.	Net capital gains (losses go on Part III)	3g.			
h.	Net section 1231 gain (losses go on Part III)	3h.			
i.	Other income (losses go on Part III)	3i.			
j.	Excess depletion adjustment	3j.			
k.	Tax-exempt income	3k.			
l.	Recapture of business credits	3l.			
m.	Other items that increase stock basis	3m.			
4.	Add lines 3a through 3m			4.	
5.	Stock basis before distributions. Add lines 1, 2, and 4			5.	
6.	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.				
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			7.	
8a.	Nondeductible expenses	8a.			
b.	Depletion for oil and gas	8b.			
9.	Add lines 8a and 8b			9.	
10.	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.	
11.	Allowable loss and deduction items. Enter the amount from Part III, line 13, column (c)			11.	
12.	Debt basis restoration (see net increase in instructions for Part II, line 8)			12.	
13.	Other items that decrease stock basis			13.	
14.	Add lines 11, 12, and 13			14.	
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-			15.	

FIGURE 4.12 WORKSHEET FOR FIGURING BASIS
P. 126

Part II—Shareholder Debt Basis

		Debt 1 ☐ Formal note ☐ Open account debt	Debt 2 ☐ Formal note ☐ Open account debt	Debt 3 ☐ Formal note ☐ Open account debt	Total
Amount 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				
Adjustments 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

Part III—Allowable Loss and Deduction Items

		(a) Current year losses and deductions	**(b)** Carryover amounts (column (e)) from the previous year	**(c)** Allowable loss from stock basis	**(d)** Allowable loss from debt basis	**(e)** Carryover amounts
1.	Ordinary business loss					
2.	Net rental real estate loss					
3.	Other net rental loss					
4.	Net capital loss					
5.	Net section 1231 loss					
6.	Other 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					

FIGURE 4.13 LETTER 5969 P. 128

Department of the Treasury
Internal Revenue Service
Large Business & International

Date:

Taxpayer ID number:

Tax periods:

Person to contact:

Contact address:

Employee ID number:

Contact telephone number:

Contact fax number:

Response due by:

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

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.

ISSUE 4: DISTRIBUTIONS TO SHAREHOLDERS P. 129

This section explains the tax treatment of distributions from S corporations to their shareholders.

NONDIVIDEND DISTRIBUTIONS P. 129

Debt basis is not considered when determining the taxability of a distribution.

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.

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.

ACCUMULATED ADJUSTMENTS ACCOUNT P. 130

- 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).

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)

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

POLLING QUESTION 4

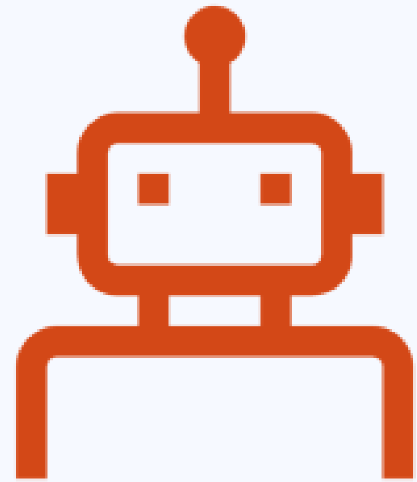
I am still paying attention.

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

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

S CORPORATION BUILT-IN GAINS TAX

P. 141



- 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.

GENERAL RULES P. 142

- 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

ISSUE 7: NET PASSIVE INVESTMENT INCOME P. 147

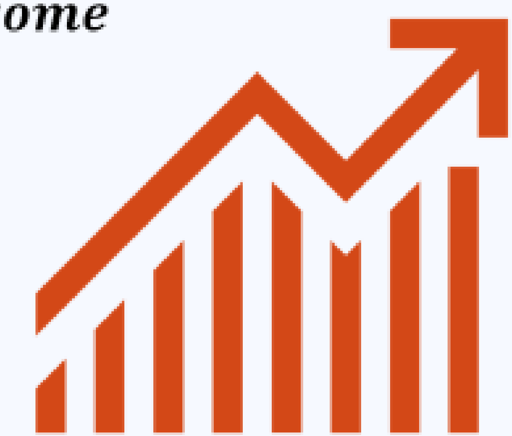
This section discusses the tax on excess net passive income.

NET PASSIVE INVESTMENT INCOME P. 147

- Excess net passive income is:

$$\frac{Passive\ Gross\ Receipts - 25\%\ Gross\ Receipts}{Passive\ Gross\ Receipts}\ x\ Net\ Passive\ Income$$

- Limited – taxable income less adjustments



Questions?