S CORPORATIONS

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TABLE OF CONTENTS

S CORPORATIONS

I. ELIGIBILITY.

A. Basic Requirements. A corporation is eligible to elect and maintain S status only if it qualifies as a small business corporation. For purposes of Subchapter S, a small business corporation:

1. is a domestic corporation;
2. has no more than 75 shareholders;
3. has no shareholders other than:
   a. individuals who are citizens or residents of the United States,
   b. estates, or
   c. certain types of trusts (grantor trusts, voting trusts, testamentary trusts for up to 60 days, and qualified Subchapter S trusts);
4. has only one class of stock; and
5. is not an ineligible corporation.

B. Number of Shareholders.

1. An S corporation must not have more than 75 shareholders. A husband and wife (and their estates), each owning stock individually, are treated as one shareholder. If they divorce, they are converted into two shareholders. If stock is held jointly by nonspouses, each joint owner is counted as a separate shareholder.

   a. The 75-shareholder limit may not be circumvented by forming multiple S corporations. The IRS has ruled adversely when, solely to avoid the 75-shareholder limit, a large group of individuals formed three separate S corporations (each having fewer than the maximum number of shareholders), which then formed a partnership for the operation of a single business. For purposes of S eligibility, the three corporations were considered as one; therefore, the shareholder limit was exceeded.

C. Eligible Shareholders. An S corporation must have as shareholders only individuals, estates, and certain types of trusts.

1. Partnerships and most corporations are not permitted as shareholders.
   a. Subsidiaries.

(1) An S corporation may not have a C corporation shareholder.

(2) S corporations can own 80 percent or more of the stock of C corporations and "qualified subchapter S subsidiaries."

(a) To qualify as a qualified subchapter S subsidiary, the subsidiary would have to:

(i) be 100 percent owned by the parent S corporation;

(ii) be eligible to elect S status if all of its stock were owned directly by its parent S corporation's shareholders; and

(iii) have the parent S corporation elect to treat the sub as a qualified subchapter S subsidiary.

2. Individuals who are nonresident aliens are ineligible.

3. Bankruptcy estates of individuals are eligible shareholders.

4. Permitted trusts include:

a. Grantor Trusts -- trusts in which all income and corpus is treated as being owned by one individual who is a U.S. citizen or resident (whether or not the individual is the grantor).

b. Voting Trusts -- trusts created primarily to exercise the voting power of the owned stock.

c. Testamentary Trusts (Wills) -- trusts that receive S stock pursuant to the terms of a will (but, in general, limited to a 60-day period of ownership).

d. Testamentary Trusts (Grantor Trusts) -- trusts in existence before death that met the requirements of 4.a., and that continue in existence after the Grantor's death (but eligible only for a limited period of time (2 years after the Grantor's death)).

e. "Qualified Subchapter S Trusts" (or QSSTs) -- trusts that own stock in one or more S corporations and are treated as trusts described in 4.a., above. A beneficiary must elect QSST status, and the terms of the trust instrument must meet the following requirements.

(1) There is only one income beneficiary of the trust during the life of the current income beneficiary, and that beneficiary is a U.S. citizen or resident.

(2) All of the income of the trust is, or is required to be, distributed currently to the one income beneficiary.

(3) Any corpus distributions that might occur, or a termination distribution, must also go to that one beneficiary, if made during the beneficiary's lifetime.

(4) The income interest of the beneficiary must terminate on the earlier of the beneficiary's death or the trust's termination.

(5) An election to be treated as an eligible S corporation shareholder must be made separately for the stock of each S corporation held by the trust.

(6) A new (successor) income beneficiary does not have to file an election to continue QSST status. However, the new beneficiary may affirmatively refuse to consent to the QSST election within 60 days of becoming the successor income beneficiary and thereby revoke the S election.

f. Electing Small Business Trusts -- may have more than one (1) current income beneficiary.

5. Foreign trusts are <u>not</u> permitted trusts.

D. <u>One Class of Stock Rule</u>. A corporation has more than one class of stock if the outstanding shares of stock do not confer identical rights to distributions and liquidation proceeds, regardless of whether the difference in rights occurs pursuant to the corporate charter, articles of incorporation, by-laws, operation of state law, administrative action, or agreement.

1. Any instrument, obligation or arrangement which constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law is treated as a second class of stock.

2. Distributions that are made by a corporation with respect to its outstanding stock and that vary with respect to timing or amount are considered non-conforming distributions and generally result in a second class of stock.

a. Transfers made by a corporation to a shareholder that are characterized as distributions under the Code or under general principles of Federal tax law are considered distributions with respect to stock for purposes of the Proposed Regulations.

3. Differences in voting rights, rights that arise out of buy-sell agreements among shareholders, and restrictions on the transferability of stock are disregarded in determining whether a corporation has more than one class of stock.

4. Stock that is substantially nonvested within the meaning of § 1.183-3(b) is not treated as outstanding stock unless the holder makes an election under § 83(b).

a. Most types of deferred compensation arrangements that do not involve property subject to § 83 are not treated as outstanding stock for purposes of Subchapter S.

5. Options that are substantially certain to be exercised are treated as a second class of stock, regardless of whether they would be treated as stock under general principles of Federal tax law.

a. Actual issuance of a second class of stock upon exercise or conversion of any other options, warrants, or debentures will end S status.

6. Purported debt instruments may be treated as a second class of stock if the debt can be characterized equity.

a. Debt that is considered a "<u>straight debt instrument</u>" is not treated as a second class of stock. A straight debt instrument is a <u>written</u>, <u>unconditional promise</u> to <u>pay</u> on demand, or on a specific date, a <u>sum certain</u> in money. The following conditions must be met:

(1) The <u>interest</u> rate and payment dates are not contingent on profits, corporate discretion, etc.

(2) The instrument is <u>not convertible</u> into stock.

(3) The <u>lender</u> is a person who is <u>eligible to hold</u> the S corporation's stock.

(4) The obligation must bear a reasonable rate of interest.

(a) Whether an obligation bears a reasonable rate of interest is based on all facts and circumstances.

(b) An obligation may provide for a variable rate of interest that is based on a current objective interest index, if the interest rate meets the reasonable interest rate requirement. Examples of an objective interest index include the prime rate of a designated financial institution or the applicable federal rate ("AFR") under § 1274(d).

(c) Two safe harbors for satisfying the reasonable interest rate requirement:

(i) The obligation has a yield to maturity that is at least equal to the AFR, but not more than five points above the AFR.

(ii) The issue price of the obligation equals the obligation's stated redemption price at maturity; the obligation's interest rate is expressed as a fixed multiple of current objective interest index or as a constant number of percentage points or basis points more or less than a current objective interest index; and the rate resulting from the formula at the time of issuance is at least equal to the AFR at that time and is not greater than five percentage points above that AFR.

E. Ineligible Corporations.

1. Corporations that cannot become S corporations follow:

a. Members of an affiliated group. A member of an affiliated group cannot be an S corporation. Effectively, this test focuses only on a subsidiary of an S corporation.

As noted earlier, an S corporation is not permitted to have any of its shares owned by another corporation. But, an S corporation is not prohibited from being a shareholder in another corporation if its ownership in the other corporation does not exceed the "affiliated group" percentage test. An affiliated group requires at least 80% ownership, so an S corporation may own less than 80% of a subsidiary. Exceptions exist for inactive subsidiaries and foreign or DISC subsidiaries owned by the S corporation on or before September 28, 1982. Also, the IRS will permit the temporary existence of an affiliated group if the S corporation purchases the stock of another corporation and liquidates it within 30 days, or if an S corporation forms a new subsidiary in completing a D reorganization. Momentary ownership of stock by a partnership has also been permitted. Additionally, an S corporation can be a partner in a partnership.

2. Financial institutions that are allowed a bad debt deduction under IRC § 585 or 593.

3. Domestic international sale corporations (DISCs) or former DISCs.

4. Insurance companies, generally, except certain casualty insurance companies.

5. Certain corporations electing to use the possession tax credit under IRC § 936.

F. Other Qualification Issues. Despite meeting the eligibility requirements of IRC § 1361, a corporation may be prohibited from converting to or maintaining S status for other reasons:

1. If a corporation formerly operated under S status but that status was subsequently revoked or terminated, the corporation must wait five years before it can reelect S status.

2. If a corporation has more than 25% of its gross receipts from passive sources in three consecutive years and if it has accumulated C corporation earnings and profits at the end of each year, then the S status is terminated at the end of the three-year period.

II. MAKING THE ELECTION.

A. Time of Making the Election.

1. For an existing C corporation that is converting to S status, the election for a desired year may be filed:

a. during the year preceding the first tax year the S election is to be effective, or

b. on or before the 15th day of the third month of the initial S corporation year.

2. For a newly formed corporation, the election must occur on or before the 15th day of the third month, measured from the activation date of the corporation. An election should not be made before a corporation either has shareholders, acquires assets, or begins doing business; an election filed before perfection of the incorporation process will be invalid.

NOTE: Since most newly formed corporations do not begin their first taxable year on the first day of a calendar month, the election deadline will not necessarily fall on the 15th of a given month.

3. Only an eligible corporation that meets all of the qualifications for S status may file an election to be an S corporation. A current year election made within the first two and one-half months is valid only if the qualification requirements are met for the portion of the year preceding the date of the election. If the corporation does not qualify for the election on any day of such year before the election is made, or if a shareholder holding stock during such year before the election is made fails to consent to the election, the election is treated as made for the next taxable year.

4. If the initial taxable year of a corporation is less than two and one-half months, an election made within two and one-half months of the first day of the taxable year is effective for the short taxable year.

5. The statutory deadline for filing the S election is "rigid."

6. As with other IRS filings, the U.S. Postal Service postmark on a mailed election governs the expiration of the allowable time period. Alternatively, the election may be hand-delivered to the IRS. When filing by mail, the election should be sent via certified mail, return receipt requested, to provide documentation of timely filing.

7. Failure to timely or properly file the S election could have severe consequences to the shareholders. For example:

a. A new entity denied S status for its first year may find that an initial operating loss is trapped within a regular corporate return.

b. A one-year C corporation that converts to S status exposes itself to the § 1374 built-in gains tax on any appreciated assets as of the date of conversion. For new entities that miss the S election deadline, an initial short-period Form 1120, with capitalization of organization and start-up costs, may be a solution.

c. A C corporation intending to convert to S status may have made distributions to its shareholders under the assumption it was an S corporation, which distributions may become taxable as dividends.

B. Method of Election. To make the election to become an S corporation, IRS Form 2553, Election by a Small Business Corporation, must be filed. The Form 2553 must be signed by a person authorized to sign the corporation's tax returns. Form 2553 must include the name of each shareholder, the number of shares owned and the dates acquired, the shareholders' Social Security numbers, and the shareholders' tax year ends (month and day). The shareholder signatures, consenting to the election.

C. Shareholder Consents to the Election.

1. The requirement that each shareholder consent to the election extends to any person who is a shareholder at the time the election is made. If the election is made during the first two months and 15 days of the year for which it is to be effective, the consent requirement extends to any person who was a shareholder during that portion of the year before the election is made. If not made on Form 2553, a shareholder consent can be made on a separate statement signed by the shareholder, including the name, address, taxpayer identification numbers of the corporation and the shareholder, number of shares owned by the shareholder, the date or dates on which stock was acquired, and the date on which the shareholder's taxable year ends. This statement is filed as an attachment to the corporate S

election (Form 2553). The shareholder's consent is binding and may not be withdrawn after a valid election is made by the corporation.

> **Caution:** If an S election is made by a corporation that has a Qualifying Subchapter S Trust (QSST) as a shareholder, a special election must also be made by the income beneficiary of the trust, in addition to the shareholder consent required on Form 2553. This separate election by the trust beneficiary to provide for eligibility of the trust as an S shareholder generally must be made after the corporation's S election, but within the later of 16 days and two months from the transfer of the corporate stock to the trust or 16 days and two months from the beginning of the first S year.

2. If the S corporation stock is owned as community property or by tenants in common, joint tenants, or tenants by the entirety, each person having such a community or joint interest must consent to the election. The consent of a minor must be made by the minor, the minor's parents, or a legal representative. The consent of an estate must be made by the executor, and the consent of a trust must be made by the person treated as the shareholder.

D. <u>Selection of the Tax Year</u>.

1. In general, an electing S corporation has three choices with respect to its accounting period:

a. conform to the December 31 calendar year, as required by IRC § 1378,

b. apply for a permitted fiscal year-end based on IRS approval of business purpose, as outlined in Revenue Procedure 87-32, or

c. elect under IRC § 444 to use a fiscal year-end of either September, October or November, and become subject to the requirement to pay an annual tax deposit to the IRS under IRC § 7519.

2. At the time of filing the S election on Form 2553, the corporation is to make a designation of its decision with respect to its accounting period. For example, an IRS approval under Revenue Procedure 87-32 for a "business purpose" fiscal year can be achieved in any one of the following ways:

a. expeditious approval of a "natural business year," if the corporation can show that for three years it has consistently received 25% or more of its gross receipts within the last two months of its desired fiscal year;

b. expeditious approval of an "ownership tax year" if the S corporation fiscal year will conform to the tax year of shareholders having more than 50% of its issued and outstanding stock; and

c. a request for approval of a business purpose fiscal year based on facts and circumstances. (Note that when a Form 2553 S election is submitted under this circumstance, a user fee will be charged for the processing of the application.

E. Invalid S Elections. The IRS has authority to:

1. Waive invalid S elections (e.g., because of an inadvertent failure to get all the necessary shareholder consents or to otherwise qualify to elect S status); and

2. Treat late elections as timely.

III. TERMINATION.

A corporation can terminate its S status either voluntarily (by revocation) or involuntarily (by losing its eligibility as a "small business corporation").

A. Termination by Revocation.

1. To voluntarily terminate S status, the corporation may file a revocation for any of its taxable years, including the first taxable year for which the election is effective. The revocation must be accompanied by the consent of shareholders who, at the time of the revocation, hold more than 50% of the number of issued and outstanding shares of stock of the corporation, including nonvoting stock.

2. The corporation must file a revocation election by the 15th day of the third month of the tax year in order to accomplish the termination for the entire year. Alternatively, the election can specify any future prospective revocation date. Revocations that designate an effective date during a tax year will require the splitting of the year into short Subchapter S and Subchapter C taxable years. An election to revoke can be made during the first year of operation as an S corporation.

a. If a revocation does not specify an effective date, the revocation is effective retroactively to the beginning of a tax year if it is made on or before the 15th day of the third month of the tax year. If made after such date, it is effective at the beginning of the following year.

3. A corporation may rescind a revocation at any time before the revocation becomes effective. The rescission is to be signed by an officer of the corporation and must be

accompanied by the signed consent of each person who became a shareholder within the period beginning on the first day after the revocation was filed and ending on the date on which the rescission is made.

B. Involuntary Termination.

1. A failure of the corporation to continue to satisfy the requirements of a small business corporation will automatically terminate the S status. The disqualifying events that terminate S corporation are as follows:

a. More than 75 shareholders.

b. Stock ownership by an ineligible shareholder (i.e., partnership, corporation, ineligible trust, or nonresident alien).

c. More than one class of stock.

d. Membership in an affiliated group of corporations, or becoming an otherwise ineligible corporation such as a bank, insurance company, DISC, etc.

e. Transfer of place of incorporation to a foreign country, and thus, no longer a domestic corporation.

In addition to the above events that cause termination because of lack of continuing eligibility, a special statutory terminating event occurs if an S corporation has Subchapter C earnings and profits combined with excessive passive income over a three-year period.

C. Short-Period Returns.

1. Except for the special rule applying to excessive passive receipts, a termination is effective as of the day on which the disqualifying event occurs. Also, many voluntary revocations will specify a prospective mid-year date for termination. This requires two short tax years, with the S corporation year ending on the day before the disqualifying event, and a regular C corporation short-period return reporting the remainder of the taxable year.

2. The due date of both short-period returns is the normal due date for the C corporation year. Therefore, the S corporation shareholders may enjoy deferral of income tax resulting from fiscal-year reporting in the year of termination. For purposes of computing the C corporation's tax for the short tax year, the income allocated to that year must be annualized and other tax attributes must be proportionately reduced. Even though two tax years are created, for purposes of determining carryover years, only one tax year is counted. The C corporation always retains the former S corporation's year-end.

D. Income Allocation in Short Termination Year. If all shareholders owning stock during the S termination year consent, and all beginning C corporation shareholders consent, the corporation can elect to report the items of income, loss, deduction, or credit for both the S corporation's short year and regular C corporation short year on the basis of the corporation's actual books and records. If such an election is not made, items of income, loss, deduction or credit for the year are allocated on a daily prorata basis. The prorata method cannot be used, however, if there is a sale or exchange of 50% or more of the corporation's stock during the year, or if an IRC Section 338 election is made in connection with a purchase of 80% or more of the S corporation's stock.

E. Passive Income Test. If a corporation has more than 25% of its gross receipts from passive sources in three consecutive years, and if it has C corporation accumulated earnings and profits (AE&P) at the end of each year, then the S status is terminated as of the beginning of the first year following the end of the three-year period.

> NOTE: A corporation that has been an S corporation since its formation would generally not be subject to termination due to its passive income. These corporations, as well as those that converted from C status but do not have any C corporation AE&P, can have an unlimited amount of passive income without terminating S status or being subject to any passive income tax. There is one exception to the concept that a corporation that has always been under S status is not subject to the passive income termination: An S corporation that acquires a C corporation in a tax-free reorganization will succeed to any AE&P of the C corporation, and thus, could be jeopardized by excessive passive receipts.

F. New Election After Termination.

1. Generally, once the S election has been terminated, the corporation must wait five years before it can reelect S status. This five-year rule applies whether the termination was voluntary or involuntary.

2. The five-year waiting period does not apply if the termination occurred before the benefits of S status were achieved. Thus, no five-year wait is required when the S election is revoked effective on the first day for which the S election would have been effective, or if the corporation did not qualify as a small business corporation on that first day.

G. Inadvertent Termination. The IRS also has the discretionary authority to continue S status despite the occurrence of a terminating event. The IRS will do this if the involuntary loss of the election was "inadvertent" and if reasonable steps were taken to remedy the defect within a reasonable period of time after discovery. The IRS may require appropriate steps to be taken by both the corporation and its shareholders.

H. Post-Termination Transition Period.

1. Following termination of S status, a special grace period exists for two important purposes:

a. Shareholders are allowed to withdraw previously taxed S corporation earnings, to the extent of the accumulated adjustments account (AAA).

b. Shareholders may restore basis in their stock, to allow the pass-through of previously unutilized S corporation losses.

2. The grace period following termination of S status represents a last change opportunity to bail previously taxed cash and basis out of the corporation in a tax-free manner.

3. The post-termination transition period is defined as the period beginning on the day after the last day of the last S year, and ending the later of:

a. One year after such last day, or

b. The due date, including extensions, for filing the return for the last S period.

4. Further, a later period is allowed that is helpful to the shareholders if termination of S status was unknown at the time. Under this rule, the shareholders have a post-termination transition period for the 120-day period beginning on the date of a determination that S status terminated. A "determination" is defined as a court decision becoming final, a closing agreement with the IRS, or an agreement between the IRS and the corporation that S status terminated.

I. Quarterly Estimates. After terminating S status, a corporation will immediately need to consider its responsibility to file quarterly estimates of corporate income taxes. Because the final S corporation return normally will not involve the payment of any corporate tax, the first C corporation return following termination of S status will not have a "prior year tax" exception on which to base quarterly estimates. Accordingly, the quarterly tax estimates for the first C corporation return must be based on actual income earned in the first C tax year.

IV. TAXATION OF S CORPORATIONS.

A. Taxes Assessed to S Corporations. Generally, income earned by an S corporation is taxed only once, at the shareholder level. There are, however, two situations that can cause the corporation itself to be subject to tax: the two taxable situations have one thing in common -- they can apply only to a corporation that was a C corporation before becoming an S corporation. A partnership or proprietorship that becomes an S corporation, or a company that starts business and simultaneously elects S corporation status, will not be subject to tax at the corporate level.

1. Two taxes that can be assessed at the S corporation level:

   a. Tax on built-in gains; and

   b. Tax on excess net passive income.

B. Other Tax Payments by S Corporations. There are three other situations that may cause an S corporation to pay tax, but these taxes are not corporate income taxes resulting from the S corporation's operations. The situations are:

1. The S corporation pays tax that was assessed to the predecessor C corporation. For example, a C corporation becomes an S corporation on January 1. Any tax due on the C corporation return for the year just ended is paid by the S corporation.

2. An S corporation may have to make required payments to elect or retain a fiscal year.

3. Some S corporations will make the installment payments of tax caused by LIFO inventory recapture when a C corporation elects S status.

C. Pass-Through Treatment of Corporate Taxes.

1. The built-in gains tax passes through separately as a loss and, for purposes of determining the character of this loss, is allocated proportionately among the recognized built-in gains that gave rise to the tax. The pass-through of long-term capital gain (under prior IRC Section 1374) and excess net passive income is reduced by the tax imposed on those gain and income items. Investment credit recapture passes through as a separately stated item and is a nondeductible corporate expense.

2. The other taxes paid by an S corporation are nondeductible expenses and pass through to shareholders as separately stated items.

D. Estimated Tax Payments. An S corporation is subject to the estimated tax payment rules if one or more of the corporate level taxes are assessed.

E. Built-In Gains Tax. Repeal of General Utilities has meant that, generally, a liquidation is treated as a sale of corporate assets at fair market value, and gain or loss is recognized at the corporate level. C corporation liquidation gain is effectively taxed twice -- once at the corporate level and again at the shareholder level as payment for stock surrendered.

This makes S corporation status more attractive because gain recognized upon liquidation generally will be taxed only once (at the shareholder level) due to the increase in stock basis that results from pass-through treatment. To discourage a C corporation from electing S corporation status to avoid double taxation from liquidation, a tax on "built-in gains" was imposed by TRA '86.

1. Corporations Affected by the Built-in Gains Tax. The Built-in gains tax applies to C corporations that make S corporation elections.

2. Built-in Gains and Net Unrealized Built-in Gain.

a. If the built-in gain rules apply, the corporation generally must pay a tax when it recognizes built-in gain on the disposition of assets on hand at the date the S election became effective. The built-in gains tax applies to both ordinary income and capital gains. The built-in gain on a specific asset is limited to the amount by which the asset's fair market value exceeded its adjusted basis at the date the S election became effective. The maximum built-in gain that an S corporation must recognize is the "net unrealized built-in gain" (i.e., the excess of the aggregate fair market value over the aggregate adjusted basis of all assets on hand as of the first day on which an S election is effective).

b. The calculation of net unrealized built-in gain allows built-in losses to offset built-in gains when determining the maximum exposure to the corporate level tax. Accounts payable as of the effective date of the S election also represent built-in losses if payments results in a deductible expense for a tax year in which the company is an S corporation. For example, assume Exxcorp. a cash-basis C corporation, elects S corporation status and has the following assets on hand on the first day it operates as an S corporation:

	Fair Market Value	**Adjusted Basis**	**Built-In Gain**
Cash	$15,000	$15,000	$ --
Accounts Receivable	60,000	--	60,000
Machinery & Equipment	30,000	95,000	(65,000)
TOTALS	$105,000	$110,000	$5,000

Exxcorp is not subject to the built-in gains tax because the aggregate basis of all the assets exceeds the total fair market value; that is, the net unrealized built-in gain is zero.

c. Now assume that Exxcorp also had $50,000 of goodwill in which it had no basis on the day that it became an S corporation. It also has $10,000 of accounts payable that will be paid and deducted after the S election is effective. The net unrealized built-in gain would be $35,000 determined as follows:

	Fair Market Value	Adjusted Basis	Built-In Gain
Cash	$15,000	$15,000	$ --
Accounts Receivable	60,000	--	60,000
Machinery & Equipment	30,000	95,000	(65,000)
Goodwill	50,000	--	50,000
TOTALS	$155,000	$110,000	$45,000
Accounts Payable			(10,000)
Net Unrealized Built-In Gain			$35,000

3. Importance of Appraisals. The presumption is that any gain on disposition of assets is built-in unless the corporation can establish otherwise. This can be done by proving that the asset that caused the gain was not on hand on the date the S election was first effective, or that the asset appreciated in value after the election date. When a C corporation becomes an S corporation, it is essential that assets be appraised to establish the values at the date the election becomes effective. Appraisals of intangible assets, such as goodwill, should not be overlooked. Of course, the importance of appraisals must be weighed against the practicality and risks associated with each specific set of circumstances. Factors such as relatively low asset values or the types of corporate assets may reduce the need to rely on a formal appraisal. If no formal appraisal is made, the corporation should retain other documentation to support asset values.

4. Distribution of Assets. The built-in gain rules apply to all taxable dispositions of assets, not just sales. Thus, distribution of property to a shareholder is a disposition of an assets, and gain recognized on such distributions is subject to the built-in gains tax rules.

5. 10-year Recognition Period. The built-in gain provisions will apply during the 10-year period beginning with the first day of the first taxable year for which the S election was effective.

6. Substituted Basis Property. The built-in gains tax applies to gains from the disposition of substituted basis property that an S corporation acquires from a C corporation. The 10-year recognition period for such assets will be measured from the date of acquisition by

the S corporation, rather than from the date of election of S corporation status. For example, an S corporation acquires appreciated realty in a substituted basis transaction, such as a reorganization, from a C corporation. The S corporation faces the built-in gains tax upon a disposition of the asset for a period of 10 years from the date that it acquired the asset. Also, the unrecognized built-in gain carries over from an exchanged asset to one received in an exchange if the basis of the new asset is determined, at least in part, by the basis in the asset exchanged.

7. <u>Income from Cash-basis Receivables, Inventory, and Other Assets</u>. The built-in gains tax is imposed on gains from the disposition of assets. An asset disposition that is subject to the built-in gains tax is defined very broadly, including any asset-based income recognition event, if the income is attributable to the period before the S election is effective. Examples are collection of accounts receivable by a cash-basis corporation, sale of inventory in the ordinary course of business, and completion of a long-term contract when the corporation is using the completed-contract method. Using the Code's definition of built-in gain, the collection of installment notes receivable could also result in built-in gain recognition if the note was executed during the C corporation period.

8. <u>Built-in Losses</u>. TAMRA expanded the definition of asset dispositions, for built-in gains purposes, to include income recognized in an S year if the income is attributable to a C year. It also, however, allowed S corporations to offset built-in gains with built-in losses. Losses are built-in if an asset's basis exceeded its fair market value at the S election's effective date. Built-in losses also occur when an amount is allowable as a deduction during the 10-year recognition period, if the expense is attributable to the C period, e.g., accounts payable or bonuses payable at the date an S election is effective. Built-in losses are beneficial to the corporation because they reduce net unrealized built-in gain, and therefore, diminish the company's maximum exposure to the tax. However, a built-in loss can offset recognized built-in gain only if the loss and gain are recognized in the same taxable year.

9. <u>Rate of Tax and Application of C Corporation Carryovers</u>. The tax is imposed at the highest tax rate applicable to a corporation in the year the gain is recognized. The tax is computed on the lesser of: (i) the amount that would be the corporation's taxable income if only recognized built-in gains and losses were taken into account; or (ii) the corporate taxable income for the year, computed as if the corporation were a C corporation. The strategy of reducing taxable income through bonuses and other expenses will be a key planning technique to minimize exposure to the built-in gains tax. Also, the corporation reduces recognized built-in

gain by unused net operating loss or capital loss carryforwards from C corporation tax years. (Capital loss carryforwards can offset only the capital gain portion of built-in gain.) Further, unused business and alternative minimum tax credit carryforwards from C corporation years are used to offset the tax payable.

10. Taxable Income Limitation and Carryover of Built-in Gain. Built-in gain subject to tax in any year is limited to the taxable income of the corporation computed as if it were a C corporation. However, if the S election was filed on or after March 31, 1988, any built-in gain not recognized because of the taxable income limitation will carry forward during the remainder of the 10-year recognition period and will be recognized in a later year to the extent there is taxable income.

11. Tax Planning Strategies.

a. Tax planning techniques to avoid or reduce the built-in gains tax generally revolve around the following techniques:

(1) reduction of net unrealized built-in gain;

(2) reduction of taxable income;

(3) utilization of C corporation carryovers;

(4) recognition of built-in losses in years that built-in gains are recognized;

(5) deferral of sales of property; and

(6) negotiation of a tax-deferred exchange (e.g., like-kind exchange).

b. In Notice 90-27, the IRS announced its intent to issue regulations that will restrict the tax benefits of installment sales as they relate to the built-in gains tax. The stated purpose of these future regulations is to ensure that installment reporting is not used to circumvent the repeal of General Utilities. The IRS had determined that it will disallow the installment method in calculating the built-in gains tax for dispositions either before or during the 10-year recognition period. When an asset containing built-in gain is sold and gain is reported on the installment method, the built-in gains tax will be calculated as if the corporation elected out of installment reporting; however, the built-in gains tax will not be due until the gain is actually recognized on the installment method. In determining the extent to which any built-in gain would have been taxed, the amount deemed taxed in any prior year will not exceed the corporation's taxable income (computed as if it were a C corporation). The excess, if any, of net recognized built-in gain over this taxable income limitation will be carried over and treated as recognized in the succeeding taxable year. The regulations to be issued will be effective for installment sales occurring after March 25, 1990. However, installment sales completed after this date will not be subject to this new rule if a binding contract was in effect before March 26, 1990.

F. Tax on Excess Net Passive Income. Passive investment income can be subject to tax at the S corporation level, but the tax does not apply unless the S corporation has C corporation accumulated earnings and profits (AE&P) at the end of the taxable year. To be subject to this tax, then, an S corporation either must have been a C corporation or must have acquired a C corporation that had AE&P. The tax can be avoided by distribution AE&P before year-end, which may be appropriate in some cases. To accomplish this, the corporation can elect to distribute AE&P before the accumulated adjustments account (AAA) is distributed. Also, the tax does not apply unless the passive investment income is more than 25% of the corporation's gross receipts for the year.

The tax on excess net passive income is imposed at the maximum corporate tax rate.

1. Definition of Excess Net Passive Income.

a. "Passive investment income" generally includes gross receipts from royalties, rents, dividends, interest, annuities, and gains from the sale or exchange of stocks or securities. However, income from rental off tangible property when significant services are rendered, such as income from hotel operations and from vehicle leasing, is not considered passive investment income. "Net passive income" is obtained by subtracting (from passive investment income) deductions directly connected with the production of passive income. To be directly connected, an item of deduction must have "proximate and primary relationship to the income."

b. "Excess net passive income" is defined in terms of a percentage of net passive income for the tax year. The percentage is calculated by dividing the passive investment income for the year in excess of 25% of the gross income for the year by the passive investment income. Multiplying this percentage by net passive income results in excess net passive income. Thus, if passive investment income for the year does not exceed 25% of gross receipts, there cannot be any excess net passive income

c. Excess net passive income can never exceed the corporation's taxable income. This means that the tax on excess net passive income will not apply if the corporation has other losses that bring its taxable income to zero. For these purposes, taxable income is computed as if the corporation were a C corporation. However, the net operating loss deduction and special deductions (except amortization of organization expenses) are not allowable.

2. Waiver of Tax.

a. The IRS has the authority to waive the tax on net passive income if the following two conditions are met:

(1) the corporation believed, in good faith, that it had no Subchapter C AE&P for the year in question; and

(2) the AE&P was distributed within a reasonable time period after the corporation realized that it had AE&P.

b. Regulations give additional guidance on how to obtain the waiver. The corporation has the burden of proof to demonstrate that it acted in good faith and with due diligence in determining that no AE&P existed for the year in question. If an audit subsequently determines that AE&P did exist, and the corporation distributes the AE&P within a reasonable time following the audit, a waiver may be grated. To obtain a waiver, the company should file a request in the form of a ruling request that includes the following information:

(1) a description of how and on what date the S corporation, in good faith and using due diligence, determined that no AE&P existed at the close of the tax year;

(2) a description of how and on what date it was determined that the corporation had AE&P at the close of the tax year;

(3) a description, including dates, of the steps taken to distribute the AE&P; and

(4) if the AE&P has not yet been distributed, a timetable for distribution and an explanation of why the timetable is reasonable.

c. The AE&P must actually be distributed by the date the waiver is to be effective.

3. Termination Due to Passive Income. If passive investment income exceeds 25% of gross income for three consecutive tax years and the S corporation has C corporation AE&P at the end of each of those years, the S corporation election will involuntarily terminate.

4. Election to Distribute Accumulated Earnings and Profits First. Since S corporations that do not have AE&P are not subject to the tax on excess net passive income and do not face the threat of inadvertent termination due to the three-year rule, it may be desirable to distribute AE&P. An election is available that allows an S corporation to distribute AE&P before distributing the AAA.

5. No Double Taxation at Corporate Level. If a gain, such as that generated by a sale of stock or securities held for investment, otherwise would be subject to both the tax on passive investment income under IRC Section 1375 and the built-in gains tax under IRC Section 1374, it will not be subject to taxation under both provisions. The amount of passive investment income considered for purposes of the Section 1375 tax will not include any recognized built-in gain or loss (that is taxable under the built-in gains tax rules of IRC Section 1374) for any year during the recognition period.

G. LIFO Recapture. A C corporation using the LIFO inventory method must add a "LIFO recapture amount" to income when it elects S corporation status. The LIFO recapture rule was designed to prevent corporations from avoiding built-in gain on sales of inventory.

1. Calculation of LIFO Recapture. The recapture amount is the excess of the inventory's FIFO value over its LIFO value at the end of the last C corporation year. The FIFO value is determined using the retail method, if that method has been used for LIFO purposes. If the retail method was not used, the FIFO value is determined by using the lower of cost or market.

2. Increase in Inventory Basis.

a. The basis of the inventory is increased by the recapture amount included in income, so the income from the sale of the inventory is taxed only once at the corporate level.

b. Note that the corporation is not required to change to the FIFO inventory method. Rather, the built-in gain on inventory is includable in income (to the extent of the difference between LIFO and FIFO) in the last C corporation year.

3. Payment of LIFO Recapture Tax. The increase in tax generated by the LIFO recapture amount is payable in four installments. The first installment is due on or before the due date (without considering extensions) of the corporation's last C corporation return. The remaining three installments are due on or before the due dates (without considering extensions)

of the corporation's returns for the three succeeding taxable years. No interest is charged on the installments unless they are made after the due dates.

V. PASS-THROUGH TO SHAREHOLDERS.

An S corporation, like a partnership, is a reporting entity. That is, the corporation reports the results of its operations to the shareholders who report those results on their individual income tax returns. This reporting process is called "pass-through." Pass-through is distinguished from distributions, which occur when the shareholder actually receives cash or property from the corporation.

A. Non-Separately Stated Items.

1. Items that pass through to shareholders are separated into two main categories: nonseparately stated income or loss and separately stated items. Nonseparately stated income or loss is the ordinary income of the corporation that passes through to each shareholder as one net amount. The breakdown or separate identify of the items does not affect the shareholder.

a. Nonseparately stated income is called taxable income by the Code. It is the "bottom line" income or loss reflected on Page 1 of the Form 1120S where it is labeled "Ordinary income (loss) from trade or business activity(ies)."

b. Only income and expenses from a trade or business are included in the nonseparately stated income or loss. All other income and expense items are stated separately.

B. Separately Stated Items. Any items of income, loss, deduction, or credit that, by itself, could affect the tax liability of any shareholder is stated separately, i.e., it is segregated and allocated separately to each shareholder. Separately stated items are reported on Schedule K of the Form 1120S. The following is a list of some of the items that are taken into account separately:

1. income and loss from each rental activity;
2. portfolio income, including interest, dividends, and royalties;
3. tax-exempt income;
4. net long-term capital gains or losses;
5. net short-term capital gains or losses;

6. gains and losses from sale or exchange of Section 1231 assets, i.e., those used in the corporation's trade or business;

7. investment interest expense;

8. charitable contributions;

9. items used in the computation of oil and gas depletion;

10. intangible drilling costs;

11. the Section 179 deduction, i.e., expensing of certain depreciable assets;

12. nondeductible expenses (including the nondeductible portion of meals and entertainment expenses and sky box rentals);

13. soil and water conservation expenditures;

14. information necessary to determine credits, e.g., wages subject to the jobs tax credit.

C. Allocation of Pass-Through.

1. Pass-Through is Allocated Per-Share, Per-Day. Pass-through items are allocated to shareholders on a per-share, per-day basis. In general, this means that pass-through items for the entire tax year are allocated equally to each day of the tax year and are in turn allocated equally among the shares of stock outstanding on each day of the tax year. A partnership, on the other hand, can specially allocate items to a partner under certain conditions. For instance, a partnership may pass through depreciation on a specific asset to the partner who contributed that asset to the partnership. There is no provision for special allocations by an S corporation.

2. When Pass-Through is Reported. The shareholder reports the pass-through items in the taxable year that includes the last day of the S corporation's taxable year.

3. Pass-Through When Stockholder Disposes of Shares.

a. If a shareholder's entire interest in the S corporation is disposed of, and all affected shareholder's consent, the corporation can make an election to allocate the pass-through items as if the year consisted of two tax years, based on normal tax accounting rules, using the company's books and records for each respective period. Therefore, if the election is made, the departing shareholder's pass-through items are determined by the actual transactions (in accordance with the corporation's normal accounting methods) that occurred during the period that the disposing shareholder owned the shares. If the election is not made (or if less than the shareholder's entire interest is disposed of), the pass-through to the departing shareholder is a per-share, per-day allocation of the S corporation's annual pass-through amount.

b. The affected shareholders include only the shareholder whose interest is terminated and any shareholders to whom the terminated shareholder transferred his or her shares.

c. On the day shares are transferred, the shares are considered to be owned by the shareholder who acquired the shares, rather than the one who disposed of the shares.

4. Pass-Through When a Shareholder Dies. When an S corporation shareholder dies, pass-through items are allocated to that deceased shareholder up to the date of death and are reported on the shareholder's final return. The pass-through items for the remainder of the S corporation's year are allocated to the deceased shareholder's estate or to the person or other entity that acquires the stock. Calculation of pass-through items is on a per-share, per-day basis unless the election is made by the corporation to use specific accounting from the actual books and records as of the date of death.

a. No Basis Step Up in Inherited S Stock. A person inheriting stock in an S corporation from an individual dying after August 20, 1996, is required to treat as income in respect of a decedent (IRD) the person's pro rata share of any item of income of the S corporation that would have been IRD if acquired directly from the decedent.

(1) The basis of the inherited stock (i.e., the value on the date of death or the alternate valuation date) is reduced by the extent to which its value is attributable to IRD.

(2) An income tax deduction is allowed for estate tax attributable to the IRD items.

5. Pass-Through When S Election Terminates.

a. Pass-through to shareholders is affected when the S election terminates at a date other than the corporation's year end. Generally, corporate items of income, loss, deduction, and credit are allocated prorata between the S and C corporation short years based on the number of days in each short year. However, a corporation can elect, with the consent of all shareholders, to allocate items between the S and C short years based on a specific accounting from the company's actual books and records for the period that the S corporation election is in effect. If there is a sale or exchange of 40% or more of the corporation's stock during the termination year, actual books and records must be used.

> **Example:** Norman and Norma each own 50% of the stock of Nan, Inc., a calendar year S corporation. On July 1, the corporation revokes the S election. If no allocation election is made, items of income, loss, deduction, and credit are allocated prorata between the S and C corporation short years based on the number of days in each year. If the corporation so elects, items are allocated between the S and C short years using specific accounting from the actual books and records during each short period. If Norman had sold all of his shares to Norma on July 1, the date the termination became effective, the corporation would be required to use specific accounting for each short period because 50% or more of the corporation's stock was transferred during the termination year.

b. After the corporate items of income, loss, deduction, or credit have been allocated between the S and C short years, the items allocated to the S short year are passed through to shareholders on a per-share, per-day basis using the number of days in the S short year.

D. Basis is Adjusted by Pass-Through Items. Each shareholder adjusts basis in stock by the pass-through items. Losses and deductions are passed through to the shareholders, but shareholder ability to deduct the loses and deductions may be limited because of basis, the passive activity loss rules, or the at-risk rules.

E. Active or Passive Nature of Pass-Through. The stockholder's share of the S corporation's nonseparately stated (taxable) income is active if the stockholder materially participates in the operations of the business. It generally is passive activity income if the shareholder does not materially participate. If the corporation is engaged in more than one activity, schedules must be attached to each shareholder's Schedule K-1, reflecting the shareholder's share of income and loss attributable to each activity. Rental income or loss passes through as a separately stated item and is generally passive. (A special rule allows up to $25,000 of losses from rental real estate if the shareholder actively participates in the operations of the rental activity.) Interest and other portfolio income pass through as separately stated items.

F. Other Pass-Through Matters.

1. How Pass-Through is Affected by Corporate Level Tax. When excess net passive income generate tax at the corporate level, pass-through of those items is reduced by this corporate tax allocable to each such item. Tax on recognized built-in gain is passed through separately to shareholders as a loss.

2. Self-Charged Interest. An S corporation shareholder who makes a loan to the corporation can offset the interest income received from that loan with interest expense passed through by the S corporation.

3. Pass-Through of the Section 179 Deduction. The Section 179 deduction (limited expensing of business assets) is limited at both the corporation and shareholder levels. Thus, the S corporation can pass-through a total of only $24,000 of Section 179 deduction, regardless of the number of shareholders. The $24,000 limitation is reduced dollar-for-dollar by the amount by which the cost of eligible property exceeds $200,000 in any taxable year.

4. Pass-Through of Charitable Contributions. Charitable contribution deductions are not limited at the corporate level. Rather, they pass through as a separately stated item, and deduction limitations, if any, are determined at the individual shareholder level.

5. Reasonable Salaries. The salary paid to a shareholder reduces the corporation's nonseparately stated income or loss and, therefore, affects the amount of income passed through to shareholders. Thus, salary can be manipulated for purposes such as shifting income among family members. However, salaries must be reasonable.

6. Interest Expense. The pass-through treatment of interest expense paid by the corporation is generally determined by reference to the use of the debt proceeds.

VI. BASIS AND LOSSES.

A. Computation of Basis.

1. Original Basis. A shareholder's initial basis in shares of S corporation stock depends on how the shares are acquired. The most common methods are as follows:

a. by outright purchase, in which case the basis is initial cost of the shares;

b. as a party to the capitalization of the corporation, in which case the basis of the stock has the same basis as the property contributed, plus gain recognized on the transfer (IRC § 351);

c. by gift, where the basis in the hands of the donee is usually the same as the basis in the hands of the donor; certain exceptions exist if gift tax is paid on the transfer or if the donor's basis is greater than the market value and the stock is sold later at a loss (IRC § 1015); or

d. by inheritance, where the basis is the fair market value at the date of death, or alternate valuation date if so elected (IRC § 1014).

2. Annual Adjustments to Basis. Each shareholder's basis is affected every year by various items of corporate income, loss, and deduction and by distributions to shareholders. The shareholder's basis is adjusted each year in accordance with the following rules:

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

(1) nonseparately stated income,

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

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

(4) half of investment tax credit ("ITC") recapture when such recapture causes a corresponding addition to an asset's basis.

b. It is decreased by the stockholder's share of:

(1) nonseparately stated loss,

(2) separately stated items of deduction or loss,

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

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

(5) half of the ITC when an asset's basis was reduced correspondingly.

c. Finally, it is decreased by distributions that are not includable in the shareholder's income.

> NOTE: Because the Tax Reform Act of 1986 (TRA '86) generally repealed ITC effective for assets after 1985, additions to stock basis because of ITC recapture can occur throughout the recovery period of assets acquired before 1986.

3. Basis Increased by Reported Income Items. No increase in basis is allowed for pass-through items that are required to be included in the shareholder's taxable

income unless the amounts are included in gross income on the shareholder's income tax return. This rule is designed to prevent a taxpayer from omitting an income item from the personal tax return, and then increasing basis for that item after the statute of limitations for reporting has expired.

4. Basis Adjusted at End of Year. Basis adjustments are made at the end of the corporation's taxable year. Basis first is increased by pass-through income items, then decreased by pass-through items of loss and deduction before considering the tax effects of distributions. The order is important because it causes the tax effects of distributions to be determined by reference to basis at the end of the corporation's year after adjustment for pass-through items. Also, this order dictates that a shareholder's stock basis in a fiscal year S corporation is determined at the end of the corporation's tax year, rather than the shareholder's year.

5. Basis Cannot Be Negative Amount. Basis cannot be reduced below zero.

6. Shareholder Responsibility for Calculation of Basis. It is the shareholder's responsibility, rather than the corporation's, to determine the proper stock or debt basis. On the other hand, balances in the accumulated adjustment account (AAA), previously taxed income (PTI), and accumulated earnings and profits (AE&P) are calculated at the corporate level. The details necessary to determine basis are not always available readily to the corporation, e.g., the shareholder may have basis from purchasing the stock, and that transaction may have occurred outside of the corporation. Normally, however, the practitioner representing the corporation will keep track of the shareholders' bases since most S corporations are relatively small and closely held. The information necessary to determine basis adjustments should be disclosed on the Form 1120S, Schedule K-1.

7. Life Insurance.

a. An S corporation may be the owner of a life insurance policy covering a shareholder or key employee. If the corporation is directly or indirectly a beneficiary of the policy, the cost of premiums paid is not deductible. Likewise, if the corporation receives insurance proceeds from the policy because of the insured person's death, the proceeds are not taxable. Because basis is increased by tax-exempt income, the proceeds of a life insurance policy increase the shareholder's stock bases. However, the proceeds evidently do not increase the AAA because tax-exempt income does not increase AAA. Thus, distribution of the proceeds can result in taxable income to the shareholders if the corporation has AE&P.

b. There has been little guidance from the IRS regarding the treatment of life insurance premiums paid by S corporations. The general rule is that basis is reduced by expenses that are not deductible and not properly capitalizable. Under that rule, life insurance premiums (on policies of which the corporation is the beneficiary) evidently are non-deductible expenditures that reduce the shareholders' stock bases. However, if the policy has a cash surrender value (CSV), it seems that the CSV is properly capitalizable. Therefore, the shareholders' stock bases are reduced by life insurance premiums, but only to the extent attributable to the "pure" life insurance coverage. The portion attributable to CSV increases is a capital expenditure, and therefore, not a reduction in basis. Also, there is no guidance from the IRS regarding how the AAA is affected by premiums expense or by fluctuations in the CSV.

B. Basis in Debt.

1. Unlike a partner, an S corporation shareholder does not increase basis by a ratable share of corporate indebtedness to this parties. This is because, while general partners remain personally liable for partnership obligations, a shareholder generally is not liable for the corporation's obligations.

2. Once a shareholder's basis in S corporation stock has been reduced to zero, losses still can be deducted to the extent the shareholder has basis in direct loans to the S corporation. To obtain basis, the shareholder must incur a true economic outlay, and the debt must be owed by the corporation to the shareholder. The shareholder's personal guarantee of the corporation's obligations to third parties does not create basis; no debt basis results solely from the insurance of the shareholder's personal note to the corporation.

3. When debt basis has been reduced previously because of losses, S corporation net income will increase the debt basis, up to the debt's face value, before it increases stock basis; i.e., corporate net income restores debt basis to the extent it has been reduced by post-1982 losses. Note that debt basis reductions that occurred before 1983 cannot be restored after 1982; debt basis can be increased only to the extent of basis reductions occurring after 1982. Also, note that this rule applies only if there is a net increase in basis for the year, i.e., the aggregate increase adjustments exceed the aggregate decrease adjustments.

4. Corporate distributions to the shareholder reduce stock basis but they do not reduce debt basis. Repayment of shareholder loans obviously reduces the shareholder's basis in such loans. Careful planning is necessary, however, when basis in shareholder loans has been used to support a loss deduction. In such cases, repayment of the loans is a taxable event to the

extent full repayment exceeds the shareholder's basis in the debt, or to the extent partial repayments exceed a prorata portion of the basis in the debt. This income will be capital gain if the debt was evidenced by a note and ordinary income if the repayment is on an open account indebtedness.

C. Deductible Losses are Limited to Basis. Aggregate losses and deductions can be deducted by the shareholder only to the extent of the shareholder's basis in stock and debt of the S corporation. Stock basis is determined, for this purpose, after including all separately and nonseparately stated income items passed through to the shareholder for the taxable year in which the aggregate loss was incurred. It should be noted that the restriction limiting losses to basis also applies to separately stated deductions. Credits are not subject to the basis limitation, however.

D. Losses Carry Over Indefinitely. A shareholder who cannot deduct a loss in the current year because of lack of basis does not necessarily lose the benefit of the loss. The loss can be carried forward indefinitely, to be used when stock or debt basis is increased, e.g., when the corporation has profits, when the shareholder contributes capital, or when the shareholder makes loans to the corporation. The carryover loss is personal to the shareholder who owned the stock when the loss occurred. Consequently, the shareholder loses the ability to deduct carryover losses when one of three circumstances occurs:

1. the S corporation election is terminated,
2. the shareholder disposes of his stock, or
3. the shareholder dies.

Through astute tax planning, the deductibility of losses can be timed to provide the maximum benefit from the deduction. Assuming that the shareholder has the ability to increase basis through capital contributions or by making loans to the corporation, the year that the loss deduction will be utilized can be manipulated by determining the proper period for basis to be increased.

E. Increasing Basis to Deduct Losses. Losses carryover indefinitely (as long as the S corporation election remains in effect). Even so, the taxpayer will want to utilize losses as soon as possible to take advantage of the tax savings. Basis increases occurring before the end of a taxable year can be used to deduct current and prior losses. Be aware, however, that increasing basis to take losses is not always the optimal course of action.

F. Losses and Shareholder Salaries. Salary paid to a shareholder is taxable to the shareholder, even if it causes the corporation to incur a loss that the shareholder cannot deduct due to basis limitations.

G. Basis in the Year Stock is Sold. The shareholder can have basis against which to deduct losses, even if the shareholder disposes of the shares during the year. The stock basis is determined as of the close of the day before the day that the stock is disposed. Debt basis is determined as of the last day that the taxpayer owned stock in the corporation.

H. Termination of S Corporation Status.

1. Generally, unused losses are not available after the S corporation election terminates. But a special relief provision allows losses to be deducted by the shareholder under certain conditions for a limited period of time, i.e., the post-termination transition period. The post-termination transition period begins on the last day of the last S year, and ends on the later of:

a. the day that is one year after such last day;

b. the due date, including extensions, of the final S corporation tax return;

c. 120 days after an IRS or judicial determination that the S election had terminated for a previous taxable year; or

d. The 120-day period beginning on the date of any determination pursuant to an audit following the termination of the S election if the audit adjusts any item of income, loss or deduction of the corporation during the period it was an S corporation.

2. Losses that have not been used when the election terminates are treated as if they were incurred on the last day of the post-termination transition period. Thus, the shareholder can increase stock basis by making additional contributions to capital during the post-termination transition period, and losses can be deducted against these increases. If losses are to be so used, however, they can only be deducted to the extent of stock basis. Increasing debt basis during that period will not allow the deduction of losses. Losses that have not been deducted by the end of the post-termination transition period cannot be utilized at a later date--they are lost forever.

3. The post-termination period can be used as a device to time loss deductions so that the loss can be taken in the last S corporation year or at the end of the post-termination transition period.

I. At-Risk Limitations.

1. At-Risk Rules. The at-risk rules further limit the amount of losses deductible by sole proprietors, partners, S corporation shareholders and certain closely held C corporation shareholders. Under IRC §465, any loss from an activity subject to the at-risk rules is limited to the amount the taxpayer has at-risk under with respect to the activity.

a. Amounts At-Risk. Under IRC §465(b), a taxpayer is considered to be at-risk only to the extent of:

(1) The money and adjusted basis of other property contributed to the activity;

(2) Amounts borrowed by the organization if the taxpayer is personally liable for the repayment of the loan.

(a) A taxpayer is personally liable if the loans are recourse or the taxpayer has pledged property (other than property used in the activity) as security for the amount borrowed.

(3) The taxpayer's share of any "nonqualified nonrecourse financing" secured by real property used in the activity. IRC §465(b)(6).

b. Amounts Not At-Risk.

(1) Amounts borrowed from (i) any person having an interest in the activity; (ii) a person related to a person having such an interest; or (iii) a person with an interest beyond that of a creditor.

(2) Amounts protected against loss through nonrecourse financing, stop loss agreements, guarantees and/or similar agreements.

c. Disallowed Deductions (IRC §465(a)(2)). Any deduction disallowed as a result of the at-risk rules may be allowed in subsequent years if the taxpayer increases his or her amount at-risk.

2. The at-risk rules apply only at the shareholder level. In many (if not most) cases, an S shareholder's at-risk amount is equal to the basis in stock and loans, and the at-risk limitations pose no problem. The shareholder is at risk for money and for the adjusted basis of property contributed to the S corporation. Loans for which the shareholder is personally liable also increases the at-risk amount. The S shareholder is not art risk for the corporation's liabilities to third parties or for guarantees of corporate debt unless funds are actually paid as a result of the guarantee.

3. At-risk amounts can differ from basis when the shareholder lends funds to the S corporation that were obtained from nonrecourse borrowings or from another person who has an interest (other than as a creditor in the activities of the corporation). In these situations, basis is increased, but the shareholder is not considered at risk with respect to such amounts.

4. Generally, different activities undertaken by an S corporation may not be aggregated for at-risk purposes, so that amounts at risk in one activity cannot be used to obtain an amount at risk in another activity unless the corporation carries on a business and at least 65% of the losses are allocated to shareholders who actively participate in the management of the business. However, activities within four categories--films and video tapes, farming, oil and gas activities, and geothermal properties--may be aggregated to determine amounts at risk. For example, S corporation shareholders will be permitted to treat all farming ventures of the corporation as a single activity.

5. As with basis limitations, losses that are limited by the at-risk rules are not allowed currently, but may be carried over until at-risk amounts are generated in subsequent years.

VII. DISTRIBUTIONS.

Distributions from an S corporation occur when the corporation makes a payment of cash or property to the shareholders based on their stock ownership. Since income earned by an S corporation is taxed to the shareholder when the corporation earns it, all or part of the distribution may have been taxed already. These previously taxed amounts generally can be distributed to the shareholder free of further tax. For this reason, S corporation distributions more closely resemble partnership distributions than C corporation distributions, which typically are taxed as dividends at the shareholder level.

A. Distributions Measured in Tiers.

1. One of the advantages of being an S corporation is that, generally, income is taxed only once; i.e., it is taxed at the shareholder level when it is earned and can be distributed free of further tax later. However, the calculation of the amount that can be distributed without current tax effect can be complicated because distributions seldom match the amounts that have been previously taxed. As distributions may include amounts that have been taxed and amounts that have not been taxed; by necessity, there are "tiers" or "levels" of distributions, and each tier has its own tax attributes.

2. Determination of the amount that can be distributed "tax free" involves an analysis of the relationship between income, basis, and distributions: the shareholder is taxed on pass-through income; the amount taxed to the shareholder increases basis; and distributions decrease basis.

> Example: Axel is the sole shareholder in Esscorp. He has a basis of $10,000 in his stock. During Year 1, the company has net income of $20,000 and Axel takes no distributions. He pays tax on the $20,000 income, and his basis increases to $30,000.
>
> In Year 2, the company breaks even, and the corporation distributes the Year 1 income, $20,000. The distribution is a nontaxable return of capital, and it reduces Axel's basis in stock.
>
> Over the two-year period, the corporation has made $20,000, Axel has paid tax on $20,000, and has received a distribution of the same amount. His basis is back to $10,000.

B. Distributions and Basis.

1. The taxability of distributions is based on a specific order depending upon whether or not the S corporation has AE&P. However, regardless of the order, basis must always be considered because distributions in excess of basis result in taxable income to the shareholder.

2. Adjustments to basis are made for the current year's items of income, loss, or deduction (pass-through items) before the tax consequences of distributions can be determined. This can cause unexpected tax results if distributions are made during the year, and the corporation's level of income is less than anticipated.

3. Although pass-through items affect both basis in stock and basis in debt, distributions reduce stock basis only.

C. Accumulated Earnings and Profits (AE&P).

1. Dividend Treatment for Distributions of AE&P.

a. Both a C corporation and an S corporation can distribute taxable dividends to the extent that the corporation has accumulated earnings and profits (AE&P).

(1) An S corporation cannot generate earnings and profits (E&P) for tax years beginning after 1982. Before 1983, however, an S corporation could generate E&P, and AE&P in the corporation at the end of the tax year beginning in 1982 would carry into the post-1982 years.

2. Calculation of C Corporation E&P. IN a C corporation adjustments must be made to the taxable income for the year to determine the amount of E&P generated in that year. (E&P is designed to more closely reflect the corporation's economic income.) Because of those adjustments, the amount of AE&P in a C corporation seldom will match the amount of the corporation's retained earnings.

3. AE&P When C Corporation Elects S Corporation Status.

a. When a C corporation becomes an S corporation, the AE&P retains its character -- that is, distributions of AE&P continue to be taxable dividends. However, distributions of S corporation income that already has been taxed can be distributed first, generally with no current tax effect on the shareholder.

b. AE&P is significant because its distribution results in a taxable dividend. An S corporation does not generate E&P for tax years beginning after 1982, but many S corporations have AE&P because of previous operation as a C corporation or as a pre-1983 S corporation. An S corporation can also have AE&P when the corporation acquires certain other corporations that have AE&P (but this is not common).

c. An S corporation will not have AE&P if the corporation:

(1) was formed after 1982;

(2) was never a C corporation; and

(3) has not acquired another corporation.

4. Reduction of AE&P. If an S corporation had AE&P on the first day of its first taxable year beginning after 1982, that amount of AE&P in effect is frozen on that date. The AE&P generally will not increase (the exception being when the corporation acquires another corporation with AE&P), and it will be reduced only by the following two types of transactions:

a. Distributions of AE&P; or

b. Certain redemptions, reorganizations, liquidations, or corporate divisions.

D. Distributions When the Corporation Does Not Have AE&P.

1. If the corporation does not have AE&P, the tax character of a distribution is determined under a two-tier system as follows:

a. A nontaxable return of capital to the extent of the adjusted basis of the stock; then

b. Capital gain from the deemed disposition of stock.

Example. Assume that Bill had basis of $30,000 in the stock of Esscorp at the beginning of the year. The corporation has nonseparately stated income of $10,000 during the year, and Bill received a distribution of $45,000 on July 1. The tax character of the distribution is computed as follows:

Calculation of Basis:	
Basis, beginning of year	$30,000
Income for the year	10,000
Subtotal	40,000
Less distributions during the year (to the extent of basis)	(40,000)
Basis, end of year	$---
Taxability of Distribution:	
Nontaxable, to extent of basis	40,000
Capital Gain from the deemed disposition of stock	5,000
TOTAL DISTRIBUTION	$45,000

E. Distributions When the Corporation has AE&P.

1. If the corporation has AE&P, more tiers are required to determine the taxability of distributions. The first tier is called the accumulated adjustments account, or AAA. It generally represents the amount of previously taxed earnings accumulated in an S corporation after 1982. If there is AE&P, the distribution order is:

a. A distribution of AAA, nontaxable to the extent of basis in stock;

b. A dividend, to the extent of AE&P;

c. A nontaxable reduction of basis, to the extent of remaining basis; and

d. Capital gain from the deemed disposition of stock.

2. If the shareholder's basis is less than the AAA, distributions are nontaxable to the extent of basis in stock and are capital gain to the extent they exceed basis.

3. The corporation also can have previously taxed income (PTI) from years beginning before 1983 that can be distributed free of further tax to the extent of a shareholder's basis. PTI is distributed after AAA, but before AE&P.

4. An S corporation can elect to distribute AE&P before distributing AAA.

F. Accumulated Adjustments Account (AAA).

1. S corporations maintain an accumulated adjustments account (AAA), an account that tracks the amount of undistributed income that has been taxed to the shareholders after 1982. The AAA (to the extent of basis) can be distributed to the shareholder free of further tax. It is not mandatory to keep an AAA if the S corporation does not have AE&P, but it may be beneficial to maintain it in any event, because part or all of the amount in the AAA can be distributed tax free after the S corporation election terminates.

2. The AAA begins at zero on the first day of the S corporation's first taxable year beginning after 1982.

a. It is increased by:

(1) separately and nonseparately stated items of income (but not by tax-exempt income), and by

(2) the excess of the corporation's deductions for depletion over basis of the property subject to depletion.

b. It is decreased by:

(1) separately and nonseparately stated items of loss or deduction (but not by expenses relating to tax-exempt income);

(2) corporation expenses that are neither deductible nor capitalizable (such as the nondeductible portion of meal expenses, fines, and nondeductible fringe benefits);

(3) the amount of the shareholder's deduction for depletion of oil and gas wells under IRC Section 611; and by

(4) distributions that are not includable in the shareholder's income (i.e., distributions that are a nontaxable return of capital to the extent of basis).

3. As stated at F.2., above, nondeductible expenditures reduce the AAA. However, there is one exception to this rule. If the S corporation pays federal income taxes attributable to the C corporation period, the AAA is not reduced; rather, the shareholder's basis is reduced.

4. Corporate losses and deductions (but not distributions) can reduce the AAA below zero.

5. The AAA is a corporate level account. Therefore, if a shareholder sells his shares, the purchaser acquires a prorata portion of the AAA.

6. The AAA can have a different balance for book purposes than it does for tax purposes.

G. Adjustments to Basis and AAA Compared.

1. The AAA generally is increased and decreased by the same adjustments as shareholder basis. Capital contributions, tax-exempt income, and expenses attributable to tax-exempt income are the most common exceptions to the rule. Tax-exempt income increases basis and expenses relating to tax-exempt income decrease basis, but these items do not increase or decrease the AAA. Because of this rule, tax-exempt income cannot be distributed tax-free until the corporation has distributed its AE&P. Also, federal taxes paid by the S corporation that are attributable to the C corporation (prior to its S election) reduce shareholder basis, but do not decrease the AAA.

2. Basis cannot be reduced below zero. However, the AAA can have a negative balance caused by corporate losses and deductions (but not by distributions).

3. AAA and AE&P are maintained at the corporate level. Keeping track of basis, however, is the responsibility of the individual shareholders. The AAA is reconciled on Schedule M of Form 1120S.

H. Examples of Distributions When Corporation has AE&P.

1. Application of Distribution Tiers. Assume that Jack is the sole shareholder in Esscorp. His stock basis at the beginning of the year is $35,000. At that time, the corporation shows the following balances:

AAA	$30,000
AE&P	38,000

Esscorp distributes $80,000 to Jack during the year. At year-end, the corporation's pass-through items were as follows:

Nonseparately stated (taxable) income	$41,000
Capital gain	4,000
Nondeductible portion of meal expense	2,000

The first step in the calculation is to determine Jack's stock basis, before considering the distributions. In this case, his basis is $78,000, determined as follows:

Balance, beginning of year	$35,000
Adjustments for income and expense:	
Nonseparately stated income	41,000
Capital gain	4,000
Nondeductible portion of meal expense	(2,000)
Balance, before distributions	$78,000

The balances in AAA and AE&P are computed as follows:

	AAA	**AE&P**
Balances, beginning of year	$30,000	$38,000
Adjustments for income and expense:		
Nonseparately	41,000	--
Capital gain	4,000	--
Nondeductible portion of meal expense	(2,000)	--
Balances, before distributions	73,000	38,000
Distributions:		
AAA	(73,000)	--
AE&P ($80,000-$73,000)	--	(7,000)
Balances, end of year	$ --	$31,000

The taxability of distributions is as follows:

	Nontaxable	**Dividend**	**Capital Gain**	**Total**
AAA	$73,000	$ --	$ --	$73,000
AE&P	--	7,000	--	7,000
TOTALS	$73,000	$7,000	$ --	$80,000

Jack's basis at the end of the year is $5,000, computed as follows:

Balance, before distributions	$78,000
Nontaxable distributions	(73,000)
Balance, end of year	$5,000

Notice that the AAA and basis are reduced by nontaxable distributions. Taxable distributions, such as those from AE&P, do not affect either basis or the AAA.

2. Distributions that Exceed AAA and AE&P. Assume the same facts as in paragraph H.1., except that the distributions during the year were $120,000. In that case, the taxability of the distributions is determined as follows:

Calculation of AAA and AE&P:

	AAA	**AE&P**
Balances, before distributions	$73,000	$38,000
Distributions:		
AAA	(73,000)	--
AE&P (120-73=47, LTD to 38)	--	(38,000)
Balances, end of year	$ --	$ --

Calculation of basis:

Basis, before distributions	$78,000
Nontaxable distributions of AAA	(73,000)
Nontaxable return of basis (to extent of remaining basis)	$5,000
Basis, end of year	$ --

Taxability of distributions:

	Nontaxable	**Dividend**	**Capital Gain**	**Total**
AAA	$73,000	$ --	$ --	$73,000
AE&P	--	38,000	--	38,000
Nontaxable to extent of basis	5,000	--	--	5,000
Capital gain from deemed disposition	--	--	4,000	4,000
TOTALS	$78,000	$38,000	$4,000	$120,000

After AE&P has been distributed, the distribution tiers drop back to two: nontaxable to extent of basis and capital gain from deemed disposition of stock.

3. Distributions When AAA Exceeds Basis. The calculation of the tax effect of distributions differs if stock basis is less than the AAA because AAA distributions are nontaxable only to the extent of stock basis. Distributions that exceed basis, up to the amount in the AAA, are capital gain from the deemed disposition of stock.

Assume the same facts as in paragraph H.2., except Jack's stock basis at the beginning of the year is $21,000. Now the tax treatment of the $120,000 distribution is computed as follows:

Calculation of basis, before distributions:	
Balance, beginning of year	$21,000
Adjustments for income and expense:	
Nonseparately stated income	41,000
Capital gain	4,000
Nondeductible portion of meal expense	(2,000)
Balance, before distributiosn	$64,000

Calculation of AAA and AE&P		
	AAA	**AE&P**
Balances, before distributions	$73,000	$38,000
Distributions:		
Nontaxable (to extent of basis)	(64,000)	--
Dividend (to extent of AE&P)	--	(38,000)
Balances, end of year	$9,000	$ --

Taxability of distributions:

	Nontaxable	**Dividend**	**Capital Gain**	**Total**
AAA	$64,000	$ --	$ --	$64,000
Capital gain from deemed disposition of stock up to balance of AAA	--	--	9,000	9,000
AE&P	--	38,000	--	38,000
Capital gain from deemed disposition of	--	--	9,000	9,000

stock				
TOTALS	$64,000	$38,000	$18,000	$120,000

*** Distributions of AAA are nontaxable to the extent of basis and then are taxed as capital gain to the extent of the remaining amount of the AAA. AE&P is distributed next, and, since basis has been reduced to zero, any distributions in excess of AE&P are capital gain.

I. Other Adjustments Account.

1. Schedule M of Form 1120S is intended to show the changes to shareholder basis and the taxability of distributions. For Schedule M purposes, the accumulated adjustments account (AAA) and other adjustments account (OAA) should be calculated using tax (not financial) accounting concepts. The AAA should be adjusted by: (i) all separately and nonseparately stated items that are used to compute shareholder taxable income; (ii) expenses that are not deductible and properly not capitalized (excluding federal income tax); and (iii) nontaxable return of capital distributions. The OAA should be adjusted by: (i) tax-exempt income and related expenses and (ii) other items that are not adjusted to another shareholder equity account.

2. In combination, AAA, OAA, and PTI represent the cumulative net change to shareholder basis in the S corporation's stock.

3. The balance sheet (Form 1120S, Schedule L) AAA and OAA can be different from Schedule M amounts. Any variances should be based solely on differences between tax and financial accounting principles (e.g., accelerated versus straight-line depreciation methods). A statement should be attached to the return that explains and reconciles any book or tax differences.

4. The OAA has no significance when determining the taxability of distributions. Once the AAA and AE&P have been distributed, the distribution tiers drop back to two: tax-free recovery of stock basis and capital gain from the deemed disposition of stock after basis has been reduced to zero.

J. Previously Taxed Income (PTI).

1. The AAA applies to tax years beginning after 1982. Prior to that, undistributed income that had been taxed to the shareholders was known as previously taxed income (PTI). If an S corporation had PTI at the start of the tax year beginning in 1983, the PTI carried over to the post-1982 years. PTI can be distributed tax-free as long as the S corporation

election remains in effect, sufficient basis exists, and shareholders retain their shares. PTI is distributed after the AAA, but before AE&P. Therefore, the distribution order, if there is PTI, is:

a. AAA to the extent of basis;

b. PTI to the extent of remaining basis (assuming stock basis exceeds AAA);

c. AE&P;

d. Nontaxable reduction of basis, to the extent of remaining basis; and

e. Capital gain from the deemed disposition of stock.

2. Since the taxable nature of distributions cannot be determined until after the results of the year's operations are known, it is difficult to distribute all of the AAA and PTI without also causing a distribution of AE&P. However, if AAA is reduced to (or below) zero, PTI can be distributed tax-free if the shareholder has sufficient basis.

3. If the corporation does not have AE&P, all distributions are nontaxable to the extent of the shareholder's basis in the stock and are capital gain from the deemed disposition of stock after basis has been recovered.

K. Comparison of PTI and AAA.

1. PTI differs from AAA in a number of respects:

a. PTI arose from operations of the S corporation before 1983 and is not affected by current operations.

b. PTI belongs to a specific taxpayer and cannot be acquired by a successor shareholder, while a new shareholder does acquire a prorata share of the AAA.

c. PTI is not available for tax-free distribution after the S election terminates. AAA can be distributed during the post-termination transition period.

2. PTI loses its ability to be distributed as a separate nontaxable layer when the S election terminates or when the shareholder disposes of shares. Because PTI does not survive these events, it is prudent to distribute PTI as soon as possible.

L. Election to Distribute AE&P Before AAA.

1. An S corporation can elect under IRC Section 1368(e)(3) to distribute AE&P before distributing AAA, thereby causing the shareholder to report dividend income.

2. Generally, an S corporation shareholder will want distributions to be nontaxable, i.e., to be distributions of AAA. There are situations, however, that make taxable distributions of AE&P beneficial. Some of these situations are as follows:

a. The shareholder wants to take advantage of lower tax brackets in the year of AE&P distribution and expects higher tax rates in future years.

b. The corporation is vulnerable to involuntary termination of the S election because of excess passive investment income. The threat of termination applies only if the corporation has (C corporation) AE&P for three consecutive tax years.

c. The corporation is subject to the tax on excess net passive income. The tax applies only if the corporation has (C corporation) AE&P.

d. The shareholder has a net operating loss that can be utilized if the shareholder reports offsetting income.

e. The shareholder is subject to the alternative minimum tax due to exclusion preferences (permanent differences) so that income is taxed at a 26-28% rate as opposed to a 39.6% rate in a year in which AMT does not apply.

f. The corporation receives tax-exempt income that can be distributed tax-free after AE&P is eliminated.

g. The shareholder has investment interest expense that cannot be deducted unless the shareholder reports investment income.

h. The shareholder has an unused investment interest expense carryforward that can be utilized if investment income is reported.

i. The shareholder could obtain a dividends-paid deduction for the accumulated earnings tax or personal holding company tax attributable to years prior to becoming an S corporation.

3. If the corporation has insufficient cash to distribute all of its AE&P, the corporation can distribute its own notes payable to the shareholders. The notes should bear market-rate terms and meet the "straight-debt" criteria of IRC Section 1361(c)(5) to avoid a second-class-of-stock taint. The IRS ruled privately that the AE&P would be reduced by the principal amount of the distributed notes, and that no gain would be recognized by the corporation under IRC Section 311(B) for distributions of appreciate property. The shareholders, however, receive dividend income in the year the notes are distributed.

4. The election to distribute AE&P applies to all distributions made during the taxable year, to the extent of the AE&P balance. The corporation cannot pick and choose specific distributions as coming from AE&P. Also, the corporation cannot treat only a portion of distributions as dividends; if the election is made, all distributions during the year are dividends until the AE&P balance has been reduced to zero.

a. There is no specific form for the election.

M. Distributions of Property. Distributions of appreciated property are treated as though the property had been sold to the distributee shareholder at its fair market value. Distributions of appreciated property can cause tax at the corporate level if the corporation is subject to the built-in gains tax or the capital gains tax. No loss is allowed if the distributed property has a fair market value that is less than the corporation's tax basis in such property.

N. Capital Gains.

1. The Tax Reform Act of 1986 repealed the capital gains exclusion. Consequently, distributions that are capital gains from the deemed disposition of stock are taxed at ordinary rates.

2. Even though ordinary rates apply, it is still necessary to determine the capital gains portion of distributions because capital gains can offset capital losses. Capital gains can also be important at the corporate level; the tax on capital gains continues to apply to certain S corporations.

O. Income Should Be Distributed Currently.

1. As a general rule, income should be distributed in the taxable year in which it is passed through to shareholders. Distributing income currently eliminates a problem that can arise if the corporation experiences a loss in a subsequent year. The loss reduces basis and AAA and can cause distributions to be taxable.

2. Distributing income currently also can be beneficial if the S corporation election terminates. The AAA can be distributed free of tax-free during the post-termination transition period, but after that period has expired, the AAA loses its tax-free attributes. It is conceivable that the S corporation election could terminate, and the corporation would not have the cash to distribute the AAA during the post-termination transition period. If income is distributed currently, the AAA is kept at a minimum, and its distribution during the post-termination transition period is not a problem.

3. Another reason for distributing income currently is to maintain the AAA at a low level so it can be distributed easily when a shareholder disposes of corporate interest. The departing shareholder undoubtedly will want to receive a distribution out of AAA, but this may not be possible if the corporation is experiencing a cash shortage. By always distributing income currently, the shareholders who are taxed on corporate pass-through are the ones who receive the distributions.

4. Even current income cannot always be distributed tax-free. This occurs when distributions exceed basis for S corporations with no AE&P (thereby generating a capital gain), or when losses have reduced the AAA below zero for companies with AE&P (triggering dividend income). No further distributions can be made from AAA until it has been replenished by income. Also, tax-exempt income cannot be distributed tax-free until all AE&P has been distributed.

5. If the S corporation borrows the funds to make distributions, the corporation has a great deal of flexibility concerning the treatment of the interest expense associated with the borrowed funds. Under the interest tracing rules, the interest expense is allocated in accordance with the shareholder's use of the distributed loan proceeds. However, the corporation can elect to allocate the interest on the borrowed funds to one or more of the corporation's expenditures (other than distributions) that are made during the same tax year, to the extent that other debt proceeds are not allocated to such expenditures. In addition, the borrowed funds cannot exceed the corporation's expenditures for the year to which debt proceeds are allocated.

P. Loans to Shareholders as Planning Devices. The taxable nature of distributions cannot be determined until income or loss for the year has been computed. This makes if difficult to distribute the exact amount of current income or the precise balances in the AAA and PTI. Loans can be an effective way to ensure that distributions are from AAA or PTI and are not taxable distributions of AE&P. Loans to shareholders can be made during the year; then, when it is close enough to the end of the year that realistic income estimates can be calculated, distributions can be made to shareholders, and the shareholders can use the distributions to repay the loans.

1. Loans can be used to avoid taxable distributions when the shareholders want to receive cash from the corporation, and the balances in AAA, PTI or the shareholders' bases are insufficient to allow a nontaxable distribution.

2. Loans always should be properly documented and should bear a fair rate of interest.

Q. IRS May Recharacterize Distributions as Wages. Pass-through and distributions from an S corporation are not subject to self-employment tax, while wages paid to a shareholder by the corporation are subject to FICA, FUTA, and other payroll taxes. Therefore, an S corporation shareholder may be tempted to reduce or eliminate shareholder salaries to avoid payroll taxes. The IRS has ruled, however, that distributions from an S corporation can be recharacterized as wages subject to payroll taxes if they are actually disguised wages. The tax practitioner should be certain to advise that S corporation clients pay reasonable salaries to their shareholders (especially in a year in which corporate distributions are made). Otherwise, valid reasons (such as a cash shortage) for not paying adequate salaries should be documented.

VIII. PASSIVE ACTIVITY LOSSES.

The basic premise of the passive activity rules is that passive losses are deductible only to the extent of passive income. If aggregate losses from all passive activities exceed the aggregate income from such activities, the taxpayer incurs a passive activity loss that cannot be deducted from nonpassive income. Nonpassive income ("nonpassive item") includes:

- income from a trade of business in which the taxpayer materially participates,
- salaries and wages, and
- portfolio income (generally interest, dividends and gains from sale of investment property).

These items retain their separate character as active trade or business income or portfolio income for tax purposes and are reported separately by the individual S corporation shareholders. Losses and credits that cannot be used because of the passive activity loss rules become "suspended" and carry forward indefinitely to apply against future passive activity income. Special rules allow utilization of suspended passive losses upon disposition of the passive activity or at the death of the shareholder.

Passive losses are not limited at the S corporation level. Rather, items of income, loss, deduction and credit are passed through to shareholders, and the appropriate limitations are determined on the individual shareholders' tax returns.

A. Passive Activity.

1. A passive activity is defined as:

a. any rental activity, or

b. a trade or business in which the taxpayer does not materially participate.

Rental activities are passive regardless of whether the taxpayer materially participates. However, certain activities that appear to be rental activities are not treated as rental activities under the temporary regulations. Under certain circumstances, losses from rental real estate activities are recategorized and can be deducted against nonpassive income.

2. Each pass-through item of income, gain, loss, or deduction must be categorized as passive or nonpassive.

B. Effects of Shareholder Participation on Pass-Through.

1. Nonseparately Stated Income. Nonseparately stated income or loss passed through to an S corporation shareholder is passive or nonpassive depending on whether the shareholder materially participates in the corporation's trade or business. Generally, if a shareholder materially participates in the S corporation's trade or business, the trade or business will not be classified as a passive activity and the passive loss limitations will not apply. If the S corporation is involved in more than one trade or business, the passive or nonpassive status must be determined for each such activity for each shareholder.

2. Separately Stated Items. Certain separately stated items also must be characterized as passive or nonpassive. If shareholder participation is relevant to a separately stated item, the character of the item is determined by reference to the shareholder's participation in the activity that generated the item. for certain other pass-through items, shareholder participation is not relevant, and the item is categorized according to the specific rules relating to that item. For example, interest income from the investment of working capital is classified as portfolio income regardless of shareholder participation.

3. Material Participation.

a. In general, an individual will be treated as materially participating in an activity if one of the following applies:

(1) The individual participates in the activity for more than 500 hours during the tax year.

(2) The individual's participation for the year constitutes substantially all of the participation in the activity of all individuals, including nonowners.

(3) The individual participates for more than 100 hours during the year, and no other individual, including nonowners, participates more hours than the taxpayer.

(4) The activity is a "significant participation activity," and the taxpayer's aggregate participation in all significant participation activities is more than 500 hours. A significant participation activity, generally, is one that the taxpayer participates in for more than 100 hours during the year.

(5) The individual materially participated for any five taxable years during the 10 immediately preceding taxable years. The five years do not have to be consecutive.

(6) The activity is a personal service activity, and the taxpayer materially participated in the activity for any three taxable years preceding the taxable year. A personal service activity for these purposes is an activity in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income producing factor.

(7) Based on all facts and circumstances, the individual materially participates on a regular, continuous, and substantial basis. This is a subjective test that evidently will be used if the shareholder does not fit into one of the other categories; but the individual's annual participation must be at least 100 hours and cannot include management activities unless no other person receives compensation for services rendered to that activity.

b. Participation includes any work done by an individual who owns an interest in the activity. If the taxpayer has a tax avoidance motive (e.g., is attempting to convert a passive loss to a nonpassive loss), hours are counted only if the work is of a type customarily done by an owner. The extent of an individual's participation in an activity can be established by any reasonable means, including (but not limited to) appointment books, calendars or narrative summaries.

c. Participation is determined by reference to the S corporation's taxable year rather than the shareholder's tax year. Also, if one spouse materially participates in the operations of the business, both spouses are deemed to materially participate.

C. Definition of an Activity.

D. Portfolio Income.

1. An S corporation shareholder (or any other individual taxpayer) cannot offset portfolio income against passive activity losses. Each item of portfolio income received by an S corporation is passed through to shareholders as a separately stated item on Schedule K-1 of Form 1120S.

2. Portfolio income includes interest, dividends, annuities and royalties not derived in the ordinary course of business. When property that generates portfolio income is disposed of, the gain or loss on the disposition is portfolio income. Gain or loss from the disposition of property held for investment (other than passive activity property) is also portfolio income. Portfolio income is reduced by expenses that are allocable to that income.

3. Portfolio income does not include income received in the ordinary course of business. Therefore, interest charged on accounts receivable is not portfolio income. Neither is dividend income received by a securities broker/dealer in the ordinary course of business. However, income from an investment of working capital is portfolio income, even if the income from the investment is used for the reasonable needs of the business and is necessary to the business. For example, if an S corporation invests funds for the purpose of buying inventory and later uses both the invested funds and the interest earned by those funds to purchase inventory, the interest income is portfolio income.

4. The income that a shareholder receives from an S corporation may or may not be portfolio income. Pass-through items can include portfolio income earned by the S corporation. Distributions of accumulated earnings and profits (AE&P) are portfolio income and not passive activity income to the shareholder.

If a shareholder makes a loan to an S corporation, the interest income from that loan can be offset by the shareholder with interest expense passed through by the corporation. This is the co-called "self-charged interest" rule.

E. Interest Expense.

1. Interest paid by the corporation can be passed through as a component of taxable income, as investment interest expense, or as other interest, depending on how the loan proceeds are used.

a. The treatment of interest expense that the shareholder incurs to purchase or carry S corporation stock may be trade or business interest expense (as opposed to a passive activity deduction) depending on the shareholder's participation in the business and the allocation of the debt to the corporation's assets (which can be done on any reasonable basis).

b. Self-charged interest -- portfolio income can be recharacterized as passive to "offset" the expense.

F. Rental Income or Loss.

1. Passive Nature of Rental Income or Loss. Income or loss from a rental activity generally is generally passive, unless the corporation provides significant services or incurs substantial costs in the rental business. Some related activities, however, are not considered rentals. For instance, operating a hotel or other similar transient lodging where substantial services are provided is not a rental activity.

2. Special Rule for Rental Real Estate. Even though rental income or loss generally is passive, a special rule allows some individuals (and certain estates) to offset up to $25,000 of nonpassive income with rental real estate losses and credits. To qualify for this special treatment, the taxpayer must own at least 10% of the value of all interests in the activity at all times during the tax year, and the taxpayer (S corporation shareholder) must "actively" participate in the operations of the rental property in both the year the loss is incurred and the year that recognition is sought, if different (under the carryover provisions).

3. Tax Return Reporting. S corporations must report rental real estate income and losses on Form 8825.

G. Oil and Gas. A special rule allows an oil and gas working interest to be treated as nonpassive under some circumstances. This rule does not apply to oil and gas interests held by S corporations, however, because the rule requires that the shareholder's liability not be limited.

H. Carryover of Unused Passive Losses.

1. Losses (and credits) that cannot be used because of the passive loss limitation rules are suspended and carry over indefinitely to be offset against future passive activity income. suspended losses can be applied against passive activity income from any source, not just from the activity that created the loss.

2. When a taxpayer disposes of the entire interest in a passive activity, that activity is no longer subject to the passive activity rules. If the activity is disposed of in a fully taxable transaction to an unrelated party, suspended losses and any loss upon disposition of the interest can be deducted, first against current net passive income and then against nonpassive income.

3. If the disposition results in a capital loss, the $3,000 capital loss limitation is applied before the offset against other income taxes place. Resulting capital loss carryovers

are not subject to the passive loss rules in years following the year of disposition. When the S corporation stock is disposed of in an installment sale, suspended losses from the activity are deductible over the term of the obligation, in proportion to the gain recognized each year.

I. Passive or Nonpassive Nature of Gain on Disposition of Property.

1. Disposition of Property. Gain or loss from the disposition of property retains the nonpassive or passive character of the activity in which the asset was used. For example, gain or loss from the sale of assets used in the operation of a trade or business is nonpassive if the taxpayer materially participates in the business. It is passive if the taxpayer does not materially participate. Gain or loss from the sale of assets (such as marketable securities) that generate portfolio income is portfolio (nonpassive) income or loss. Gain or loss on the disposition of rental property is passive income or loss.

2. Disposition of S Corporation Stock. The disposition of S corporation stock is treated as a disposition of an interest in each of the S corporation's activities, i.e., trades or businesses, rentals or investment activities. Thus, if all of the S corporation's assets are used in the operation of its business, gain or loss on the disposition of the shareholder's stock is characterized by shareholder participation in the business. It is not passive if the shareholder materially participated in the operations of the business and passive if the shareholder did not materially participate. Matters are more complicated, however, if the S corporation owns assets other than those used in its trade or business, e.g., investments or rental property. In that case, the general rule is that gains or losses are allocated among activities as if the S corporation had sold its assets on the "applicable valuation date."

a. Generally, the applicable valuation date is either:

(1) the beginning of the S corporation's tax year in which the shareholder disposes of stock, or

(2) the date on which the stock disposition occurs.

b. The S corporation (rather than the shareholder) chooses the applicable valuation date.

J. Certain Passive Income Treated as Nonpassive. The IRS has authority to recharacterize passive income items as nonpassive. Congress granted this authority to limit a taxpayer's ability to convert nonpassive income into passive income that would offset passive losses. (Note that this puts the IRS in a "heads-I-win, tails-you-lose" position on these items because losses are passive and income is recharacterized as nonpassive.)

The IRS has identified six situations that will cause a portion of the gross passive income to be reclassified as nonpassive.

1. Property Rented to a Nonpassive Activity (Self-Rented Property). This recharacterization rule affects taxpayers who rent property to a trade or business in which the taxpayer materially participates. In that case, losses from the rental are passive, but the amount of gross rental income equal to the net rental activity income from the property for the year is recharacterized as nonpassive income. This rule does not apply to income attributable to the rental of property under a written, binding contract entered into before February 19, 1988.

Example: Assume that Joe owns all of the stock of Joecorp, an S corporation. He rents equipment to the corporation beginning in March 1988 and incurs expenses of $10,000 from the property for the year. The gross rental income is $12,000 for that year. the $10,000 expenses are deductible up to the income from the rental; the remaining $2,000 of income is recharacterized as nonpassive.

2. Significant Participation Activities. Significant participation occurs when the taxpayer works more than 100 hours in an activity. A taxpayer who works more than 500 hours in all significant participation activities combined is considered to materially participate in those activities, and income and losses from such activities will be nonpassive. If the taxpayer works fewer than 500 hours in all significant participation activities combined, overall losses from the significant participation activities are passive, but if there is net gain, a portion of the gross rental income will be recharacterized as nonpassive. In such cases, the net income of each activity with positive net income for the year is multiplied by a fraction; the numerator is the combined net income for all significant participation activities and the denominator is the combined net income for the activities with positive net income. The result is the amount of gross income for each activity with positive net income that is recharacterized as nonpassive.

Example: Janet is a shareholder in two S corporations, Acorp and Beecorp. She works in Acorp 200 hours during the year and in Beecorp 125 hours during the year. Her nonseparately stated (taxable) pass-through income from Acorp is $12,000, consisting of $15,000 income and $3,000 of deductions. Beecorp passes through a $10,000 nonseparately stated loss to her consisting of $20,000 income and $30,000 of deductions. Gross income from Acorp of $2,000 ($12,000 x $2,000/$12,000) is recharacterized as nonpassive. In effect, the $10,000 net loss from Beecorp is offset by $10,000 of the net income from Acorp. The remaining $2,000 of

Acorp's income is deemed nonpassive. (An overall loss would be passive.) If Janet had worked more than 500 hours in the activities (say, 400 in Acorp and 125 in Beecorp), she would be deemed to materially participate in the operations of the corporations and both overall income and losses would be nonpassive.

3. Rental of Nondepreciable Property. Generally, rental income or loss is passive. But net income from a rental activity will be recharacterized as nonpassive if less than 30% of the unadjusted basis of the rented property is subject to depreciation. This rule effectively prevents rental income from farmland and other nondepreciable real estate from creating passive income to offset passive losses.

4. Net Passive Income from a Passive Equity-Financed Lending Activity.

5. Net Income from Property Rented Incidental to Development Activity.

6. Income from Licensing of Intangible Property by a Pass-Through Entity.

IX. TAX ACCOUNTING PERIODS AND METHODS.

A. Introduction.

1. Fiscal Years. S corporations, partnerships and personal service corporations can retain or adopt fiscal years if certain conditions are met. However, there is a significant cost. Most S corporations that use a fiscal year must make an election under IRC Section 444 and must pay for the privilege by making "required payments." The rules also allow an S corporation to retain or adopt a fiscal year without making required payments if there is a business purpose for the year.

2. Accounting Methods. S corporations must use an accounting method that clearly reflects income. S corporations, unlike C corporations, are not subject to the TRA '86 requirement to use the accrual method of accounting, unless the S corporation is a "tax shelter."

3. Fringe Benefits. There are limitations associated with fringe benefits paid on behalf of shareholders owning more than 2% of the corporation's stock.

4. IRS Audit Procedures. S corporations are subject to the same uniform audit procedures as partnerships, whereby examinations are conducted at the corporate level. An exception applies to small S corporations.

B. Fiscal Years.

1. Permitted Year. The S corporation taxable-year rules, which are similar to those governing partnerships, state that an S corporation must use a permitted year.

a. A permitted year is a taxable year that:

(1) ends on December 31, or

(2) is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS.

(a) Business Purpose. Rev. Proc. 87-32 (1987-2 C.B. 14), provides that, to establish a business purpose, S corporations must:

i) Satisfy the natural business year test (the 2 month/25% test) set forth in Rev. Proc. 83-25;

ii) Satisfy an ownership tax year test, in which the entity can use the same tax year as that of shareholders owning more than 50% of its stock; and

iii) Otherwise establish a business purpose based on all the facts and circumstances, including the tax and nontax consequences.

a) Rev. Rul. 87-57, 1987-2 C.B. 117, sets forth situations illustrating when a satisfactory business purpose will be deemed to exist. Under the ruling, if the requested tax year creates deferral or distortion of a taxpayer's income, the taxpayer must demonstrate compelling reasons -- more than just issues of convenience -- for the requested tax year.

b. The Section 444 Election.

(1) As an alternative to using a permitted year, IRC Section 444 allows an S corporation to elect to use a fiscal year if the fiscal year meets certain criteria. IRC Section 7519 states that the entity must make required payments if a fiscal year is elected. The required payments are intended to approximate the amount of tax that would be paid by the shareholder if the corporation changed to a calendar year. Thus, in most cases, the payments offset the income tax deferral provided by the fiscal year.

(a) A very important exception allows an S corporation with an acceptable business purpose to retain or adopt a fiscal year without making the Section 444 election. An S corporation that has a business purpose for its fiscal year is exempt from the Section 444 rules and does not have to make required payments.

(2) If the Section 444 election is made, there are restrictions on the fiscal years that can be chosen. Corporations making the Section 444 election are limited to year-ends of September 30, October 31 or November 30.

c. User Fee for Fiscal Year Applications. A user fee is assessed when an S corporation applies for a business-purpose fiscal year, other than one that will be expeditiously approved.

C. Accounting Methods.

1. Overall Methods of Accounting. An S corporation, although usually not a taxpaying entity, may opt to use accounting methods separate from the methods used by its shareholders.

2. Specific Accounting Methods. An S corporation, like all tax entities, can choose (but must refrain from changing without permission) its method of accounting for such items as depreciation, inventory costing, installment reporting, etc.

3. LIFO Recapture. RA '87 contained a provision that affects C corporations electing S status while using the LIFO inventory method. The C corporation must recognize as income the excess of the inventory's FIFO value over its LIFO value at the end of the last C corporation year. The increase in tax generated by such inclusion is payable in four annual installments beginning with the final C return.

4. Installment Sales. Like other entities, an S corporation can report sales of nondealer property on the installment method.

5. Interest Capitalization Rules. TRA '86 requires the capitalization of interest incurred on debt that is allocable to the production of "qualified property."

a. Shareholder Interest Expense. With respect to S corporations, as well as other pass-through entities, interest capitalization requirements are to be applied first at the corporate level and then at the shareholder level. After the corporation applies its accumulated production expenditures to its traced and avoided-cost debt, any excess expenditures are allocated to the shareholders who in turn are subject to the interest capitalization rules (the tracing and avoided-cost rules) at the shareholder level. Therefore, the shareholders may be forced to capitalize interest that was not residence, personal, or otherwise traceable interest on debt incurred at the shareholder level. In such cases, the shareholder will maintain an asset consisting solely of the capitalized interest attributable to the shareholder's portion of the S corporation's production expenditures. The shareholder will then account for such capitalized interest in the same manner as the corporation would have accounted for such interest (i.e., depreciation, cost of goods sold). If the shareholder's interest in the S corporation is sold or exchanged, the remaining amount of such capitalized interest will be included in basis for purposes of computing gain or loss on disposition.

b. Corporate Level Interest Expense. Interest incurred by the S corporation that is not allocated to its own production expenditures, but is otherwise deductible, is treated as incurred by the shareholders. Therefore, when such interest is passed through, the interest capitalization rules will apply to any production expenditures of the shareholders. If such interest was incurred by the S corporation during a shareholder's period of production of qualified property, the shareholder must capitalize the pass-through interest to the extent the related corporate debt does not exceed the remaining production expenses of the shareholder. In such cases, the pass-through becomes an asset to the shareholder.

D. Fringe Benefits. In a C corporation, the cost of fringe benefits is generally deductible at the corporate level, and the employee who receives the benefit can generally exclude the value from income. In an S corporation, however, employee fringe benefits paid on behalf of a "2% shareholder" are subject to special rules. There is uncertainty regarding which fringe benefits are subject to these special rules, as well as the mechanics of implementing the restrictions. However, the benefits affected by these rules appear to include:

- group-term life insurance coverage up to $50,000,
- medical reimbursement plans,
- payments to accident and health plans,
- disability plans,
- meals and lodging furnished for the convenience of the employer,
- the $5,000 death benefit exclusion, unless paid out of a qualified plan, and
- cafeteria plans.

Some fringe benefits evidently are not covered by the special rules. These include:

- pension and profit sharing plans,
- death benefit exclusion, if paid from a qualified plan,
- group legal services,
- dependent care assistance, and
- no-additional-cost services, qualified employee discounts, working condition fringes, and de minimis fringes.

The cost of these fringe benefits is deductible by the corporation, up to the limits specified in the relevant Code sections, regardless of the percentage of stock that the recipient shareholder owns.

1. 2% Shareholder Rules. The Code states that, in the case of employee fringe benefits, an S corporation will be treated as a partnership, and a two-percent shareholder will be treated as a partners in a partnership. A two-percent shareholder owns more than 2% of the corporation's outstanding stock or owns stock possessing more than 2% of the combined voting power of the stock on any day during the tax year. Both direct and constructive ownership under the attribution rules of IRC Section 318 are used in determining the 2% amount.

a. The cost of fringe benefits paid on behalf of an employee who is not a two-percent shareholder is deductible by the corporation, and the value of the fringe benefit is excludable by the employee under the usual rules. However, it is not clear how the fringes paid on behalf of a two-percent shareholder are handled. The Senate Report to the Subchapter S Revision Act of 1982 (SSRA) says that these fringes are not deductible at the corporate level and that the shareholder can take a deduction on his individual return if the expense would otherwise be deductible. However, a corporate level deduction may be allowable if the cost of the fringe benefit is "reasonable" and is treated as compensation.

2. Retirement Plans. Subject to certain restrictions and limitations, shareholder-employees of C corporations can borrow from the corporation's qualified retirement plan without adverse tax effects. However, if a shareholder-employee owning more than 5% of an S corporation's stock borrows from its qualified plan, the loan is treated as a prohibited transaction. In such cases, the employee-shareholder is considered a disqualified person and, as such, is subject to a 5% penalty on the amount borrowed for each year the loan is outstanding. These rules pose a tax trap for a C corporation that is considering electing S corporation status. When an S election is made, any outstanding loans from the corporation's qualified plan to a five-percent-or-more shareholder will violate the prohibited transaction rules. There are no grandfather provisions to protect existing loans.

a. Nonqualified deferred compensation plans offer employers an alternative way to provide supplemental or expanded benefits to a targeted group of employees. Such plans can be designed without regard to the antidiscrimination rules governing qualified plans and can be much less expensive to establish and maintain than qualified plans. The employer gets a deduction for amounts that are reported as employee income. Provided that there are no substantial limitations or restrictions, an employee reports income with respect to a nonqualified plan to the extent amounts are paid, credited to an account, set apart, or otherwise made available.

b. One area of concern for S corporations considering or using a deferred compensation plan is the second class of stock issue. A second class of stock would cause immediate termination of S status. However, the IRS has ruled favorably on this issue with regard to so-called phantom stock plans.

E. IRS Audit Procedures. The present "unified audit procedures" require that all Subchapter S items be determined at the corporate level. Temporary regulations define "Subchapter S items" as virtually any item of income, deduction, or credit that potentially affects a shareholder's tax, including the characterization of shareholder contributions and distributions, and valuation of property transferred between the S corporation and its shareholders. Therefore, if the IRS wishes to assess additional tax at the shareholder level based on perceived incorrect treatment of an item at the corporate level, it is prohibited from initiating a deficiency proceeding against the shareholder. The IRS must first conduct a proceeding at the corporate level.

1. Exception for Small S Corporations. Small S corporations, defined as those having no more than five shareholders at any time during the year, are exempt from the unified audit procedures, thus allowing examination issues to be resolved at the individual shareholder level. However, small S corporations can elect to be subject to the unified procedures by attaching an election statement, signed by all shareholders, to the S corporation tax return for the first year the election is to apply. The election is binding on all future years unless the IRS grants permission for its revocation. Taxes payable at the S corporation level, such as the built-in gains continue to be subject to the unified audit procedures even if the small S corporation exemption applies.

2. Consistency Requirements. S corporation shareholders are required to treat S corporation items on a consistent basis with respect to the item's treatment on the corporate return. The only exception arises when the shareholder notifies the IRS of the inconsistency. Such notice is given on a completed Form 8082 attached to the shareholder's return. If a shareholder treats an item inconsistently and fails to provide notice, the IRS may make a computational adjustment to the shareholder's return without commencing a corporate proceeding or sending the shareholder a deficiency notice. The adjustment would make the shareholder's treatment of the item consistent with the corporation's treatment.

3. Tax Matters Person. S corporations may designate annually, in a space provided on the income tax return, a shareholder to serve as the "tax matters person" (TMP). A nonshareholder corporate officer or nonshareholder employee cannot be designated as the TMP.

4. Statute of Limitations. The statute of limitations is important at the S corporation level when the S corporation is liable for tax or when the corporation's S status has terminated for a given year. The statute also applies at the S corporation level for the determination of tax at the shareholder level when the unified audit procedures apply. No specific rules pertaining to S corporations exist; Congress simply made the partnership rules applicable to S corporations. The statute generally commences when Form 1120S is filed, or on the return's due date if the return is filed before that date.

a. Generally, if the unified audit procedures are not in effect, the statute runs separately for each shareholder of an S corporation and depends on the date on which the shareholder filed a return, not the date on which the S corporation filed its return. However, the Ninth Circuit Court of Appeals reversed and remanded a case to the Tax Court, ruling that once the statute of limitations had run on the S corporation's return, the IRS was precluded from adjusting the shareholder's return for S corporation matters.

b. A shareholder who omits the allocable share of S corporation income will be subject to a six-year statute of limitation if the item is material to the return, unless adequate disclosure is provided at both the corporate and shareholder levels.

F. Procedural Matters.

1. Estimated Taxes. In order to avoid an estimated tax underpayment penalty, S corporation shareholders must consider the effect that S corporation income has on their quarterly tax installments. The Code provides that S corporation income or loss is passed through to shareholders on a daily basis. A 1986 Private Letter Ruling clarifies this rule's application to estimated tax payments when calculating cumulative taxable income for the annualized income installment method. This ruling holds that shareholders must take into account their prorata share of the S corporation's actual taxable income for any S corporation year ending with or within their tax years to the extent that taxable income or loss was attributable to the months in the S corporation's tax year that ended on or before the due date of the payment period. The shareholder computes the amount of the S corporation's income or loss for a given period as if the S corporation's taxable year ended on the last day of the payment period.

This means that shareholders using the annualized income installment method must consider the S corporation income throughout the year, rather than taking the entire corporate income into account as of the date the corporate year ends. However, only S corporation income that will be included in the shareholder's current year return must be considered. For example, assume that the S corporation has retained a business-purpose taxable year ending on August 31 and its cumulative net income is as follows:

September 1 through March 31	$20,000
September 1 through May 31	$33,000
September 1 through August 31	$50,000

John, the sole shareholder, must consider these amounts in his estimate payments due April 15, June 15 and September 15, respectively. Income from the corporation's year, beginning september 1 of the current year, does not have to be considered because it will not be included in John's taxable income until his following calendar tax year.

Shareholders of seasonal businesses sometimes can apply these rules to their advantage. Losses early in the calendar year can be used to reduce estimated tax payments under the annualized income installment method. Conversely, shareholders of S corporations that earn proportionately more income in the earlier part of the year can avoid an estimated tax underpayment penalty by basing their quarterly tax payments on last year's tax if it produces the lowest tax payment

An S corporation is required to make estimated tax payments under IRC Section 6655. The requirements apply only if the corporation is subject to one or more of the taxes that can be assessed at the corporate level.

2. Filing Requirements. As with regular C corporations, the annual corporate tax return for an S corporation (Form 1120S) is due by the fifteenth day of the third month following the close of the taxable year and can be extended for six months by filing Form 7004 timely. Filing of Form 1120 instead of Form 1120S could revoke the S election if it is signed by a sole shareholder.

3. Penalties. If pass-through income or loss is computed incorrectly, a resulting penalty normally applies at the shareholder level. If the corporation's tax (e.g., built-in gains tax) is deficient, penalties may apply at the corporate level.

Penalties for late filing may also be assessed against an S corporation, but they are limited by the amount of tax on the return that, in most cases, is zero.

If an S corporation invests in a tax shelter, the S corporation and each shareholder must report the shelter's identification number on Form 8271. For purposes of the accuracy-related penalty of IRC Section 6662, disclosure and intent are generally tested at the S corporation level, but the shareholder should also consider disclosure on his or her own return of any questionable item reported by the corporation.

X. RECAP -- DECIDING TO ELECT S CORPORATION STATUS.

A. Tax Advantages Vis a Vis C Corporation Status. As opposed to C corporation status, S corporation status:

1. Generally avoids the double taxation of corporate income by having corporate income taxed in the shareholders' returns.

2. "Avoids" the maximum income tax rate imposed on certain personal service corporations that operate as C corporations.

3. Facilitates shareholder deduction of investment interest expense.

4. Passes through corporate losses, deductions and credits to the shareholders.

5. Shifts income to other members of the family.

6. Avoids the personal holding company tax for corporations with passive income and no C corporation earnings and profits.

7. Avoids the risk of an accumulated earnings tax.

8. Avoids the IRC § 448 requirement that forces certain C corporations to convert from the cash to the accrual method of accounting. (Note, however, that all tax shelters, regardless of C or S corporate status, must use the accrual method.)

9. Avoids the C corporation alternative minimum tax, particularly the adjustment for adjusted current earnings.

10. Achieves tax-free pass-through of tax-exempt interest income (contrast a distribution of tax-exempt income to a C corporation shareholder is fully taxable as a dividend).

11. Eliminates C corporation (unreasonable compensation) "deemed" dividend risk upon IRS audit.

12. Minimizes the appearance of a hobby loss issue.

13. Can decrease payroll tax costs by reducing corporate salaries (and increasing S corporation distributions).

B. Tax Disadvantages.

1. Potential prohibited transaction penalties and plan disqualification because of loans from qualified retirement plans to S corporation shareholder-employees.

2. Triggering of the built-in gains tax following conversion from C status to S status.

Caution: Corporations with appreciated receivables and inventory, such as service corporations with zero basis receivables or farm corporations with zero basis inventories, face imposition of the built-in gains tax in their first year of S status.

3. Restrictions on deductibility of pass-through losses and deductions to an S shareholder arising from:

a. insufficient tax basis (in stock and debt).

b. the passive activity rules -- lack of material participation by the shareholder.

c. of the at-risk rules.

4. Lack of certain special tax attributes that are available to regular corporations (e.g., 70% or 80% corporate dividend received deduction, use of existing C corporation ITC, NOL or capital loss carryovers, use of the 15% C corporation lower tax tier for earnings reinvested within the business).

5. The need to comply with the eligibility tests to preserve S status (i.e., 75 shareholder limit; prohibition against corporations, partnerships, and some trusts as S shareholders; restrictions against affiliated groups and banks as S corporations).

6. Imposition of a top-rate corporate tax if more than 25% of the gross receipts are from passive investment income and the corporation has accumulated earnings and profits from C corporation years.

7. Loss of statutory fringe benefits for shareholders who own, directly or indirectly, more than 2% of the stock of the S corporation. Because S shareholders are not subject to the self-employment Social Security tax, they may not qualify for the 25% medical insurance deduction in their Form 1040.

8. Conversion to a permitted tax year-end, generally December 31, or compliance with the Section 444 fiscal year election requirements.

9. Possible state income tax detriment (e.g., a state with taxing nexus does not recognize S status; if recognized, S income may be fully taxable to the shareholder based on state of residency compared to a C corporation's ability to apportion its income out of the state under the multi-state three-factor apportionment formula).

10. If a regular C corporation using the LIFO inventory method makes an S election after December 17, 1987, the LIFO reserve (excess of FIFO inventory amount over LIFO inventory) is recaptured, with the tax computed in the final C corporation tax return and payable in four equal annual installments.

11. Estate tax planning options regarding the shareholder's successor in interest are limited if an S election will be maintained after the shareholder's death; successors that are ineligible shareholders (such as complex trusts or simple trusts with more than one income beneficiary) will cause a termination of S status.

C. Nontax Considerations.

1. The attribute of limited legal liability favors an S corporation over a proprietorship or general partnership.

2. An S election can cosmetically improve the financial statement of a C corporation by eliminating the need to record income tax expense and liabilities.

D. C to S Conversion Issues/Problems.

1. LIFO Inventory; § 1363(d).

a. Rule. A C corporation that makes an S election must recapture and include in its gross income an amount equal to the "LIFO recapture amount."

b. The "LIFO recapture amount" is the excess of:

(1) The inventory amount of the corporation's inventory computed under the FIFO method; over

(2) The inventory amount computed under the LIFO method.

c. Applies only to corporations using the LIFO method at the time the S election is made.

d. The "LIFO recapture amount" must be included in the corporation's income for its last year as a C corporation.

e. The tax attributable to the LIFO recapture is spread over four years.

f. The basis of the inventory is increased by the amount of the LIFO recapture.

g. Presumably the corporation continues to use the LIFO method. However, the inventory amount has been increased to be the same as it would be on the FIFO method. Does this cause problems for computing inventory in the future?

2. Pension Plan Problems.

a. A pension plan sponsored by an S corporation is subject to the Keogh rules.

(1) A loan to a plan participant who is a 5% shareholder is prohibited. Thus, if there is an outstanding loan from the pension plan to a participant/5% shareholder at the time the S election becomes effective, the loan may subject the plan to excise taxes and may disqualify the plan. Therefore, such loans should be repaid before the S election becomes effective.

3. Fringe Benefits (Rev. Rul. 91-26).

a. Under § 1372(a), an S corporation is treated as a partnership for the purpose of applying the fringe benefit rules, and a 2% shareholder of the S corporation is treated as a partner. Pursuant to Code Sec. 1372, Accident and health insurance premiums paid by an S corporation on behalf of a 2% shareholder-employee as consideration for services rendered are treated like guaranteed payments that are includable in the shareholder's income and deductible by the shareholder under Code Sec. 162(l). The S corporation can deduct as salary and wages the accident and health insurance premiums paid on behalf of its 2% shareholder-employees and is required to file a Form W-2 for each 2% shareholder-employee that includes the cost of premiums paid in wages. The practical effect of this rule is to deny the S corporation a deduction for fringe benefit payments made by it. The portion of each such payment made on behalf of a 2% shareholder is passed through to the shareholder and may be deducted by the shareholder (if otherwise allowed).

(1) This rule applies to the following fringe benefits: group term life insurance benefits (§ 79); death benefits (§ 101(b)); accident and health plan benefits (§§ 105, 106); and meals and lodging provided for the convenience of the employer (§ 119). It is not clear whether this rule applies to other fringe benefits.

(2) This rule has the effect of making these fringe benefit payments nondeductible, except for 25% of health insurance premiums.

4. Fiscal Year End.

a. In general, an S corporation is required to use a December 31 year end.

b. Exceptions:

(1) Natural business purpose.

(2) Years ending on September 30, October 31 or November 30. if the election rules of § 444 are followed.

c. The switch to a calendar year end will destroy any deferral that had been obtained by using the C corporation's fiscal year end.

d. If the C corporation had been using a fiscal year and income was being deferred from year to year, the shareholder will have a "bunching" of income in the year the S election is effective.

e. Example.

Corporation X is a C corporation whose taxable year ends on March 31. X's sole shareholder is individual A.

Suppose that X earns $200,000 net income each year before A's salary. A's salary each year is $200,000. Thus X's net income each year is $0. X pays A's entire $200,000 salary on March 31.

If X makes an S election effective April 1, 2001, X's taxable year will change to December 31. X will have a short year beginning on April 1, 1991, and ending on December 31, 2001. X will have $150,000 of income during this period.

A will have $350,000 of income during the 2001 calendar year, consisting of $200,000 of salary received on March 31, 2001, and the $150,000 of income earned by X during the short period ending on December 31, 2001. This will be true whether the $150,000 earned during the short period is paid to A as a salary on December 31, 2001, or whether the $150,000 is recognized by A as pass-through income from X on December 31, 2001.

5. Related Party Transactions. Under § 267, an otherwise deductible payment made by an accrual-method C corporation to a cash-method taxpayer who owns more

than 50% of the corporation's stock may be deducted only when the payee-shareholder (receives and) takes into income the payment. If the payor corporation is an S corporation, this rule applies to a payment made to any shareholder, without regard to the amount of stock owned.

6. Corporate-Level Tax on Built-In Gains; § 1374.

a. Examples.

(1) Corporation X is a C corporation that made an S election that became effective on January 1, 1998. On January 1, 1998, X owned only one asset, unimproved land with a basis of $100 and a fair market value of $150.

On June 1, 2001, X sells the land for $300 cash. X's gain is $200, and its net recognized built-in gain is $50. X must pay big tax of 34% on $50.

(2) Corporation X is a C corporation that made an S Election that became effective on January 1, 1998. On January 1, 1998, X owned the following assets:

Asset	Adjusted Basis	FMV
Land and building	$200	$500
Equipment	$200	100
	$400	$600

X's net unrealized built-in gain is $200.

On January 1, 1998, X sold the equipment for $100. As a result, S sustained a $100 recognized built-in loss.

Assume that X disposes of no other assets during its taxable ending December 31, 1998. Since X has no net recognized built-in gain during 1998, there will be no built-in gain tax. However, X gets no benefit from the $100 recognized built-in loss. The loss will, however, pass through to X's shareholder(s) (assuming sufficient basis, etc.).

(3) Assume the same facts as in Example (2), above. On June 1, 2001, X sells the land and building for $750, when the basis of the land and building is $150.

X's gain on the sale is $600 and its net recognized built-in gain is $300. However, since X's net unrealized built-in gain (computed as of January 1, 1998) was $200, the portion of X's $300 net recognized built-in gain that will be taken into account will be limited to $200.

b. "Net recognized built-in gain" is limited to the amount of the corporation's taxable income (computed as if the corporation were a C corporation, with certain adjustments) during the year in question.

(1) To the extent that net recognized built-in gain (computed without regard to the taxable income limitation) exceeds the corporation's taxable income, the amount of such excess is carried forward to the corporation's next succeeding taxable year and is treated as a recognized built-in gain in the succeeding year.

(2) This rule applies only to corporations whose S elections were made on or after March 31, 1988.

(3) It appears that the amount of the carryforward that is treated as recognized built-in gain in the next succeeding year is not included in the computation of the corporation's taxable income in such next succeeding year.

(a) The IRS position on this issue is founded on the rationale for the taxable income limitation, which is that corporate tax should be based on the corporation's ability to pay.

(4) Examples.

(a) Corporation X is a former C corporation whose S election was made in 1997 and become effective on January 1, 1998.

In 1999, X has a net recognized built-in gain of $100. However, X's 1999 taxable income is only $75. Thus, X's net recognized built-in gain is limited to $75. The excess of $100 over $75 = $25 will be carried forward into 2000 and treated as a recognized built-in gain in 2000.

(b) Assume the same facts as in Example (1), above. Further assume that X's only recognized built-in gain in 2000 is the $25 of recognized built-in gain carried into 2000 from 1999; and that X's 2000 taxable income (computed without regard to the $25 recognized built-in gain carried into 2000 from 1999) is $10.

X's 2000 net recognized built-in gain will be $10 and the excess of $25 over $10 = $15 will be carried into 2000 and treated as a recognized built-in gain in 2000.

c. Recognition Period.

(1) The "recognition period" is defined as the 10-year period beginning on the date the corporation's S election is effective.

(a) Note that the definition refers to 10 years, not 10 taxable years.

(2) Example.

Corporation X is a C corporation whose taxable year ends on June 30. X makes an S election that becomes effective on July 1, 1991. As a result of the S election, X's taxable year automatically changes to December 31.

The 10-year recognition period extends from July 1, 1991 to June 30, 2001.

Query: What happens if an asset is disposed of in 2001 that generates a net recognized built-in gain. Must X close its year (for this purpose) on June 30, 2001, with only recognized built-in gains recognized on or before June 30, 2001, triggering the built-in gains tax?

d. Deduction for Tax Paid. The BIG tax is a true double tax since the gains which are the subject of the tax are (also) passed through to the S Corporation's shareholder(s) and taxed (again) to them. To soften this result somewhat and to make it correspond to the liquidation model that is the basis of the built-in gain rules, the tax paid by the corporation is treated as a loss sustained by the S Corporation with respect to the taxable year that the tax is imposed.

(1) Section 1366(f)(2) provides that the character of this loss will be determined by allocating the loss proportionately among the recognized built-in gains giving rise to the BIG tax. This means that the loss can be capital or ordinary, depending on the mix of the recognized built-in gains giving rise to the built-in gain tax. It can also lead to some unusual results if the tax is paid with respect to recognized gains that have been carried forward from a prior year.

(2) Example.

Suppose that in 1998 corporation X has a $50,000 recognized built-in long-term capital gain and a $50,000 recognized built-in gain that is ordinary income. Assume that X has only one shareholder, individual A. X's taxable income in 1998 is zero. As a result, the $100,000 net recognized built-in gain is carried forward into 1999 and treated as a recognized built-in gain in that year. Assume that X's taxable income in 1999 is (without regard to recognized built-in gains carried forward from 1998) $100,000.

Presumably the built-in gains carried forward into 1999 retain their character, even though the statute does not address this point.

X will pay $34,000 of tax with respect to 1999 attributable to the $100,000 of recognized built-in gain carried forward from 1998. This $34,000 will be allocated equally between the long-term capital gain and the ordinary gain, so that X will be treated as sustaining a $17,000 long-term capital loss and a $17,000 ordinary loss in 1999.

X's $100,000 of 1999 taxable (ordinary) income will pass through to its shareholder, as will the $17,000 long-term capital loss and the $17,000 ordinary loss. The $100,000 of recognized built-in gain will not pass through since they were carried forward from 1998 only for the purpose of computing X's 1999 built-in gain tax. In fact, these recognized built-in gains passed through to X's shareholder in 1998 in conjunction with X's other income and loss items.

A can claim the $17,000 long-term capital losses as a deduction against his capital gains and, in any event, up to $3,000 per year. Assuming that the $34,000 aggregate loss is fully deductible by A, the total tax paid with respect to the $100,000 of built-in gains recognized in 1999 is $34,000 plus .31 (assuming a 31% federal tax bracket) times $66,000 = $34,000 + $20,460 = $54,460. Thus, the effective tax rate on the recognized built-in gain is 54.46%.

e. Reporting.

(1) An S Corporation subject to the BIG tax computes the tax in Part IV of Schedule D (Form 1120S). The amount so computed is carried to line 22b on the front of Form 1120S.

(2) In addition, the corporation must disclose the amount of its net unrealized built-in gain existing as of the end of the current taxable year, as reduced for all built-in gains recognized in prior years (see Question R on page 2 of Form 1120S).

7. Problems Caused by Passive Investment Income.

a. Two Problem Areas.

(1) Loss of S election.

(2) Corporate-level tax.

b. Loss of S Election; Section 1362(d)(3).

(1) A corporation's S election will terminate whenever the corporation:

(a) Has subchapter C earnings and profits at the close of each of 3 consecutive taxable years; and

(b) Has gross receipts for each of such taxable years more than 25% of which are passive investment income.

(2) In such an event, the corporation's S election will terminate effective on the first day of its fourth taxable year.

(3) "Subchapter C earnings and profits" are earnings and profits of the corporation accumulated during the years it was a C corporation.

(4) "Passive investment income" means, with certain modifications, gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

c. Corporate-Level Tax; Section 1375.

(1) A corporate-level tax is imposed on an S corporation for any taxable year if the corporation has:

(a) Subchapter C earnings and profits at the end of that taxable year; and

(b) Gross receipts more than 25% of which are passive investment income.

(2) The tax is imposed at the rate of 34% on the corporation's "excess net passive income."

(a) "Excess net passive income" can be computed by using the following formula:

$$ENPI = NPI \times \frac{PII - (.25 \times GR)}{PII}$$

ENPI = excess net passive income

NPI = net passive income

PII = passive investment income

GR = total gross receipts

(b) "Net passive income" means passive investment income reduced by deductions directly connected with the production of such passive investment income.

(c) The IRS takes the position that "interest" includes tax-exempt interest for the purpose of the passive investment income rules.

(d) ENPI cannot exceed the corporation's taxable income. For this purpose, taxable income is computed as if the corporation was a C corporation, with certain modifications.

d. Example.

Corporation X is a former C corporation that elected S status in 1996. Individual A is the sole shareholder of X. X has $500,000 of subchapter C earnings and profits. On December 31, 2000, X sold its business to an unrelated buyer. On January 1, 2000, X had $500,000 in cash and a 5-year interest-only installment note in the principal amount of $500,000 received from the buyer in connection with the December 31, 2000 sale. X also had a 5-year consulting agreement with the buyer under which X was to receive $60,000 a year for consulting services.

During its taxable year ending December 31, 2001, X will have $40,000 of interest income from investing its $500,000 cash in certificates of deposit, $50,000 of interest income from the $500,000 installment note and $60,000 of consulting income. Assume that X has no deductions directly connected with the production of its interest income.

X's total gross receipts during 2001 will be $150,000. Of these, $90,000 will be classified as passive investment income. Since X has subchapter C earnings and profits, X must pay a tax at the rate of 34% of its excess net passive income.

X will have excess net passive income = $52,500 in 2001. X must pay tax = $17,850.

e. Planning Options/Alternatives. Corporation X in Example d., above, would like to avoid the corporate tax on excess net passive income. What can it do?

(1) One possibility is for X to invest its cash in tax-exempt securities.

(a) Suppose that corporation X in Example 4, above, invested its $500,000 cash in tax-exempt securities rather than certificates of deposit, and that X will earn $40,000 of tax-exempt interest in 2001 from this investment. As noted above, the IRS takes the position that tax-exempt interest is an item of passive investment income. Thus, X would still have $52,500 of excess net passive income in 2001 on which it must pay tax of $17,850.

(2) Another possibility is for X to pay enough deductible compensation to A to reduce its taxable income to zero.

(a) X's 2001 taxable income in Example 4, above, will be $150,000.

(b) X's excess net passive income cannot exceed its taxable income. If X pays $150,000 of deductible compensation to A, X's taxable income will be zero, its excess net passive income will be zero, and its tax will be zero.

(3) X could also invest its cash in tax-exempt securities and pay enough deductible compensation to A to reduce its taxable income to zero.

(a) If X in Example 4 has $40,000 of tax-exempt interest, rather than $40,000 of taxable interest, its 2001 taxable income will be $110,000.

(b) If X pays $110,000 of deductible compensation to A, X's taxable income will be zero, its excess net passive income will be zero, and its tax will be zero.

(4) X could distribute its $500,000 cash to A as a dividend and thereby reduce the amount of its subchapter C earnings and profits to zero.

(a) If X does this, it must make sure that the distribution is considered a taxable dividend rather than a reduction of its accumulated adjustments account (if any).

(b) If A consents, X can elect under Section 1368(e)(3) to have the distribution be considered first a dividend distribution out of its accumulated earnings and profits.

(c) If X does this, A will have $500,000 of ordinary income on which A must pay tax at the rate of 31%. Thus A's tax will be $155,000.

(d) By eliminating its subchapter C earnings and profits in this manner, X will be able to avoid the corporate-level tax on its passive investment income in all future years and will also ensure that it will not lose its S election after three years.

XI. CALIFORNIA S CORPORATIONS.

A. Conformity. Corporations electing S corporation status for federal tax purposes are deemed to have elected S corporation status for state tax purposes, unless they make an express C corporation status election using FTB 3560.

1. California's conformity to federal provisions recognizing S corporations as pass-through entities is partial in that (i) California imposes both a 1.5% tax and the minimum tax at the corporate level, (ii) California law prohibits the election of S corporation status by savings and loan associations, banks, and financial corporations that use the reserve method of accounting for bad debts under California law, while federal law prohibits such an election by

financial institutions that use the reserve method of accounting for bad debts under federal law, and (iii) California imposes a minimum tax on qualified subchapter S subsidiaries.

B. S Corporation Election; Termination of Status. Generally, a federal S corporation is treated as a California S corporation, unless the corporation elects to be treated as a regular corporation for state purposes on a return filed with the FTB by the 15th day of the third month of the year in which the corporation elects federal S status.

1. A federal S corporation that elects to continue as a regular corporation for state purposes may elect to become a California S corporation in subsequent taxable years unless prohibited federally. For purposes of the tax imposed on built-in gains and on excess passive investment income (see below), taxpayers that do elect California S corporation status are allowed to use their federal election date for purposes of applying the rules of these separate taxes.

2. The deadline for filing a California election to be a regular corporation is the last date allowed for filing a federal S election.

3. Termination of a federal S corporation election simultaneously terminates the California election; however, an S corporation may terminate its California S corporation status without terminating its federal S corporation status. In such a case, written notification must be made to the FTB.

4. Under federal law ad adopted by California, if an S corporation terminates its election, it is ineligible to make another S corporation election for five years without the consent of the FTB (the IRS for federal purposes).

C. S Corporation Shareholders. The California taxation of shareholders of federal S corporations that have elected S corporation status for California purposes is the same as federal.

1. Nonresident Shareholders. Nonresident shareholders are taxed on the portion of their distributive shares of an S corporation's income or loss, as modified for California purposes, that is derived from sources within the state.

a. Nonresident Shareholders. To ensure that all nonresident shareholders pay their taxes, the law requires each S corporation that has one or more shareholders who is a nonresident or a trust with nonresident fiduciaries to submit to the Franchise Tax Board (FTB): (i) names of all shareholders; and (ii) statements from all nonresident shareholders that they consent to California's jurisdiction to tax their California S corporation income on the pro rata basis of their ownership interest. Nonresident shareholders of an S corporation may elect to file a single group return in the same manner as nonresident partners under the personal income tax law.

2. Part-Year Resident Shareholders. A part-year resident shareholder is taxed on his or her entire distributive share of S corporation income or loss, as modified for California purposes, if the shareholder is a California resident on the last day of the S corporation's income year. (Instructions for Schedule CA (540NR).) A part-year resident shareholder who is a nonresident on the last day of the S corporation's income year is taxed in the same manner as a nonresident shareholder.

XII. RECENT DEVELOPMENTS.

A. In Gitlitz v. Commissioner, 121 S.Ct. 701, January 9, 2001, the Supreme Court put to rest the controversy regarding the treatment of cancellation of indebtedness income by an S corporation and its shareholders. The United States Tax Court, 1998 WL 66085, upheld deficiencies, and taxpayers appealed. The United States Court of Appeals for the Tenth Circuit, 182 F.3d 1143, affirmed, and certiorari was granted. Abrogating Gaudiano v. Commissioner, 216 F.3d 524, and Witzel v. Commissioner, 200 F.3d 496, the court's decision came in two parts:

1. First, the Supreme Court found that although cancellation of indebtedness income is not included in income when the S corporation is insolvent, it remains an item of income for purposes of passing through to shareholders and increasing basis.

2. Secondly, the Supreme Court additionally held that the S corporation shareholder may use the pass-through basis increase to deduct suspended losses, before the S corporation's tax attributes need be reduced at the corporate level.

B. Restructuring of Ownership of S Corporation Through Use of Single-Member Entities. In PLR 200008015, the IRS provided an example of a reorganization of the ownership of an S corporation utilizing a single-member entity that preserves the ownership of the S corporation by individuals.

1. In PLR 200008015, X a corporation organized under State 1, elected to be treated as an S corporation. A and B were individual shareholders of X. Under an overall business plan, A formed a single member LLC and a limited partnership, under State 2. A planned to exchange a percentage of its ownership in X for a 100% ownership interest in the single member LLC. Subsequently, A planned to transfer A's remaining interest in X to the limited partnership at the same time the single-member LLC transferred its entire interest in X to

the limited partnership. In exchange, A would receive a percentage limited partnership interest and the single-member LLC would receive a percentage general partnership interest in the limited partnership.

2. B set up an identical structure under State 2.

3. None of the entities planned to elect to be treated as an association taxable as a corporation for federal income tax purposes.

4. Under Regs. Section 301.7701-3(b)(1)(ii), a domestic partnership or LLC that has a single owner, and does not elect to be traded as an association, is disregarded as an entity separate from its owner for federal tax purposes.

5. After completing the proposed reorganization, A and B would be the sole owners of separate limited partnerships owning a portion through a single-member limited liability and owning a portion directly. Because each limited partnership would be treated as owned by a single owner, they would be disregarded for federal tax purposes and A and B each would be treated as directly owning X stock held by each limited partnership.

6. Thus, in PLR 200008015, A and B would transfer control of X to the LLCs and limited partnerships for state law purposes, possibly to add an additional layer of liability protection or to facilitate other ownership restructuring in the future. But, for federal tax purposes, the use of the single-member entities would retain 100% of the ownership of X by A and B, thus preserving the S corporation status.

C. Code Section 304 Applies to S Corporations.

1. In FSA 200041009, the IRS concluded that Code Section 304 applies where an S corporation purchases the stock of a C corporation from shareholders in control of both corporations. The IRS concluded that, under the facts presented, the deemed redemption arising form applying Code Section 304 will not receive exchange treatment under Code Section 302(a), and that Code Section 1368(b) and (c) apply to the deemed distribution in redemption.

2. The FSA's conclusion that Code Section 1368 applies may present an opportunity in certain situations for shareholders of brother-sister C and S corporations to bail out C corporation earnings tax-free currently. However, FSA 200041009 left unanswered the taxability of the deemed distributions.

3. The IRS issued FSA 200111004 in follow-up to 200041009. Additionally, the IRS issued CCA 200111004 providing the same guidance. FSA 200111004, the IRS

confirmed that S corporation shareholder is entitled to its entire basis in the stock of Acquiring, and it is not limited to the shareholder's basis in the hypothetical Acquiring stock.

D. Stock Basis Adjustment Rule for Distributions in Complete Liquidation of an S Corporation Clarified.

1. Shareholders of S corporation need to know the adjustments that are to be made to their stock bases in determining the gain or loss from a distribution under Code Section 331. Regs. Section 1.1367-1(d)(1) fails to specify the timing of stock basis adjustments where a shareholder receives a series of liquidating distributions treated as in full payment in exchange for his or her stock. In PLR 200106009, the IRS clarified the timing of stock basis adjustments. The IRS concluded that, for purposes of determining the amount of such gain or loss, the shareholder's basis is to be determined after giving effect to the adjustments provided in Code Section 1367(a), including the S corporation's gain on liquidating assets sales, for the taxable year.

2. PLR 200106009 clarifies the fact that Code Section 301 does not apply to any distribution in complete liquidation and that the distribution rules of Code Section 1368 will not apply. This distinction is meaningful where an S corporation has accumulated earnings and profits that would cause a distributee shareholder to have dividend treatment under Code Section 1368(c)(2), whereas the shareholder would have sale or exchange treatment under Code Section 331.

E. Notice 2001-35, 2001-23 I.R.B. 1314, provides a proposed revenue procedure modifying, amplifying, and superseding Rev. Proc. 87-32, 1987-2 C.B. 396. The proposed revenue procedure provides additional circumstances under which the IRS will grant automatic approval for an adoption, change, or retention in annual accounting period based on requests that the Service has granted under its current ruling practice. Notice 2001-35, Section 8.01, also provides audit protection to taxpayers adopting, changing, or retaining an annual accounting period under the proposed revenue procedure.

Notice 2001-35 makes the following significant changes to Rev. Proc. 87-32:

1. Clarifying that an S corporation or electing S corporation may automatically change to its required taxable year (§ 4.01(1));

2. Allowing a an S corporation or electing S corporation to automatically change to a natural business year that satisfies the 25% gross receipts test (similar to the 25%

gross receipts test of Rev. Proc. 87-32, see above), regardless of whether such year results in more deferral of income than its present taxable year (§ 4.01(2));

S CORPORATIONS

APPENDIX I

CORPORATE FORMS

APPENDIX I - CORPORATE FORMS.

ÿ Election by Small Business Corporation (75 days from date of incorporation)

  ÿ IRS Form 2553
  ÿ FTB Form 3560

[ADD 2553]

[ADD 3560]

APPENDIX II

COMPARISONS AND EXAMPLES

CHOICE OF ENTITY

Comparison of Characteristics of
Partnerships (LLCs) and Corporations

NON-TAX

ITEM
PARTNERSHIP (LLC)
CORPORATION

Liability of owners
General partners have unlimited personal liability for partnership debts and obligations. Limited partners' liability for partnership debts and obligations is limited to their investment.
Shareholders' liability for corporate debts and obligations is limited to their investment.

Transfer-ability of ownership
Partners cannot transfer their ownership interests without the consent of other partners.
Shares are freely transferable.

Management

Every general partner has a right to participate equally in management. Limited partners have no right to participate in management.

Shareholders elect the directors, who appoint the officers/managers of the corporation. Shareholders have no right to participate in management.

Duration

A partnership cannot have perpetual existence. A partnership is terminable at will unless a definite term is provided.

A corporation may have perpetual existence.

Public offering

Very difficult

C corporations -- yes.

S corporations -- no.

TAX

Taxation
(operating profits)

(See table comparing Federal v. State)

Partnerships are not taxed as separate entities. Partnership income and losses flow directly to the partners' tax returns.

C corporations are taxed as separate legal entities. Shareholders are taxed on dividends paid by the corporation.

S corporations are not taxed as separate legal entities. S Corporation income and losses flow directly to the shareholders' tax returns.

Losses deductible by owners

Investment plus prorated share of partnership liabilities

C corporations -- no.

S corporations -- limited to amount invested and loaned to corporation

Subject to passive activity loss rules

(IRC §469)

Yes

C corporations -- generally no.

S corporations -- yes.

Special allocations

Possible, if substantial economic effect

No.

Fiscal Year

(IRC §444, §7579 and

§2804)

May end up to three months earlier than years of principal partners.

C corporations -- any fiscal year.

S corporations -- may end up to three months earlier than year of principal stockholders.

Tax-free fringe benefits

Limited

C corporations -- all permitted by law.

S corporations -- limited.

TAX

Tax-free merger

(IRC §368)

No

C corporations -- yes.

S corporations -- yes.

Accumulated earnings tax (IRC §531)

No

C corporations -- yes.

S corporations -- no.

Personal holding company tax

(IRC §541)

No

C corporations -- yes.

S corporations -- no.

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(IRC §541)

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C corporations -- yes.

S corporations -- no.

CHOICE OF ENTITY

Taxation of Operations

FEDERAL V. STATE

FORM OF ENTITY

FEDERAL

CALIFORNIA

Partnership

100% taxed to owner

(a) 100% taxed to owner

(b) $800 annual fee for limited partnerships

LLC

100% taxed to owner

(a) 100% taxed to owner

(b) $800 annual fee LLCs

(c) Gross receipt tax on LLCs

S Corporation

(a) Usually 100% taxed to owner

(b) Possible built-in gain tax

(c) Possible passive activity loss tax

(a) Usually 100% taxed to owner

(b) Possible built-in gains tax

(c) Possible passive activity loss tax

(d) $800 minimum tax

(e) 1.5% net income tax

C Corporation

(a) 100% taxed to corporation

(a) 100% taxed to corporation

A. ORGANIZING THE ENTERPRISE - TAX

C

CORPORATION

S

CORPORATION

GENERAL

PARTNERSHIP

(LLC)

LIMITED

PARTNERSHIP

1. CONSEQUENCES OF ADDING NEW SHAREOWNERS WITH APPRECIATED PROPERTY

a. Entity Level

Corporations/ Partnerships

No gain.

No gain.

No gain.

No gain.

b. Owner Level

Shareholder/Partners (IRC §351)

39.6% tax unless the new shareholder receives 80% of the stock.

39.6% tax unless the new shareholder receives 80% of the stock.

No tax

No tax

B. OPERATING CONSIDERATIONS - TAX

C

CORPORATION

S

CORPORATION

GENERAL

PARTNERSHIP
(LLC)

LIMITED
PARTNERSHIP

1. INCOME SPLITTING ADVANTAGES - EXAMPLE 2

Maximum income splitting available is $10,701 annually (not available to personal service corporations).
No income splitting is possible.
No income splitting is possible.
No income splitting is possible.

2. INCOME SHIFTING POSSIBILITIES - EXAMPLE 3

As income is taxed to the entity, no income shifting is possible without the payment of a double tax on dividend income.
As income is taxed to the owners of the shares, income shifting is possible.
As income is taxed to the owners of the shares, income shifting is possible.
As income is taxed to the owners of the shares, income shifting is possible.

3. APPLICATION OF IRC SECTION 83 TO TRANSFERS OF INTERESTS TO EMPLOYEES OR INDEPENDENT CONTRACTORS - EXAMPLE 4

a. Entity Level Corporation/
Partnership
The corporation recognizes no gain on the transfer of its stock and is allowed a deduction equal to the fair market value of the shares.

The corporation recognizes no gain on the transfer of its stock and is allowed a deduction equal to the fair market value of the shares.

The partnership recognizes gain only to the extent of the fair market value of the interest transferred and is allowed an equivalent deduction.

The partnership recognizes gain to the extent of the fair market value of the interest transferred and is allowed an equivalent deduction.

b. Owner Level Shareholder/Partner

Transferee recognizes compensation income equal to the fair market value of the property received.

Transferee recognizes compensation income equal to the fair market value of the property received.

Transferee recognizes compensation income equal to the fair market value of the property received.

Transferee recognizes compensation income equal to the fair market value of the property received.

4. DISPROPORTIONATE/SPECIAL ALLOCATIONS OF INCOME, GAINS, LOSSES, ETC.

(Substantial Economic Effect?)

No

No

Yes

Yes

5. FRINGE BENEFIT LIMITS

No limits

Not allowed (2% shareholders);

(1) $5,000 death benefit exclusion (IRC § 101(b)),

(2) exclusion for accident and health plans (IRC § 105, 106),

(3) exclusion of cost of $50,000 of group term life (IRC § 79),

(4) exclusion of meals and lodging for the convenience of the employer (IRC § 119).
Not allowed (2% shareholders);

(1) $5,000 death benefit exclusion (IRC § 101(b)),

(2) exclusion for accident and health plans (IRC § 105, 106),

(3) exclusion of cost of $50,000 of group term life (IRC § 79),

(4) exclusion of meals and lodging for the convenience of the employer (IRC § 119).
Not allowed (2% shareholders);

(1) $5,000 death benefit exclusion (IRC § 101(b)),

(2) exclusion for accident and health plans (IRC § 105, 106),

(3) exclusion of cost of $50,000 of group term life (IRC § 79),

(4) exclusion of meals and lodging for the convenience of the employer (IRC § 119).

6. DEDUCTION OF NET OPERATING LOSSES

a. Entity Level Corporation/
Partnership
Losses are only deductible by the corporation and net loss carryforwards may be lost or their deduction delayed upon a change in ownership.

Losses are deductible by the shareholders to the extent they have basis in their stock or have made loans to the corporation. Corporate loans from nonshareholders are not allowed as basis.

Losses are deductible by the partners to the extent of their basis. Partnership debts are considered as partner basis.

Losses are deductible by the partners to the extent of their basis. Partnership debts are considered as partner basis.

b. Owner Level Shareholder/Partner

Entity losses are not a tax factor to the shareholders.

Entity losses are allowed to the shareholders to the extent of the basis in their shares and loans to the corporation.

Entity losses are allowed to the partners to the extent of their basis.

Entity losses are allowed to the partners to the extent of their basis.

7. IRC §541 "PASSIVE INCOME" LIMITATIONS

a. Entity Level Corporation/
Partnership

If the corporation receives a significant amount of "passive income," in relation to its other income, a Personal Holding Company tax may be imposed.

If the corporation has no C corporation earnings and profits there are no limitations. If the corporation has C corporation earnings and profits, passive income may terminate its S election.

There are no limitations.

There are no limitations.

8. QUALIFIED PLAN RULES

No specific limits

No plan loans to 10% shareholders

No plan loans to 10% partners. [Check lump sum distribution availability.]

No plan loans to 10% partners. [Check lump sum distribution availability.]

C. STRUCTURAL CONSIDERATIONS - TAX

C

CORPORATION

S

CORPORATION

GENERAL

PARTNERSHIP

(LLC)

LIMITED

PARTNERSHIP

1. TAX CONSEQUENCES OF LIQUIDATIONS - EXAMPLE 5

a. Entity

Corporation/

Partnership

34% tax on gain1

No tax

No tax

No tax

b. Owner

Shareholder/Partner

28% tax on gain

28% tax on gain

No tax

No tax

c. Combined

52.48% tax on gain

28% tax on gain

No tax

No tax

2. TAX CONSEQUENCES OF REDEMPTIONS - EXAMPLE 6

a. Entity

Corporation/

Partnership

34% tax1

No tax

No tax

No tax

b. Owner

Shareholder/Partner

28% tax

(1) The retiring shareholder will pay a 28% tax on any recognized gain.

(2) The remaining shareholders will incur a tax on the payments of 28%. The remaining shareholders will receive a basis increase equal to the before-tax income which will be deductible on sale of liquidation of the corporation.

(1) No tax on property redemptions. 28% tax on cash redemptions.

(2) No tax to remaining shareholders is possible. (§ 736.)

(1) No tax on property redemptions. 28% tax on cash redemptions.

(2) No tax to remaining shareholders is possible. (§ 736.)

c. Combined

52.48% tax

48.2% tax on cash redemption. 28% tax on property redemptions.

28% tax on cash redemptions. 0% on property redemptions.

28% tax on cash redemptions. 0% on property redemptions.

3. REQUIREMENTS TO DIVIDE THE BUSINESS AMONG ITS OWNERS WITHOUT TAX ("REORG")

a. Entity

Corporation/

Partnership

The transaction must satisfy the requirements of IRC Section 368(a)(1)(D) and IRC Section 355.

The transaction must satisfy the requirements of IRC Section 368(a)(1)(D) and IRC Section 355.

The assets of the partnership may be distributed without tax (but see IRC § 751(b)).

The assets of the partnership may be distributed without tax (but see IRC § 751(b)).

b. Impact of Reorg on Owner Shareholder/ Partner

The shareholders are protected from the corporation's creditors.

The shareholders are protected from the corporation's creditors.

The partners are fully liable for the partnership's liabilities.

The general partner is fully responsible for the liabilities of the partnership but the limited partners are protected. Use of a corporate general partner may provide protection similar to C corporations.

R.U.L.P.A. 15632(b)(1)

"(b) A limited partner does not participate in the control of the business within the meaning of subdivision (a) solely by doing one or more of the following:

(1) Being a contractor for or an agent or employee of the limited partnership or of a general partner, or an officer, director, or shareholder of a corporate general partner."

4. BASIS CONSEQUENCES ON THE DEATH OF AN OWNER - EXAMPLE 7

There is no increase in the basis of the entity's assets, only the shareholder's stock.
There is no increase in the basis of the entity's assets, only the shareholder's stock.
The assets of the partnership may be increased to fair market value.
The assets of the partnership may be increased to fair market value.

5. BASIS CONSEQUENCES OF A PURCHASE OF AN INTEREST IN THE ENTITY

There is no increase in the basis of the entity's assets, only the shareholder's stock.
There is no increase in the basis of the entity's assets, only the shareholder's stock.
The assets of the partnership may be increased to fair market value.
The assets of the partnership may be increased to fair market value.

D. STRUCTURAL CONSIDERATIONS - NON TAX

C
CORPORATION

S
CORPORATION
GENERAL

PARTNERSHIP

(LLC)

LIMITED

PARTNERSHIP

1. AVOIDANCE OF LIABILITY (OTHER THAN PROFESSIONAL MALPRACTICE)

a. Entity

Corporation/

Partnership

The entity's assets are subject to creditor claims.

The entity's assets are subject to creditor claims.

The entity's assets are subject to creditor claims.

The entity's assets are subject to creditor claims.

2. VARIANCES IN VOTING RIGHTS

Variances are allowed

Some variances are allowed

Variances are allowed

Variances are allowed

3. NUMBER OF PERMISSIBLE OWNERS

No limit

75 Shareholders

No limit

No limit

EXAMPLE 1

DOUBLE TAXATION

Entity
Flow Thru1
Individual/
Owner

Entity

Income
100,000
100,000

Tax 34.00%
(34,000)
N/A

66,000
100,000

Individual

Income
66,000
100,000

Tax 39.60%
(26,196) 39.60%
(39,196)

Net Cash
to Owner

39,864

60,864

Benefit of Single Level of Tax

21,000

EXAMPLE 2

INCOME SPLITTING ADVANTAGES

Assume: $200,000 Worth of Income

C CORP
S CORP/

CORPORATION

SHAREHOLDER

PARTNERSHIP, LLC, OR SOLE

PROPRIETOR

Taxable Income

$100,000

$100,000

$200,000

Federal Income Tax

(22,250)

(22,404)

(55,355)

Net Cash

$ 77,750

$ 77,596

$144,645

Net Cash to C Corp

77,750

N/A

Net Cash to Entity & Owner

$155,346

$144,645

Net Cash to S Corp/Sole Prop.

(144,643)

INCOME SPLITTING ADVANTAGE OF C CORP

$ 10,701

EXAMPLE 3

INCOME SHIFTING ADVANTAGES

Assume: $100,000 of Income

C CORPORATION

S CORPORATION

PARTNERSHIP OR LLC

CHILD

PARENT

CHILD

PARENT

CHILD

PARENT

Taxable Income

$100,000

$0

$80,000

$20,000

$80,000

$20,000

Federal Tax

($ 25,779)

$0

($20,199)

($ 3,000)

($20,199)

($ 3,000)

After Tax Cash

$74,221

$76,801

$76,801

ADVANTAGE:

C Corp v. S Corp

C Corp v. S.P.

S Corp v. S.P.

N/A

N/A

N/A

$ 2,580

N/A

N/A

N/A

$ 2,580

N/A

EXAMPLE 4

TAX CONSEQUENCES OF IRC SECTION 83 TRANSFERS

Assume: Value Transferred of $1,000,000

C

CORPORATION

S

CORPORATION

PARTNERSHIP,

LLC, OR SOLE PROPRIETORSHIP

Value Transferred

$1,000,000

$1,000,000

$1,000,000

Basis

($ 0)

($ 0)

($ 0)

Gain Recognized

NONE

NONE

$1,000,000

Compensation Deduction

($1,000,000)

($1,000,000)

($1,000,000)

Net Tax Benefit

($1,000,000)

($1,000,000)

$ 0

EXAMPLE 5

TAX CONSEQUENCES OF A LIQUIDATION

Assume: $1,000,000 In Value

$0 Entity Basis

$0 Owner Basis

C

CORPORATION

S

CORPORATION

PARTNERSHIP,

LLC, OR SOLE PROPRIETORSHIP

ENTITY LEVEL TAX:

Value of Assets

$1,000,000

$1,000,000

$1,000,000

Basis of Assets

(0)

(0)

(0)

Gain

$1,000,000

$1,000,000

$1,000,000

Federal Tax (34%)

(340,000)

(0)

(0)

After Tax Net

$ 660,000

$1,000,000

$1,000,000

SHAREHOLDER/

PROPRIETOR LEVEL:

Liquidation Proceeds

$ 660,000

$1,000,000

$1,000,0001

Basis

(0)

(0)

(0)

Gain

$ 660,000

$1,000,000

NOT

Federal Tax (28%)

(184,800)

(280,000)

RECOGNIZED

After Tax Net

$ 475,200

$ 720,000

$1,000,000

ADVANTAGE:

C Corp v. S Corp

C Corp v. S.P.

S Corp v. S.P.

N/A

N/A

N/A

$ 244,800

N/A

N/A

N/A

$ 524,800

$ 280,000

EXAMPLE 6

TAX CONSEQUENCES OF REDEMPTION USING APPRECIATED ASSETS

Assume: Redemption Price $1,000,000

$0 Entity Basis

$0 Owner Basis

C Corporation

S Corporation

Partnership, LLC or

Sole Proprietorship

ENTITY LEVEL:

Value

$1,000,000

$1,000,000

$1,000,000

Federal Tax

34%   (340,000)

N/A

N/A

After Tax Net

$ 660,000

$1,000,000

$1,000,000

SHAREHOLDER/

PROPRIETOR LEVEL

Pass-Thru Income

N/A

$1,000,000

N/A

Federal Tax

(280,000)

After Tax Net

See Below

$ 720,000

See Below

Redemption Proceeds

$660,000

$1,000,000

$1,000,000

Basis

None

(1,000,000)

None

Gain on Redemption

$660,000

$ 0

$1,000,000

Federal Tax

28% (184,800)

N/A

28% (280,000)

After Tax Net

$ 475,200

See Above

$ 720,000

TOTAL TAXES PAID

Entity

$ 340,000

$ 0

$ 0

Owner-Seller

184,800

280,000

280,000

Total Taxes Paid

$ 524,800

$ 280,000

$ 280,000

Net Redemption Proceeds

$ 475,200

$ 720,000

$ 720,000

ADVANTAGE

C corp v. S corp

N/A

$ 244,800

N/A

C corp v. Sole Prop

N/A

N/A

$ 244,800

S corp v. Sole Prop

N/A

N/A

N/A

EXAMPLE 7

TAX CONSEQUENCES OF AN OWNER'S DEATH OR
THE PURCHASE OF AN INTEREST

Assume: Value of Inventory at Date of Death is $1,000,000

C
CORPORATION

S
CORPORATION
PARTNERSHIP,
LLC, OR SOLE PROPRIETORSHIP

Gross Entity Sales
$1,000,000
$1,000,000

$1,000,000

Less:

Entity Basis

(0)1

(0)

(1,000,000)2

Gain

$1,000,000

$1,000,000

$ 0

Federal Tax

($ 340,000)

($ 396,000)

($ 0)

ADVANTAGE:

C Corp v. S Corp

C Corp v. S.P.

S Corp v. S.P.

$ 56,000

N/A

N/A

N/A

N/A

N/A

N/A

$340,000

$396,000

EXAMPLE 8

EMPLOYMENT TAXES

I. Corporation

A. FICA

Employee	(.0620 x $76,200)	$4,724.40
Employer	(.0620 X $76,200)	4,724.40

$9,448.80

B. Medicare

Employee 1.45% x Unlimited

Employer 1.45% x Unlimited

C. Federal Unemployment

.008 x $7,000 $ 56.00

D. State Disability

.0071 x $46,327 $ 324.28

E. Workers Compensation

Varies

F. State Unemployment

Rate varies x $7,000

G. ETT (training)

.001 x $7,000 $ 7.00

II. Sole Proprietorship

A. FICA

.124 x $76,200 = $9,448.80

B. Medi-Care

2.9% x Unlimited

C. Workers' Compensation

Varies - majority stockholders can waive