Chattanooga Tax Practitioners
Chattanooga, Tennessee
November 9, 2011

# CURRENT ISSUES AFFECTING S CORPORATIONS

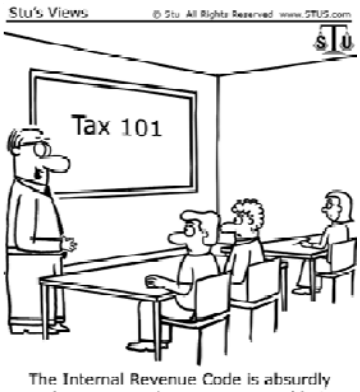
Ronald A. Levitt

Sirote & Permutt
2311 Highland Ave S
Birmingham, AL 35205
205-930-5274
rlevitt@sirote.com

Sirote

1


2




The Internal Revenue Code is absurdly complex or, as we lawyers say, a goldmine.

3

CURRENT ISSUES AFFECTING S CORPORATIONS

**TAX RATE CHANGES**

- **CURRENT TAX RATES FOR 2011, 2012 AND 2013**

**Individual Income Tax Rates (2011 and 2012)**

| Tax Bracket | Single | Married Filing Jointly |
|---|---|---|
| 10% Bracket | $0 - $8,500 | $0 - $17,000 |
| 15% Bracket | $8,500 - $34,500 | $17,000 - $69,000 |
| 25% Bracket | $34,500 - $83,600 | $69,000 - $139,350 |
| 28% Bracket | $83,600 - $174,400 | $139,350 - $212,300 |
| 33% Bracket | $174,400 - $379,150 | $212,300 - $379,150 |
| 35% Bracket | $379,150+ | $379,150+ |

4

CURRENT ISSUES AFFECTING S CORPORATIONS

**TAX RATE CHANGES**

- **CURRENT TAX RATES FOR 2011, 2012 AND 2013**

**Estimated Individual Income Tax Rates (2013)**

| Tax Bracket | Single | Married Filing Jointly |
|---|---|---|
| 15% Bracket | $0 - $34,850 | $0 - $58,200 |
| 28% Bracket | $34,850 -$84,350 | $58,200 -$140,600 |
| 31% Bracket | $84,350 - $176,000 | $140,600 - $214,250 |
| 36% Bracket | $176,000 - $382,650 | $214,250 - $382,650 |
| 39.6% Bracket | over $382,650 | over $382,650 |

**The rates above also apply to ordinary income that flows through an S corporation, LLC or partnership to its shareholders, members or partners**

5

CURRENT ISSUES AFFECTING S CORPORATIONS

**TAX RATE CHANGES**

- **CURRENT TAX RATES FOR 2011, 2012 AND 2013**

**Tax Rate on Long-Term Capital Gain (Non-Corporate Taxpayers)**

| 2011 and 2012 | 2013 |
|---|---|
| 15% maximum rate | 20% maximum rate |

These rates also apply to net long-term capital gain that flows through an S corporation, LLC or partnership to its shareholders, members or partners.

6

CURRENT ISSUES AFFECTING S CORPORATIONS

**TAX RATE CHANGES**

- **CURRENT TAX RATES FOR 2011, 2012 AND 2013**

**Tax Rate on Dividends (Non-Corporate Taxpayers)**

| 2011 and 2012 | 2013 |
|---|---|
| 15% maximum rate | 39.6% maximum rate |

7

CURRENT ISSUES AFFECTING S CORPORATIONS

**TAX RATE CHANGES**

- **CURRENT TAX RATES FOR 2011, 2012 AND 2013**

**Maximum Marginal Federal Tax Rate on a C Corporation's Income or Gain that is Distributed as a Dividend to the Shareholders as *Ordinary Income***

| 2011 and 2012 | 2013 |
|---|---|
| 44.75% | 60.74% |

8

CURRENT ISSUES AFFECTING S CORPORATIONS

**TAX RATE CHANGES**

- **CURRENT TAX RATES FOR 2011, 2012 AND 2013**
  - **If rates Increase in 2013:**
    - **Will C Corporations become more popular?**
    - **Double tax on dividends.**
    - **Double tax on sale of assets.**

9

CURRENT ISSUES AFFECTING S CORPORATIONS

**TAX RATE CHANGES**

- **CURRENT TAX RATES FOR 2011, 2012 AND 2013**
  - **If no changes before 2013:**
    - **Sell capital gain assets.**
    - **Choose not to utilize like-kind exchange provision (Section 1031).**
    - **Choose not to use installment sales method (Section 453).**
    - **Dispose of installment obligations payable after 12/31/12 (Section 453B).**
    - **For S corporations with CE&P, make a distribution or deemed distribution of CE&P.**

10

CURRENT ISSUES AFFECTING S CORPORATIONS

**CHOICE OF ENTITY**

- **U.S. Treasury Secretary Timothy Geithner told the Senate Finance Committee on February 15, 2011 that Congress should "revisit" long-standing rules that give businesses a choice of paying taxes as a corporation or through a structure such as a partnership or S corporation through which they can report business income on individual tax returns.**

11

CURRENT ISSUES AFFECTING S CORPORATIONS

**CHOICE OF ENTITY**

**Statistics Regarding Choice of Entity**

| | 2010 | 2011 (Projected) | 2015 (Projected) | 2018 (Projected) |
|---|---|---|---|---|
| **Form 1065** | 3,508,856 | 3,501,600 | 3,824,800 | 4,086,700 |
| **Form 1120S** | 4,508,078 | 4,527,000 | 4,929,300 | 5,252,100 |
| **Form 1120** | 2,016,551 | 1,926,800 | 1,814,600 | 1,759,800 |

12

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Circuit Holds Taxpayer to Contractual Seventh Circuit Reverses Tax Court's Recharacterization of Unreasonable Compensation as Dividend**.
  - In *Menard, Inc. v. Comm'r*, 560 F.3d 620 (CA-7, 2009), the Seventh Circuit reversed the holding of the Tax Court and found that the compensation paid by a corporation to its chief executive officer constituted reasonable compensation rather than a non-deductible dividend distribution to him.

13

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Circuit Holds Taxpayer to Contractual Seventh Circuit Reverses Tax Court's Recharacterization of Unreasonable Compensation as Dividend**.
  - The relevant authority in this area is Section 162(a)(1), which allows a deduction for ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including a "reasonable allowance" for salaries or other compensation for personal services actually rendered.

14

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Circuit Holds Taxpayer to Contractual Seventh Circuit Reverses Tax Court's Recharacterization of Unreasonable Compensation as Dividend**.
  - Reg. §1.162-7(a) provides that the test of deductibility in the case of compensation payments is whether such payments are reasonable *and* are, in fact, payments purely for services.

15

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Circuit Holds Taxpayer to Contractual Seventh Circuit Reverses Tax Court's Recharacterization of Unreasonable Compensation as Dividend**.
  - In reviewing the Tax Court decision, the Seventh Circuit pointed out that a corporation is ***not*** required to pay dividends. The main focus of the Tax Court decision was whether Mr. Menard's compensation exceeded that of comparable CEOs in 1998.

16

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Circuit Holds Taxpayer to Contractual Seventh Circuit Reverses Tax Court's Recharacterization of Unreasonable Compensation as Dividend**.
  - The Seventh Circuit found that salary is just the beginning of a meaningful comparison, because it is only one element of a compensation package. Based on various considerations and the fact that an independent investor would be satisfied with an 18.8% rate of return, the Seventh Circuit concluded that Mr. Menard's compensation was ***not*** excessive in 1998, and that the Tax Court committed clear error in finding that Mr. Menard's compensation was unreasonable.

17

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Tax Court Applies Independent Investor Test**.
  - In *Multi-Pak Corp. v. Comm'r*, TCM 2010-139, the Tax Court held that the compensation paid by the taxpayer's wholly owned corporation for one of the years in issue (2002) was reasonable, but recharacterized a portion of the compensation paid to the taxpayer in the other year in issue (2003) as a non-deductible dividend distribution because the amount of compensation paid to the taxpayer in that year was unreasonable.

18

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Tax Court Applies Independent Investor Test**.
  - In determining the rate of return which would be received by the hypothetical independent investor, the Tax Court in Multi-Pak divided the taxpayer's net profit (after payment of compensation and a provision for income taxes) by the year-end shareholder's equity as reflected in its financial statements. This yielded a return on equity of 2.9% for 2002 and negative 15.8% for 2003.

19

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Tax Court Applies Independent Investor Test**.
  - The court concluded that although an independent investor may prefer to see a higher rate of return than the 2.9% in 2002, they believed that an independent investor would note that Mr. Unthank was the sole reason for the company's significant rise in sales in 2002 and would be satisfied with the 2.9% rate of return.

20

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Tax Court Applies Independent Investor Test**.
  - However, the court agreed with the IRS that a negative 15.8% return on equity in 2003 called into question the level of Mr. Unthank's compensation for that year.
  - Consequently, the court felt that if Mr. Unthank's salary was reduced to $1,284,104 in 2003, which would result in a return on equity of 10% in 2003, that would be sufficient to satisfy an independent investor.

21

CURRENT ISSUES AFFECTING S CORPORATIONS

**UNREASONABLE COMPENSATION**

- **Tax Court Applies Independent Investor Test**.
  - Although the Tax Court did evaluate each of the five factors set forth in the *Elliotts* case, it seemed to rely primarily on the independent investor test in reaching its conclusions as to the reasonableness of the compensation paid to Mr. Unthank in 2002 and 2003.

22

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Court Recharacterizes Personal Goodwill as Corporate Goodwill in Sale of Dental Practice**.
  - In Howard v. U.S., 106 AFTR2d 2010-5533 (E.D. Wash. 2010), the court denied the taxpayer's motion for a summary judgment and granted the government's motion for summary judgment in finding that goodwill in connection with the sale of a dental practice was corporate goodwill rather than personal goodwill.

23

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Court Recharacterizes Personal Goodwill as Corporate Goodwill in Sale of Dental Practice**.
  - The government argued that the goodwill was corporate goodwill versus personal goodwill for three main reasons.
    - The goodwill at issue was a corporate asset because the taxpayer was an employee with the corporation and had a covenant not to compete with the corporation.
    - The corporation earned the income and correspondingly earned the goodwill.
    - Attributing the goodwill to the taxpayer would not comport with the economic reality.

24

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Court Recharacterizes Personal Goodwill as Corporate Goodwill in Sale of Dental Practice**.
  - The court found that the goodwill was an asset of the corporation and not of the taxpayer personally because of the contractual obligation of the taxpayer under the Employment Agreement to continue to work for and not to compete against his corporation.
  - *See Martin Ice Cream v. Comm'r*, 110 TC 189 (1998); and *Norwalk v. Comm'r*, TCM 1998-279.

25

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **First Circuit Holds Taxpayer to Contractual Allocation**.
  - In *Muskat v. Comm'r*, 103 AFTR2d 2009-666 (1st Cir. 2009), the First Circuit Court of Appeals rejected taxpayer's refund suit based on the taxpayer's claim that payments contractually delineated as payments for taxpayer's covenant not to compete and originally reported by the taxpayer as ordinary income, actually were payments for taxpayer's personal goodwill, taxable as capital gain.

26

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Tax Court Recharacterizes Payments for Personal Goodwill as Ordinary Income**.
  - In *Kennedy v. Comm'r*, TCM 2010-206, the Tax Court held that payments received by a shareholder of an employee benefits consulting company which was a C corporation did not constitute payments for personal goodwill, and consequently, were taxable as ordinary income.

27

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Tax Court Recharacterizes Payments for Personal Goodwill as Ordinary Income**.
  - James Kennedy was the sole shareholder of an employee benefits consulting firm taxed as a C corporation for federal income tax purposes. Kennedy was approached by another company that proposed to acquire the assets of Mr. Kennedy's corporation.

28

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Tax Court Recharacterizes Payments for Personal Goodwill as Ordinary Income**.
  - Late in the negotiations, Mr. Kennedy's attorney consulted with a tax advisor who informed him that if the transaction was structured as an asset purchase, then the payment would be taxed twice, once at the corporate level and again at the shareholder level when distributed to Mr. Kennedy.

29

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Tax Court Recharacterizes Payments for Personal Goodwill as Ordinary Income**.
  - The tax advisor alternatively suggested that Kennedy take the position that he owned the personal goodwill of the business, and that he enter into an Agreement for Assignment of Know-How and Goodwill, an Asset Purchase Agreement and a Consulting Services Agreement.

30

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Tax Court Recharacterizes Payments for Personal Goodwill as Ordinary Income**.
  - Only $10,000 of the purchase price was allocated to the assets of the C corporation, with the remaining amounts being allocated 75% to the sale of Kennedy's personal goodwill and the remaining 25% being allocated to the Consulting Services Agreement.

31

CURRENT ISSUES AFFECTING S CORPORATIONS

**GOODWILL**

- **Tax Court Recharacterizes Payments for Personal Goodwill as Ordinary Income**.
  - The taxpayer argued that under *Martin Ice Cream Company v. Comm'r*, 110 TC 189 (1998), the court was compelled to conclude that Kennedy owned personal goodwill and that the payments he received from the purchaser were to purchase personal goodwill since Kennedy did not have a non-compete agreement with his corporation.

32

CURRENT ISSUES AFECTING S CORPORATIONS

**GOODWILL**

- **Tax Court Recharacterizes Payments for Personal Goodwill as Ordinary Income**.
  - The Tax Court held that the amounts paid were consideration for services rather than goodwill because there was no economic reality to the contractual allocation of payments to personal goodwill.
  - Specifically, the court found that the allocation of 75% of the total consideration paid by the purchaser to personal goodwill was a "tax-motivated afterthought" that occurred late in the negotiations.

33

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - The self-employment tax is the same as the total rate for the employers' and employees' FICA tax (2.9% HI tax rate and 12.4% OASDI tax rate).
  - For 2011, the maximum amount of self-employment income subject to the OASDI portion of the SE Tax is $106,800.

34

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Health Care and Education Reconciliation Act of 2010**.
  - The recently enacted Health Care and Education Reconciliation Act of 2010, H.R. 4872, P.L. 111-152, imposes a new Medicare tax on unearned income on partners, members of LLCs taxed as partnerships and S corporation shareholders.
  - The new Medicare tax provisions are effective for tax years beginning after 12/31/12.

35

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Health Care and Education Reconciliation Act of 2010**.
  - Specifically, Section 1411(a)(1) imposes a 3.8% Medicare tax on the lesser of (a) "net investment income" or (b) the excess of modified adjusted gross income over $250,000 in the case of taxpayers filing a joint return and over $200,000 for other taxpayers.

36

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Health Care and Education Reconciliation Act of 2010**.
  - Under Section 1411(c)(A)(i), "net investment income" includes gross income from interest, dividends, annuities, royalties, and rents other than such income which is derived in the ordinary course of a trade or business.

37

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Health Care and Education Reconciliation Act of 2010**.
  - Additionally, the term "net investment income" includes: (1) any other gross income derived from a trade or business if such trade or business is a passive activity within the meaning of Section 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under Section 469 with respect to the taxpayer.

38

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Health Care and Education Reconciliation Act of 2010**.
  - The Health Care and Education Reconciliation Act of 2010 also increased the Medicare portion of the self-employment tax by .9% (to 3.8%) on wages in excess of $250,000 in the case of taxpayers filing a joint return and more than $200,000 for other taxpayers.

39

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - Net earnings from self-employment" includes:
    - net income from a sole proprietorship; and
    - the individual's distributive share of income or loss from any trade or business carried on by a partnership of which he is a partner

40

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - There are several exceptions to the definition of "net earnings from self-employment," including the following:
    - Rentals.
    - Dividends and Interest.
    - Gain or Loss.
    - Limited Partners.

41

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - The application of the SE Tax to members of a limited liability company is problematic. The latest version of the proposed regulations were published in the Federal Register on January 13, 1997 (62 Fed. Reg. 1702 January 13, 1997).

42

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - As a result of the controversy created by the proposed SE Tax regulations, the Taxpayer Relief Act of 1997, Pub. L. No. 105-34 Section 935 (1997), prohibits the issuance or effectiveness of temporary or final regulations with respect to the definition of a limited partner under Section 1402(a)(13) prior to July 1998.

43

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - Prop. Reg. §1.1402-2(h) defines a "limited partner" as an individual holding an interest in an entity classified as a partnership unless:
    - The individual has personal liability for the debt of or claims against the partnership by reason of being a partner.
    - The individual has authority under the law of the jurisdiction in which the partnership is formed to contract on behalf of the partnership.
    - The individual participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.

44

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - Additionally, there are three exceptions to the general rule set forth in Prop. Reg. §1.1402-2(h), as follows:
    - Under the first exception, an individual who holds more than one class of interest in a partnership and who is not a limited partner under the general definition, may still be treated as a limited partner with respect to a specific class of interest.

45

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - The second exception applies to an individual who holds only one class of interest and who cannot meet the general definition of limited partner because he or she participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.

46

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Self-Employment Tax**.
  - The third exception applies to a service partner in a service partnership and provides that regardless of whether the individual can satisfy the general definition of a limited partner under one of the above-described exceptions, that individual may not be treated as a limited partner.

47

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **FICA Tax.**
  - For 2011, the maximum amount of wages subject to the OASDI portion of the FICA tax (and the self-employment tax) is $106,800.
    - OASDI = 6.2% on Employer and Employee.
    - HI = 1.45% on Employer and Employee.

48

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **FICA Tax.**
  - The Revenue Reconciliation Act of 1993 repealed the dollar limit on wages subject to the HI portion of the FICA tax and on self-employment income subject to the HI portion of the self-employment tax.
  - In order for shareholder-employees of S corporations to realize employment tax savings by withdrawing funds in the form of distributions rather than compensation, such distributions must not be recharacterized as "wages" for FICA purposes or as "net earnings from self-employment" for purposes of the self-employment tax.

49

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **FICA Tax.**
  - Dividends on shares of stock issued by a corporation are specifically excluded from the definition of net earnings from self-employment. §1402(a)(2).
  - Rev. Rul. 59-221, 1959-1 CB 225. S corporation's income does not constitute net earnings from self-employment for purposes of the tax on self-employment income.

50

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **FICA Tax.**
  - Because wages paid to shareholder-employees of S corporations are subject to Social Security taxes while S corporation income and distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions rather than wages.

51

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **FICA Tax.**
  - Where an S corporation has both shareholders who are employees and shareholders who are not employees, the increase in the amount of distributions received by the shareholders who are employees will be less than the amount by which their wages were reduced (since distributions must also be made to the shareholders who are not employees).

52

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **FICA Tax.**
  - Additionally, a program that minimizes the amount of wages paid to shareholder-employees will increase
    - purchase price formulas based on earnings;
    - bonus formulas for employees who are not shareholders of the S corporation that are based on earnings.
  - Decreasing the amount of wages paid to shareholder-employees of S corporations also will reduce the contribution base for contributions to the corporation's qualified plans.

53

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recharacterization of Distributions as Wages.**
  - Rev. Rul. 74-44, 1974-1 CB 287.
  - Rev. Rul. 71-86, 1971-1 CB 285.
  - Rev. Rul. 73-361, 1973-2 CB 331.
  - Ltr. Rul. 7949022.
  - *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990).
  - *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 80 (9th Cir. 1990).
  - *C.D. Ulrich v. U.S.*, 692 F. Supp. 1053 (D. Minn. 1988).

54

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recharacterization of Distributions as Wages.**
  - *Veterinary Surgical Consultants, P.C. v. Comm'r*, 117 TC 14 (2001).
  - *Van Camp and Brennion v. U.S.*, 251 F.3d 862 (9th Cir. 2001).
  - *Old Raleigh Realty Corp. v. Comm'r*, TC Summ. Op. 2002-61.
  - *David E. Watson P.C. v. U.S.*, 2010-1 USTC ¶50,444.

55

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recharacterization of Distributions as Wages.**
  - In non-abusive situations, the IRS may have difficulty in successfully asserting that distributions made by S corporations to shareholder-employees should be recharacterized as wages subject to Social Security taxes.

56

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - In October 2006, the Senate Finance Committee issued a follow-up report entitled "Additional Options to Improve Tax Compliance," which contained a proposal, among other things, that would generally treat service partnerships, LLCs and S corporations the same for self-employment purposes, so that the distributive share of income of a partner, member or shareholder from a service entity would be subject to self-employment tax.

57

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - Senator Rangel introduced a Bill in 2007 that would essentially subject all income from a service entity, whether a partnership, LLC or S corporation, to the SE Tax.
  - The Joint Committee on Taxation again addressed the SE Tax issue in JCT Report (JCX-48-08) on Selected Federal Tax Reform Issues Relating to Small Business, Choice of Entity for a June 5, 2008, Senate Finance Committee Hearing.

58

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - In IRS Fact Sheet FS-2008-25, the IRS again reminds taxpayers that shareholder-employees must receive reasonable compensation for their services from their S corporations. See e.g., *Radtke v. U.S*, 895 F.2d 1196 (CA-7 1990), and *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 80 (CA-9 1990).
  - Lists a number of factors.

59

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - On January 15, 2010, the United States Government Accountability Office ("GAO") released a report entitled "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules" (the "Report") (December 15, 2009, GAO-10-195).
  - The purported purpose of the GAO study was to look at "compliance challenges" for S corporations and their shareholders.

60

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - The genesis of the GAO study seems to be the report released on October 19, 2006 entitled "Additional Options to Improve Tax Compliance" that was prepared by members of the Joint Committee on Taxation. The purpose of this report was to find ways to close the "tax gap."
  - The report proposed that a partner's, member's or shareholder's distributive share of income from a service entity would be subject to the self-employment tax.

61

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - In reaction to the Senate Finance Committee Report, the American Bar Association Tax Section issued comments which provided, among other things, that the rules currently in effect for S corporations were correct and should not be changed.

62

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - Specifically, the ABA Tax Section stated the following:

    > Such a wholesale expansion of the base would not simply close the "tax gap"; instead it would represent a significant change in law for numerous closely-held businesses that are complying currently with the law.

63

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - The Report was issued without an opportunity to review it, and as was feared, the Report contains several statements that are highly controversial and appear to be quite misleading, including statements that there have been "long-standing problems with S corporation compliance" and that there was misreporting on 68% of S corporation income tax returns.

64

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - Although not expressly stated, the clear implication of the Report is that S corporations are somehow aberrantly noncompliant and abusive.
  - In response to a Records Request, the GAO stated that the Senate Finance Committee, as the Requester of the Report, ***refused*** to authorize the release of any information relating to the Report.

65

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - It appears that simply reporting a deduction amount on the wrong line would constitute "misreporting" for purposes of the 68% noncompliance rate, ***even though it had no impact on the S corporation's taxable income or the overall tax liability of the S corporation's shareholders***.

66

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - The second problem with the 68% "misreporting" percentage appears to be one of scale because there was no "de minimis" exception.
  - If a misclassification constitutes "noncompliance" and there is not a meaningful de minimis exception, it would not be surprising to find a noncompliance rate of 100% on any type of income tax return.

67

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - Finally, it is important to note that the Report cites deduction of ineligible expenses as the most common error. Most certainly, this is not a problem unique to S corporations, but is a problem which is just as prevalent, if not more prevalent, in sole proprietorships, partnerships (including LLCs taxed as partnerships), and C corporations.

68

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010.**
    - Section 413 of the American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213 (the "Act"), adds new §1402(m) to subject certain S corporation shareholders to the self-employment tax imposed under §1402 on their distributive share of the income of an S corporation.

69

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010.**
    - Specifically, Section 1402(m)(1)(a) provides that in the case of any "disqualified S corporation," each shareholder of such disqualified S corporation who provides "substantial services" with respect to the "professional service business" referred to in Section 1402(m)(1)(C) must take into account such shareholder's pro rata share of all items of income or loss described in Section 1366 in determining the shareholder's net earnings from self-employment.

70

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010.**
    - A disqualified S corporation is defined in Section 1402(m)(1)(C) as:
      - any S corporation which is a partner in a partnership which is engaged in a professional service business if substantially all of the activities of such S corporation are performed in connection with such partnership; and
      - any other S corporation which is engaged in a "professional service business" if the "principal asset" of such business is the "reputation and skill" of three or fewer employees.

71

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010.**
    - Section 1402(m)(3) defines the term "professional service business" as being any trade or business if substantially all of the activities of such trade or business involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

72

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010.**
    - Except as otherwise provided by the Secretary, a shareholder's pro rata share of items of the S corporation subject to the self-employment tax will be increased by the pro rata share of such items of each member of such shareholder's family (within the meaning of Section 318(a)(1)) who does not provide substantial services with respect to such professional service business.

73

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010.**
    - Additionally, Section 1402(m)(2) provides that in the case of any partnership which is engaged in a professional service business, Section 1402(a)(13) -- which generally exempts limited partners from the self-employment tax -- shall not apply to any partner who provides substantial services with respect to such professional service business.

74

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010.**
    - Proposal is too Broad and Unfairly Taxes Small Businesses Complying with the Law.
    - Proposal is Inconsistent with Long-Standing Policy.
    - Provision is Contrary to Recently Enacted Health Reform Bill.
    - IRS Already has Tools Necessary to Combat Abusive Situations.

75

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010**.
    - Rev. Rul. 74-44, 1974-1 CB 287; *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. United States*, 918 F.2d 80 (9th Cir. 1990).
    - Provision Unfairly Discriminates Against Small Business.
    - Provision Inappropriately Taxes S Corporation Shareholders on Other Family Members' Distributive Share of Income.

76

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010**.
    - Provision is Ambiguous and Invites Litigation – key examples include:
      - The definition of the term "professional service business" in the provision has, contrary to decades of prior statutory tax law, been expanded to include lobbying, athletics, investment advice or management, and brokerage services.
      - The provision uses the undefined term "substantial services" numerous times.

77

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010**.
    - Provision is Ambiguous and Invites Litigation – key examples include:
      - The new provision would require S corporations engaged in a professional service business to determine whether its principal asset is the "reputation and skill" (again, undefined) of three or fewer employees.

78

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax.**
  - **The American Jobs and Closing Tax Loopholes Act of 2010**.
    - Provision is Ambiguous and Invites Litigation – key examples include:
      - S corporations engaged in a professional service business would be required to get valuations of each of their assets in order to determine their principal assets -- such a valuation would be extremely difficult and expensive to obtain, as assets such as reputation and skill are not easily valued.

79

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax**.
  - Concern Over Lack of Transparency; No Open and Informed Debate.
  - Need for S Corporations for America's Small and Family-Owned Businesses.
  - In response to a waive of criticism, Senators Snowe and Enzi introduced an amendment to delete the new provision imposing self-employment tax on certain S corporations.

80

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax**.
  - Additionally, Senator Baucus, on 6/16/2010, introduced a new substitute to the House-passed bill which amends the S corporation provision.
  - Specifically, the proposal as amended by Senator Baucus would change the definition of a "disqualified S corporation" to mean any other S corporation which is engaged in a professional service business ***if "80% or more of the gross income of such business is attributable to the service of three or fewer shareholders of such corporation***."

81

CURRENT ISSUES AFFECTING S CORPORATIONS

**EMPLOYMENT TAX ISSUES**

- **Recent Attempts to Subject S Corporations to Self-Employment Tax**.
  - On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, which departs from its immediate predecessor, the American Jobs and Closing Tax Loopholes Act of 2010, most notably in that it would ***not*** impose self-employment payroll taxes on the pass-through income of S corporation shareholders.

82

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**
  - *Nathel* involved two brothers, Ira and Sheldon Nathel (the taxpayers), who organized three S corporations (G&D, W&N, and W&N Cal) with a third person, Gary Wishnatzki (Gary). Each of the taxpayers contributed capital in exchange for 25% of each of the S corporations. Gary owned the other 50% of each of the S corporations.

83

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**
  - In addition, the taxpayers each made loans on open account to G&D and W&N Cal (open-account debt) and were employed by W&N.

84

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**
  - In 1999, G&D borrowed approximately $2.5 million from two banks (bank loans) and the three shareholders each personally guaranteed the bank loans. Because of losses realized by G&D and W&N Cal, as of 1/1/2001, the taxpayers had zero basis in their shares of G&D and W&N Cal and reduced basis in their open-account debt under Section 1366(a)(2) and (b)(2), which provide for a reduction in the basis of stock and debt when losses pass through to the shareholders of an S corporation.

85

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**
  - The shareholders had disagreements and determined to reorganize the S corporations and the bank loans. Following the reorgani-zation, Gary owned 100% of G&D, the taxpayers owned 100% of W&N, and W&N Cal was liquidated.

86

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**

  In 2001, the following transactions occurred:

  **With respect to G&D--**
  - In February of 2001, G&D paid each of the taxpayers $649,775 on the open account debt.
  - In spring and summer of 2001, each of the taxpayers made additional capital contributions to G&D of $537,228.
  - The taxpayers were released from their guarantees of the bank loans.
  - Gary assumed the guarantees of the bank loans.
  - All of the taxpayers' stock in G&D was redeemed by G&D in exchange for no payment.

87

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**

  **With respect to W&N Cal-**

  - The taxpayers contributed $181,396 to capital.
  - Gary contributed $362,794 to capital.
  - W&N Cal paid outstanding third-party loans of $725,586.
  - W&N Cal paid $161,250 to each of the taxpayers to satisfy the open account debt obligation.
  - W&N Cal liquidated and the taxpayers received nothing in exchange for their stock.

88

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**
  - **With respect to W&N, Gary was fully redeemed in exchange for no payment on his stock.**

89

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**
  - On audit, the IRS determined that the capital contributions increased the shareholders' basis in their stock ***but did not restore or increase the*** shareholders' ***basis in the debt owed to them by the S corporations.*** The IRS also concluded that, as a result of their increased basis, the taxpayers recognized a capital loss on redemption and liquidation of their stock in G&D and W&N Cal.

90

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**
  - If the taxpayers had prevailed on the issue of the characterization of a capital contribution as tax-exempt income of the partnership, the "net increase" would have restored basis to the open account debt and reduced their income recognition on repayment of that debt. In addition, the taxpayers would not have recognized a capital loss on the liquidation of their interests in G&D and W&N Cal.

91

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**

  The court noted that upholding the taxpayers' position would undermine three cardinal and longstanding principles of the tax law:

  a. That a shareholder's contributions to the capital of a corporation increase the basis of the shareholder's ***stock*** in the corporation.

  b. That ***equity and debt are distinguishable*** and are treated differently by both the Code and the courts.

  c. That contributions to the capital of a corporation do not constitute income to the corporation.

92

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt.**
  - The court distinguished the holding in *Gitlitz*, 531 U.S. 206, 87 AFTR 2d 2001-417 (2001), saying that, unlike income from discharge of debt, contributions to the capital of a corporation are not listed in Section 61 as an item of gross income. In addition, Section 118 and the regulations under Section 118 (Reg. §1.118-1) specifically provide that capital contributions do ***not*** constitute income to a corporation.

93

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **QSub Election Does Not Increase Shareholders' Basis in Parent S Corporation**.
  - In ILM 201114017, 12/2/2010, the IRS rejected an inventive argument advanced by the taxpayers that upon a deemed liquidation of a corporation upon making a QSub election, any unrecognized gain as a result of the application of Section 332 (the difference between the fair market value of the subsidiary's stock and the parent S corporation's tax basis in the stock) passes through to the shareholders of the S corporation as "tax-exempt income" under Section 1366(a)(1)(A) so as to increase their basis in the S corporation under Section 1367(a)(1)(A).

94

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **QSub Election Does Not Increase Shareholders' Basis in Parent S Corporation**.
  - In the memorandum, the IRS cited three reasons for rejecting the taxpayers' argument that a deemed liquidation under Section 332 as a result of the QSub election produced tax-exempt income which flowed through to the S corporation shareholders increasing their basis under Section 1367(a)(1)(A).

95

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **QSub Election Does Not Increase Shareholders' Basis in Parent S Corporation**.
  - First, the IRS found that the legislative history of Section 332 made it clear that a Section 332 liquidation changes only the form of property ownership and, therefore, produces no accession to wealth that could be deemed an item of income under Section 1366. The IRS pointed out that nonrecognition provisions, such as Section 332, differ significantly from income exclusion provisions such as Section 103. Section 103 excludes state and local bond interest from a taxpayer's gross income for federal tax purposes.

96

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **QSub Election Does Not Increase Shareholders' Basis in Parent S Corporation**.
  - **First**, the IRS found that the legislative history of Section 332 made it clear that a Section 332 liquidation changes only the form of property ownership and, therefore, produces no accession to wealth that could be deemed an item of income under Section 1366. The IRS pointed out that nonrecognition provisions, such as Section 332, differ significantly from income exclusion provisions such as Section 103. Section 103 excludes state and local bond interest from a taxpayer's gross income for federal tax purposes.

97

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **QSub Election Does Not Increase Shareholders' Basis in Parent S Corporation**.
  - **Second**, the IRS found the taxpayers' reliance on *Gitlitz v. Comm'r*, 531 U.S. 206 (2001), misplaced because Gitlitz involved a cancellation of indebtedness, which produces a clear accession to wealth, whereas there is no accession to wealth in the case of a Section 332 liquidation, and applying Gitlitz to a Section 332 liquidation would produce a result inconsistent with general principles of statutory construction.

98

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **QSub Election Does Not Increase Shareholders' Basis in Parent S Corporation**.
  - The IRS also cited *Nathel v. Comm'r*, 131 TC 262 (2008), aff'd, 615 F.3d 83 (CA-2, 2010), in support of its position. In Nathel, the court rejected the taxpayer's argument that capital contributions to a corporation should increase their basis in the S corporation's indebtedness under Section 1367(b)(2) because the capital contributions constituted tax-exempt income within the meaning of Section 1366(a)(1)(A).

99

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **QSub Election Does Not Increase Shareholders' Basis in Parent S Corporation**.
  - **Finally**, the IRS found that the taxpayers' position would frustrate the congressional purpose underlying both Section 332 and Section 1374, in that Congress intended that Section 332 provide a timing benefit and not a permanent exclusion from income.

100

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Treatment of Suspended Losses in Connection with Adjustment of S Corporation Stock Basis**.
  - In comments by the New York State Society of Certified Public Accountants ("New York CPAs Comment on IRS's Interpretation of Regulations on Basis of S Corporation Stock." 2011 TNT 102-19 (5/23/2011)) and The Florida Bar Tax Section ("Florida Bar Tax Section Comments on S Corporation Stock Basis Issue," 2011 TNT 117-21 (June 15, 2011)), both groups have commented on an issue concerning the IRS's interpretation of Section 1366(d)(2)(A) and Reg. §1.1366-2(a)(2) regarding the effect of suspended losses in calculating a shareholder's basis in an S corporation's stock for the current year.

101

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Treatment of Suspended Losses in Connection with Adjustment of S Corporation Stock Basis**.
  - The specific issue relates to the treatment of losses that were not deductible because of the basis limitation on deductibility of losses under Section 1366(d)(2) (Suspended Losses), in calculating a shareholder's basis in S corporation stock for the current year, and in particular, with respect to the basis ordering rules.

102

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Treatment of Suspended Losses in Connection with Adjustment of S Corporation Stock Basis**.
  - Under the general basis ordering rules of Subchapter S, a shareholder's basis is first increased for income items, then reduced for distributions made by the S corporation to the shareholder (but not below zero), and finally decreased (but not below zero) by items of loss and deduction.

103

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Treatment of Suspended Losses in Connection with Adjustment of S Corporation Stock Basis**.
  - The comments submitted by both The Florida Bar Tax Section and the New York Society of CPAs state that suspended losses should not be segregated (unless otherwise required to be separately stated due to the nature of the suspended loss or deduction), but should be treated as if they arose in the next year with respect to that shareholder and combined with like items incurred in the current year.

104

CURRENT ISSUES AFFECTING S CORPORATIONS

**BASIS DEVELOPMENTS**

- **Treatment of Suspended Losses in Connection with Adjustment of S Corporation Stock Basis**.
  - However, in discussions with Susan L. Kerrick and Mark Pierce, both S corporation technical advisors for the IRS's Chief Counsel Office (Passthroughs and Special Industries), they have indicated that the IRS position is that any suspended loss (regardless of its nature) is a "separately stated item" which does not reduce basis until after distributions reduce basis.

105

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Basis Limitation on Pass Through of Losses and Deductions**.
  - Section 1366(d)(1) provides that the total amount of losses and deductions taken into account by an S corporation shareholder for any tax year cannot exceed the sum of:
    - The adjusted basis of the shareholder's stock in the S corporation (Section 1366(d)(1)(A)); and
    - The shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. Section 1366(d)(1)(B).

106

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Indebtedness Giving Rise to Basis Under §1366(d)(1)(B)**
  - Two requirements must generally be met in order for a loan to create basis under Section 1366(d)(1)(B):
    - The indebtedness must run directly from the S corporation to the shareholder; and
    - The shareholder must have made an "actual economic outlay," i.e., the shareholder must be poorer in a material sense after the transaction than he was before the transaction began.

107

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Must Run Directly from the S Corporation to the Shareholder**.
  - The IRS and the courts have consistently held that the indebtedness of the S corporation must run directly to the shareholder himself, and not to a related entity, in order for the shareholder to increase his basis in the S corporation. Exceptions ("Incorporated Pocketbook" Theory):
    - *Culnen v Comm'r*, TCM 2000-139
    - *Yates v. Comm'r*, TCM 2001-280

108

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructuring Resulting in Basis Increase**.
  - The common denominator in each of these rulings and cases (*other than Yates and Culnen and Rose*) is that the transaction originally involved a loan from an unrelated third-party lender.

109

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

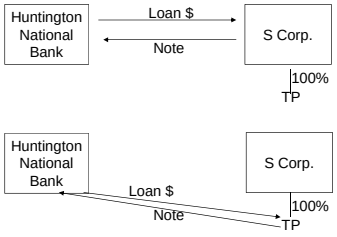
- **Loan Restructuring Resulting in Basis Increase**.
  - Revenue Ruling 75-144 and *Gilday v. Comm'r*. Shareholders were permitted to increase their basis in the S corporation where they substituted their own promissory notes for the S corporation's promissory notes to a third-party bank. The bank released the S corporation, and the S corporation issued its own promissory notes to the shareholders.

110

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Resulting in Basis Increase**.
  - ***Miller v. Comm'r*, TCM 2006-125**

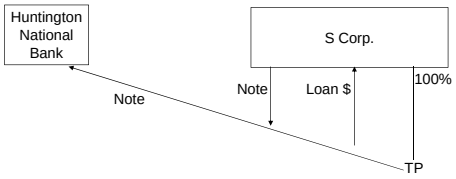



111

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Resulting in Basis Increase**.
  - ***Miller v. Comm'r*, TCM 2006-125**

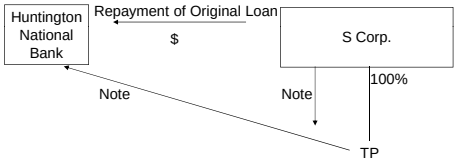



112

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Resulting in Basis Increase**.
  - ***Miller v. Comm'r*, TCM 2006-125**




113

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

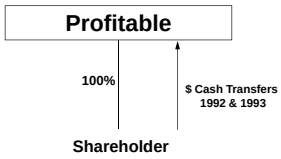
- **Loan Restructurings Resulting in Basis Increase**.
  - ***Miller v. Comm'r*, TCM 2006-125**
    - Also see Private Letter Rulings 8747013, 9811016, 9811017, 9811018 and 9811019.

114

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Resulting in Basis Increase**.
  - ***Rose v. Comm'r*, 101 AFTR 2d 2008-1888, 2008-1 USTC ¶50,318 (CA-11, 2008)**

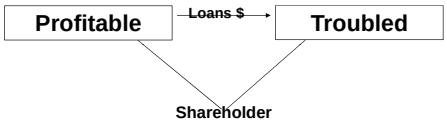



115

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Resulting in Basis Increase**.
  - ***Rose v. Comm'r***

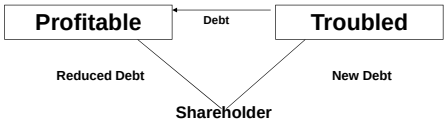



116

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Resulting in Basis Increase**.
  - ***Rose v. Comm'r***




**"Pays" some of Troubled's debt to Profitable by Reducing Loans owed to him by Profitable**

117

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

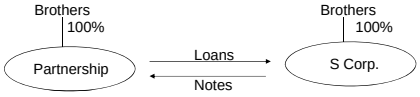
- **Loan Restructurings Not Resulting in Basis Increase**.
  - The one constant in each of these rulings and cases is that the transaction originally involved a loan from an entity controlled by the shareholder, rather than from an unrelated third-party lender.
    - TAM 9403003.
    - *Underwood v. Comm'r*.
    - *Shebester v. Comm'r*.
    - *Griffith v. Comm'r*.
    - *Wilson v. Comm'r*.
    - *Hitchins v. Comm'r*.
    - *Bhatia v. Comm'r*.
    - *Thomas v. Comm'r*.
    - *Oren v. Comm'r*.
    - *Kaplan v. Comm'r*.
    - *Ruckriegel v. Comm'r*.
    - TAM 200619021.
    - *Kerzner v. Comm'r*.

118

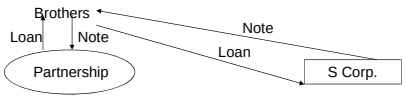
CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - ***Ruckriegel v. Comm'r,* TCM 2006-78**




Subsequently, new notes were executed by Brothers to the Partnership, and then by S corporation to Brothers, with original Notes from S Corporation to Partnership being cancelled.




119

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - ***Ruckriegel v. Comm'r,* TCM 2006-78**
    - The court rejected the IRS's argument that the "economic outlay" requirement is met only if a taxpayer invests in or lends to the S corporation either his own funds or funds that are borrowed from an unrelated party to whom he is personally liable.

120

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

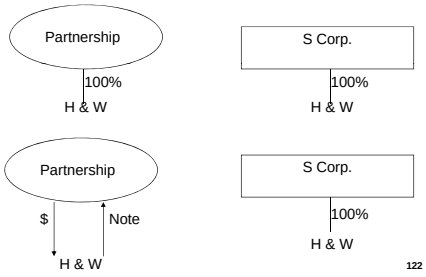
- **Loan Restructurings Not Resulting in Basis Increase**.
  - ***Ruckriegel v. Comm'r,* TCM 2006-78**
    - The court in *Ruckriegel* further stated: " …we find no categorical rule, under §1366(d)(1)(B), the regulations thereunder, applicable case law, or indeed, as a matter of plain common sense, requiring a common shareholder to fund the S corporation's losses with funds from his mattress or with funds borrowed by him from a bank or other unrelated party, rather than with funds obtained from another controlled entity, in order to obtain a basis in the unprofitable S corporation to the extent of the funding."

121

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***

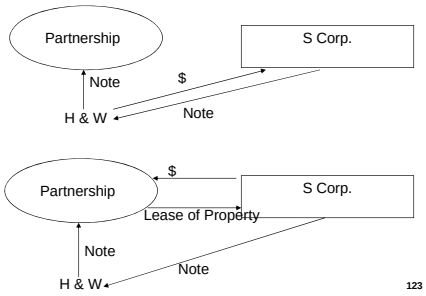



122

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***




123

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***
    - The IRS concluded that as a result of the circular route of the funds (from the Partnership to taxpayers, from taxpayers to S Corp and from S Corp back to the Partnership), the "economic insignificance" of the terms of the notes, the lack of repayment on the notes and the limits imposed on the taxpayers' ultimate liability to the Partnership, it was clear that no "economic outlay" that left the taxpayers "poorer in a material sense" occurred.

124

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***
    - In reaching its decision, the Tax Court cited *Oren v. Comm'r*, TCM 2002-172 *aff'd* 357 F.3d 854 (CA-8, 2004), for the proposition that transactions involving a brief, circular flow of funds (beginning and ending with the original lender) designed solely to generate bases in an S corporation have no economic substance and therefore do not evidence the required economic outlay.

125

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***
    - Specifically, the Tax Court held that each year, the partnership lent money to the taxpayers, the taxpayers then lent the proceeds to the S corporation and the S corporation then paid rent back to the partnership. From the Tax Court's point of view, the transaction lacked economic sense or substance since the money wound up right where it started.

126

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***
    - The Tax Court also distinguished *Gilday v. Comm'r*, TCM 1982-242, even though it too involved a circular flow of funds. The sole distinction in that case was that the original lender was an unrelated third party bank, and the court found that "when funds come from an unrelated third party, the arm's-length transaction tends to insure that repayment will be enforced."

127

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***
    - Although the Tax Court characterized the transaction as a "circular flow of funds," both the Tax Court and the IRS have granted basis increases in almost identical situations (or in situations with even less favorable facts).

128

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***
    - *Kerzner*, just like TAM 200619021, represents an expansion of the IRS's "not so kind and gentle" approach to back-to-back loans in the S corporation area.

129

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Not Resulting in Basis Increase**.
  - **TAM 200619021 and *Kerzner***
    - It is also particularly disturbing to note that the Tax Court openly acknowledges in the Kerzner case that the partnership could not make loans except out of its "net profits (after debt service to HUD)," and as such, **such funds were clearly subjected to taxation and the taxpayers (as partners of the partnership) clearly had a tax cost basis in such distributions**.

130

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Should Result in Basis Increase Regardless of Whether Obligee on Shareholder's Note is Unrelated Third-Party Lender or Related Corporation**
  - Back-to-back loans are not inherently abusive.
  - Distinctions drawn by IRS and courts unwarranted and not justified under the Code.
  - Testing actual economic outlay by reference to whether shareholder is poorer in a material sense after transaction is inappropriate.
  - IRS simply assuming that if the loan is between related parties it will never be repaid.

131

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Should Result in Basis Increase Regardless of Whether Obligee on Shareholder's Note is Unrelated Third-Party Lender or Related Corporation**
  - The IRS is punishing S corporation shareholders for having access to cash from a source other than a third-party lender.
  - IRS is implicitly applying an attribution rule in the context of §1366(d)(1)(B). There is no authority to apply an attribution rule in this context.
  - The IRS's concern that funds borrowed by a shareholder from his controlled or wholly-owned corporation will not be repaid is misplaced.

132

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **Loan Restructurings Should Result in Basis Increase Regardless of Whether Obligee on Shareholder's Note is Unrelated Third-Party Lender or Related Corporation**
  - The IRS would treat such indebtedness as indebtedness for other purposes of the Code such as the imputed interest rules under §7872.
  - The IRS's approach to basis more restrictive than the at-risk limitation rules under §465 as set forth in Proposed Regulations Section 1.465-24(a)(1).

133

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **IRS Has Announced on Several Occasions it Plans to Issue Regulations on Back-to-Back Loans**.
  - 10/30/2008
  - 3/5/2010
  - 2/25/2011
  - 5/16/2011

134

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **ABA Tax Section Submits Comments on Qualification of Debt as "Indebtedness of an S Corporation to a Shareholder" under Section 1366(d)(1)(B) in Connection with Back-to-Back Loans**.
  - The Comments were approved and submitted on behalf of the American Bar Association Section of Taxation to the Treasury Department and the IRS on July 26, 2010.
    - Back-to-Back Loans are Not Inherently Abusive Transactions Regardless of Whether Funds are Provided by Unrelated Third Party or a Related Party.

135

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **ABA Tax Section Submits Comments on Qualification of Debt as "Indebtedness of an S Corporation to a Shareholder" under Section 1366(d)(1)(B) in Connection with Back-to-Back Loans**.
  - ❖ No Statutory Basis for Denying Basis Increases for Back-to-Back Loans.
  - ❖ No Economic Basis for Denying Basis Increases for Back-to-Back Loans.

136

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **ABA Tax Section Submits Comments on Qualification of Debt as "Indebtedness of an S Corporation to a Shareholder" under Section 1366(d)(1)(B) in Connection with Back-to-Back Loans**.
  - ➢ Recommendation.
    - ❖ The ABA Tax Section recommends that the Treasury and the IRS adopt regulations that provide for basis increases under Section 1366(d)(1)(B), regardless of the source of the funds used by the S corporation shareholder to make the loan, provided that there is a bona fide indebtedness between the shareholder and the lender of the funds.

137

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **ABA Tax Section Submits Comments on Qualification of Debt as "Indebtedness of an S Corporation to a Shareholder" under Section 1366(d)(1)(B) in Connection with Back-to-Back Loans**.
  - ➢ Recommendation.
    - ❖ The regulations should focus on those factors that would be critical in the legal enforcement of the loans against the shareholder and the S corporation, respectively. Such factors include contemporaneous written documentation, interest at or above the AFR, clear payment terms, disclosure in financial statements, etc.

138

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK TO BACK LOANS AND S CORPORATION BASIS**

- **AICPA Proposes Safe Harbor for Back-to-Back Loans**.
  - The AICPA's safe harbor provides that a shareholder note will be treated as debt qualified to permit the S corporation's shareholder to increase his basis in indebtedness from the corporation and, assuming the at-risk and passive activity loss limitations are met, to deduct losses under Section 1366(d), if the following seven points are met:
    - The note is a written unconditional promise by the corporation to pay the shareholder, on demand or on a specified date, a sum certain in money.

139

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **AICPA Proposes Safe Harbor for Back-to-Back Loans**.
    - The interest rate specified in the instrument meets, at the minimum, the published applicable federal rate for the type of loan and for the time the loan is made.
    - Interest payment dates are specified in the instrument.
    - The instrument is legally enforceable under state law.

140

CURRENT ISSUES AFFECTING S CORPORATIONS

**BACK-TO-BACK LOANS AND S CORPORATION BASIS**

- **AICPA Proposes Safe Harbor for Back-to-Back Loans**.
    - The S corporation is not an obligor or co-obligor on the note issued by the shareholder to the primary lender in a back-to-back situation.
    - Interest and principal payments are made pursuant to the Agreement. A doctrine of substantial compliance as opposed to strict compliance would apply.
    - Loans are reported appropriately on tax returns and year-end financial statements, if any, of the company and shareholder.

141

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Introduction**.
  - Section 1374 imposes a corporate-level tax on the built-in gains of S corporations that were previously C corporations. Section 1374 as originally enacted applies to built-in gains recognized by a corporation during the 10 calendar year period following such corporation's conversion to S status. Section 1374(d)(7).

142

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Small Business Jobs Act of 2010**.
  - Section 2014 of the Small Business Jobs Act of 2010 amends Section 1374 to provide for the reduction of the recognition period during which corporations that converted from C corporation status to S corporation status are subject to the built-in gain tax from 10 years to 5 years for taxable years beginning in 2011.

143

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Small Business Jobs Act of 2010**.
  - The text of the amendment reads as follows:

    (b) Special Rules for 2009, 2010 and 2011. - No tax shall be imposed on the net recognized built-in gain of an S corporation - (i) in the case of any taxable year beginning in 2009 or 2010, if the 7th taxable year in the recognition period preceded such taxable year, or (ii) in the case of any taxable year beginning in 2011, if the 5th year in the recognition period preceded such taxable year.

144

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Small Business Jobs Act of 2010**.
  - Effective Date.
    - It is interesting to note that the proposed amendment specifically uses the term "taxable year" in connection with the recognition period for taxable years beginning in 2009 and 2010, but only uses the term "year" (not taxable year) in connection with the recognition period for a taxable year beginning in 2011.

145

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **American Recovery and Reinvestment Tax Act of 2009**.
  - Economic Stimulus Bill provides that for taxable years beginning in 2009 and 2010, BIG tax under Section 1374 doesn't apply if 7th taxable year in corporation's recognition period preceded such taxable year.

146

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **American Recovery and Reinvestment Tax Act of 2009**.
  - Specifically, §1374(d)(7)(B), as amended by the 2009 Act, reads as follows:

    "(B) SPECIAL RULE FOR 2009 AND 2010. - In the case of any taxable year beginning in 2009 or 2010, no tax shall be imposed on the net unrecognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year. The preceding sentence shall be applied separately with respect to any asset to which paragraph (8) applies."

147

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **American Recovery and Reinvestment Tax Act of 2009**.
  - **Disposition of Assets in 2009 and 2010 by Converted C Corporations**.
    - Clearly, for dispositions made by converted C corporations in 2009 or 2010, no built-in gain tax will apply to such S corporation if the ***7th taxable year*** in the recognition period preceded the year of disposition (2009 or 2010).
    - Taxable year standard versus calendar year standard.
    - Short Taxable Years.

148

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **American Recovery and Reinvestment Tax Act of 2009**.
  - **Dispositions on Installment Sales Method Occurring in 2009 or 2010**.
    - If the disposition occurred in 2009 or 2010, could such disposition still be subject to the built-in gain tax in 2011 or later years if sales proceeds are received in such years (which are within the original 10-year recognition period) and the corporation is reporting its gain on the installment method under Section 453?
    - Statutory language versus Committee Reports.

149

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **American Recovery and Reinvestment Tax Act of 2009**.
  - **Installment Sale of Assets Prior to 2009 or 2010**.
    - Is a disposition occurring ***prior*** to 2009 or 2010 subject to the built-in gain tax under new Section 1374(d)(7)(B) if gain is recognized under the installment method in 2009 or 2010 (and the 7-year taxable year test is met for such years)?

150

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **American Recovery and Reinvestment Tax Act of 2009**.
  - **Application to Assets Acquired in Carryover Basis Transactions**.
    - Section 1374(d)(8) and Reg. §1.1374-8(a) provide that if an S corporation acquires any asset in a transaction in which the S corporation's basis in the acquired asset is determined in whole or in part by reference to a C corporation's basis in such asset, Section 1374 applies to the net recognized built-in gain attributable to the asset so acquired.

151

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **American Recovery and Reinvestment Tax Act of 2009**.
  - **Application to Assets Acquired in Carryover Basis Transactions**.
    - New Section 1374(d)(7)(B) may apply differently (based on calendar years rather than taxable years) to assets acquired in a carryover basis transaction under Section 1374(d)(8).
    - Express statutory language versus legislative history.

152

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **American Recovery and Reinvestment Tax Act of 2009**.
  - **Application to Assets Acquired in Carryover Basis Transactions**.
    - Section 2(h) of the Tax Technical Corrections Act of 2009, H.R. 4169, 111th Cong., 1st Sess., introduced on 12/2/09, would strike the phrase "7th taxable year" and insert "7th year" in Section 1374(d)(7)(B) retroactively for tax years beginning after 2008.
    - AICPA has requested that any change in statutory language be prospective only.

153

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Ltr. Rul. 200925005**.
  - In Ltr. Rul. 200925005, the IRS ruled that the payment of certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable of the corporation at the time of its conversion to S status would constitute built-in deduction items

154

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Ltr. Rul. 200925005**.
  - Built-in gain tax items specifically include the collection (after the conversion to S status) of pre-conversion accounts receivable by a cash-basis taxpayer ***(a built-in income item)***. Likewise, built-in loss items specifically include the payment (after the conversion to S status) of pre-conversion payables by a cash-basis taxpayer ***(a built-in deduction item)***.

155

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Ltr. Rul. 200925005**.
  - A common method that has been employed by practitioners to avoid the built-in gain tax imposed on the accounts receivable of a cash basis service corporation is to accrue bonuses (in an amount equal to its collectible receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in its first tax year as an S corporation.

156

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Ltr. Rul. 200925005**.
  - Ltr. Rul. 200925005 makes it clear that the built-in gain tax on accounts receivable can be avoided by the converted corporation paying out compensation related to such accounts receivable to its shareholder-employees within the first two and one-half months of the corporation's first tax year as an S corporation.

157

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **S Corporation Allowed to Identify Publicly Traded Partnership Units to Avoid Built-In Gain Tax.**
  - Ltr. Rul. 200909001 addresses the application of Section 1374 to a sale of units in a publicly traded partnership taxed as a partnership where the S corporation or its subsidiaries own some units with a holding period less than the 10-year recognition period and other units with a holding period greater than the 10-year recognition period.

158

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **S Corporation Allowed to Identify Publicly Traded Partnership Units to Avoid Built-In Gain Tax.**
  - Ltr. Rul. 200909001 holds that TP's sale of separately identified PS1 common units, after the units have been held for more than the 10-year recognition period under Section 1374(d)(7), will not subject TP to built-in gain tax under Section 1374(a), citing Cf Reg. §1.1223-3(c)(2).

159

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Determines Value of Partnership Interests for Built-In Gain Tax**.
  - In *Ringgold Telephone Co. v. Comm'r,* TCM 2010-103, the Tax Court determined the fair market value of a partnership interest owned by an S corporation for purposes of determining the built-in gain tax imposed under Section 1374.

160

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Determines Value of Partnership Interests for Built-In Gain Tax**.
  - The taxpayer was a C corporation which elected to be taxed as an S corporation effective 1/1/2000. The taxpayer owned a 25% partnership interest in Cellular Radio of Chattanooga ("CRC").
  - On 11/27/2000, BellSouth acquired the taxpayer's 25% interest in CRC for $5,220,423.

161

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Determines Value of Partnership Interests for Built-In Gain Tax**.
  - The taxpayer reported the recognized built-in gain attributable to the sale of its interest in CRC using a fair market value as of 1/1/2000 of $2,600,000.
  - The IRS, on the other hand, asserted a deficiency based on a fair market value equal to the $5,220,423 sales price of the CRC interest.

162

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Determines Value of Partnership Interests for Built-In Gain Tax**.
  - The Court considered:
    - the evidence presented by the taxpayer's expert;
    - the evidence presented by the IRS's expert;
    - the probative value of the sale to BellSouth;
    - the effect of the right of first refusal contained in the Partnership Agreement; and
    - the unique circumstances surrounding BellSouth's purchase of the partnership interest.

163

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Determines Value of Partnership Interests for Built-In Gain Tax**.
  - The court concluded that the values yielded by the business enterprise analysis ($2,718,000), the distribution yield analysis ($3,243,000) and the BellSouth sales price ($5,220,423) should be weighted equally in arriving at the fair market value of the CRC interest, resulting in a fair market value of $3,727,141.
  - Planning opportunity.

164

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Adopts Estate's 17.4% Discount for Built-In Gains Tax.**
  - In *Estate of Litchfield*, T.C. Memo. 2009-21, involving the valuation of a trust's minority interest in a family S corporation and C corporation, the Tax Court adopted the estate claimed 17.4% discount for potential built-in gains taxes of the S corporation, rejecting the IRS's 2% discount.

165

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Adopts Estate's 17.4% Discount for Built-In Gains Tax.**
  - Regarding application of a BIG discount, the Tax Court first determined that a willing buyer/willing seller would negotiate and agree to significant discounts to Net Asset Value to account for estimated corporate level taxes that would be due on a sale of the nonoperating assets of an S corporation.

166

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Adopts Estate's 17.4% Discount for Built-In Gains Tax.**
  - The court found that the estate's assumptions relating to asset turnover was based on more accurate data than the IRS's assumptions. Accordingly, the Tax Court accepted the estate expert's estimate of BIG discounts.

167

CURRENT ISSUES AFFECTING S CORPORATIONS

**BUILT-IN GAIN TAX DEVELOPMENTS**

- **Tax Court Adopts Estate's 17.4% Discount for Built-In Gains Tax.**
  - The court noted, however, that its acceptance of a turnover rate that resulted in the S corporation's assets being deemed to be sold during the 10-year recognition period was based on the unique facts of the case, and that not all S corporations will be allowed a BIG tax discount. See, *Dallas*, T.C. Memo. 2006-212.

168

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - In Rev. Rul. 2008-18, the IRS ruled that in the two situations presented in the rulings, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the S election of the existing corporations did not terminate (and were carried over to the newly formed corporations), but that the newly formed corporations would be required to obtain new employer identification numbers.

169

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - In situation 1 of the ruling, B, an individual, owned all of the stock of Y, an S corporation. In year 1, B forms Newco and contributes all of the Y stock to Newco, which meets the requirements for qualification as a small business corporation. Newco timely elects to treat Y as a qualified subchapter S subsidiary (QSub) effective immediately following the transaction. The ruling states that the transaction meets the requirements of an F reorganization under Section 368(a)(1)(F). In year 2, Newco sells 1% of the stock of Y to D, an unrelated party.

170

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - In situation 2, C, an individual, owns all of the stock of Z, an S corporation. In year 1, Z forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merges with and into Z, with Z surviving and C receiving solely Newco stock in exchange for his stock of Z. Consequently, C owns 100% of Newco, which in turn owns 100% of Z. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub effective immediately following the transaction. Again, the ruling expressly states that the transaction meets the requirements of an F reorganization.

171

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - The ruling first cites Rev. Rul. 64-250, 1964-2 C.B. 333, which provided that when an S corporation merges into a newly formed corporation in a transaction qualifying as a reorganization under Section 368(a)(1)(F) and the newly formed surviving corporation also meets the requirements of an S corporation, the reorganization does ***not*** terminate the S election, and as such, the S election remains in effect for the new corporation (without the new corporation being required to file a new S election).

172

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - The ruling then cites Rev. Rul. 73-526, 1973-2 C.B. 404, in which the IRS concluded that where an S corporation merged into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation.

173

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Rev. Rul. 2008-18 provides, however, that since the publication of Rev. Rul. 73-526, the Code has been amended to provide the classification of certain wholly-owned subsidiaries of S corporations as QSubs and the regulations under Section 6109 have been amended to address the effect of QSub elections under Section 1361.

174

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Specifically, Reg. §301.6109-1(i)(1) provides that any entity that has a federal employer identification number will retain that employer identification number if a QSub election is made for the entity under Reg. §1.1361-3 or if a QSub election that was in effect for the entity terminates under Reg. §1.1361-5.

175

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Additionally, Reg. §301.6109-1(i)(2) provides that, except as otherwise provided in regulations or other published guidance, a QSub must use the parent S corporation's employer identification number.

176

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Additionally, for tax years beginning after 12/31/2004, Section 1361(b)(3)(E) was amended to provide that except to the extent provided by the IRS, QSubs are not disregarded for purposes of information returns. Further, QSubs are not disregarded for certain other purposes as provided in the regulations.

177

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - For example, Reg. §1.1361-4(a)(7) provides that a QSub is treated as a separate corporation for purposes of employment tax and related employment requirements effective for wages paid on or after 1/1/2009. Because a QSub is treated as a separate corporation for certain federal tax purposes, the QSub must retain and use its employer identification number when it is treated as a separate corporation for federal tax purposes.

178

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Because of these recent changes, the IRS concluded that it would not be appropriate for the acquiring corporation in a reorganization under Section 368(a)(1)(F) to use the employer identification number of the transferor corporation that becomes a QSub.

179

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Thus, in situation 1, although Y's original S election will not terminate but will continue for Newco, Newco will be required to obtain a new employer identification number and Y will retain its employer identification number even though a QSub election is made for it and will be required to use its original employer identification number anytime Y is otherwise treated as a separate entity for federal tax purposes.

180

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Additionally, in year 2, when Newco sells 1% of the stock of Y to D, Y's QSub election will terminate under Section 1361(b)(3)(C) and Y will be required to use its original employer identification number following the termination of its QSub election.

181

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Likewise, in situation 2, Z's original S election will not terminate as a result of the F reorganization but will continue for Newco, and as such, Newco will not be required to file a new S election. Again, however, Newco will be required to obtain a new employer identification number and Z must retain its employer identification number even though a QSub election is made for Z and must use its original employer identification number any time it is otherwise treated as a separate entity for federal tax purposes or if its QSub election terminates.

182

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations.**
  - Rev. Rul. 2008-18 applies to F reorganizations occurring on or after 1/1/2009. For F reorganizations occurring on or after 3/7/2008 and before the effective date of the ruling, taxpayers may rely on Rev. Rul. 2008-18.

183

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **Merger of Parent S Corporation into QSub Constitutes an F Reorganization.**
  - In Ltr. Rul. 201007043, the IRS ruled that an S corporation's merger into its wholly owned qualified subchapter S subsidiary (QSub) constituted a tax-free reorganization under Section 368(a)(1)(F) without adversely affecting S corporation status.

184

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **Merger of Parent S Corporation into QSub Constitutes an F Reorganization.**
  - In the ruling, the S corporation and one of its two wholly owned QSubs desired to combine their assets and operations into a single corporation in order to take advantage of planned efficiencies and to reduce expenses and redundancies. Because certain legal agreements of the QSub prohibited the QSub from merging upstream into the S corporation, it was decided that the S corporation should merge downstream into the QSub.

185

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **Merger of Parent S Corporation into QSub Constitutes an F Reorganization.**
  - Citing Rev. Rul. 64-250, 1964-2 CB 333, the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSub following the merger. Additionally, citing Rev. Rul. 2004-85, 2004-2 CB 189, the IRS found that the status of the S corporation's other QSub would not terminate as a result of the F reorganization.

186

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **S Corporation Sale of Assets Structured as F Reorganization Upheld.**
  - In Ltr. Rul. 201115016, the IRS ruled that the contribution of all of an S corporation's stock to a new wholly owned corporation (NewCo) in exchange for all of NewCo's shares, followed by NewCo's making a QSub election, qualifies as an F reorgination, that NewCo will be eligible to be treated as an S corporation and that such S election will be treated not as if it had terminated, but instead had remained in effect.

187

CURRENT ISSUES AFFECTING S CORPORATIONS

**F REORGANIZATIONS AND QSUBS**

- **S Corporation Sale of Assets Structured as F Reorganization Upheld.**
  - This ruling allowed the owner of the S corporation to use this F reorganization structure to create a holding company subsidiary QSub structure, retaining the portion of the S corporation's assets the shareholder wanted to keep in the parent S corporation and dropping into the QSub the assets the shareholder desired to sell through a sale of the stock of the now QSub, which will be treated as an asset sale.

188

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **IRS Recharacterizes Dividends to Sole Shareholder of S Corporation as Wages.**
  - In *David E. Watson PC v. United States*, 107 AFTR 2d ¶2011-311, 2010-1 USTC ¶50,444 (S.D. Iowa 2010), the Tax Court denied the taxpayer's Motion for Summary Judgment in connection with its claim for refund of employment taxes paid where the IRS recharacterized dividends paid by the S corporation to its sole shareholder as wages subject to employment taxes.

189

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **IRS Rules that Disproportionate Distributions Did Not Terminate S Corporation Election.**
  - In Ltr. Rul. 201006026, the IRS ruled that disproportionate distributions made by an S corporation to its two shareholders did not cause the corporation to have a second class of stock under Section 1361(b)(1)(D), and as such, the corporation's S election was not terminated.

190

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **IRS Rules that Disproportionate Distributions Did Not Terminate S Corporation Election.**
  - Under the facts of the ruling, an S corporation made disproportionate distributions to its shareholders. It was represented in the ruling, however, that each share in the S corporation had identical rights to liquidation proceeds and distributions, that no provisions existed in the governing documents, regulations, or bylaws that varied those rights and that no other binding agreement existed that varied those rights. Additionally, it was represented that a corrective distribution to the shareholders was made which resulted in distributions proportionate to the S corporation shareholders since its inception as an S corporation.

191

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **IRS Rules that Disproportionate Distributions Did Not Terminate S Corporation Election.**
  - Based upon the representations made in the ruling, the IRS concluded that the disproportionate distributions did not create a second class of stock for purposes of Section 1361(b)(1)(B). However, the IRS expressly stated that the ruling was contingent upon the S corporation making corrective distributions so that each shareholder has received distributions proportionate to their interests and that the failure to make such corrective distributions would render the ruling void.

192

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **IRS Rules that Disproportionate Distributions Did Not Terminate S Corporation Election.**
  - Conditioning the ruling on the S corporation making corrective distributions should not be required since the regulations make it clear that disproportionate distributions (that are not the result of a governing provision) cannot cause the corporation to have a second class of stock. This is the same result as reached by the IRS in Ltr. Rul. 200802002.

193

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **IRS Rules that Disproportionate Distributions Did Not Terminate S Corporation Election.**
  - It would have been more appropriate to provide that if corrective distributions were not made, the IRS would have the authority to recharacterize those payments to give them appropriate tax effect, but would in no event result in the corporation having a second class of stock.

194

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **Sole Shareholder Liable for Corporation's Taxes as Transferee.**
  - In *Holmes*, 107 AFTR2d 2011-1554 (DC Colo., 2011), the court held that a corporation's sole shareholder was liable as the transferee for federal income taxes assessed against the corporation.

195

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **Sole Shareholder Liable for Corporation's Taxes as Transferee.**
  - The corporation, an S corporation, incurred an excess capital gains tax liability under Section 1374 as in effect prior to its amendment by the Tax Reform Act of 1986, as the result of the disposition of most or all of its assets. During the period in issue, the corporation made distributions in cash to its sole shareholder totaling $3,671,110. The distributions to the taxpayer were intended to wind down the business in a tax advantageous way and were in accordance with the advice of the corporation's accountant.

196

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **Sole Shareholder Liable for Corporation's Taxes as Transferee.**
  - The government asserted that it was entitled to obtain payment for the corporation's tax liability from the distributions made to the corporation's sole shareholder because, among other reasons, the distributions were part of a liquidation that could be claimed by a creditor under applicable state law.

197

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **Sole Shareholder Liable for Corporation's Taxes as Transferee.**
  - The taxpayer argued the statute applied only to the assets distributed after the corporation dissolved and that since the corporation was not officially dissolved until 2005, distributions he received before that date could not be applied to the corporation's debt. The court rejected the taxpayer's argument and stated that the statute applied to assets received by owners in liquidations before or after the official act of dissolution. Consequently, the court ruled that the taxpayer was liable for the corporation's taxes up to the amount of distributions he received from the corporation.

198

CURRENT ISSUES AFFECTING S CORPORATIONS

**MISCELLANEOUS S CORPORATION DEVELOPMENTS**

- **Shareholder Filing for Dissolution Had to Report His Share of S Corporation's Income.**
  - In a Summary Opinion, *Rocchio*, TC Summary Opinion 2011-58, the Tax Court has held that a taxpayer had to report his pro rata share of a family owned S corporation's income on his return even though, due to an ongoing family dispute, he had filed for judicial dissolution of the company and hadn't received income from the entity.

199

**Chatanooga Tax Practitioners**
**Novermber 9, 2011**

## CURRENT ISSUES AFFECTING S CORPORATIONS

**Ronald A. Levitt**

**Sirote & Permutt**
**2311 Highland Ave S**
**Birmingham, AL 35205**
**205-930-5274**
**rlevitt@sirote.com**

Sirote

200