CHAPTER 15

S CORPORATIONS*

A. INTRODUCTION

We have seen that a C corporation's net income is taxable at a flat rate of 21 percent,[1] and those earnings are taxed again when distributed as dividends to noncorporate shareholders.[2] Although many techniques have been devised to avoid the impact of the double tax regime, that framework nonetheless remains the principal feature distinguishing the taxation of incorporated and unincorporated businesses. In comparison, partnerships and limited liability companies are treated for tax purposes as conduits whose income and deductions pass through to the partners or members as they are realized, with the various items retaining their original character in the process.[3] Because income is taxed at the partner level, partnership distributions of cash and property generally do not produce any additional tax liability.[4]

In the early days of our tax history, taxpayers sought to obtain the state law benefits of the corporate form (limited liability, centralized management, etc.) without having to endure the sting of the double tax. Congress attempted to accommodate this desire over 60 years ago when it enacted Subchapter S, which allows the shareholders of a "small business corporation" to elect to avoid a corporate level tax in most situations. The stated purpose of Subchapter S was to permit a business to select its legal form "without the necessity of taking into account major differences in tax consequence."[5]

As originally adopted, Subchapter S was a modified corporate scheme of taxation rather than a partnership-like pass-through regime. This early version was a strange hybrid of corporate and partnership concepts, laden with complexity. In these formative years, an electing small business necessarily depended on skilled lawyers and accountants to avoid Subchapter S's many technical traps. Calls for reform began with a 1969 Treasury Department study, which in general proposed a liberalization of the eligibility requirements and the adoption of a conduit

* See generally Eustice, Kuntz, & Bogdanski, Federal Income Taxation of Subchapter S Corporations.

1 I.R.C. § 11.

2 I.R.C. §§ 61(a)(7), 301.

3 I.R.C. § 702(a), (b). Most limited liability companies are treated as partnerships for tax purposes. See Chapter 1E2a, supra, and Schwarz, Lathrope & Hellwig, Fundamentals of Partnership Taxation (11th ed. 2019).

4 I.R.C. § 731(a).

5 S.Rep. No. 1983, 85th Cong., 2d Sess. § 68 (1958), reprinted in 1958–3 C.B. 922.

approach more closely conforming to the tax treatment of partnerships.[6] Congress gradually relaxed the eligibility requirements through piecemeal legislation, most notably the Subchapter S Revision Act of 1982.[7] The 1982 Act greatly reduced the tax disparities between Subchapter S corporations and partnerships by replacing the modified corporate structure of Subchapter S with a statutory scheme which is similar but not identical to the tax treatment of partnerships and partners under Subchapter K. That Act also introduced the terminology now used in the Code. Electing small business corporations are called "S corporations" while other corporations are known as "C corporations."[8]

Subsequent legislation further liberalized the Subchapter S eligibility requirements and eliminated technical traps for corporations seeking to elect and maintain S corporation status. As a result of these reforms, the tax differences between partnerships and S corporations have narrowed, making operation as an S corporation a viable, albeit much less flexible, alternative for some closely held businesses. But significant differences in tax treatment remain between S corporations and unincorporated businesses. Subchapter S status is available only for corporations that satisfy the statutory definition of "small business corporation" in Section 1361(b). This definition restricts eligibility to corporations with 100 or fewer shareholders; prohibits more than one class of stock; and limits the types of permissible shareholders. Moreover, partners' bases in their partnership interests are increased by their share of partnership liabilities,[9] while debts incurred by an S corporation to outsiders have no effect on the bases of the corporation's shareholders in their stock. This difference may have an impact upon the ability of investors to utilize losses generated by the enterprise and the treatment of distributions.[10] Subchapter K also offers partners more flexibility in determining their individual tax results from partnership operations. Partnership allocations of specific items of income or deduction to a particular partner will be respected as long as the allocation has substantial economic effect, while shareholders of an S corporation are required to report a pro rata share of each corporate item.[11]

A pass-through tax regime for corporate entities is most attractive when the individual tax rates are on a relative par with corporate tax rates. For a brief time in the late 1980s, the top individual marginal rate fell below the maximum rate for C corporations, influencing many closely held businesses requiring the corporate form and able to meet the

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6 See U.S. Treasury Department, Technical Explanation of Treasury Tax Reform Proposals: Hearings Before the House Comm. on Ways and Means, 91st Cong., 1st Sess. 5228–5275 (April 22, 1969).

7 Pub. L. No. 97–354 (1982), reprinted in 1982–2 C.B. 702.

8 I.R.C. § 1361(a).

9 I.R.C. § 752(a).

10 See also I.R.C. § 469, limiting the current deductibility of losses from certain passive activities.

11 Compare I.R.C. § 704(b)(2) with I.R.C. §§ 1366(a) & 1377(a).

eligibility requirements to operate as S corporations. The current tax landscape, however, is markedly different. The Tax Cuts and Jobs Act significantly reduced the maximum corporate rate from 35 percent to the current 21 percent flat rate. This rate reduction far outpaced the decline in the highest individual tax rates from 39.6 percent to 37 percent. As a result, the prospect of conducting a business through a C corporation and retaining earnings to be taxed at lower rates has once again gained traction and may make the S corporation alternative less attractive in some situations.

It was once thought that the emergence of the limited liability company, with its far greater flexibility, and the ease of electing partnership status for tax purposes under the check-the-box classification regulations, threatened to send S corporations to the sidelines. Despite these developments and the reduction of the corporate income tax rate, it would be premature to predict the demise of the S corporation. Many existing S corporations remain on the scene and the Subchapter S corporation tax regime and governance structure are relatively simple and familiar. In fact, S corporations became the most common corporate entity type in 1997 and, for taxable years ending in 2018, the latest for which data is available, 70.6 percent of all corporations filing tax returns were S corporations.[12] In 2018, the number of S corporation returns (5,128,058) exceeded the number of partnership returns (4,239,198).[13] Thus, because S corporations continue to be an option for many operating businesses, a study of the fundamentals of Subchapter S is essential for a comprehensive understanding of business enterprise taxation. It also is instructive to compare the provisions of Subchapters S and K and to consider which of these pass-through taxation models is preferable from a policy standpoint.[14]

B. ELIGIBILITY FOR S CORPORATION STATUS

Code: § 1361.

Eligibility to make a Subchapter S election is limited to a "small business corporation," defined in Section 1361(b) as a domestic corporation[15] which is not an "ineligible corporation" and which has: (1) no more than 100 shareholders, (2) only shareholders who are individuals, estates, and certain types of trusts and tax-exempt organizations, (3) no nonresident alien shareholders, and (4) not more than one class of stock. The 100-shareholder limit disqualifies publicly traded corporations from S status, and the one-class-of-stock rule shuts

12 See Internal Revenue Service Data Book, 2018, Table 3.

13 Id.

14 See Section H of this chapter, infra.

15 I.R.C. § 1361(b)(1). A domestic corporation is defined as a corporation created or organized in the United States or under the laws of the United States or of any state or territory. Reg. §§ 1.1361–1(c); 301.7701–5.

the door to corporations with complex capital structures. Significantly, however, there is no cap on the income or asset value of a "small business corporation." Although most S corporations conduct relatively small businesses and many have only one shareholder, some very large enterprises operate as S corporations, including a few with assets exceeding $100 million.[16]

Some remaining aspects of the S corporation eligibility requirements are summarized below.

Ineligible Corporations and Subsidiaries. An "ineligible corporation" may not qualify as a "small business corporation."[17] Certain types of corporations, such as banks and insurance companies, are "ineligible" because they are governed by other specialized tax regimes.[18] At one time, any corporation that was a member of an "affiliated group" also was ineligible to be an S corporation—a rule that effectively precluded S corporations from owning 80 percent or more of the stock of another C or S corporation.[19] Under current law, S corporations may hold subsidiaries under certain conditions. C corporation subsidiaries generally are permitted,[20] and a parent-subsidiary relationship between two S corporations also is allowed if the parent elects to treat its offspring as a "qualified subchapter S subsidiary" ("QSSS"), which generally is defined as a 100 percent owned domestic corporation that is not an "ineligible corporation" and otherwise would qualify for S status if all of its stock were held by the shareholders of its parent.[21] If this QSSS election is made, the subsidiary is disregarded for tax purposes, and all of its assets, liabilities, income, deductions, and credits are treated as belonging to its S parent.[22] The regulations provide detailed procedures to govern revocation and other terminations of a QSSS election. In general, they treat a terminating event as a deemed incorporation of a new subsidiary that is governed by general tax principles.[23]

Number of Shareholders. Congress has made S corporations more widely available by gradually increasing the number of permissible shareholders. The current 100-shareholder limit[24] is nearly triple an earlier 35-shareholder cap. For purposes of this limit, a married couple (and their estates) are counted as one shareholder regardless of their

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[16] See, e.g., IRS Statistics of Income Integrated Business Data (Table 1: Selected Financial Data on Businesses: 1980–2012).

[17] I.R.C. § 1361(b)(1).

[18] I.R.C. § 1361(b)(2).

[19] I.R.C. § 1361(b)(2)(A) (pre-1997).

[20] The S parent, however, may not join in a consolidated return with the C corporation. I.R.C. § 1504(b)(6). See Chapter 13B for a discussion of consolidated returns.

[21] I.R.C. § 1361(b)(3)(B). For election procedures, see Reg. § 1.1361–3(a).

[22] I.R.C. § 1361(b)(3)(A). See Reg. § 1.1361–4(a)(1). If a subsidiary was in existence and had a prior tax history, the QSSS election triggers a deemed liquidation of the subsidiary under Sections 332 and 337 as of the day before the election is effective. Reg. § 1.1361–4(a)(2).

[23] See Reg. § 1.1361–5(b).

[24] I.R.C. § 1361(b)(1)(A).

form of ownership.[25] If stock is jointly owned (e.g., as tenants in common or joint tenants) by other than a husband and wife, each joint owner is considered a separate shareholder.[26] In the case of a nominee, guardian, custodian, or agent holding stock in a representative capacity, the beneficial owners of the stock are counted toward the 100-shareholder limit.[27]

In addition to the special rule for spouses, all the members of a "family" (and their estates) are treated as a single shareholder for purposes of the 100-shareholder limit.[28] A family is defined as the lineal descendants (and their spouses and former spouses) of a common ancestor who is no more than six generations removed from the youngest generation shareholder as of the later of the date the S election is made, the earliest date that a family member holds stock in the corporation, or October 22, 2004.[29]

Eligible Shareholders. Congress also has gradually expanded the eligible S corporation shareholder pool. Once limited to individuals who were U.S. citizens or resident aliens, the permissible shareholder list now also includes decedent's and bankruptcy estates,[30] certain types of trusts discussed in more detail below,[31] qualified pension trusts, and charitable organizations that are exempt from tax under Section 501(c)(3).[32] A corporation still may not make an S election if any of its shareholders are C corporations, partnerships, ineligible trusts, or nonresident aliens.[33]

When Subchapter S was first enacted, trusts were not eligible shareholders, primarily because of Congress's desire for a relatively simple one-tier corporate tax regime where all beneficial owners were clearly identifiable. In response to the pleas of tax advisors to closely held businesses, Congress gradually relented by permitting various widely used types of trusts to be S corporation shareholders if certain conditions are met. Under current law, the trusts that are permissible shareholders include:

(1) Voting trusts, in which case each beneficial owner is treated as a separate shareholder;[34]

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25 I.R.C. § 1361(c)(1)(A)(i); Reg. § 1.1361–1(e)(2).

26 Reg. § 1.1361–1(e)(1).

27 Id.

28 I.R.C. § 1361(c)(1)(A)(ii). If a married couple is part of a family they are counted as part of a family. I.R.C. § 1361(c)(1)(B)(i).

29 I.R.C. § 1361(c)(1)(B). Adopted children and foster children are treated as children by blood. I.R.C. § 1361(c)(1)(C). A spouse is considered to be of the same generation as the individual to whom the spouse is married. I.R.C. § 1361(c)(1)(B)(ii).

30 I.R.C. § 1361(b)(1)(B), (c)(3).

31 See infra text accompanying notes 34–49.

32 I.R.C. §§ 1361(b)(1)(B), (c)(6). The trade-off for tax-exempt pension trusts and Section 501(c)(3) organizations is that their interest in the S corporation is treated as an interest in an "unrelated trade or business," and any net income is generally taxable at the trust or corporate rates. I.R.C. § 512(e)(1).

33 I.R.C. § 1361(b)(1)(B).

34 I.R.C. § 1361(c)(2)(A)(iv), (B)(iv).

(2) Grantor trusts—i.e., domestic trusts treated for tax purposes as owned by their grantor—provided the grantor is an individual who is a U.S. citizen or resident.[35] An example would be the commonly used revocable living trust created to provide for continuity of asset management in the event of the grantor's disability and to avoid probate administration on death. For purposes of the 100-shareholder limit, the deemed owner of the trust is treated as the shareholder.[36]

(3) Former grantor trusts that continue as testamentary trusts, but only for the two-year period following the grantor's death.[37] The former deemed owner's estate is treated as the S corporation shareholder.[38]

(4) Testamentary trusts that receive S corporation stock under the terms of a will, but again only for the two-year period after the date of transfer of the stock to the trust.[39] The testator's estate continues to be treated as the S corporation shareholder.[40]

(5) Qualified Subchapter S trusts ("QSSTs"), defined generally as trusts all of the income of which is actually distributed or must be distributed currently to one individual who is a U.S. citizen or resident.[41] A QSST may only have one current income beneficiary, who must elect QSST status and, as a result, is treated as the owner for tax purposes of the portion of the trust consisting of the S corporation stock with respect to which the election was made.[42] Among other things, the QSST definition permits a Qualified Terminable Interest Property ("QTIP") Trust,[43] the most widely used type of estate tax marital deduction trust created for the benefit of a surviving spouse, to hold S corporation stock.

(6) Electing small business trusts ("ESBTs"), a statutory creation that potentially expands the usefulness of S corporations in estate planning for a family business. All the beneficiaries of an ESBT must be individuals or estates who are eligible S corporation shareholders, nonresident aliens, or charitable organizations holding contingent

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35 I.R.C. § 1361(c)(2)(A)(i). Foreign grantor trusts are not eligible shareholders. I.R.C. § 1361(c)(2)(A), flush language.

36 I.R.C. § 1361(c)(2)(B)(i).

37 I.R.C. § 1361(c)(2)(A)(ii).

38 I.R.C. § 1361(c)(2)(B)(ii).

39 I.R.C. § 1361(c)(2)(A)(iii).

40 I.R.C. § 1361(c)(2)(B)(iii).

41 I.R.C. § 1361(d).

42 Id.

43 See I.R.C. § 2056(b)(7).

> remainder interests.[44] The beneficial interests in an ESBT must have been acquired by gift or bequest, not purchase,[45] and the trust must elect ESBT status to qualify as an S corporation shareholder.[46] Each potential current beneficiary of the trust is treated as a shareholder for purposes of the 100-shareholder limit,[47] but the trust's pro rata share of S corporation income is taxable to the trust at the highest individual marginal rates under rules specially designed for this purpose.[48] The significance of the ESBT category is that it permits inter vivos and testamentary trusts with more than one beneficiary—e.g., a "sprinkling" trust where the trustee has discretion to determine whether and how much income or corpus to distribute among several beneficiaries—to qualify as an S corporation shareholder.

The regulation treating a family as one shareholder for the 100-shareholder limit explains that the rule applies to family members who own stock directly as well as those who are shareholders because they are beneficiaries of a QSST or ESBT.[49]

One-Class-of-Stock Requirement. An S corporation may issue both stock and debt, but it may not have more than one class of stock.[50] The purpose of this rule is to simplify the allocation of income and deductions among an S corporation's shareholders and prevent "special allocations" and their potential for income shifting. The one-class-of-stock requirement has spawned many controversies over its history, but the issuance of final regulations has resolved the most contentious issues.

An S corporation generally is treated as having one class of stock if all of its outstanding shares confer identical rights to distributions and liquidation proceeds.[51] Significantly, differences in voting rights among classes of common stock are disregarded, permitting an S corporation to issue both voting and nonvoting common stock.[52] In determining whether outstanding stock confers identical rights to distribution and liquidation proceeds, the regulations look to the corporate charter, articles of

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44 I.R.C. § 1361(e)(1)(A)(i), (c)(2)(B)(v). Charitable remainder trusts, however, may not be S corporation shareholders. I.R.C. § 1361(e)(1)(B)(iii). See also Rev. Rul. 92–48, 1992–1 C.B. 301.

45 I.R.C. § 1361(e)(1)(A)(ii).

46 I.R.C. § 1361(e)(1)(A)(iii). Trusts that already have made a QSST election or are wholly exempt from tax do not qualify as ESBTs. I.R.C. § 1361(e)(1)(B).

47 I.R.C. § 1361(c)(2)(B)(v). If there are no potential current income beneficiaries, then the trust is treated as the shareholder for that period. Id.

48 I.R.C. § 641(c).

49 Reg. § 1.1361–1(e)(3)(ii).

50 I.R.C. § 1361(b)(1)(D).

51 Reg. § 1.1361–1(*l*)(1). "Outstanding stock" generally does not include stock that is subject to a substantial risk of forfeiture under Section 83 unless the holder has made the Section 83(b) election. Reg. § 1.1361–1(*l*)(3).

52 I.R.C. § 1361(c)(4); Reg. § 1.1361–1(*l*)(1).

incorporation, bylaws, applicable state law, and binding shareholders' agreements.[53]

Commercial contractual arrangements, such as leases, employment agreements, or loan agreements, are disregarded in determining whether a second class of stock is present unless a principal purpose of the agreement is to circumvent the one class of stock requirement.[54] For example, differences in salary or fringe benefits paid to employee-shareholders under compensation agreements will not result in a second class of stock if the agreements are not designed to circumvent the requirement.[55] Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability or termination of employment also are disregarded in determining whether an S corporation has a second class of stock.[56] Other shareholder buy-sell, stock transfer and redemption agreements are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights unless: (1) a principal purpose of the agreement is to circumvent the one-class-of-stock requirement, and (2) the purchase price under the agreement is significantly in excess of or below the fair market value of the stock. Agreements that provide for a purchase or redemption of stock at book value or at a price between book value and fair market value satisfy the purchase price standard.[57]

Unless the straight debt safe harbor applies,[58] any instrument, obligation or arrangement issued by a corporation (other than outstanding stock) is treated as a second class of stock if: (1) it constitutes equity under general tax principles, and (2) a principal purpose of issuing or entering into the instrument, obligation or arrangement is to circumvent the distribution and liquidation rights of outstanding shares or the limitation on eligible shareholders.[59] Safe harbors from reclassification are provided for short-term unwritten advances to the corporation that do not exceed $10,000 and obligations held proportionately among the shareholders.[60] The existence of various corporate instruments that give holders the right to acquire stock (e.g., call options or warrants) also may create a second class of stock

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53 Reg. § 1.1361–1(*l*)(2)(i).

54 Reg. § 1.1361–1(*l*)(2)(i).

55 Reg. § 1.1361–1(*l*)(2)(vi) Examples (3) & (4). Any distributions (actual, constructive or deemed) that differ in timing or amount are given appropriate tax treatment. For example, even though an employment agreement does not result in a second class of stock, excessive compensation paid under the agreement is not deductible. Reg. § 1.1361–1(*l*)(2)(i), (vi) Example (3).

56 Reg. § 1.1361–1(*l*)(2)(iii)(B).

57 Reg. § 1.1361–1(*l*)(2)(iii)(A). A good faith determination of fair market value is respected unless it is substantially in error and was not determined with reasonable diligence. Id. A determination of book value is respected if it is determined in accordance with generally accepted accounting principles or used for any substantial nontax purpose. Reg. § 1.1361–1(*l*)(2)(iii)(C).

58 See I.R.C. § 1361(c)(5) and notes 62–69, infra, and accompanying text.

59 Reg. § 1.1361–1(*l*)(4)(ii)(A).

60 Reg. § 1.1361–1(*l*)(4)(ii)(B).

depending upon whether the right is substantially certain to be exercised by the holder.[61]

Straight Debt Safe Harbor. The interaction of the one-class-of-stock limitation with the debt vs. equity classification issues encountered under Subchapter C[62] historically presented some knotty problems for S corporations with outstanding debt. In the formative years of Subchapter S, the Service adopted a practice of reclassifying nominal S corporation debt owed to shareholders as a second class of stock, causing the corporation to lose its S status.[63] This threat has diminished considerably by a safe harbor provision in Section 1361(c)(5) under which "straight debt" is not treated as a disqualifying second class of stock. "Straight debt" is defined as any written unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate and payment dates are not contingent on profits, the borrower's discretion or similar factors; (2) the instrument is not convertible (directly or indirectly) into stock; and (3) the creditor is an individual (other than a nonresident alien), an estate or trust that would be a qualifying shareholder in an S corporation, or a person that is actively and regularly engaged in the business of lending money.[64] The fact that an obligation is subordinated to other debt of the corporation does not prevent it from qualifying as straight debt.[65]

Obligations that qualify as straight debt are not classified as a second class of stock even if they would be considered equity under general tax principles and they generally are treated as debt for other purposes of the Code.[66] Thus, interest paid or accrued on straight debt is treated as such by the corporation and the recipient and does not constitute a distribution governed by Section 1368.[67] But if a straight debt instrument bears an unreasonably high rate of interest, the regulations provide than an "appropriate" portion may be recharacterized and treated as a payment that is not interest.[68] If a C corporation has outstanding debt obligations that satisfy the straight debt definition but may be classified as equity under general tax principles, the safe harbor ensures that the obligation will not be treated as a second class of stock if the C corporation elects to convert to S status.

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61 Reg. § 1.1361–1(*l*)(4)(iii). Exceptions are provided for certain call options in connection with loans or to employees and independent contractors. If the strike price of a call option is at least 90 percent of the fair market value of the underlying stock on the date the option is issued, it is not substantially certain to be exercised. Reg. § 1.1361–1(*l*)(4)(iii)(B)–(C).

62 See generally I.R.C. § 385 and Chapter 3B, supra.

63 The courts, however, usually were not receptive to this argument. See, e.g., Portage Plastics Co. v. United States, 486 F.2d 632 (7th Cir.1973).

64 I.R.C. § 1361(c)(5)(B).

65 Reg. § 1.1361–1(*l*)(5)(ii).

66 I.R.C. § 1361(c)(5)(A); Reg. § 1.1361–1(*l*)(5)(iv).

67 Id.

68 Id. Such a reclassification does not result in a second class of stock.

The conversion and change of status also is not treated as an exchange of the debt instrument for stock.[69]

PROBLEM

Unless otherwise indicated, Z Corporation ("Z") is a domestic corporation which has 120 shares of voting common stock outstanding. In each of the following alternative situations, determine whether Z is eligible to elect S corporation status:

(a) Z has 99 unrelated individual shareholders, each of whom owns one share of Z stock. The remaining 21 shares are owned by A and his brother, B, as joint tenants with right of survivorship.

(b) Same as (a), above, except that A and B are married and own 11 of the 21 shares as community property. The remaining 10 shares are owned 5 by A as her separate property and 5 by B as his separate property.

Ok while stock in A's estate, once distribute to F -> election terminate

(c) In (b), above, assume that the shareholders of Z elected S corporation status. What will be the effect on Z's election if one year later A dies and bequeaths her interest in Z stock to F, her long-time friend?

(d) Same as (a), above, except that the remaining 21 shares are held by a voting trust which has three beneficial owners.

(e) Same as (a), above, except that the remaining 21 shares are owned by a revocable living trust created by an individual, the income of which is taxed to the grantor under § 671.

(f) Same as (a), above, except that the remaining 21 shares are owned by a testamentary trust under which the surviving spouse has the right to income for her life, with the remainder passing to her children. The trust is a "qualified terminable interest trust" (see § 2056(b)(7)).

(g) Assume Z has 100 individual shareholders and forms a partnership with two other S corporations, each of which also have 100 individual shareholders, for the purposes of jointly operating a business. Z's one-third interest in this partnership is its only asset.

Only care outstanding share

(h) Z has 100 shares of Class A voting common stock and 50 shares of Class B nonvoting common stock outstanding. Apart from the differences in voting rights, the two classes of common stock have equal rights with regard to dividends and liquidation distributions. Z also has an authorized but unissued class of nonvoting stock which would be limited and preferred as to dividends. The Class A common stock is owned by four individuals and the Class B common stock is owned by E and F (a married couple) as tenants-in-common.

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69 Reg. § 1.1361–1(*l*)(5)(v).

(i) Same as (h), above, except that Z enters into a binding agreement with its shareholders to make larger annual distributions to shareholders who bear heavier state income tax burdens. The amount of the distributions is based on a formula that will give the shareholders equal after-tax distributions. would be a problem

(j) Z has four individual shareholders each of whom own 100 shares of Z common stock for which each paid $10 per share. Each shareholder also owns $25,000 of 15-year Z bonds. The bonds bear interest at 3% above the prime lending rate established by the Chase Manhattan Bank, adjusted quarterly, and are subordinated to general creditors of Z.

C. ELECTION, REVOCATION AND TERMINATION

Code: §§ 1362 (omit (e)(5)–(6)); 1378. Skim §§ 444(a), (b), (c)(1), (e); 7519(a), (b), (d)(1), (e)(4).

Electing S Corporation Status. An otherwise eligible corporation may elect S corporation status if all the shareholders consent.[70] Once made, an election remains effective until it is terminated under Section 1362(d).[71] An election is effective as of the beginning of a taxable year if it is made either during the preceding taxable year or on or before the fifteenth day of the third month of the current taxable year.[72] If the election is made during the first 2½ months of the year, the S corporation eligibility requirements must have been met for the portion of the taxable year prior to the election, and all shareholders at any time during the pre-election portion of the year must consent to the election.[73] If the eligibility requirements are not met during the pre-election period or if any shareholder who held stock during that period does not consent, the election does not become effective until the following taxable year.[74] In some cases, however, such as where an election is technically invalid because of the corporation's inadvertence or failure to obtain all the requisite shareholder consents on time, the Service may grant dispensation and waive the defect if there is reasonable cause.[75]

70 I.R.C. § 1362(a). For rules and procedures on shareholders' consent to an S election, see Reg. § 1.1362–6.

71 I.R.C. § 1362(c). See generally Reg. § 1.1362–2.

72 I.R.C. § 1362(b)(1). Elections made not later than 2 months and 15 days after the first day of the taxable year are deemed made during the year even if the year is shorter than 2 months and 15 days. I.R.C. § 1362(b)(4). For rules on how to count months and days for this purpose, see Reg. § 1.1362–6(a)(2)(ii). For the Service's authority to treat a late election as timely if there was reasonable cause for the tardiness, see I.R.C. § 1362(b)(5). See Rev. Proc. 2013–30, 2013–36 I.R.B. 173, for the procedures to obtain relief for a late election.

73 I.R.C. § 1362(b)(2).

74 I.R.C. § 1362(b)(2)(B).

75 I.R.C. § 1362(f). An ineffective election to treat (1) a subsidiary as a qualified subchapter S subsidiary or (2) a family as one shareholder may also be salvaged under Section 1362(f).

Revocation of Election. An S corporation election may be revoked if shareholders holding more than one-half of the corporation's shares (including nonvoting shares) consent to the revocation.[76] The revocation may specify a prospective effective date.[77] If a prospective effective date is not specified, a revocation made on or before the fifteenth day of the third month of the taxable year is effective on the first day of the taxable year and a revocation made after that date is effective on the first day of the following taxable year.[78]

Termination of Election. Apart from revocation, an S corporation election may be terminated if the corporation ceases to satisfy the definition of a small business corporation or, in certain circumstances, if the corporation earns an excessive amount of passive investment income.[79] The first ground for termination is easily illustrated. Terminating events include: (1) exceeding 100 shareholders; (2) issuance of a second class of stock; or (3) transfer of stock to an ineligible shareholder. In all those cases, the corporation will cease to be a small business corporation and its S corporation election will terminate on the day after the disqualifying event.[80] To prevent or cure transfers that may jeopardize a corporation's S corporation status, the shareholders will be well advised at the outset to enter into an agreement restricting stock transfers.

The limitation on passive investment income is more complex. An election to be an S corporation will terminate if for three consecutive taxable years the corporation's "passive investment income" exceeds 25 percent of its gross receipts and the corporation has Subchapter C earnings and profits.[81] A termination triggered by excess passive investment income is effective beginning on the first day of the taxable year following the three year testing period.[82] It is important to note that the Subchapter C earnings and profits requirement has the effect of rendering this limitation inapplicable to a corporation that has always been an S corporation or which has been purged of its earnings and profits.[83] Passive investment income generally is defined as gross receipts from royalties, rents, dividends, interest, and annuities,[84] but it

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76 I.R.C. § 1362(d)(1)(B). See Reg. § 1.1362–2(a).

77 I.R.C. § 1362(d)(1)(D).

78 I.R.C. § 1362(d)(1)(C). If the revocation is effective on a day other than the first day of a taxable year (e.g., because a prospective date is selected in the middle of the year), the taxable year will be an "S termination year," and the corporation will be taxed pursuant to rules in Section 1362(e). See Reg. § 1.1362–3 and infra text accompanying notes 89–90.

79 I.R.C. § 1362(d)(2), (3).

80 I.R.C. §§ 1361(b)(1)(A)–(D); 1362(d)(2)(B).

81 I.R.C. § 1362(d)(3). See Reg. § 1.1362–2(c). Prior years in which the corporation was not an S corporation are not considered for purposes of the passive investment income component of this test. I.R.C. § 1362(d)(3)(A)(iii)(II).

82 I.R.C. § 1362(d)(3)(A)(ii).

83 An S corporation, however, may acquire earnings and profits under Section 381 in a corporate acquisition.

84 I.R.C. § 1362(d)(3)(C)(i). The statute also contains rules for certain specialized items. See I.R.C. § 1362(d)(3)(C)(ii)–(v).

does not include gains on the disposition of property, or dividends received by an S corporation from a C corporation subsidiary to the extent they are attributable to earnings and profits of the subsidiary that are derived from the active conduct of a trade or business.[85] For purposes of the overall gross receipts definition, gross receipts from sales or exchanges of stock or securities are considered only to the extent of gains.[86] Gross receipts on the disposition of capital assets other than stock or securities are taken into account only to the extent of the excess of capital gains over capital losses from such dispositions.[87]

When an S corporation election terminates during the S corporation's taxable year, the corporation experiences an "S termination year," which is divided into two short years: an S short year and a C short year.[88] Income, gains, losses, deductions and credits for an S termination year generally may be allocated between the two short years on a pro rata basis or the corporation may elect to make the allocation under its normal accounting rules.[89] The corporation's tax liability for the short taxable year as a C corporation is then computed on an annualized basis.[90]

Inadvertent Terminations. If an S corporation election is terminated, the corporation generally is not eligible to make another election for five taxable years unless the Treasury consents to an earlier election.[91] Section 1362(f) provides relief if a termination is caused by the corporation ceasing to be a small business corporation or by excessive passive investment income. The corporation will be treated as continuing as an S corporation and the terminating event will be disregarded if: (1) the Service determines that the termination was inadvertent, (2) the corporation takes steps within a reasonable time to rectify the problem, and (3) the corporation and its shareholders agree to make whatever adjustments are required by the Service.[92] The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. Under the regulations, inadvertence may be established by showing that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the

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85 I.R.C. § 1362(d)(3)(C)(iv).

86 I.R.C. § 1362(d)(3)(B)(ii).

87 I.R.C. § 1362(d)(3)(B)(i).

88 I.R.C. § 1362(e)(1). The C short year begins on the first day the termination is effective. I.R.C. § 1362(e)(1)(B).

89 See Reg. § 1.1362–3. To use normal accounting rules, an election must be filed by all persons who are shareholders during the S short year and all persons who are shareholders on the first day of the C short year. I.R.C. § 1362(e)(3). The pro rata allocation method may not be used in an S termination year if there is a sale or exchange of 50 percent or more of the stock in the corporation during the year. I.R.C. § 1362(e)(6)(D). For more rules on taxing an S termination year, see I.R.C. § 1362(e)(6).

90 I.R.C. § 1362(e)(5)(A).

91 I.R.C. § 1362(g).

92 I.R.C. § 1362(f).

election, or that the event took place without the knowledge of the corporation notwithstanding its due diligence to prevent the termination.[93] For example, if a corporation in good faith determines that it has no Subchapter C earnings and profits but the Service later determines on audit that the corporation's S election terminated because it had excessive passive investment income for three consecutive years while it also had accumulated earnings and profits, it may be appropriate for the Service to find that the termination was inadvertent.

Taxable Year of an S Corporation. To preclude S corporations from using fiscal years to achieve a deferral of the shareholders' tax liability, S corporations must use a "permitted year," which is defined as either a calendar year or an accounting period for which the taxpayer establishes a business purpose.[94] The Service has ruled that the business purpose requirement may be satisfied if the desired tax accounting period coincides with a "natural business year"[95] and has quantified the concept with the same 25-percent test applicable to partnerships seeking to use a natural business fiscal year.[96] Under this test, a natural business year exists if 25 percent or more of the S corporation's gross receipts for the selected 12-month period are earned in the last two months. This 25-percent test must be met in each of the preceding three 12-month periods that correspond to the requested fiscal year.[97]

Section 1378 makes it clear that tax deferral for shareholders does not constitute a business purpose for a fiscal year. The legislative history also identifies several factors which generally do not support a claim of business purpose:[98]

> The conferees intend that (1) the use of a particular year for regulatory or financial accounting purposes; (2) the hiring patterns of a particular business, e.g., the fact that a firm typically hires staff during certain times of the year; (3) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and (4) the fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis ordinarily will not be sufficient to establish that the business purpose requirement for a particular taxable year has been met.

Fiscal Year Election. Congress has modified these strict taxable year requirements by allowing S corporations to elect to adopt, retain or

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[93] Reg. § 1.1362–4(b).

[94] I.R.C. § 1378(b). See Reg. § 1.1378–1.

[95] Rev. Proc. 2006–46, 2006–2 C.B. 859.

[96] Id. at §§ 2.02, 2.06, 5.07.

[97] If the taxpayer does not have the required period of gross receipts, it cannot establish a natural business year under the revenue procedure. Rev. Proc. 2006–46, supra note 95.

[98] H.R.Rep. No. 99–841, 99th Cong., 2d Sess. II–319 (1986).

change to a fiscal year under certain conditions, including the payment of an entity-level tax designed to represent the value of any tax deferral to the shareholders that would result from the use of the fiscal year. The rules governing the fiscal year election and the required entity-level payment are found in Sections 444 and 7519.

Section 444 permits a newly formed S corporation to elect to use a taxable year other than the calendar year required by Section 1378 provided that the year elected results in no more than a three-month deferral of income to the shareholders.[99] An election and the Section 7519 payment is not required, however, for any S corporation that has established a business purpose for a fiscal year under Section 1378(b)(2).[100]

The trade-off for a Section 444 fiscal year election is that the corporation must make a "required payment" under Section 7519 for any taxable year for which the election is in effect. The mechanics of the required payment are annoyingly complex, but the concept is clear. An electing S corporation must pay and keep "on deposit" an amount roughly approximating the value of the tax deferral that the shareholders would have achieved from the use of a fiscal year. Thus, if an S corporation whose shareholders all used calendar years elected a fiscal year ending September 30, the corporation would be required to pay a tax that supposedly equaled the tax benefit from the three months deferral received by the shareholders.[101] Under a de minimis rule, no payment is required if the amount due is less than $500,[102] and a payment made in one year generates a balance "on deposit" that may be used in subsequent years.[103]

A B C D
300 100 100 100
Snowshoe.

PROBLEM

Snowshoe, Inc. ("Snowshoe"), a ski resort located in Colorado, was organized by its four individual shareholders (A, B, C and D) and began operations on October 3 of the current year. A owns 300 shares of Snowshoe voting common stock and B, C and D each own 100 shares of Snowshoe nonvoting common stock. Each share of common stock has equal rights with respect to dividends and liquidation distributions. Consider the following questions in connection with the election and termination of Snowshoe's S corporation status:

(a) If the shareholders wish to elect S corporation status for Snowshoe's first taxable year, who must consent to the election? What difference would it make if, prior to the all sh.

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99 I.R.C. § 444(a), (b)(1).

100 See I.R.S. Notice 88–10, 1988–1 C.B. 478.

101 We say "supposedly" because the Section 7519 "required payment" is determined mechanically, without regard to amounts actually deferred by the shareholders. See I.R.C. § 7519(b), (c) and (d) for the details.

102 I.R.C. § 7519(a)(2).

103 I.R.C. § 7519(b)(2), (e)(4).

election, B sold her stock to her brother, G? What difference would it make if B is a partnership which, prior to the election, sold its stock to H, an individual?

(b) What is the last day an effective Subchapter S election for Snowshoe's first taxable year is permitted?

(c) If the shareholders elect S corporation status, what taxable year will Snowshoe be allowed to select?

In the following parts of the problem, assume that Snowshoe elected S corporation status during its first taxable year.

(d) Can A revoke Snowshoe's Subchapter S election without the consent of B, C or D?

(e) If C sold all of his stock to Olga, a citizen of Sweden living in Stockholm, what effect would the sale have on Snowshoe's status as an S corporation?

(f) Same as (e), above, except that C only sold five shares to Olga and had no idea that the sale might adversely affect Snowshoe's S corporation status.

(g) Would it matter if Snowshoe's business is diversified and 45% of its gross receipts come from real estate rentals, dividends and interest?

D. TREATMENT OF THE SHAREHOLDERS

Code: §§ 1363(b), (c); 1366(a)–(c), (d); 1367. Skim §§ 1366(f); 1371(b); 1377.

1. PASS-THROUGH OF INCOME AND LOSSES: BASIC RULES

Entity Treatment. Although an S corporation is generally exempt from tax,[104] it nonetheless must determine its gross income,[105] deductions and other tax items in order to establish the amounts which pass through to the shareholders. Like a partnership, an S corporation computes its "taxable income" in the same manner as an individual except that certain deductions unique to individuals (e.g., personal exemptions, alimony, medical and moving expenses) are not allowed.[106] In addition, deductions normally available only to corporations, such as the dividends received deduction, are not allowed,[107] but an S corporation may elect to deduct and amortize its organizational expenses under Section 248.[108] Finally, a wide variety of items must be separately

[104] For the few limited exceptions, see Section F of this chapter, infra.

[105] Section 1366(c) provides that a shareholder's pro rata share of the S corporation's gross income is used to determine the shareholder's gross income.

[106] I.R.C. § 1363(b)(2).

[107] S.Rep. No. 97–640, 97th Cong., 2d Sess. 15 (1982), reprinted in 1982–2 C.B. 718, 724.

[108] I.R.C. § 1363(b)(3).

computed in order to preserve their special tax character as they passthrough to the shareholders.[109]

Although an S corporation is generally not a *taxable* entity, it is treated as an entity for various purposes. For example, tax elections affecting the computation of items derived from an S corporation (e.g., to defer recognition of gain on an involuntary conversion under Section 1033) generally are made at the corporate level,[110] as are the exclusions from discharge of indebtedness income in Section 108 and the accompanying rules on reduction of tax attributes.[111] Likewise, limitations on deductions (e.g., the dollar limitation under Section 179 on expensing the cost of certain recovery property) apply at the corporate level and often at the shareholder level as well.[112] And like a partnership, an S corporation is treated as an entity for filing tax returns and other procedural purposes.[113]

Pass-Through of Income and Deductions. Once the S corporation's tax items have been identified, the next step is to determine the manner in which they pass through to the shareholders. First, income and deductions are characterized at the corporate level.[114] Section 1366(a)(1)(A) provides that items which may have potentially varying tax consequences to the individual shareholders must be separately computed. The most common of these items are capital and Section 1231 gains and losses, qualified dividends, interest and other types of "portfolio income" under the Section 469 passive loss limitations, tax-exempt interest, charitable contributions, investment interest expense, foreign taxes, intangible drilling expenses and depletion on oil and gas properties.[115] Thus, Section 1231 gains and losses do not fall into any corporate hotchpot; rather, they pass through and are aggregated with each shareholder's other Section 1231 gains and losses in order to determine their ultimate character. All the nonseparately stated items are aggregated and the resulting lump sum passes through as ordinary income or loss.

In determining its taxable income, an S corporation is not entitled to any charitable deduction. Rather, corporate charitable contributions pass through to the shareholders without regard to the 10 percent of taxable

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109 I.R.C. §§ 1363(b)(1); 1366(a)(1)(A).

110 I.R.C. § 1363(c)(1).

111 I.R.C. § 108(d)(7). Under this rule, discharge of indebtedness income may be excluded from gross income if the S corporation is bankrupt or insolvent even if the shareholders are not. In contrast, if all or part of a partnership debt is cancelled, the discharge of indebtedness income is allocated to the partners who must individually determine if an exclusion is available. I.R.C. § 108(d)(6).

112 See, e.g., I.R.C. § 179(d)(8).

113 I.R.C. § 6037. Cf. I.R.C. §§ 6221–6241.

114 I.R.C. § 1366(b). See Reg. § 1.1366–1(b).

115 See generally Reg. § 1.1366–1(a)(2). See also Rev. Rul. 84–131, 1984–2 C.B. 37, where the Service ruled that a shareholder's share of an S corporation's investment interest is a separately stated item.

income limit generally applicable to C corporations.[116] Contributions are categorized by the individual taxpayer percentage limitations (e.g., 60 percent for cash contributions and 30 percent for gifts of capital gain property to public charities) and pass through as such to the shareholders.[117] Charitable contributions of appreciated capital gain property by S corporations are generally deductible by the shareholders at the fair market value of the contributed property, subject to any reductions required by Section 170(e) (e.g., for ordinary income property).

Allocation and Timing. The shareholders of an S corporation take into account their respective pro rata shares of income, deductions and other separately stated items on a pro rata, per share daily basis.[118] For this purpose, "pro rata" means in proportion to each shareholder's ownership of stock. Unlike partnerships and LLCs, S corporations have no flexibility to make special allocations by agreement. As for timing, these items are reported in the shareholder's taxable year in which the corporation's taxable year ends.[119] For example, if an S corporation with a natural business year uses a fiscal year ending January 31, 2021, the shareholders will report the respective pass-through items on their 2021 calendar year tax returns, thus achieving a healthy deferral of any gains or an unfortunate delay in recognizing any losses. A deceased shareholder's Subchapter S items are allocated on a daily basis between the shareholder's final income tax return and the initial return of the decedent's estate.[120]

Treatment of a Family Group. To guard against easy assignments of income, if a "member of the family" of an S corporation shareholder (defined to include a spouse, ancestors, and lineal descendants) performs services for or furnishes capital to the corporation without receiving reasonable compensation, the Service is authorized to reallocate tax items to properly reflect the value of the services or capital.[121] The IRS may invoke this power even if the provider of services or capital does not own any stock of the corporation but is merely related to a shareholder.

Basis Adjustments. S corporation shareholders increase the basis of their stock by their respective shares of income items (including tax-exempt income[122]) and reduce basis (but not below zero) by their pro rata

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[116] I.R.C. § 170(b)(2)(A).

[117] Reg. § 1.1366–1(a)(2)(iii). See I.R.C. § 170(b)(1).

[118] I.R.C. § 1366(a)(1). See § 1377(a)(1) for the method of determining each shareholder's "pro rata share."

[119] I.R.C. § 1366(a)(1).

[120] Id. See also Reg. § 1.1366–1(a)(1).

[121] I.R.C. § 1366(e).

[122] Discharge of indebtedness income excluded under Section 108 is not "tax-exempt" income under Section 1366(a)(1)(A) and thus does not increase basis. I.R.C. § 108(d)(7)(A). But see Gitlitz v. Commissioner, 531 U.S. 206 (2001), where the Supreme Court allowed a basis increase for a tax year before the Code was amended to permit this inappropriate result.

share of losses, deductions,[123] and non-deductible expenses which are not capital expenditures, and by tax-free distributions under Section 1368. Under the Code's ordering rules, basis is first increased by current income items, then decreased by distributions, and finally decreased (to the extent permitted) by any losses for the year.[124] Any additional losses in excess of a shareholder's stock basis must be applied to reduce the shareholder's basis (again, not below zero) in any corporate indebtedness to the shareholder.[125] If the basis of both stock and debt is reduced, any subsequent upward adjustments must first be applied to restore the basis in the indebtedness to the extent that it was previously reduced before increasing the basis of the stock.[126] These basis adjustments are generally made as of the close of the S corporation's taxable year unless a shareholder disposes of stock or the corporation's debt to the shareholder is wholly or partially repaid during the year, in which case the adjustments with respect to the transferred stock are made immediately prior to the disposition or repayment.[127]

2/3. 1/3

A B

200 sh. Basis. 12K. 100 sh 6K

PROBLEMS

1. S Corporation is a calendar year taxpayer which elected S corporation status in its first year of operation. S's common stock is owned by A (200 shares with a $12,000 basis) and B (100 shares with a $6,000 basis). During the current year, S will have the following income and expenses:

Business income	$92,000	x separate
Tax-exempt interest	$ 1,000	1366.(a)
Salary expense	$44,000	x separate.
Depreciation	$ 8,000	x.
Property taxes	$ 7,000	
Supplies	$ 4,000	x.
Interest expense paid on a margin account maintained with S Corp.'s stock broker	$ 6,000	separately stated.
Gain from the sale of equipment:		
§ 1245 gain	$ 7,000	OI
§ 1231 gain	$12,000	Cbi rate. Loss → OI loss separately.
STCG from the sale of AT&T stock	$ 7,500 separate	

[123] When an S corporation makes a charitable contribution of appreciated property, the shareholders reduce basis by their pro rata share of the adjusted basis (not fair market value) of the contributed property. I.R.C. § 1367(a)(2), flush language.

[124] I.R.C. §§ 1366(d)(1)(A); 1368(d), last sentence. For other details on stock and debt basis adjustments, see Reg. § 1.1367–1, –2.

[125] I.R.C. § 1367(b)(2)(A).

[126] I.R.C. § 1367(b)(2)(B).

[127] Reg. § 1.1367–1(d)(1), –2(d)(1).

LTCL offset STCG.

LTCG from the sale of Chrysler stock held for two years	$15,000
separately. LTCL from the sale of investment real estate held for two years	$ 9,000
x deductible. Bribe of government official	$ 6,000
separately. Recovery of a bad debt previously deducted	$ 4,500

(a) How will S Corporation, A and B report these events? Compare § 704(b)(2) and (c).

(b) What is A's basis in his S stock at the end of the current year?

(c) Whose accounting method will control the timing of income and deductions?

(d) If S realizes a gain upon an involuntary conversion, who makes the election under § 1033 to limit recognition of gain?

(e) Would it matter if the equipment would have been property described in § 1221(a)(1) if held by A?

2. D, E and F each own one-third of the outstanding stock of R Corporation (an S corporation). During the current year, R will have $120,000 of net income from business operations. The net income is realized at a rate of $10,000 per month. Additionally, in January of this year R sold § 1231 property and recognized a $60,000 loss.

sold 1/2 stock midyr.
→ ∴ 1/4 stock of 1/3 income
∴ 1/2 of everything.

(a) Assume D's basis in her R stock at the beginning of the year is $10,000. If D sells one-half of her stock to G midway through the year for $25,000, what will be the tax results to D and G?

(b) What difference would it make in (a), above, if D sold all of her stock to G for $50,000?

of sold sh. stk original basis of 1/2
+10k share of income − 5k loss = 10k

2. DEDUCTION FOR QUALIFIED BUSINESS INCOME

G, R can elect to terminate the yr. § 1377(a)(2)

Code: § 199A(a), (b)(1)–(3), (4), (6), (c), (d)(1)–(3), (e)(1) & (2), (f)(1)(A), (i).

report income for 1st half of yr.
20k business income.
full 20k §1231 loss,
∴ x net change to basis.
50k − 10k = 40k gain.
∴ 20k business income.
basis: 50k + 20k = 70k.

Introduction. One of the most significant changes made by the Tax Cuts and Jobs Act was the reduction of corporate income tax rates. Prior to the Act, C corporations were subject to graduated tax rates on corporate income that peaked at 35 percent. The 2017 Act replaced those graduated rates with a single corporate income tax rate of 21 percent.[128]

During the gestation period of the 2017 Act, legislators who favored tax relief for business income became concerned about the prospect of providing a significant rate reduction for public companies and other C corporations to the exclusion of "small businesses," a loosely defined category that includes many enterprises conducted in the form of "pass-through" entities such as S corporations and partnerships. Business income generated by a pass-through entity, while subject to only one level of income tax imposed at the owner level, can be taxed at rates as high

[128] See I.R.C. § 11(b).

as 37 percent for individual owners. Congress enacted Section 199A to level the playing field for the many taxpayers utilizing a pass-through entity to conduct their businesses.

At its most basic level, Section 199A provides an income tax deduction to individuals, trusts and estates equal to 20 percent of the "qualified business income" generated through a sole proprietorship, partnership, LLC, S corporation, trust, or estate.[129] When fully available, the deduction effectively lowers the tax rate applicable to such income from 37 to 29.6 percent (80 percent of 37 percent) for the highest income taxpayers. Although the Section 199A deduction is not allowed in computing adjusted gross income,[130] it nonetheless is available to all taxpayers regardless of whether they itemize deductions or claim the standard deduction.[131]

Despite its fairly straightforward purpose, Section 199A contains a complex web of defined terms, limitations, anti-abuse rules, and industry-specific provisions. Much of this complexity is designed to deny or limit the deduction for high-income taxpayers who conduct either: (1) service-oriented businesses, or (2) other businesses which do not have sufficiently large employee payrolls or a mix of lower payrolls and a significant investment in depreciable real estate and equipment.

In keeping with the "fundamentals" approach, the text below offers a general description of this daunting statute's framework and addresses its application in a few typical situations.

Qualified Business Income Defined. The first step under Section 199A is to determine the "qualified business income" ("QBI") of each of the taxpayer's qualified trades or businesses.[132] QBI is the net amount of qualified items of income, gain, deduction and loss that are effectively connected with the conduct of a qualified trade or business within the United States and which are included or allowed in determining taxable income for the taxable year.[133]

QBI must be derived from a qualified "trade or business," a term that is not defined by either the statute or the legislative history of Section 199A. The regulations fill the gap by providing that "trade or business" should be defined by its meaning under Section 162, excluding the trade

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129 Unless Congress extends Section 199A, the deduction is scheduled to terminate for taxable years beginning after 2025. I.R.C. § 199A(i).

130 I.R.C. § 62(a). Thus, the Section 199A deduction has no effect on other deductions which are subject to limitations based on adjusted gross income. See, e.g., § 170(b) (percentage limitations on the charitable deduction); § 213(a) (limitation on deduction for medical expenses).

131 I.R.C. § 63(b)(3).

132 The deduction technically is based on a taxpayer's qualified business income amount, which also includes qualified dividends from real estate investment trusts (including REIT mutual funds) and qualified publicly traded partnership income. I.R.C. § 199A(a), (b)(1), (e)(3) & (4). Special rules also apply to certain agricultural and horticultural cooperatives. I.R.C. § 199A(g). Those aspects of Section 199A are not discussed here.

133 I.R.C. § 199A(c)(1), (3)(A).

or business of providing services as an employee.[134] This cross reference requires an analysis based on the vast body of case law and administrative guidance interpreting the term for purposes of the ordinary and necessary business expense deduction.[135]

If a taxpayer is actively engaged in an activity and has a profit motive, it is usually not very difficult to achieve trade or business status under the Section 162 standard. The major definitional question requiring clarification is whether a taxpayer's rental real estate activity can be a qualified trade or business. The Service declined to deem all rental real estate activity to be a trade or business or establish a bright line test, but it has provided a safe harbor in the form of a proposed revenue procedure.[136] Under this guidance, a rental trade or business enterprise will be treated as a trade or business if at least 250 hours of services are performed annually with respect to the business by the owner or others, such as employees and independent contractors. The types of service that count toward the 250-hour requirement include maintenance, repairs, collection of rent, payment of expenses, providing services to tenants, and efforts to rent the property. The safe harbor also requires the taxpayer to maintain contemporaneous separate books and records and bank accounts for the business. Activities specifically excluded from the safe harbor are triple net leases (where the lease requires the tenant to pay all real estate taxes, maintenance, and insurance), and rented property that is used in part as a residence (such as a vacation home). If an enterprise fails to satisfy the requirements of the safe harbor, it still may qualify as a trade or business if it otherwise meets the more general requirements in the regulations.

Consistent with the intention to limit the deduction to operating income, the definition of QBI excludes a broad range of items that generally are derived from investment activities—including, among other things, capital gains or losses, dividends, and interest (other than interest properly allocated to a trade or business).[137] Similarly,

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[134] Reg. § 1.199A–1(b)(14). The regulations include a special rule providing that, solely for purposes of Section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a "trade or business" if the rental or licensing activity and the related business are commonly controlled (i.e., the same owner or group of owners must own 50 percent or more of both the rental property and the related business) even if the activity does not rise to the level of a Section 162 trade or business.

[135] See, e.g., Higgins v. Commissioner, 312 U.S. 212 (1941) (whether a trade or business exists is a factual determination); Commissioner v. Groetzinger, 480 U.S. 23 (1967) (a trade or business must be regular and continuous, pursued full time, and not be a sporadic activity or mere hobby).

[136] See Notice 2019–07, 2019–09 I.R.B. 740 (providing form of proposed revenue procedure).

[137] I.R.C. § 199A(c)(3)(B). Interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business, while interest income received on accounts receivable for services or goods provided by the trade or business is properly allocable to the trade or business for this purpose. Reg. § 1.199A–3(b)(2)(ii)(C).

deductions and losses attributable to these items are not taken into account in determining QBI.[138]

Section 199A fails to address one type of income frequently encountered in a business setting: Section 1231 gains and losses. Most Section 1231 gains and losses are derived from sales or exchanges of assets used in a trade or business, which suggests they should be included in QBI. But the Section 1231 characterization process may result in items being characterized as capital gains and losses, which are explicitly excluded from the definitions of QBI. The regulations resolve this statutory ambiguity by falling back on the characterization process employed by Section 1231. If the taxpayer's Section 1231 gains exceed Section 1231 losses so that all those gains and losses are characterized as long-term capital gains and losses, they are excluded from the definition of QBI.[139] Alternatively, if the taxpayer's Section 1231 gains and losses are characterized as ordinary rather than capital, they are included in QBI, assuming the other statutory requirements are satisfied.

Treatment of Income from Services. The most significant exclusion from the definition of QBI relates to compensation income. Because performing services as an employee is not a trade or business for purposes of Section 199A, wages received by an employee are not QBI.[140] QBI also does not include reasonable compensation paid to a taxpayer for services rendered to a qualified trade or business.[141] The exclusion of "reasonable compensation" from QBI was intended to signal that amounts paid to a shareholder-employee of an S corporation could include amounts that are not formally designated as compensation, if the corporation fails to pay its shareholder-employee reasonable compensation for services.[142] In contrast, income earned by a sole proprietor or an independent contractor generally may qualify as QBI. Thus, Section 199A does not exclude all income from labor or services from QBI. Instead, the rules initially distinguish between income from labor or services based on whether the taxpayer has the legal status of being an "employee." In so doing, the statute ensures that income generated from services provided by an employee is fully taxed at ordinary income tax rates.

To illustrate these distinctions, assume Alice conducts a business that provides pet care services for individuals who work during the day.

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138 I.R.C. § 199A(c)(3)(B)(vii).

139 See Reg. § 1.199A–3(b)(2)(ii)(A) (excluding all capital gains and losses, and "including any item treated as one of such items under any other provision of the Code").

140 I.R.C. § 199A(d)(1)(B).

141 I.R.C. § 199A(c)(4)(A).

142 Preamble to Proposed Section 199A Regulations, REG–107892–18, Explanation of Provisions, at 37–38 (Aug. 8, 2018), 2018–35 I.R.B. 353. The Service has indicated that this recharacterization approach is limited to the S corporation context. The final regulations under Section 199A describe this exclusion from QBI as "reasonable compensation received by a shareholder from an S corporation." Reg. § 1.199A–3(b)(2)(ii)(H).

Because she is not an employee, Alice's entire income from her sole proprietorship qualifies as QBI, even though the bulk of that income is generated by her personal services. If Alice's business grows and she hires Brady as an employee to help service her expanding customer base, the salary Alice pays to Brady will not be QBI. Does the difference in how Alice and Brady are treated under Section 199A make sense? To be sure, many sole proprietors are exposed to a large degree of entrepreneurial risk and their businesses may involve a significant investment of capital. But the distinctions drawn in the definition of QBI do not focus on those factors. Instead, the statute generally operates in an "all or nothing" fashion, based on the taxpayer's status as an employee.

For pass-through entities, the rules regarding income from labor or services differ depending on whether the entity is an S corporation or a partnership or LLC. Because an S corporation is treated as an entity separate from its shareholders, an S corporation shareholder who performs service for the corporation is generally treated as an employee for tax purposes. Accordingly, QBI does not include reasonable compensation paid to the shareholder-employee or amounts recharacterized as such,[143] but a shareholder's pro rata share of an S corporation's net business profits generally will qualify for the 20 percent deduction.

Determining the Section 199A Deduction. Once the QBI from each of the taxpayer's qualified trades or businesses is determined, the taxpayer multiplies the QBI from each such trade or business by 20 percent and the Section 199A deduction generally equals the sum of those separate calculations.[144] Various limitations apply, both when calculating the deductible amount for each trade or business and the total allowable Section 199A deduction. Overall, the Section 199A deduction may not exceed 20 percent of the excess of the taxpayer's taxable income (determined without regard to the Section 199A deduction), reduced by net capital gain.[145] This limitation typically will apply only when the bulk of an individual's taxable income consists of QBI. If, in a given year, the sum of the taxpayer's QBI calculations is negative, the taxpayer has a loss for the year from the combined qualified trades or businesses that will carry over to the next year when it will be treated as a loss from a qualified trade or business.[146]

To illustrate a straightforward application of Section 199A, assume A, a single taxpayer who does not itemize deductions, practices law as a solo practitioner. Over the course of the year, A's practice generates $140,000 of legal fees and $2,000 of interest income from her business

[143] I.R.C. § 199A(c)(4)(A); see Rev. Rul. 74–44, 1974–1 C.B. 287.

[144] I.R.C. § 199A(a)(1), (b)(1)–(2)(A).

[145] I.R.C. § 199A(a)(2), (e)(1). Net capital gain generally consists of net long-term capital gains (including collectibles gains and unrecaptured section 1250 gains) less net short-term capital losses (see I.R.C. § 1222(11)), plus qualified dividends. Reg. § 1.199A–1(b)(3).

[146] I.R.C. § 199A(c)(2).

deposits. A incurs $40,000 of deductible expenses attributable to her practice, and she has no other sources of income. In this case, A is engaged in a qualified trade or business under Section 199A, as she is not providing services in an employee capacity. While her net income from the practice totals $102,000, only $100,000 constitutes QBI because the $2,000 of interest income is excluded from the definition.[147] A's taxable income (computed without the Section 199A deduction) is $90,000 ($102,000 minus a $12,000 standard deduction) and she has no net capital gain.[148] Accordingly, A may deduct 20 percent of the lesser of (1) her $100,000 of QBI from the law practice or (2) the $90,000 of taxable income amount. Thus, A's Section 199A deduction is $18,000 (20 percent of $90,000), reducing her final taxable income to $72,000. Note that if A were an associate in a law firm and her wages as an employee were $100,000, she would not be entitled to any deduction under Section 199A.

Limitations for High-Income Taxpayers. The basic application of Section 199A becomes considerably more complex once a taxpayer reaches certain taxable income thresholds. Those thresholds—determined without reference to the deduction otherwise provided by Section 199A—are $157,500 for a single taxpayer and $315,000 for married taxpayers filing jointly (with each figure being indexed for inflation after 2018). Once these thresholds are reached, Section 199A imposes two additional independent limitations. First, the statute excludes certain specified service-predominant activities from the definition of a qualified trade or business. Second, the statute imposes a cap on the amount otherwise deductible under Section 199A for a trade or business, determined by reference to a percentage of the W-2 wages paid by the business (i.e., wages paid to its employees) or, alternatively, by reference to a lesser percentage of W-2 wages paid and the cost of the depreciable property used by the business in the production of QBI. These limitations, addressed in more detail below, are fully phased in when taxable income reaches $50,000 above the threshold amount for single taxpayers ($210,700 in 2019) and $100,000 above the threshold amount for married taxpayers filing jointly ($421,400 in 2019). Within the phase-in range, the limitations are each applied based on the ratio by which the taxable income of the taxpayer over the threshold amount bears to $50,000 for single taxpayers, or $100,000 for married taxpayers filing jointly.[149] For purposes of simplicity, the discussion below will refer to the limitations as applied in their fully phased-in form to "high-income taxpayers."

Limitation for Specified Service Trades or Businesses. For high-income taxpayers, Section 199A excludes any "specified service trade or

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147 The IRS's position is that interest income earned on working capital, reserves, and similar funds is not QBI because it is not allocable to a trade or business. Reg. § 1.199A–3(b)(2)(ii)(C); see I.R.C. § 199A(c)(3)(B)(iii).

148 The example disregards inflation adjustments to the standard deduction.

149 I.R.C. § 199A(b)(3)(B), (d)(3)(B).

business" ("SSTB") from the definition of a qualified trade or business.[150] An SSTB for this purpose includes any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and any trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners.[151] Notably, engineers and architects are excluded from the list of affected trades or businesses, while investment managers and traders in securities are singled out for inclusion in the SSTB category.[152]

As explained in the legislative history of the 2017 Act, the taxable income thresholds at which the exclusion for an SSTB begin to apply were intended by Congress "to deter high-income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20 percent deduction under the provision."[153] The exclusion, however, applies without regard to the taxpayer's subjective motivation. Returning to the basic example above, if A were married and filed a joint return with her husband B who earned $350,000 in salary as an employee, A's law practice would no longer constitute a qualified trade or business for purposes of Section 199A.[154]

The catch-all provision in the definition of SSTB—that is, any trade or business the principal asset of which is the reputation or skill of its employees or owners—garnered considerable attention within the tax community, as a significant amount of income of small businesses in particular can be traced to the human capital of their owners or employees. The "reputation or skill" category therefore was potentially broad in scope. The Service, however, has signaled that it does not intend to pursue an expansive interpretation of that aspect of the statute. Noting that the clause was intended to encompass "a narrow set" of trades or businesses not otherwise specifically enumerated in the statute, the regulations limit this category to trades or businesses generating the following three types of income: (1) endorsement fees; (2) fees attributable to licensing an individual's image, likeness, name, etc.; and (3) appearance fees.[155] Note that these categories are largely predicated on the reputation of the individual generating the fee income as opposed to the individual's skill in a particular field alone.

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150 I.R.C. § 199A(d)(1)(A), (3).

151 I.R.C. § 199A(d)(2) (incorporating, with modifications, the definition under I.R.C. § 1202(e)(3)(A)). The regulations define each of these fields in meticulous detail. See Reg. § 1.199A–5(b)(2)(ii)–(vii).

152 I.R.C. § 199A(d)(2).

153 H.R. Rep. No. 415–466, 115th Cong., 1st Sess. 222 (2017).

154 Given the loss of the Section 199A deduction for A in this setting, the couple would want to explore the prospect of filing separate returns. The threshold amounts for applying the limitations on high-income taxpayers under Section 199A are the same for single individuals and for married individuals filing separately. I.R.C. § 199A(e)(2)(A).

155 Reg. § 1.199A–5(b)(2)(xiv).

If a particular trade or business constitutes an SSTB within the meaning of Section 199A(d)(1)(A) and the taxpayer is subject to this limitation in determining QBI, none of the tax items from the business may be considered in determining QBI whether or not the taxpayer actually participates in the service activity. Given this blanket prohibition, the Service has articulated a de minimis rule for businesses that generate only a fraction of income from specified service activities. A trade or business is not treated as an SSTB for purposes of Section 199A(d)(1)(A) if the business has gross receipts of $25 million or less and less than 10 percent of its gross receipts is attributable to the performance of services in one of the statutorily designated fields or activities.[156]

The denial of a Section 199A deduction for income generated through an SSTB for high-income taxpayers creates a powerful incentive for businesses to segregate proscribed service activities from other sources of income. The Service is well aware of this incentive and has responded with an anti-abuse rule. Under the Section 199A regulations, if a trade or business provides property or services to an SSTB and the two trades or businesses share 50 percent or more common ownership (directly or by way of attribution), that portion of the trade or business providing the property or service to the 50 percent or more SSTB is treated as a separate SSTB as to the related parties.[157] To illustrate this basic anti-abuse rule, assume a doctor owns an office building that she leases exclusively to her medical practice. Because the entire building is provided to a commonly controlled SSTB (her medical practice), the leasing arrangement is also treated as an SSTB. The anti-abuse rule eliminates the incentive the doctor has to separate the rental income from her professional services in order to obtain a Section 199A deduction with respect to the rental income. However, if only half of the building were leased to the practice with the other half being leased to an unrelated party, the leasing operation would not be considered an SSTB in its entirety. Rather, only the half of the rental income derived from the medical practice would be treated as generated from an SSTB, preventing its inclusion in QBI.

Limitations Based on W-2 Wages and Unadjusted Basis in Qualified Property. In addition to limitations on the range of activities that will constitute a qualified trade or business, high-income taxpayers face a separate limitation on the amount that can be deducted under Section 199A. For high-income taxpayers, the deductible amount for any qualified trade or business is limited to the greater of: (1) 50 percent of the "W-2 wages" with respect to the qualified trade or business, or (2) the sum of 25 percent of those "W-2 wages" plus 2.5 percent of the unadjusted

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156 Reg. § 1.199A–5(c)(1)(i). If the gross receipts of the trade or business exceed $25 million, the de minimis safe harbor applies only if less than 5 percent of gross receipts are attributable to otherwise specified service activities. Reg. § 1.199A–5(c)(1)(ii).

157 Reg. § 1.199A–5(c)(2)(i). The attribution rules of Section 267(b) and Section 707(b) are applied for this purpose. Reg. § 1.199A–5(c)(2)(iii).

basis immediately after acquisition of all "qualified property" used in the trade or business.[158]

The scope of W-2 wages for purposes of this limitation includes the total amount of wages subject to income tax withholding, amounts paid into qualified retirement accounts (such as Section 401(k) plans), and certain other forms of deferred compensation paid to the employees of the business.[159] For labor-intensive businesses, 50 percent of W-2 wages paid by the business likely will serve as the relevant cap on the amount deductible from that trade or business. On the other hand, for capital-intensive businesses such as real estate ventures, the alternate cap likely will be higher. This limitation starts with 25 percent of W-2 wages paid by the trade or business and adds 2.5 percent of the unadjusted basis (immediately after acquisition) of "qualified property." Qualified property encompasses depreciable tangible property—real or personal—held by and available for use in a qualified trade or business at the close of the taxable year, which is used in the production of qualified business income, and for which the depreciable period of the property has not ended before the close of the taxable year.[160] The "depreciable period" of property for purposes of Section 199A ends upon the later of (a) 10 years after the date the property is placed in service, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under Section 168 (determined without regard to the alternative depreciation system of Section 168(g)).[161]

Apportionment Rules. Section 199A is applied at the shareholder level in the case of businesses operated as S corporations.[162] Accordingly, all the tax items of the business, together with the W-2 wages and the unadjusted basis in qualified property, must be allocated among the shareholders. Section 199A provides special rules for this purpose. An S corporation is required to report these items to its shareholders on a Schedule K-1, and must identify any trade or business that is an SSTB.[163]

Each S corporation shareholder takes into account only that person's "allocable share" of each item of income, gain, deduction and loss from the qualified trade or business.[164] The allocable share of a shareholder in an S corporation is based on pro-rata stock ownership. With respect to determining the cap applicable to a taxpayer's deduction under Section 199A, those amounts will be determined by reference to the shareholder's

[158] I.R.C. § 199A(b)(2)(B).

[159] I.R.C. § 199A(b)(4).

[160] I.R.C. § 199A(b)(6)(A).

[161] I.R.C. § 199A(b)(6)(B). The additional first-year depreciation afforded under Section 168(k) does not affect the applicable recovery period under Section 168(c) for this purpose. See Reg. § 1.199A–2(c)(2)(ii).

[162] I.R.C. § 199A(f)(1)(A)(i).

[163] See generally Reg. § 1.199A–6(b).

[164] I.R.C. § 199A(f)(1)(A)(ii).

allocable share of the W-2 wages and unadjusted basis of qualified property in the trade or business.[165]

Example. The example below illustrates the operation of Section 199A in a situation implicating the limitations on high-income taxpayers.

C, a single taxpayer, is a 25 percent shareholder of an S corporation that operates a restaurant. C's pro rata share of net operating income from the corporation totals $100,000 for the year. C also has $200,000 of taxable income from sources unrelated to the business, subjecting him to the high-income limitations imposed by Section 199A. The S corporation pays its employees $120,000 in wages during the taxable year. The corporation leases the building in which the restaurant is located, but it owns equipment and furnishings having a $400,000 unadjusted basis and a recovery period of ten years under Section 168. The corporation expensed the cost of the equipment and furnishings under Section 168(k) when it placed them into service two years ago.

C's deduction under Section 199A is equal to the lesser of: (1) 20 percent of C's allocable share of qualified income from the trade or business (note that it is not a specified service trade or business), or (2) the greater of: (a) 50 percent of the C's allocable share of the W-2 wages paid by the S corporation or (b) 25 percent of C's allocable share of the W-2 wages paid by the corporation plus 2.5 percent of the unadjusted basis of qualified property used in the corporation's trade or business. C's pro rata share of all tax items from the business is based on his 25 percent stock ownership and thus the starting point for calculating C's deduction under Section 199A is 20 percent of $100,000, or $20,000. However, this amount is limited to the greater of the following two amounts: 50 percent of C's $30,000 share of W-2 wages paid by the S corporation ($15,000) or 25 percent of C's $30,000 share of W-2 wages ($7,500) plus 2.5 percent of C's $100,000 share of the unadjusted basis of qualified property held by the corporation ($2,500), for a total of $10,000. Accordingly, C's deduction under Section 199A is capped at $15,000, the higher of these two amounts.

PROBLEM

Alice is a world famous chef who operates Chez Panache ("Chez"), a restaurant structured as an S corporation. She is the sole shareholder. In the current year, Chez generates $2.5 million of gross receipts and incurs $1 million of deductible operating expenses. In addition, the corporation pays Alice a salary of $200,000 and $400,000 in wages to other employees. Chez's net income is thus $900,000, all of which passes through to Alice, who has no income from other sources. Assume that the corporation does not own any "qualified property" within the meaning of § 199A(b)(6).

(a) Consider whether Alice is entitled to a § 199A deduction with respect to her income from Chez's business.

165 I.R.C. § 199A(f)(1)(A)(iii).

(b) Same as (a), above, except Chez does not pay Alice any salary, so that her share of net profits from the business is $1.1 million.

3. LOSS LIMITATIONS

Code: § 1366(d).

a. IN GENERAL

Section 1366(d) limits the amount of losses or deductions that may pass through to a shareholder to the sum of the shareholder's adjusted basis in the stock plus the adjusted basis in any indebtedness of the corporation to the shareholder. Losses disallowed because of an inadequate basis may be carried forward indefinitely and treated as a loss in any subsequent year in which the shareholder has a basis in either stock or debt.[166] A special rule also provides that if a shareholder's stock is transferred under Section 1041 to a spouse or former spouse incident to a divorce, any suspended loss or deduction may be carried forward indefinitely by the transferee-spouse.[167] As illustrated by the *Harris* case, which follows this Note, one of the most litigated issues to arise under Subchapter S has involved the determination of a shareholder's basis in S corporation stock and debt for purposes of applying the general loss limitation rules in Section 1366(d).

Losses that pass through to a shareholder of an S corporation also may be restricted by the at-risk limitations in Section 465, the passive activity loss limitations in Section 469, and the Section 461(*l*) limitation on excess business losses of noncorporate taxpayers.[168] The at-risk rules are applied on an activity-by-activity basis, except that activities constituting a trade or business generally are aggregated if the taxpayer actively participates in the management of the trade or business and at least 65 percent of the losses are allocable to persons actively engaged in the management of the trade or business.[169] The passive activity loss limitations cast a wider net and may delay an investor's ability to deduct legitimate start-up losses passing through from a new business operating as an S corporation unless the investor also materially participates in the activity.[170] Finally, S corporation losses that survive after application of Sections 465 and 469 are subject to the Section 461(*l*) limitation on excess business losses of noncorporate taxpayers. An "excess business loss" is generally defined as a net loss from all of the taxpayer's trade or business activities in excess of $250,000, or $500,000 in the case of a joint

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166 I.R.C. §§ 1366(d)(2)(A); 1366(a)(1).

167 I.R.C. § 1366(d)(2)(B).

168 These limitations apply on a shareholder-by-shareholder basis rather than at the corporate level. I.R.C. §§ 465(a)(1)(A); 469(a)(2)(A).

169 I.R.C. § 465(c)(3)(B).

170 I.R.C. § 469(c)(1).

return.[171] The $250,000 and $500,000 amounts are adjusted for inflation after 2018.[172] Any loss disallowed under Section 461(*l*) carries over to the next year and is treated as a net operating loss under Section 172.[173]

b. BASIS OF S CORPORATION DEBT TO A SHAREHOLDER

For purposes of the Section 1366(d) loss limitations, the regulations provide general guidance on how to determine the basis of an S corporation's indebtedness to its shareholders. Shareholders only obtain basis in S corporation debt if it is "bona fide," a determination made under general tax principles and based on all the facts and circumstances.[174] Relevant factors under the extensive case law include evidence of intent to make a loan (e.g., proper documentation and adherence to a payment schedule), objective indicia of indebtedness, and economic reality (e.g., whether a third party lender would loan money under similar circumstances). These general principles are given further signs of life through examples applying the bona fide indebtedness test to situations where there is a loan directly from a shareholder to an S corporation; a back-to-back loan arrangement where one S corporation makes a loan to a shareholder and the shareholder then makes a loan to a different S corporation; and a loan restructuring where an individual who is the sole shareholder of two S corporations receives the loan of one corporation to the other in a distribution.[175]

A different but frequently litigated issue is whether an S corporation shareholder obtains basis credit as a result of guaranteeing a debt of the corporation. That issue is addressed in the *Harris* case, below, and the Note that follows the case.

Harris v. United States

United States Court of Appeals, Fifth Circuit, 1990.
902 F.2d 439.

■ GARWOOD, CIRCUIT JUDGE:

Facts and Proceedings Below

In June 1982, Taxpayers contracted with Trans-Lux New Orleans Corporation to purchase for $665,585 cash a New Orleans pornographic theater that they intended to convert into a wedding hall. The Taxpayers' obligations under the contract were conditioned on their being able to secure from a third party a loan for not less than $600,000 repayable in

171 I.R.C. § 461(*l*)(3)(A).

172 I.R.C. § 461(*l*)(3)(B).

173 I.R.C. § 461(*l*)(2).

174 Reg. § 1.1366–2(a)(2)(i).

175 See Reg. § 1.1366–2(a)(2)(iii) Examples 1–3.

fifteen to twenty years.[1] Shortly before this time, Taxpayers had contacted John Smith (Smith), a real estate loan officer with Hibernia National Bank (Hibernia), to discuss the possibility of obtaining financing for the impending acquisition. Smith orally committed to lend Taxpayers $700,000.[2]

Subsequently, to shield themselves from the potential adverse publicity that could follow from the purchase of the pornographic theater, as well as to limit their personal liability and enhance their chances of qualifying for industrial revenue bonds to finance the theater's renovation, in July 1982 Taxpayers formed Harmar (Harmar), a Louisiana corporation, which elected to be taxed pursuant to Subchapter S of the Internal Revenue Code, to purchase and operate the subject property. Harris and Martin each initially contributed $1,000 to the corporation, receiving its stock in return, and each also loaned Harmar $47,500 to satisfy operating expenses. Harris and Martin were the sole shareholders of Harmar, each owning half of its stock.

The purchase of the theater closed on November 1, 1982, and the theater was conveyed to Harmar on that date. Hibernia furnished the $700,000 necessary to close the transaction. In borrowing the funds necessary to acquire the subject property, Harmar executed two promissory notes payable to Hibernia for $350,000 each, each dated November 1, 1982. One of these notes was secured by a $50,322.09 Hibernia certificate of deposit in Harris' name and another $304,972.49 certificate of deposit in the name of his wholly-owned corporation, Harris Mortgage Corporation. Harmar secured the other note, in accordance with its collateral pledge agreement, by its $3,000,000 note (which was unfunded apart from the $700,000) and its collateral mortgage on the theater, each executed by Harmar in favor of Hibernia and dated November 1, 1982. Under the terms of the collateral pledge agreement executed by Harmar in reference to the $3,000,000 note and mortgage, the mortgage secured "not only" Harmar's $350,000 note to Hibernia, "but also any and every other debts, liabilities and obligations" (other than consumer credit debt) of Harmar to Hibernia whether "due or to become due, or whether such debts, liabilities and obligations" of Harmar "are now existing or will arise in the future." Thus, the collateral mortgage secured the full $700,000 loan from Hibernia. Additionally, Taxpayers each executed personal continuing guarantees of Harmar indebtedness in the amount of $700,000 in favor of Hibernia. Smith testified in his deposition that the transaction was structured so that half the loan, as represented by one of the $350,000 notes, would be primarily secured by the certificates of deposit and the other half, represented by

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1 As part of the contract, Taxpayers deposited with the seller $32,500, all of which was to be applied to the purchase price. In the event Taxpayers were unable to procure the loan, the purchase contract called for their deposit to be refunded.

2 Smith asserted in his deposition that he did not know the purpose of the borrowed funds in excess of the purchase price, but he surmised that the money was intended for improvements to the theater. No written loan commitment was ever issued.

the other $350,000 note, primarily by the mortgage on the property purchased, with the entire amount also secured by Taxpayers' individual guarantees.

On its income tax return for the year ending December 31, 1982, Harmar reported a net operating loss of $104,013. Pursuant to [the predecessor of Section 1366], Taxpayers each claimed half of the loss as a deduction on their 1982 individual returns,[5] concluding that their bases in Harmar were in fact greater than Harmar's net operating loss for that year and that they therefore were entitled to deduct the entire loss on their personal returns. On audit, the Internal Revenue Service (IRS) found to the contrary and determined that Harris and Martin each had a basis of $1,000 in his Harmar stock and an adjusted basis in Harmar's indebtedness to each of them as shareholders of $47,500. Pursuant to I.R.C. [§ 1366(d)], the IRS limited Taxpayers' deductions of the net operating loss to what it considered to be their bases in Harmar, $48,500 each. The IRS's disallowance of a portion of the deductions claimed by Taxpayers[6] resulted in additional tax liability, including interest, for Martin of $3,150.58 and for Harris of $1,280. Taxpayers paid the tax in dispute and now appeal the district court's summary judgment dismissing their suit for refund.

Discussion

Taxpayers contend on appeal that in determining the deduction allowable for Harmar's net operating loss, the IRS should have included in Taxpayers' bases in their Harmar stock the full value of the $700,000 Hibernia loan they guaranteed. I.R.C. [§ 1366] permits a Subchapter S shareholder to deduct from his personal return a proportionate share of his corporation's net operating loss to the extent that the loss does not exceed the sum of the adjusted basis of his Subchapter S corporation stock and any corporate indebtedness to him. See section [1366(d)(1)]. To arrive at their basis figure, Taxpayers seek to recast the transaction in question. They in essence urge that we disregard the form of the Hibernia loan—one from Hibernia to Harmar—in favor of what Taxpayers consider as the substance of the transaction—a $700,000 loan from Hibernia to them, the $700,000 proceeds of which they then equally contributed to Harmar's capital account. As evidence of their view of the substance of the transaction, Taxpayers point to the deposition testimony of Smith indicating that Hibernia looked primarily to Taxpayers, rather than to Harmar, for repayment of the loan, and they call attention to the $700,000 guarantees they each provided Hibernia as well as the $355,294.58 in certificates of deposit that Harris pledged to Hibernia as part of the November 1, 1982 loan transaction.

In its summary judgment memorandum, the district court declared that Brown v. Commissioner, 706 F.2d 755 (6th Cir.1983), was "on all

[5] Harris and Martin claimed deductions for Harmar's loss of $52,006 and $52,007, respectively.

[6] The IRS disallowed $4,506 of Harris' deduction and $4,507 of Martin's.

fours" with the instant case and therefore resolved it. In *Brown,* the Sixth Circuit rejected shareholders' substance over form argument in ruling that the shareholders' guarantees of loans to their Subchapter S corporation could not increase their bases in their stock in the corporation unless the shareholders made an economic outlay by satisfying at least a portion of the guaranteed debt. Id. at 757. Without such an outlay, the *Brown* court concluded that " 'the substance matched the form' " of the transaction before it. Id. at 756. The reasoning of *Brown* was followed by the Fourth Circuit in Estate of Leavitt v. Commissioner, 875 F.2d 420 (4th Cir.1989), *aff'g,* 90 T.C. 206 (1988). There, the court, affirming the en banc Tax Court, held that shareholder guarantees of a loan to a Subchapter S corporation did not increase shareholders' stock basis because such guarantees had not "cost" shareholders anything and thus did not constitute an economic outlay. *Leavitt,* 875 F.2d at 422 & n. 9.[7] In reaching this conclusion, the Fourth Circuit affirmed as not clearly erroneous a finding of the Tax Court that the loan, in form as well as in substance, was made to the corporation rather than to the shareholders.[8] Id. at 424. The court rejected appellants' suggestion that it employ the debt/equity principles espoused in Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.1972), in determining whether the shareholders had actually made an economic outlay,[9] instead choosing to employ a debt/equity analysis only after making a finding that an economic outlay had occurred. *Leavitt,* 875 F.2d at 427. The *Leavitt* court reasoned that the legislative history of section [1366] limiting the basis of a Subchapter S shareholder to his corporate investment or outlay could not be circumvented through the use of debt/equity principles. Id. at 426 & n. 16. See generally Bogdanski, Shareholder Guarantees, Interest Deductions, and S Corporation Stock Basis: The Problems with Putnam, 13 J.Corp.Tax'n 264, 268–89 (1986).

Taxpayers press this Court to follow the contrary holding of Selfe v. United States, 778 F.2d 769 (11th Cir.1985). There, the Eleventh Circuit ruled that a shareholder's guaranty of a Subchapter S corporation loan could result in an increase in equity or debt basis even though the

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[7] In reasoning that the shareholders had not increased their stock bases as a result of their guarantees, the court turned to I.R.C. § 1012, which defines basis of property as its cost. Id. at 422 n. 9. Cost of property, in turn, is defined in the Treasury Regulations as the "amount paid for such property in cash or other property." 26 C.F.R. § 1.1012–1(a).

[8] The court noted that the loan in question had been made by the bank directly to the corporation, the loan payments were made by the corporation directly to the bank, and neither the corporation nor the shareholders reported the payments as constructive dividends. Id.

Under *Leavitt,* the presumption is that the form will control and that presumption will not be surmounted absent the shareholder's satisfying the higher standard applicable to a taxpayer's seeking to disavow the form he selected and recast a transaction. See Bowers, Building Up an S Shareholder's Basis through Loans and Acquisitions, J. Tax'n S Corp., Fall 1989, at 22, 29.

[9] In *Plantation Patterns,* this Court considered whether a Subchapter C corporation could deduct interest payments made on its debt and whether its shareholders had resulting dividend income. The Court, using a debt/equity analysis, affirmed a Tax Court finding that a corporation's interest payments on debentures were constructive dividends and could not be deducted as interest payments. Id. at 723–24. * * *

shareholder had not satisfied any portion of the obligation. *Selfe,* 778 F.2d at 775. The court remanded the case to the district court for it to employ debt/equity principles in determining if the loan in question was in substance one to the shareholder rather than to the corporation. Id.

The courts have uniformly ruled that a shareholder must make an economic outlay to increase his Subchapter S corporation stock basis. Taxpayers assert that if we look beyond the form of the transaction at what they contend is its substance—a loan from Hibernia to them, which in turn they contributed to Harmar as capital—we must find that a $700,000 outlay occurred and that their stock bases therefore correspondingly increased. They contend that use of debt/equity principles will lead us to such a conclusion.

Ordinarily, taxpayers are bound by the form of the transaction they have chosen; taxpayers may not in hindsight recast the transaction as one that they might have made in order to obtain tax advantages. * * * The IRS, however, often may disregard form and recharacterize a transaction by looking to its substance. Higgins v. Smith, 308 U.S. 473, 60 S.Ct. 355, 357, 84 L.Ed. 406 (1940). The Tax Court has recognized an exception to the rule that a taxpayer may not question a transaction's form in cases such as this one in which the shareholder argues that guaranteed corporate debt should be recast as an equity investment on the shareholder's part. Blum v. Commissioner, 59 T.C. 436, 440 (1972).

In this case we find that the transaction as structured did not lack adequate substance or reality and that an economic outlay justifying the basis claimed by Taxpayers never occurred.

The summary judgment evidence reflects that the parties to this transaction intended that the Hibernia loan be one to the corporation. Each of the two $350,000 promissory notes was executed by and only in the name of Harmar. The notes have been renewed and remain in the same form, namely notes payable to Hibernia in which the sole maker is Harmar. Hibernia, an independent party, in substance earmarked the loan proceeds for use in purchasing the subject property to which Harmar took title, Harmar contemporaneously giving Hibernia a mortgage to secure Harmar's debt to Hibernia. The bank sent interest due notices to Harmar, and all note payments were made by checks to Hibernia drawn on Harmar's corporate account. Harmar's books and records for all years through the year ended December 31, 1985, prepared by its certified public accountant, reflect the $700,000 loan simply as an indebtedness of Harmar to Hibernia. They do not in any way account for or reflect any of the $700,000 as a capital contribution or loan by Taxpayers to Harmar, although they do reflect the $1,000 capital contribution each Taxpayer made and Harmar's indebtedness to Taxpayers for the various cash advances Taxpayers made to it. The Harmar financial statements for the year ended December 31, 1986, are the first to show any contributed capital attributable to the Hibernia loan. Further, Hibernia's records showed Harmar as the "borrower" in respect to the $700,000 loan and the renewals of it. Harmar's 1982 tax return, which covered August 15 through December 31, 1982, indicates that Harmar deducted $12,506 in interest expenses. Because only the Hibernia loan generated such expenses for that period, it is reasonably inferable that the deduction corresponded to that loan. The 1982 Harmar return showed no distribution to Taxpayers, as it should have if the $700,000 Hibernia loan on which Harmar paid interest was a loan to the Taxpayers. Further, the return shows the only capital contributed as $2,000 and the only loan from stockholders as $68,000, but shows other indebtedness of $675,000. In short, Harmar's 1982 income tax return is flatly inconsistent with Taxpayers' present position. Moreover, there is no indication that Taxpayers treated the loan as a personal one on their individual returns by reporting Harmar's interest payments to Hibernia as constructive dividend income. In sum, the parties' treatment of the transaction, from the time it was entered into and for years thereafter, has been wholly consistent with its unambiguous documentation and inconsistent with the way in which Taxpayers now seek to recast it. Hibernia was clearly an independent third party, and the real and bona fide, separate existence of Harmar is not challenged. The parties did what they intended to do, and the transaction as structured did not lack adequate reality or substance.

Moreover, if the transaction is to be "recast," it is by no means clear that it should be recast in the form sought by Taxpayers, namely as a cash loan to them from Hibernia followed by their payment of the cash to Harmar as a contribution to its capital, and Harmar's then using the cash to purchase the building. Such recasting does not account for Hibernia's mortgage on the building. In any event, if the transaction is to be recast, why should it not be recast as a loan by Hibernia to Taxpayers, with the Taxpayers using the funds to themselves purchase the building, giving Hibernia a mortgage on the building to secure their debt to it, and then transferring the building, subject to the mortgage, to Harmar as a contribution to capital? Presumably in that situation Taxpayers' bases in their Harmar stock would be reduced by the amount of the debt secured by the mortgage under I.R.C. § 358(d). See Wiebusch v. Commissioner, 59 T.C. 777, aff'd per curiam "on the basis of the opinion of the Tax Court," Wiebusch v. Commissioner, 487 F.2d 515 (8th Cir.1973).[15] While section 358(d) likely does not affect stockholder basis in the debt of the Subchapter S corporation to the stockholder, Taxpayers have not sought to recast the transaction as a loan by Hibernia to them followed by their loan of the proceeds to Harmar; indeed even after Harmar's books were rearranged starting with the year ending December 31, 1986, the books

[15] See also Megaard, No Stock Basis for Shareholder Guarantee of S Corporation Debt, 15 J.Corp.Tax'n 340 (1989). Megaard explains that "[u]nder Section 358(d), the assumption by a corporation of its shareholder's debt is treated as money received which reduces the shareholder's basis in the stock." Id. at 349. Cf. id. at 350 ("Having the corporation's assets encumbered by the shareholder's personal debt runs the risk of a basis reduction under Section 358 should the Service argue that the transaction was a purchase by the shareholder of the * * * assets followed by a contribution of the assets to the corporation subject to the debt.").

do not show any indebtedness in this respect of Harmar to Taxpayers and do continue to show Harmar as owing the money in question to Hibernia. There is simply no evidence of Harmar indebtedness to Taxpayers in respect to these funds.

Taxpayers' guarantees and Harris' pledge of certificates of deposit do not undermine the intent of the parties that Harmar be the borrower in this transaction. It certainly is not difficult to fathom that a careful lender to a new, small, closely held corporation such as Harmar would seek personal guarantees from all of its shareholders. See Bogdanski, supra, at 269. Moreover, the wholly unperformed guarantees do not satisfy the requirement that an economic outlay be made before a corresponding increase in basis can occur. See generally *Underwood,* 535 F.2d at 312. In the same light, Harris' pledge to Hibernia of some $355,000 in certificates of deposit of his (and Harris Mortgage Corporation) does not provide such an outlay.[16]

We conclude that the transaction must be treated as it purports to be and as the parties treated it—namely as a loan by Hibernia to Harmar, all payments on which through the relevant time have been made by Harmar to Hibernia. For any funds or other assets Taxpayers have actually provided to Harmar as loans or contributions, Taxpayers are, of course, entitled to basis additions as of the time such contributions or loans were furnished by them to Harmar, but they are not entitled to a 1982 basis addition for Hibernia's 1982 $700,000 loan to Harmar, notwithstanding that it was also secured by Taxpayers' execution of guarantees and Harris' pledge to Hibernia of his and Harris Mortgage Corporation's certificates of deposit in the total face amount of some $355,000.

Conclusion

There was no genuine dispute as to any material fact necessary to sustain the Government's summary judgment motion. The district court's judgment is correct and it is therefore

Affirmed.

NOTE

In *Harris,* the Fifth Circuit joined several other circuits[176] and the Tax Court[177] in holding that the guarantee of an S corporation's loan by its shareholders may not be treated as an additional investment in the

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16 Taxpayers would have us, in effect, convert this pledge to Hibernia into a $700,000 cash contribution made to Harmar by Taxpayers equally. But that did not happen. Taxpayers do not contend that the certificates of deposit were contributed to Harmar's capital.

176 See, e.g., Brown v. Commissioner, 706 F.2d 755 (6th Cir.1983); Estate of Leavitt v. Commissioner, 875 F.2d 420 (4th Cir.1989), cert. denied, 493 U.S. 958, 110 S.Ct. 376 (1989); Uri v. Commissioner, 949 F.2d 371 (10th Cir.1991); Sleiman v. Commissioner, 187 F.3d 1352 (11th Cir. 1999); Grojean v. Commissioner, 248 F.3d 572 (7th Cir. 2001); Maloof v. Commissioner, 456 F.3d 645 (6th Cir. 2006).

177 See, e.g., Estate of Leavitt v. Commissioner, 90 T.C. 206 (1988); Hitchins v. Commissioner, 103 T.C. 711 (1994).

corporation which will increase the shareholders' bases for purposes of the loss limitation rule in Section 1366(d). In conflict with this line of authority is the Eleventh Circuit's decision in Selfe v. United States.[178] In *Selfe,* the court reasoned that debt-equity principles under Subchapter C were applicable in determining whether a shareholder-guaranteed debt should be characterized as a capital contribution. In remanding the case for a determination of whether the shareholder's guarantee amounted to either an equity investment or a shareholder loan to the corporation, the court directed the district court to apply the principles of *Plantation Patterns,* a Subchapter C case discussed in *Harris*. Despite the seeming conflict among the circuits, the Supreme Court has resisted the temptation to add this fascinating tax issue to its docket.[179]

The regulations now confirm the majority rule as articulated in *Harris*. They provide that a shareholder does not obtain basis credit in indebtedness of an S corporation merely by guaranteeing a loan, or acting as a surety, accommodation party, or in some similar capacity relating to a loan. But if a shareholder is called upon to make a payment on the corporation's indebtedness as a result of a guaranty or similar arrangement, then the shareholder may increase the basis of indebtedness to the extent of the amount of the payment.[180]

c. SUBCHAPTER S PRECONTRIBUTION LOSSES AND SECTION 362(e)(2)

Code: § 362(e)(2).

The rules for allocating and characterizing gains and losses that are inherent in property contributed to a partnership ("precontribution gains and losses") are one of the principal features of the Subchapter K partnership tax regime. Under Section 704(c)(1)(A), precontribution gains and losses generally must be taxed to the contributing partner, and Section 724 prevents partners from gaining a tax advantage by converting precontribution ordinary income into capital gain and precontribution capital loss into ordinary loss. Other provisions buttress these rules by preventing shifting of precontribution gains and losses through partnership distributions and dispositions of partnership interests.[181] In short, Subchapter K has an array of provisions designed to ensure that a partner who contributes property with a precontribution gain will be taxed on that gain and that precontribution losses may not be shifted to other partners.[182]

Subchapter S is relatively primitive compared to its Subchapter K cousin in the treatment of precontribution gains and losses. Under Section 1377, precontribution gains and losses are taxed like any other

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[178] 778 F.2d 769 (11th Cir.1985).

[179] The Court denied the taxpayer's petition for certiorari in the *Estate of Leavitt* case, supra note 176.

[180] Reg. § 1.1366–2(a)(2)(ii). See Reg. § 1.1366–2(a)(2)(iii) Example 4.

[181] I.R.C. §§ 704(c)(1)(B); 737; 751(a).

[182] Section 704(c)(1)(C) prevents a shift of precontribution losses to other partners, even a transferee partner.

gain or loss under a per-share, per-day allocation method.[183] Precontribution gains and losses in an S corporation are thus routinely shifted to other shareholders.

Congress decided to attack various schemes by taxpayers to duplicate losses by way of transactions involving corporations. Section 362(e)(2) was one of the provisions enacted to curb those abuses. That section provides that if a shareholder transfers property with an aggregate built-in loss to a corporation in a Section 351 transaction, the corporation's basis in the property must be reduced to the fair market value of such property.[184] If more than one asset is contributed, the basis reduction is allocated among the property in proportion to their respective built-in losses immediately before the transaction.[185] As an alternative to reducing the property's basis, the shareholder and the corporation may elect to reduce the basis of the stock that was received for the property to the stock's fair market value immediately after the transfer.[186]

Section 362(e)(2) potentially will defer or limit precontribution losses in an S corporation, sometimes in a very unusual way. For example, assume that an individual decides to form an S corporation by contributing property with a $20,000 basis and $12,000 fair market value for all of the corporation's stock in a Section 351 exchange. Under Section 362(e)(2), the property's basis will be reduced to $12,000 and the precontribution loss in the property will disappear. If the corporation were to sell the property for $12,000, there would be no gain or loss recognized by the corporation. The shareholder's basis in the stock, however, would still be $20,000 so the loss would remain in the shares. The timing of the loss, however, would be deferred until the shareholder either liquidates the corporation or sells the stock. Alternatively, assume that the shareholder and the corporation elect to reduce the basis of the shareholder's stock to $12,000. In that case, the basis of the property in the corporation would remain at $20,000. If the corporation were to sell the property, it would recognize its $8,000 loss, which would pass through to the shareholder. The shareholder's stock basis would then be reduced by the loss down to $4,000, putting the shareholder in a position where a sale of the stock for its $12,000 fair market value would result in an $8,000 gain. Over time, the shareholder would report an $8,000 loss and an $8,000 gain, the net result being that the loss essentially disappeared. Finally, assume that the shareholder also contributed property with a $10,000 built-in gain to the S corporation at the same time as the transfer of the property with the built-in loss. In that case, no reduction in the basis of the loss property or the stock would be required under Section

183 The regulations hold out the possibility of attacking plans to alter the character of precontribution gains and losses in an S corporation. See Reg. § 1.1366–1(b)(2) & (3).

184 I.R.C. § 362(e)(2)(A).

185 I.R.C. § 362(e)(2)(B).

186 I.R.C. § 362(e)(2)(C).

362(e)(2) because the two properties that were transferred did not have an aggregate built-in loss.

It is hard to believe that Congress considered the effects on Subchapter S when it enacted Section 362(e)(2). That section now lurks as a trap for those who either receive poor advice or are not initiated in the ways of Subchapters C and S. Until Congress fixes this problem, taxpayers planning a new venture involving property with a built-in loss will be well advised to consider structuring the venture as a limited liability company or partnership governed by Subchapter K. Alternatively, another strategy for preserving a built-in loss in property would be to offer to make the property available to an S corporation through a leasing arrangement.

PROBLEM

D H.
1/2 1/2 2000 basis
4k
Ace.

The Ace Sporting Goods Store (an S corporation) is owned by Dick and Harry. Dick and Harry each own one-half of Ace's stock and have a $2,000 basis in their respective shares. At incorporation, Dick loaned $4,000 to Ace and received a five year, 12% note from the corporation.

(a) If Ace has an $8,000 loss from business operations this year, what will be the results to Dick and Harry? Do you have any suggestions for Harry? Would it matter if on December 15 Ace borrowed $4,000 from its bank on a full recourse basis? What if Dick and Harry personally guaranteed the loan? Compare §§ 752(a) and 722.

6k -> 3k income each,
Harry: 3k income – 2k carryover loss = 1k income.
basis ↗ to 1k.
Dick: 3k income without offsetting loss.

(b) If Ace has $6,000 of net income from business operations next year, what will be the results to Dick and Harry?

(c) What difference would it make in (a), above, if the $8,000 loss was made up of $2,000 of losses from business operation and a $6,000 long-term capital loss? See Reg. § 1.704–1(d)(2).

(d) What would be the effect in (a), above, if Ace's S corporation status was terminated at the end of the current year?

4. SALE OF S CORPORATION STOCK

Code: § 1(h).

The tax consequences of a sale of S corporation stock are determined by regulations promulgated under the "look-through" rules of Section 1(h). In general, S corporation stock is treated as a capital asset that gives rise to capital gain or loss on sale. Unlike the more complex approach taken by Subchapter K to the sale of a partnership interest, Subchapter S historically has not required selling shareholders to characterize a portion of their gain or loss on a stock sale by reference to the types of assets (e.g., ordinary income property) held by the corporation at the time of the sale. When Congress enacted the Section 1(h) capital gains rate regime, however, it authorized the Service to prescribe appropriate regulations to apply the various maximum capital gains rates to the sale of interests in pass-through entities.[187]

The Section 1(h) regulations apply a partial capital gains "look-through" rule for sales and exchanges of interests in an S corporation.[188] Shareholders who sell S corporation stock held for more than one year may recognize collectibles gain (taxable at a maximum rate of 28 percent) and residual capital gain, which is generally taxable at a maximum rate of 20 percent,[189] The selling shareholder's share of collectibles gain is defined as the amount of the net collectibles gain (but not net collectibles loss) that would be allocated to that shareholder if the S corporation transferred all of its collectibles in a fully taxable transaction immediately before the transfer of the stock.[190] The selling shareholder's residual capital gain is the amount of long-term capital gain or loss that the shareholder would recognize on the sale of the stock ("pre-look-through capital gain or loss") minus the shareholder's share of collectibles gain.[191] The look-through rules do not extend to other corporate assets, such as inventory or depreciable equipment, that would generate ordinary income, or to real estate that would produce unrecaptured (i.e., 25-percent) Section 1250 gain on a corporate-level sale. In contrast, on the sale of a partnership interest, the portion of consideration received by a partner that is attributable to ordinary income assets is taxed to the selling partner as ordinary income.[192] What is the policy justification for this more limited "pick and choose" look-through approach for S corporations?

The regulations illustrate these rules with the following example.[193] Assume that X, Inc., which always has been an S corporation and is owned equally by individuals A, B, and C, invests in antiques. After they were purchased, the antiques appreciated in value by $300. A owned one-third of the X stock and has held the stock for more than one year. A's adjusted basis in the X stock is $100. If A were to sell all of the X stock to T for $150, A would recognize $50 of pre-look-through long-term capital gain. If X were to sell all of the antiques in a fully taxable transaction immediately before the transfer to T, A would be allocated $100 of collectibles gain on account of the sale. Therefore, A will recognize $100 of collectibles gain on account of the collectibles held by X. The difference between A's pre-look-through capital gain or loss ($50) and the collectibles gain ($100) is A's residual long-term capital gain or loss on

187 I.R.C. § 1(h)(9).

188 Reg. § 1.1(h)–1.

189 Reg. § 1.1(h)–1(a). In limited situations (e.g., where a transaction is governed by provisions of Subchapter C that treat gain on a sale or redemption of stock as ordinary income), shareholders also may recognize ordinary income on a sale of their S corporation stock. See, e.g., I.R.C. §§ 304, 306.

190 Reg. § 1.1(h)–1(b)(2)(ii). A shareholder's share of collectibles gain is limited to the amount attributable to the portion of the stock transferred that was held for more than one year.

191 Reg. § 1.1(h)–1(c).

192 I.R.C. § 741.

193 Reg. § 1.1(h)–1(f) Example 4.

the sale of the X stock. Thus, A will recognize $100 of collectibles gain and $50 of residual long-term capital loss on the sale of A's X stock.

E. DISTRIBUTIONS TO SHAREHOLDERS

Code: §§ 311(b); 1368; 1371(a)(1), (c), (e); Skim § 301(a), (b) & (d).

S Corporations Without Earnings and Profits. If an S corporation has no accumulated earnings and profits, distributions to shareholders are treated as a tax-free return of capital which is first applied to reduce the shareholder's stock basis.[194] Any distribution in excess of basis is treated as gain from the sale or exchange of property—capital gain if the stock is a capital asset.[195] Virtually all S corporations formed after 1982 do not generate earnings and profits[196] and are governed by this simple regime. This basic taxing pattern for distributions by S corporations also governs any distribution of property to which Section 301(c) would apply.[197] Thus, the tax consequences of transactions characterized as Section 301 distributions by other Code provisions, such as Sections 302 (redemptions) and 305 (stock dividends), are determined under Section 1368.

S Corporations with Earnings and Profits. S corporations with earnings and profits present more challenging problems because of the need to harmonize the Subchapter S rules with the corporation's prior C history. Distributions by a C corporation to its shareholders are taxable as dividends to the extent of the corporation's current and accumulated earnings and profits.[198] Some S corporations may have accumulated earnings and profits attributable to prior years when they were governed by Subchapter C. In addition, an S corporation may have inherited the earnings and profits of another company in a corporate acquisition subject to Section 381. In all these cases, the undistributed earnings have not been taxed at the shareholder level and represent an irresistible temptation for a tax-free bailout. There is no free lunch, however, and it thus becomes necessary to identify those distributions which should be taxed at the shareholder level because they are made out of accumulated earnings and profits.

Congress devised a new tax concept—the "accumulated adjustments account" ("AAA")—to serve as the reference point for determining the source of distributions by an S corporation with accumulated earnings and profits. The AAA represents the post-1982 undistributed net income of the corporation. It begins at zero and is increased and decreased annually in a manner similar to the adjustment of the basis in a

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194 I.R.C. § 1368(b)(1).

195 I.R.C. § 1368(b)(2).

196 I.R.C. § 1371(c)(1). An S corporation formed after 1982 may generate earnings and profits for any year in which it is not an S corporation and may acquire earnings and profits under Section 381 in a corporate acquisition. See Chapter 9C, supra.

197 I.R.C. § 1368(a). See Section G of this chapter, infra.

198 I.R.C. §§ 301(c)(1), 316.

shareholder's stock.[199] Any distribution by an S corporation with accumulated earnings and profits is treated as a tax-free return of capital to the extent it does not exceed the AAA.[200] A distribution in excess of the AAA is treated as a dividend to the extent of accumulated earnings and profits,[201] and any portion of the distribution still remaining after both the AAA and accumulated earnings and profits are exhausted is treated first as a recovery of basis and then as gain from the sale of property.[202]

One might reasonably ask at this point: what is the purpose of this statutory scheme? The answer is more straightforward than it first appears. The function of the AAA is to identify the source of distributions by those few S corporations with accumulated earnings and profits. It permits the corporation to make a tax-free distribution of the net income recognized during its S corporation era which already was taxed at the shareholder level. Only after these previously taxed earnings are exhausted will a distribution be considered as emanating from accumulated earnings and profits.[203]

Distributions of Appreciated Property. At the shareholder level, the Section 1368 distribution rules make no distinction between distributions of cash and other property. At the corporate level, however, an S corporation that distributes appreciated property (other than its own obligations) recognizes gain in the same manner as if the property had been sold to the shareholder at its fair market value.[204] This familiar rule, borrowed from Subchapter C, applies to liquidating and nonliquidating distributions of property by an S corporation.[205] The gain is not taxed to the corporation but, like other corporate-level income, it

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[199] I.R.C. § 1368(e)(1)(A); Reg. § 1.1368–2. Unlike a shareholder's basis, however, the AAA is not increased by tax-exempt income items and is not decreased for expenses related to tax-exempt income. The Section 199A deduction for qualified business income also has no effect on the AAA. Reg. § 1.199A–1(e)(1). The adjustments also may result in a negative AAA. Reg. § 1.1368–2(a)(3)(ii). In addition, no adjustment is made for federal taxes attributable to any taxable year in which the corporation was a C corporation. Id.

[200] I.R.C. § 1368(c)(1). Except to the extent provided in regulations, the AAA is allocated proportionately among distributions if the distributions exceed the AAA. See Reg. § 1.1368–2(b), (c).

[201] I.R.C. § 1368(c)(2).

[202] I.R.C. § 1368(c)(2), (3). For additional details about the AAA, see Reg. § 1.1368–2.

[203] In lieu of these rules, an S corporation may elect, with the consent of all shareholders who have received distributions during the year, to treat distributions as a dividend to the extent of accumulated earnings and profits. I.R.C. § 1368(e)(3); Reg. § 1.1368–1(f)(2). There normally is little incentive to make this election. One possible motivation would be to enable the corporation to sweep its Subchapter C earnings and profits account clean and thus avoid the corporate level tax and possible termination of S corporation status that would result from the co-existence of Subchapter C earnings and profits and excessive passive investment income. See I.R.C. § 1375. A similar election is provided during a post-termination transition period. I.R.C. § 1371(e)(2).

[204] I.R.C. § 311(b). An S corporation may not recognize loss, however, on a distribution of property that has declined in value. I.R.C. § 311(a). Subject to several complex exceptions, partnerships may distribute appreciated property without current recognition of gain. I.R.C. § 731(b).

[205] See I.R.C. § 1371(a), which provides that, except as otherwise provided in Subchapter S, the provisions of Subchapter C apply to S corporations and their shareholders. For more on the coordination of Subchapters S and C, see Section G of this chapter, infra.

passes through to the distributee shareholder, who takes a fair market value basis in the distributed property.[206] The shareholder's basis in his S corporation stock is reduced by the fair market value (not the adjusted basis) of the distributed property.[207]

368 (d). basis adjustment first.

PROBLEMS

take into account full yr income

Dewey: 3k business income
1K LTCG.
basis: 7K.
Milt: 6k business income.
2K LTCG.
basis: 13K.

1. Ajax Corporation is a calendar year taxpayer which was organized two years ago and elected S corporation status for its first taxable year. Ajax's stock is owned one-third by Dewey and two-thirds by Milt. At the beginning of the current year, Dewey's basis in his Ajax shares was $3,000 and Milt's basis in his shares was $5,000. During the year, Ajax will earn $9,000 of net income from operations and have a $3,000 long-term capital gain on the sale of 100 shares of Exxon stock. What results to Dewey, Milt and Ajax in the following alternative situations?

    (a) On October 15, Ajax distributes $5,000 to Dewey and $10,000 to Milt.

    Distribution: tax free.

    (b) On October 15, Ajax distributes $8,000 to Dewey and $16,000 to Milt. Same basis as as: Dewey: 1k gain → 0 basis. Milt

    Dewey basis: 7K − 5K = 2K.
    Milt basis: 13K − 10K = 3K.

    (c) Ajax redeems all of Dewey's stock on the last day of the year for $20,000. What result to Dewey?

    (d) On October 15, Ajax redeems one-fourth of Dewey's stock for $5,000 and one-fourth of Milt's stock for $10,000.

    distribution of loss property × create loss for corp.

    (e) Ajax distributes a parcel of land with a basis of $9,000 and a fair market value of $8,000 to Dewey and a different parcel with a basis of $13,000 and fair market value of $16,000 to Milt.

    (f) On October 15, Ajax distributes its own notes to Dewey and Milt. Dewey receives an Ajax five year, 12% note with a face amount and fair market value of $8,000 and Milt receives an Ajax five year, 12% note with a face amount and fair market value of $16,000.

2. P Corporation was formed in 2011 by its two equal shareholders, Nancy and Opal, and elected S corporation status at the beginning of the current year. On January 1, Nancy had a $1,000 basis in her P stock and Opal had a $5,000 basis in her stock. P has $6,000 of accumulated earnings and profits from its prior C corporation operations and has the following results from operations this year:

Gross income	$32,000
Long-term capital gain	$ 4,000
Salary expense	$18,000
Depreciation	$ 8,000

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[206] I.R.C. § 301(d)(1).

[207] I.R.C. §§ 1367(a)(2)(A), 1368.

What are the tax consequences to Nancy, Opal and P Corporation in the following alternative situations.

(a) On November 1, P distributes \$5,000 to Nancy and \$5,000 to Opal.

(b) Same as (a), above, except that P distributes \$10,000 to Nancy and \$10,000 to Opal.

(c) What difference would it make in (a), above, if P also received \$4,000 of tax-exempt interest during the year and distributed \$2,000 of the interest to Nancy and \$2,000 to Opal?

(d) During the current year P makes no distributions. On January 1 of next year Nancy sells her P stock to Rose for \$6,000. If P breaks even on its operations next year, what will be the result to Rose if P distributes \$6,000 to each of its shareholders next February 15?

(e) During the current year P makes no distributions. Nancy and Opal revoke P's Subchapter S election effective January 1 of next year. Assume P Co. has \$5,000 of earnings and profits next year. What results to Nancy and Opal if P distributes \$7,000 to each of them on August 1 of next year?

F. TAXATION OF THE S CORPORATION

Code: §§ 1363; 1374; 1375.

The major benefit of a Subchapter S election is the elimination of tax at the corporate level. But this immunity from tax is not absolute. As part of its continuing mission to patrol abuse, Congress has provided that in certain limited situations an S corporation may be subject to tax under Section 1374 on certain built-in gains inherent in corporate property and under Section 1375 on a portion of its passive investment income.

Tax on Certain Built-in Gains: Section 1374. When Congress repealed the *General Utilities* doctrine, it recognized that the shareholders of a C corporation might elect S corporation status in order to avoid the corporate-level tax imposed under the new statutory scheme.[208] For example, assume Liquidating Co. is a C corporation, holds highly appreciated assets, and is owned by shareholders A and B, who also would realize large taxable gains if they sell their stock or liquidate the company. If A and B cause Liquidating Co. to sell its assets and liquidate, or to distribute its assets in complete liquidation, Liquidating Co. will be taxed on its gains and A and B also will be taxed on their stock gains.[209] If Liquidating Co. qualified as a "small business corporation," A and B could elect S corporation status in order to reduce the double-tax burden on the sale or liquidation. The company then could sell its assets and the gains would pass through to A and B, whose stock bases would

208 See Chapters 4D, 5E and 7B2, supra.

209 See I.R.C. §§ 331; 336; 1001(a).

be correspondingly increased. The effect of the S corporation/liquidation strategy would be to avoid the full impact of the double tax.

Section 1374 blocks this opportunity by taxing an S corporation that has a "net recognized built-in gain" at any time within five years of the effective date of its S corporation election.[210] At the outset, two important limitations on this tax should be noted. First, Section 1374 applies only if the corporation's S election was made after December 31, 1986.[211] Second, it does not apply to a corporation that always has been subject to Subchapter S.[212]

In general, Section 1374 is designed to tax an S corporation on the net gain that accrued while it was subject to Subchapter C if that gain is subsequently recognized on sales, distributions and other dispositions of property within a five-year "recognition period" beginning with the first taxable year in which the corporation was an S corporation. For this purpose, any gain recognized during the recognition period, including income from "ripe" items such as cash-basis accounts receivable or Section 453 installment obligations, is a "recognized built-in gain" unless the corporation establishes either that it did not hold the asset at the beginning of its first S taxable year or the recognized gain exceeds the gain inherent in the asset at that time.[213] Conversely, any loss recognized during the recognition period, including deductible items attributable to the corporation's pre-S life, is a "recognized built-in loss" to the extent that the S corporation establishes that it held the asset at the beginning of its first S year and the loss does not exceed the loss inherent in the asset at that time.[214] Since the taxpayer has the burden of proof under these definitions, a C corporation making an S election should obtain an independent appraisal of its assets to establish their value on the relevant date in order to avoid being taxed on gain arising under the S regime and to benefit from the losses that accrued during the corporation's C years.

The Section 1374 tax is computed by applying the highest rate applicable to C corporations (currently the 21 percent flat rate) to the S corporation's "net recognized built-in gain," which is defined as the corporation's taxable income computed by taking into account only recognized built-in gains and losses but limited to the corporation's

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[210] I.R.C. § 1374(a), (d)(7)(A). The "recognition period" was temporarily reduced from ten to seven years and then to five years beginning in 2009 and permanently reduced to five years for taxable years beginning in 2015. I.R.C. § 1374(d)(7)(B), (C). The five-year time period applies separately to any asset transferred from a C to an S corporation where the S corporation takes a carryover basis, such as in a tax-free reorganization. Id. See I.R.C. § 1374(d)(8).

[211] Tax Reform Act of 1986, P.L. No. 99–514, 99th Cong., 2d Sess. § 633(b) (1986).

[212] I.R.C. § 1374(c)(1). This exemption may not apply, however, if the S corporation had a "predecessor" that was a C corporation. Id. This could occur, for example, where a C corporation was acquired by the S corporation in a tax-free reorganization.

[213] I.R.C. § 1374(d)(3), (5)(A).

[214] I.R.C. § 1374(d)(4), (5)(B).

taxable income computed generally as if it were a C corporation.[215] The purpose of the taxable income limitation is to ensure that Section 1374 does not tax the corporation on more income than it actually realizes during the taxable year. To prevent taxpayers from avoiding the tax by manipulating the timing of post-conversion losses, Section 1374(d)(2)(B) provides that any net recognized built-in gains not taxed because of the taxable income limitation are carried forward and treated as recognized built-in gain in succeeding years in the recognition period. Finally, the amount of net recognized built-in gain taken into account for any taxable year may not exceed the net unrealized built-in gain at the time the corporation became an S corporation reduced by any net recognized built-in gains which were subject to Section 1374 in prior taxable years.[216]

The Section 1374 tax easily could be avoided if it applied only to built-in gains recognized on the disposition of assets that were held by the S corporation at the beginning of its first S taxable year. For example, assume that a C corporation converting to S status holds an asset (Oldacre) with a built-in gain which it subsequently exchanges for property of like kind (Newacre) in a Section 1031 nonrecognition transaction. The gain inherent in Oldacre is preserved in Newacre's exchanged basis under Section 1031(d). If the corporation disposes of Newacre within five years after switching to S status, the Section 1374 tax should apply to the built-in "C gain" even though Newacre was not held on the first day that the corporation was subject to Subchapter S. Section 1374(d)(6) ensures this result by providing that an asset taking an exchanged basis from another asset held by the corporation at the time it converted to S status shall be treated as having been held as of the beginning of the corporation's first S year. In the above example, the built-in gain inherent in Oldacre on the conversion from C to S status is recognized under Section 1374 if the corporation disposes of Newacre at a gain during the recognition period.

Section 1374(d)(8) is another testament to Congress's protective attitude toward the double tax. It ensures that built-in gain in assets acquired by an S corporation from a C corporation in a tax-free reorganization does not escape a corporate level tax. For this purpose, the recognition period commences as of the date the asset is acquired rather than on the beginning of the first taxable year for which the corporation was an S corporation.[217]

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215 I.R.C. § 1374(b)(1), (d)(2). Taxable income, as defined in Section 63(a), is modified by disregarding certain deductions (e.g., the dividends received deduction) and net operating losses. I.R.C. §§ 1374(d)(2)(A)(ii); 1375(b)(1)(B). Net operating loss and capital loss carryforwards from prior years as a C corporation are taken into account in computing the amount subject to tax under Section 1374. I.R.C. § 1374(b)(2).

216 I.R.C. § 1374(c)(2), (d)(1).

217 I.R.C. § 1374(d)(8). See Section G of this chapter, infra, for an overview of the tax consequences when an S corporation is the acquiring or target corporation in a tax-free reorganization.

Tax advisors began to plot strategies to reduce the impact of Section 1374 soon after it was enacted. For example, it was suggested that the tax might be avoided if an S corporation sold an asset with built-in gain during the recognition period on the installment method but delayed receipt of any payments (and thus any recognized gain) until after the recognition period had expired.[218] Not surprisingly, the Service has expressed its displeasure with this gambit. The regulations provide that the built-in gain rules will continue to apply to income recognized under the installment method during taxable years ending after the expiration of the recognition period. The gain, when recognized, will be subject to tax under Section 1374.[219]

Tax on Passive Investment Income. When it widened the gates to Subchapter S, Congress became concerned that a C corporation with earnings and profits might make an S election and redeploy substantial amounts in liquid assets yielding passive investment income such as dividends and interest. Left unchecked, this strategy would enable a profitable C corporation to move to the single-tax regime of Subchapter S and pass through the investment income to its shareholders, who might delay, perhaps forever, paying any shareholder-level tax on the Subchapter C earnings and profits. This plan had particular allure when a C corporation sold all of its operating assets and was seeking an alternative to the shareholder-level tax that would be imposed under Section 331 on a distribution of the proceeds in complete liquidation.[220]

The Code includes two weapons to foil the Subchapter S/passive income ploy. As discussed earlier, an S corporation with accumulated earnings and profits from its prior life as a C corporation will lose its S status if it has passive investment income that exceeds 25 percent of its gross receipts for three consecutive taxable years.[221] In addition, even before its S status is terminated, the corporation will be subject to a corporate-level tax under Section 1375. The tax, which equals 21 percent of the corporation's "excess net passive income," is imposed if an S corporation has earnings and profits from a taxable year prior to its S election and more than 25 percent of the corporation's gross receipts for the taxable year consist of "passive investment income."[222]

For purposes of the Section 1375 tax, "passive investment income" is defined as gross receipts from royalties, rents, dividends, interest, and annuities.[223] Gains on the disposition of property, interest earned on obligations acquired from the sale of inventory, the gross receipts of certain lending and finance institutions, and dividends received from a C

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[218] See, e.g., Taggart, "Emerging Tax Issues in Corporate Acquisitions," 44 Tax L. Rev. 459, 481 (1989).

[219] Reg. § 1.1374–4(h)(1). For the relationship of this rule to other aspects of Section 1374, see Reg. § 1.1374–4(h)(2)–(5).

[220] See Chapter 8B1, supra.

[221] I.R.C. § 1362(d)(3). See Section C of this chapter, supra.

[222] I.R.C. § 1375(a).

[223] I.R.C. §§ 1375(b)(3); 1362(d)(3)(C)(i).

corporation subsidiary that are derived from the active conduct of a trade or business, are not passive investment income.[224] To prevent easy manipulation of the gross receipts test, only the excess of gains over losses from dispositions of capital assets (other than stock and securities) is included in overall gross receipts, and gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains.[225] The term "stock or securities" is interpreted expansively and includes stock rights, warrants, debentures, partnership interests, and "certificates of interest" in profit-sharing arrangements.[226]

The computation of the Section 1375 tax is a technician's dream (and a student's nightmare?). The base for the Section 1375 tax, "excess net passive income," is a percentage of the corporation's "net passive income," which is generally equal to passive investment income less deductions directly connected with the production of such income.[227] To arrive at excess net passive income, net passive income is multiplied by a ratio, which has a numerator equal to the excess of passive investment income over 25 percent of gross receipts for the year, and a denominator equal to passive investment income for the year.[228] There is one final caveat: excess net passive income cannot exceed the corporation's taxable income for the year computed with the special changes described in Section 1374(d)(4).[229]

An example may help control the pollution. Assume that X Corporation made a Subchapter S election last year and will have accumulated earnings and profits from prior C corporation operations at the end of its current taxable year, in which X has $50,000 of income from its regular business operations and $35,000 of business deductions. X also receives $15,000 of interest income and $10,000 of dividends and incurs $5,000 of expenses directly related to the production of the investment income.

Is X subject to the Section 1375 tax? The corporation will have Subchapter C earnings and profits at the close of its taxable year and more than 25 percent of its gross receipts are passive investment income ($25,000 out of $75,000 of gross receipts), so the tax is potentially applicable. X's net passive income is $20,000 ($25,000 of passive investment income less directly connected expenses), and it will have $5,000 of excess net passive income ($20,000 of net passive income multiplied by a ratio having $6,250 as the numerator ($25,000 of passive investment income reduced by 25 percent of gross receipts) and $25,000 as the denominator (passive investment income)). Since excess net passive income does not exceed X's taxable income as determined under

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224 I.R.C. § 1362(d)(3)(C)(ii)–(iv).
225 I.R.C. §§ 1375(b)(3); 1362(d)(3)(B); 1222(9).
226 See Reg. § 1.1362–2(c)(4)(ii)(B)(3).
227 I.R.C. § 1375(b)(2).
228 I.R.C. § 1375(b)(1)(A).
229 I.R.C. § 1375(b)(1)(B).

Section 1374(d)(4), the corporation's tax liability will be $1,050 ($5,000 × 21 percent).

Section 1375(d) offers one avenue for relief from the Section 1375 tax. The tax may be waived if the S corporation establishes to the satisfaction of the Service that it determined, in good faith, that it had no earnings and profits at the close of a taxable year and, within a reasonable period after discovering earnings and profits, they were distributed. The addition of an "anti-blunder" provision to this complex area is a welcome sign and one hopes the Service is merciful in its administration of Section 1375(d).

Congress also considered the interaction of Sections 1374 and 1375 with the provisions taxing the shareholders of an S corporation. Any Section 1374 tax is treated as a loss (characterized according to the built-in gain subject to tax) sustained by the S corporation which will pass through to the shareholders, and each item of passive investment income is reduced by its proportionate share of the Section 1375 tax.[230]

It is important to keep the application of Sections 1374 and 1375 in perspective. A new corporation making a Subchapter S election generally does not have to be concerned with either provision. Section 1374(c)(1) will protect the corporation from the Section 1374 tax and, since the corporation's activities will not generate earnings and profits,[231] Section 1375 cannot apply to the corporation. Therefore, Sections 1374 and 1375 normally will not play a role in deciding whether to utilize a partnership or an S corporation for a new venture.

Additional considerations come into play if a C corporation is considering a move to a single tax regime. An operating C corporation must consider the impact of Sections 1374 and 1375 on a possible Subchapter S election. Weighed against these penalty provisions is the fact that a shift from C corporation to partnership status requires a liquidation of the corporation, which may result in significant current corporate and shareholder tax liability.[232] The immediate tax cost of converting to a partnership or limited liability company may be significant enough to tip the balance in favor of a Subchapter S election and force an accommodation with Sections 1374 and 1375, if planning cannot successfully eliminate their impact.

PROBLEMS

1. Built-in Corporation ("B") was formed in 2011 as a C corporation. The shareholders of B elected S corporation status effective as of January 1, 2016, when it had no Subchapter C earnings and profits and the following assets:

[230] I.R.C. § 1366(f)(2), (3).

[231] I.R.C. § 1371(c)(1).

[232] See I.R.C. §§ 331, 336, 1001.

Asset	Adj. Basis	F.M.V.
Land	$30,000	$20,000
Building	$10,000	$35,000
Machinery	$15,000	$30,000

For purposes of this problem, disregard any cost recovery deductions that may be available to B. Consider the shareholder and corporate level tax consequences of the following alternative transactions:

(a) B sells the building for $50,000 in 2019; its taxable income for 2019 if it were not an S corporation would be $75,000.

(b) Same as (a), above, except that B's taxable income for 2019 if it were not an S corporation would be $20,000.

(c) Same as (a), above, except that B also sells the machinery for $40,000 in 2020, when it would have substantial taxable income if it were not an S corporation.

(d) B trades the building for an apartment building in a tax-free § 1031 exchange and then sells the apartment building for $50,000 in 2019, when it would have substantial taxable income if it were not an S corporation.

(e) B sells the building for $90,000 in 2022.

2. S Corporation elected S corporation status beginning in 2016 and will have Subchapter C earnings and profits at the close of the current taxable year. This year, S expects that its business operations and investments will produce the following tax results:

Gross income from operations	$75,000
Business deductions	$60,000
Tax-exempt interest	$23,000
Dividends	$12,000
Long-term capital gain from the sale of investment real property	$35,000

(a) Is S Corporation subject to the § 1375 tax on passive investment income? If so, compute the amount of tax.

(b) Same as (a), above, except that S receives an additional $5,000 of tax-exempt interest.

3. The San Diego Bay Boat Storage and Marina Corporation ("Bay") was formed in 2014 as a C corporation and has substantial accumulated earnings and profits. Bay's business consists of three primary activities. About one-third of Bay's gross receipts are derived from marine service and repair work conducted by its two mechanics. Another one-third of Bay's total receipts come from the rental of berths to boat owners. Berthing fees vary depending upon the size of the particular boat. A boat owner renting a berth from Bay must pay a separate charge to have Bay's employees launch or haul out his boat. However, if given advance notice, Bay employees will fuel an owner's boat, charging only for the fuel. The remainder of Bay's receipts come from dry storage of boats. Owners pay $500 per month for dry storage in Bay's warehouse where a Bay employee is on duty 24 hours a day. For this fee, Bay employees will launch, fuel (with a charge for fuel) and haul out the boat whenever requested by the owner. Bay's mechanics also will perform a free engine analysis every other year for owners of power boats in dry storage.

Bay is considering the possibility of making a Subchapter S election and has requested your advice concerning any problems which it may have. What difference would it make if Bay were a newly formed corporation?

G. COORDINATION WITH OTHER INCOME TAX PROVISIONS

1. SUBCHAPTER C[233]

Code: §§ 1371; 1372.

It is important to remember that an S corporation is still a corporation for many tax purposes. It is organized in the same manner as other corporations, and it may engage in most of the transactions and experience the corporate adjustments encountered throughout this text. After incorporating or escaping from Subchapter C, S corporations may make nonliquidating distributions of property or stock, engage in redemptions, or acquire other businesses in either taxable or tax-free transactions. They may sell their assets and liquidate, be acquired by another corporation, or divide up into two or more separate corporations. The tax consequences of these and other events in an S corporation's life cycle are determined by a patchwork quilt of Code sections pieced together from Subchapters C and S. The resulting product provides a challenging opportunity to study the uneasy relationship between a double tax regime and a pass-through scheme.

Section 1371(a) begins the statutory snake dance with the deceptively simple general rule that the provisions of Subchapter C apply to an S corporation and its shareholders. This broad admonition is subject to two related exceptions. First, any provision in the Code specifically applicable to S corporations naturally will apply. Second, if the provisions of Subchapter C are "inconsistent with" Subchapter S, the S rules are controlling. Reliable authority is sparse on precisely how Congress intended to harmonize the rules, but the Service gradually has offered guidance. The details are best raised in the context of specific transactions.

Formation of a Corporation. All the basic rules studied in connection with the formation of a C corporation apply to newly formed S

[233] See generally McMahon & Simmons, "When Subchapter S Meets Subchapter C," 67 Tax Law. 231 (2014).

corporations.[234] Shareholders who comprise the founding 80 percent or more "control" group do not recognize gain or loss on the transfer of property to the corporation if the requirements of Section 351(a) are met, but realized gain is recognized to the extent the shareholder receives boot[235] or if the transferred liabilities exceed the shareholder's basis for the transferred property.[236] Shareholders determine their basis in stock, debt obligations and other boot received under Section 358. The corporation takes a transferred basis in any contributed assets under Section 362(a). Organizational expenditures may be deducted and amortized if the corporation elects to do so under Section 248, and the benefit of the deductions passes through to the shareholders.

Several other formation issues, most relating to the "small business corporation requirements," are unique to S corporations. To qualify for the S election, the corporation must be mindful of the 100-shareholder limit and the prohibition against certain types of shareholders (e.g., nonresident aliens, partnerships). As for capital structure, an S corporation is limited to one class of stock and thus may not issue preferred stock, but it is free to issue debt, preferably in a form that qualifies for the straight debt safe harbor.[237] Unlike a corporation facing the double tax, an S corporation has no particular incentive to issue pro rata debt to its shareholders.[238]

S Corporations as Shareholders. At one time, an S corporation in its capacity as a shareholder of another corporation was treated as an individual for purposes of Subchapter C. The purpose of this rule was to ensure that an S corporation would not qualify for the Section 243 dividends received deduction, which is designed to prevent double taxation at the corporate level and thus should not be available to a pass-through entity.[239] As drafted, however, the rule had a ripple effect on other transactions, leading Congress to repeal it and clarify the tax consequences of many of the transactions discussed below. The legislative history includes a reminder that S corporations, like individuals, may not claim a dividends received deduction or treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.[240]

Distributions and Liquidating Sales. As discussed earlier,[241] Subchapter S generally preempts Subchapter C in determining the tax consequences of nonliquidating distributions. Section 1368 specifically

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234 See generally Chapter 2, supra.

235 I.R.C. § 351(b).

236 I.R.C. § 357(c).

237 I.R.C. § 1361(c)(5).

238 For the advantages and disadvantages of issuing debt in the S corporation setting, see Eustice, Kuntz & Bogdanski, Federal Income Taxation of S Corporations ¶ 6.03[1].

239 See, e.g., S.Rep. No. 640, 97th Cong., 2d Sess. 15, reprinted in 1982–2 C.B. 718, 724–725.

240 See H.R. Rep. No. 104–737, 104th Cong., 2d Sess. 56 (1996).

241 See Section E of this chapter, supra.

provides that it shall apply to any distribution to which Section 301(c) otherwise would apply. This means that Section 1368 is the reference point not only for routine nonliquidating distributions but also other transactions, such as dividend-equivalent redemptions and taxable stock distributions, which are classified under Subchapter C as distributions to which Section 301 applies.[242] We have seen that an S corporation recognizes gain under Section 311(b) on a distribution of appreciated property but, unless Section 1374 applies, that gain is not taxed at the corporate level. Instead, the gain passes through to the shareholders, who may increase their stock basis by their respective shares of the gain.

In the case of liquidating distributions and sales, Subchapter C reassumes center stage. Liquidating distributions generally trigger recognition of gain or loss to an S corporation under Section 336 in the same manner as if the corporation were subject to Subchapter C. Sales of assets pursuant to a plan of complete liquidation also are taxable. In either case, however, these gains will pass through to the shareholders and be subject to a single shareholder-level tax unless Section 1374 intercedes. An S corporation also may make a liquidating sale on the installment method. Under certain conditions, these installment obligations may be distributed without triggering corporate-level gain (unless Section 1374 applies), and the shareholders may use the installment method to report the gain.[243] The *character* of the shareholder's gain in this situation is not determined by reference to their stock, which ordinarily would be a capital asset, but rather "in accordance with the principles of Section 1366(d)"[244]—i.e., as if the corporate-level gain on the sale of the asset had been passed through to the shareholders.[245]

Subchapter C also governs the shareholder-level consequences of a complete liquidation. An S corporation shareholder treats distributions in complete liquidation as in full payment in exchange for the stock under Section 331. Although liquidating distributions and sales result in only one level of tax to an S corporation and its shareholders,[246] variations between the shareholder's stock basis and the corporation's basis in its assets may have an impact on the character of the shareholder's gain or loss. For example, assume A owns all of the stock of S, Inc. (an S corporation with no prior C history) and has a $2,000 basis in her S stock.

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[242] See, e.g., I.R.C. §§ 302(d); 305(b). Section 306 is unlikely to apply in the S setting, however, because an S corporation may not issue preferred stock.

[243] See I.R.C. § 453B(h). To qualify for corporate-level nonrecognition, the S corporation must distribute the obligation in complete liquidation. In addition, the obligations must result from sales of assets (other than nonbulk sales of inventory) during the 12-month period following the adoption of the liquidation plan. See I.R.C. § 453(h).

[244] I.R.C. § 453B(h).

[245] Thus, if the installment sale would have given rise to ordinary income, that character will pass through to the shareholders when they collect the installment obligations.

[246] This is because the corporate-level gain on a liquidating distribution or sale results in upward basis adjustments to the shareholder's stock under Section 1367. A double tax would be imposed, however, if Section 1374 applies.

Assume S owns one ordinary income asset which has a $10,000 fair market value and a $1,000 adjusted basis. If S sells the asset, it will recognize $9,000 of ordinary income. The gain passes through to A, and her stock basis is increased by $9,000, to $11,000, under Section 1367. When S liquidates and distributes $10,000 cash to A, she recognizes a $1,000 long-term capital loss. Alternatively, if the ordinary income asset had a $2,000 basis, S would recognize $8,000 of ordinary income on its sale which would pass through to A, increasing her stock basis to $10,000. When S liquidates and distributes $10,000 cash to A, she would recognize no additional gain or loss.

Taxable Acquisitions of S Corporations. An acquisition of an S corporation may be structured as either a purchase of stock from the shareholders or a purchase of assets from the corporation. The method chosen affects not only the amount, character and timing of gain but also may have an impact on the tax status of the S corporation and perhaps even the acquiring party if it also is an S corporation.

An asset acquisition often is preferable because the purchaser will obtain a cost basis in the S corporation's assets at the cost of only a shareholder-level tax.[247] For example, assume P, Inc. wishes to acquire T, Inc. (an S corporation with no prior C history). If P purchases T's assets, any gain or loss recognized by T on the sale will pass through to its shareholders, and P will obtain a cost basis in the assets. T's shareholders will increase their stock basis by any gain recognized on the sale under Section 1367, thus avoiding a second tax on the same economic gain when T liquidates.

If P is a C corporation and purchases a controlling interest in the T stock, the T shareholders recognize gain or loss on the sale, and P takes a cost basis in the stock it acquires. T's S election will terminate, however, because an S corporation is not permitted to have any C corporation shareholders.[248] If P does not make a Section 338 election, T retains its historic bases in its assets, and as a new C corporation it will face the prospect of a corporate-level tax on any built-in gain. If P makes a Section 338 election to obtain a cost basis in T's assets, T—which loses its S status on the acquisition—must pay an immediate corporate-level tax as a result of the deemed asset sale, which is rarely a good outcome.[249] If P and T jointly make a Section 338(h)(10) election, the regulations provide that old T (still considered an S corporation at this point) recognizes gain

[247] Once again, this assumes that the corporation has no built-in gains that would be taxed under Section 1374. In contrast, a taxable acquisition of assets from a C corporation generates tax at both the corporate and shareholder levels if the target liquidates. See Chapter 8B, supra.

[248] I.R.C. §§ 1362(d)(2); 1361(b)(1)(B). After 1996, two or more S corporations may have a parent-subsidiary relationship in which case they are treated as one S corporation for tax purposes. I.R.C. § 1361(b)(3).

[249] T's S election terminates when P acquires T's stock, and its short C year includes the day of the terminating event. Thus, the gain on the deemed asset sale must be reported on a one-day return for old T's "short C year." See I.R.C. §§ 1362(e)(1)(B); 338(a)(1). The economic burden of the corporate-level tax is borne by P unless it is reflected in the price paid for the stock.

or loss on the deemed sale of its assets and then is deemed to have distributed those assets in complete liquidation.[250] The gain or loss on the deemed asset sale passes through to T's shareholders, with resulting basis adjustments to their T stock. Those adjustments then may be taken into account in determining the shareholders' gain or loss under Section 331 on the deemed complete liquidation of old T.[251]

The regulations under Section 336(e) offer treatment essentially equivalent to a Section 338(h)(10) election when S corporation shareholders make a qualified stock disposition, which basically is a sale, exchange or distribution within a 12-month period of an 80 percent or more controlling interest. A Section 336(e) election is available for dispositions of stock that do not qualify under Section 338(h)(10), such as sales to noncorporate buyers or a combination of sales and distributions. If a Section 336(e) election is made in connection with a stock sale, the S corporation target is deemed to sell its assets to a new corporation while still an S corporation; the shareholders take their pro rata share of the gains and losses into account and adjust their stock basis; and the old target S corporation is deemed to make a distribution to its shareholders and go out of business.[252]

The benefit of either a Section 338(h)(10) or Section 336(e) election is that a stock sale will be taxed as if it were a sale of the S corporation's assets. Whether that tax treatment is beneficial to the parties requires careful analysis of several variables, including the tax character of those assets. For example, a deemed asset sale may not be desirable if it gives rise to a significant amount of ordinary income such as when the corporation's assets are weighted towards inventory, receivables, and property triggering recapture of depreciation or amortization. By comparison, the "look-through" rules on a sale of S corporation stock do not extend to ordinary income property[253] and thus the entire gain on a stock sale may qualify for the lower capital gains rates.

Taxable Acquisitions by S Corporations. When the purchasing corporation ("P") is an S corporation, the primary concern usually is the preservation of P's S status. If P purchases the assets of T, the mix of consideration used in the transaction must be tailored to the S corporation eligibility requirements. P thus should avoid using its own stock or hybrid debt in order to avoid running afoul of the 100-shareholder limit or the prohibition against having more than one class of stock.[254]

When an S corporation acquires the stock of T, the acquisition will not necessarily result in a loss of the acquiring corporation's S status because S corporations may have controlled C corporation subsidiaries.

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[250] See Reg. § 1.338(h)(10)–1(d)(3)(i); –1(d)(4)(i).

[251] See Reg. § 1.338(h)(10)–1(d)(5)(i).

[252] Reg. §§ 1.336–2(b)(1)(i)–(iii), –2(h)(8) Example 2.

[253] See Section D4 of this chapter, supra.

[254] See generally I.R.C. § 1361(b).

In addition, an acquiring S corporation is eligible to make a Section 338 election, which will trigger immediate recognition of all T's gains and losses. Finally, if an S corporation acquires 80 percent or more of T's stock and liquidates T, the liquidation will be tax free to both corporations under Sections 332 and 337. Following that liquidation, however, any of T's built-in gains while it was a C corporation may later be subject to tax under Section 1374 upon a subsequent disposition.[255]

Tax-Free Reorganizations. An S corporation may be either the target or the acquiring corporation in a tax-free acquisitive reorganization. Looking first to situations where an S corporation is the target, it will lose its S status if it remains in existence as an 80 percent or more subsidiary following a tax-free acquisition of its stock by a C corporation in a Type B reorganization or reverse triangular merger. If an S corporation-target's assets are acquired in a merger or Type C reorganization, the transaction may proceed on a tax-free basis, and the target will terminate its existence as a result of the merger or the liquidation that must follow a Type C reorganization.

If an S corporation is the acquiring corporation in a tax-free reorganization, it will issue new stock to the target shareholders. Whatever form of acquisition is used, care must be exercised to avoid termination of the election by exceeding the 100-shareholder limit or inheriting an ineligible shareholder. Now that S corporations may have subsidiaries, a Type B stock-for-stock acquisition, once impossible without losing S status, is now a feasible alternative. Similarly, acquisition of the assets of a C corporation in a Type A or C reorganization should not adversely affect the acquirer's S election, but the earnings and profits from the target's C years could jeopardize the acquiring corporation's S status or subject it to the Section 1375 tax if it has substantial passive investment income.[256] Moreover, an S corporation that is the acquiring corporation in a Type A or C reorganization or a forward triangular merger will inherit the target's tax attributes, including its earnings and profits, under Section 381, and its accumulated adjustments account if the target is an S corporation with a prior C history.[257] Finally, any assets acquired from a C corporation in a tax-free reorganization trigger a new five-year recognition period for purposes of the Section 1374 tax on built-in gains.[258]

Corporate Divisions. An S corporation may divide itself into separate corporations in a transaction that is tax-free at both the corporate and shareholder levels if all the requirements of Section 355 are met. Even when S corporations were not permitted to have subsidiaries, the Service was tolerant in this area, ignoring the transitory nature of a subsidiary

255 As to built-in gains, see I.R.C. § 1374(d)(8); Reg. § 1.1374–8.

256 I.R.C. §§ 1362(b)(3); 1375.

257 For rules on AAA carryovers, see Reg. § 1.1368–2(d)(2).

258 I.R.C. § 1374(d)(8).

formed in preparation for a division.[259] After the division, the new corporation (or corporations, in the case of a split-up) may immediately make an S election.[260]

2. NET INVESTMENT INCOME TAX

Section 1411, which applies to individuals, estates and trusts, imposes a 3.8 percent tax on the lesser of the taxpayer's "net investment income" or adjusted gross income (with some specialized modifications) in excess of certain high-income thresholds ($250,000 for married filing jointly taxpayers and $200,000 for single and unmarried head of household filers).[261] "Net investment income" is generally interest, dividends, annuities, royalties, and income from Section 469 passive activities (i.e., trade or business activities in which the taxpayer does not materially participate).[262] S corporations pass through net investment income items and related expenses to their shareholders. Shareholders who are active in the business (i.e., who "materially participate" in a trade or business activity) are not subject to the net investment income tax on their pro rata share of the S corporation's business income. As we will see shortly, that same income also may escape federal employment taxes.[263]

Dispositions of S corporation stock raise additional issues under the net investment income tax. If the selling shareholder does not materially participate in any activities of the business, the transaction is classified as a disposition of an interest in a passive activity and the capital gain or loss is included in net investment income.[264] If the seller materially participates in one or more of the corporation's business activities, proposed regulations require a complex look-through approach under which each separate trade or business activity is deemed to have been sold for its fair market value. The shareholder's pro rata shares of gains and losses from the hypothetical sales of material participation activities are excluded in determining the shareholder's net investment income.[265]

3. STATE AND LOCAL TAXES

The tax laws of most states with an income tax recognize a federal S corporation election and treat S corporations as pass-through entities.

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[259] See, e.g., G.C.M. 39678 (1987).

[260] For other issues, such as how to divide up the accumulated adjustments account, see Eustice, Kuntz & Bogdanski, supra note 238, at ¶ 12.10.

[261] I.R.C. § 1411(a)(1).

[262] I.R.C. § 1411(c).

[263] See Section H of this chapter, infra. Legislation has been proposed to curtail this opportunity.

[264] I.R.C. § 1411(c)(1)(A)(iii).

[265] Prop. Reg. § 1.1411–7(a)(1), interpreting I.R.C. § 1411(c)(4). The proposed regulations provide an optional simplified method for shareholders with very small shares of net investment income items or if the gain or loss on the stock sale does not exceed $250,000. Prop. Reg. § 1.1411–7(c).

But there are exceptions and other potential complications caused by a lack of uniformity at the state level. For example, S corporations organized in California must pay the greater of the $800 minimum franchise tax or 1.5 percent of net income. Other states impose modest business privilege or minimum taxes on S corporations even if they have no net income. Some states (e.g., New York and New Jersey) may require a separate S election to be filed. A few taxing jurisdictions (e.g., New Hampshire, Tennessee, Texas, the District of Columbia, and New York City) treat an S corporation as a separate taxable entity. S corporations with multi-state connections also may confront other issues, such as the need to apportion their income among the states in which they conduct business activities and withhold income taxes on income allocable to nonresident shareholders.

PROBLEMS

1. Hi-Flying Co. is an aggressive growth company which was formed as a C corporation many years ago to develop new innovative technology. Hi-Flying has been successful and expects to receive inquiries concerning possible taxable and tax-free takeovers in the next few years. Can Hi-Flying's shareholders improve their tax situation in a future takeover by making an S election? In general, if Hi-Flying makes an S election, would you advise a potential corporate purchaser desiring a cost basis in Hi-Flying's assets to structure its acquisition as a purchase of stock or assets?

2. Target Corporation ("T") is a C corporation which has substantially appreciated assets and is a takeover candidate being pursued by several suitors. Purchasing Corporation ("P") has a Subchapter S election in effect and is considering making a bid for T. Consider the tax consequences of the following acquisition offers by P:

(a) P will offer to purchase T's stock for cash or a combination of cash and P notes.

(b) P will acquire T in a Type C reorganization.

H. COMPENSATION ISSUES

S corporation shareholders commonly serve as officers, directors and employees of their corporation. Individuals with this multiple status can choose whether to withdraw cash as compensation for their services or as a shareholder distribution. Salary payments are deductible by the corporation as a business expense (with the benefit of the deduction passing through to the shareholders), and are includible in the employee's gross income. These "wages" also are subject to federal employment taxes imposed on both the employer and the employee.).[266] Under the social security component of the Federal Insurance Contributions Act (known as FICA), the tax is 12.4 percent of wages paid up to an indexed cap ($132,900 for 2019) and is split equally between the

266 Wages also may be subject to state and local employment taxes.

employer and the employee. The additional Medicare tax is 2.9 percent of all wages (so there is no cap), also split equally between employer and employee.[267] For wages over certain high-income thresholds ($250,000 for married taxpayers who file a joint return, $200,000 for unmarried and head of household filers), the Medicare tax rate on the employee's share of the excess is increased to 3.8 percent.[268] Under a parallel system, self-employed taxpayers are subject to a 12.4 percent tax on their self-employment income up to the indexed cap and a 2.9 percent Medicare tax on all their self-employment income (3.8 percent for earnings over the high-income thresholds).[269]

S corporation shareholders generally are not subject to employment taxes on amounts that are not received as "wages," such as distributions, and a shareholder's pro rata share of the corporation's business income is not taxed as self-employment income. By contrast, general partners and members of LLCs who are active in their firm's business are subject to self-employment tax on their distributive share of trade or business income. "Guaranteed" payments for services rendered to or on behalf of a partnership or LLC also are generally treated as income from self-employment.[270]

Because the payment of salaries to shareholders usually results in a tax "wash" in the case of a profitable corporation (the compensation deduction reduces the operating income that passes through to the shareholders), the *income* tax consequences of salaries and distributions may be identical.[271] It is the escalating employment tax base and the disparate treatment of S corporations and partnerships that have influenced some service providers to form S corporations to avoid the uncapped Medicare tax by foregoing much or even all of their salaries and instead withdrawing cash through shareholder distributions.

To illustrate, assume that Consultant is a single taxpayer who has $500,000 of net earnings from her consulting practice and no other earned income. If she conducts her business as a sole proprietor, her self-employment tax will be 12.4 percent of self-employment income up to the applicable cap, 2.9 percent on the first $200,000 of self-employment income and 3.8 percent on the $300,000 of self-employment income that exceeds the $200,000 high-income threshold for single taxpayers. Assume, alternatively, that Consultant incorporates her practice and elects S corporation status and the corporation nets the same $500,000, all attributable to Consultant's services, pays Consultant a salary of $200,000, and either retains the $300,000 balance or distributes it to

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267 I.R.C. §§ 3101; 3111; 3121. The employee portion is collected through withholding from wages. I.R.C. § 3102.

268 I.R.C. §§ 3101(b)(2); 3121(b).

269 I.R.C. § 1401. Self-employed taxpayers may take an above-the-line deduction for one-half of the self-employment tax paid. I.R.C. § 164(f).

270 I.R.C. § 1402.

271 The tax results are more complex, however, if the S corporation has losses for the taxable year. See Eustice, Kuntz & Bogdanski, supra note 238, ¶ 11.02[2].

Consultant as a dividend. If this arrangement is respected, Consultant saves the $11,400 of Medicare tax (3.8 percent of $300,000) that would have been owed on the last $300,000 of her earnings not paid out as wages.

This strategy became known as the "John Edwards loophole" after it was revealed during the 2004 Presidential election campaign that Vice Presidential candidate and former Senator John Edwards had conducted his lucrative law practice as an S corporation, paying himself a relatively modest salary and withdrawing many millions more as distributions. The maneuver also was utilized by former House Speaker Newt Gingrich, who conducted his consulting and public speaking businesses through S corporations that in 2010 paid him $444,000 in wages out of roughly $2.84 million of total net earnings, saving $69,000 in Medicare taxes.[272] Anecdotal evidence suggests that these are not isolated examples and may explain why over 60 percent of S corporations have only one shareholder.[273]

The *Radtke* case, below, is one court's hostile reaction to this maneuver in an extreme fact pattern.

Joseph Radtke, S.C. v. United States

United States District Court, Eastern District of Wisconsin, 1989.
712 F.Supp. 143, affirmed 895 F.2d 1196 (7th Cir.1990).

ORDER

■ TERENCE T. EVANS, DISTRICT JUDGE.

* * *

FACTS

None of the facts are disputed.

Joseph Radtke received his law degree from Marquette University in 1978. The Radtke corporation was incorporated in 1979 to provide legal services in Milwaukee. Mr. Radtke is the firm's sole incorporator, director, and shareholder. In 1982, he also served as the unpaid president and treasurer of the corporation, while his wife Joyce was the unpaid and nominal vice-president and secretary. The corporation is an electing small business corporation, otherwise known as a subchapter S corporation. This means that it is not taxed at the corporate level. All corporate income is taxed to the shareholder, whether or not the income is distributed.

In 1982, Mr. Radtke was the only full-time employee of the corporation, though it employed a few other persons on a piece-meal and part-time basis. Under an employment contract executed between Mr.

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[272] This information was revealed when Senator Edwards and Speaker Gingrich made their tax returns available to the public during their unsuccessful Presidential campaigns.

[273] The most recent available data is for 2012. See IRS Statistics of Income, Returns of Active Corporations, Form 1120S for Tax Year 2012, Table 6.

Radtke and his corporation in 1980, he received "an annual base salary, to be determined by its board of directors, but in no event shall such annual salary be less than $0 per year * * * . Employee's original annual base salary shall be $0." This base salary of $0 continued through 1982, a year in which Mr. Radtke devoted all of his working time to representing the corporation's clients.

Mr. Radtke received $18,225 in dividends from the corporation in 1982. Whenever he needed money, and whenever the corporation was showing a profit—that is, when there was money in its bank account—he would do what was necessary under Wisconsin corporate law to have the board declare a dividend, and he would write a corporate check to himself.

Mr. Radtke paid personal income tax on the dividends in 1982. The Radtke corporation also declared the $18,225 on its form 1120S, the small business corporation income tax return. But the corporation did not file a federal employment tax form (Form 941) or a federal unemployment tax form (Form 940). In other words, it did not deduct a portion of the $18,225 for Social Security (FICA) and unemployment compensation (FUTA). The IRS subsequently assessed deficiencies as well as interest and penalties. The Radtke corporation paid the full amount that IRS demanded under FUTA—$366.44—and it also paid $593.75 toward the assessed FICA taxes, interest, and penalties. Then the corporation sued here after a fruitless claim for refunds.

DISCUSSION

* * *

The Radtke corporation acknowledges that wages are subject to FICA and FUTA taxes, but it argues that the Internal Revenue Code nowhere treats a shareholder-employee's dividends as wages for the purpose of employment taxes. The government, on the other hand, contends that "since Joseph Radtke performed substantial services for Joseph Radtke, S.C., and did not receive reasonable compensation for such services other than 'dividends', the 'dividends' constitute 'wages' subject to federal employment taxes." The government does not allege that the Radtke corporation is a fiction that somehow failed to comply with Wisconsin statutes governing corporations.

The Federal Insurance Contributions Act defines "wages" as "all remuneration for employment," with various exceptions that are not relevant to this dispute. 26 U.S.C. § 3121(a). Similarly, the Federal Unemployment Tax Act defines "wages" as "all remuneration for employment," with certain exceptions that are not relevant. 26 U.S.C. § 3306(b). (Dividends are not specifically excepted in either act, and "remuneration" is not defined.) Mr. Radtke was clearly an "employee" of the Radtke corporation, as the plaintiff concedes. *See* 26 U.S.C. §§ 3121(d) and 3306(i). Likewise, his work for the enterprise was obviously "employment." *See* 26 U.S.C. §§ 3121(b) and 3306(c).

According to the Radtke corporation, not all "income" can be characterized as "wages." I agree. See Royster Company v. United States, 479 F.2d 387, 390 (4th Cir.1973) (free lunches did not constitute "wages" subject to FICA and FUTA); Central Illinois Public Service Co. v. United States, 435 U.S. 21, 25, 98 S.Ct. 917, 919, 55 L.Ed.2d 82 (1978) (reimbursement for lunches not "wages" subject to withholding tax; Court says in dicta that dividends are not wages).

At the same time, however, I am not moved by the Radtke corporation's connected argument that "dividends" cannot be "wages." Courts reviewing tax questions are obligated to look at the substance, not the form, of the transactions at issue. Transactions between a closely held corporation and its principals, who may have multiple relationships with the corporation, are subject to particularly careful scrutiny. Whether dividends represent a distribution of profits or instead are compensation for employment is a matter to be determined in view of all the evidence.

In the circumstances of this case—where the corporation's only director had the corporation pay himself, the only significant employee, *no* salary for substantial services—I believe that Mr. Radtke's "dividends" were in fact "wages" subject to FICA and FUTA taxation. His "dividends" functioned as remuneration for employment.

It seems only logical that a corporation is required to pay employment taxes when it employs an employee. See Automated Typesetting, Inc. v. United States, 527 F.Supp. 515, 519 (E.D.Wis.1981) (corporation liable for employment taxes on payments to officers who performed more than nominal services for corporation); C.D. Ulrich, Ltd. v. United States, 692 F.Supp. 1053, 1055 (D.Minn.1988) (discussing case law defining who is an "employee"; court refuses to enjoin IRS from collecting employment taxes from S corporation that paid dividends but no salary to sole shareholder and director, a certified public accountant who worked for the firm). See also Rev. Rul. 73–361, 1973–2 C.B. 331 (stockholder-officer who performed substantial services for S corporation is "employee," and his salary is subject to FICA and FUTA tax); Rev. Rul. 71–86, 1971–1 C.B. 285 (president and sole stockholder of corporation is "employee" whose salary is subject to employment taxes, even though he alone fixes his salary and determines his duties).

An employer should not be permitted to evade FICA and FUTA by characterizing *all* of an employee's remuneration as something other than "wages." Cf. Greenlee v. United States, 87–1 U.S.T.C. Para. 9306 (corporation's interest-free loans to sole shareholder constituted "wages" for FICA and FUTA where loans were made at shareholder's discretion and he performed substantial services for corporation). This is simply the flip side of those instances in which corporations attempt to disguise profit distributions as salaries for whatever tax benefits that may produce. See, e.g., Miles-Conley Co. v. Commissioner, 173 F.2d 958, 960–61 (4th Cir.1949) (corporation could not deduct from its gross income excessive salary paid to president and sole stockholder).

Accordingly, the plaintiff's motion for summary judgment is DENIED, and the defendant's motion for summary judgment is GRANTED. The plaintiff is ORDERED to pay the remaining deficiency on its 1982 FICA taxes along with the assessed interest, penalties, and fees.

NOTE

Subsequent Case Law Developments. In accord with *Radtke* are Fred R. Esser, P.C. v. United States,[274] Dunn & Clark, P.A. v. Commissioner,[275] Spicer Accounting Inc. v. United States,[276] Veterinary Surgical Consultants, P.C. v. Commissioner,[277] David E. Watson, P.C. v. United States[278], and Nu-Look Design, Inc. v. Commissioner.[279] A contrary result was reached in Davis v. United States,[280] where the court declined to recharacterize S corporation distributions as taxable wages. *Davis* is distinguishable, however, because the shareholders performed only minor services on behalf of the S corporation.

IRS Enforcement. The S corporation employment tax avoidance strategy has presented enforcement challenges for the IRS. Even if the Service spots the issue, it must engage in a fact intensive analysis to determine whether an S corporation owner-employee has been paid "reasonable compensation." Many abuse cases appear to go undetected.

Proposed Legislation. Proposals have been introduced to curb or eliminate the Medicare tax avoidance strategy but Congress has yet to act. The goal is to place S corporations on a level playing field with partnerships and LLCs and curb gaming of the system by service providers to S corporations. The most recent version of a proposal was advanced by the Obama administration and would have subjected S corporation shareholders who materially participate in professional service businesses (e.g., law, accounting, health, consulting, architecture, performing arts, athletics) to self-employment tax on their entire share of an S corporation's active business income. Owners who do not materially participate also would have been taxable but only on an amount equal to reasonable compensation, if any, for services they provided to the business.[281] A more refined approach was taken by former Ways and Means Committee chairman Dave Camp in his Tax Reform Act of 2014. The Camp proposal also would have extended the self-employment tax to S corporation business income passing through to shareholders who materially participate but, in recognition that some business income may be a return on capital rather than labor, it would

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274 750 F.Supp. 421 (D.Ariz.1990).

275 57 F.3d 1076 (9th Cir.1995).

276 918 F.2d 90 (9th Cir.1990).

277 117 T.C. 141 (2001).

278 757 F.Supp.2d 877 (S.D. Iowa 2010), aff'd 668 F.3d 1008 (8th Cir. 2012).

279 356 F.3d 290 (3d Cir. 2004), cert. denied, 543 U.S. 821 (2004).

280 74 AFTR 2d 5618 (D.Colo.1994).

281 General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals 169 (Dept. of the Treasury, Feb. 2016).

provide a "nonlabor income deduction" generally equal to 30 percent of net business income.[282]

Fringe Benefits. Fringe benefits paid by an S corporation to its shareholder-employees also are subject to special treatment. Section 1372 provides that an S corporation shall be treated as a partnership for purposes of employee fringe benefits, and any shareholder owning either more than two percent of the corporation's outstanding stock or more than two percent of the total voting power of all stock will be treated as a partner. As a result, an S corporation seldom can provide benefits, such as a medical reimbursement plan or group-term life insurance, which are deductible by the corporation and excludable from gross income of its shareholder-employees.[283]

I. TAX POLICY ISSUES: SUBCHAPTER K VS. SUBCHAPTER S[284]

The check-the-box elective classification regime discussed in Chapter 1 made it easier for virtually any closely held business to obtain pass-through taxation treatment. This has resurrected the longstanding debate on the most desirable structure for a pass-through system. The excerpt below, from a study by the Joint Committee on Taxation, compares the tax treatment of partnerships and S corporations and surveys the competing views on the need to retain two different pass-through regimes.

Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues

(JCS–6–97) 23–25 (April 8, 1997).

Need for multiple sets of rules for pass-through entities

[The issuance of final check-the-box classification regulations raises a set of issues regarding] whether there is a continuing need in the tax law for parallel pass-through systems for general business activities.[42] Although S corporations (and their shareholders) generally are treated similarly to partnerships (and their partners), significant differences exist, some of which favor S corporations while others favor partnerships.

For example, the items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner pursuant to

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282 For a detailed description, see Joint Comm. on Taxation, Technical Explanation of the Tax Reform Act of 2014: Title I-Tax Reform for Individuals 79–85 (JCX–12–14, Feb. 26, 2014).

283 For special rules relating to health insurance, see I.R.C. § 162(*l*)(1), (5), and Rev. Rul. 91–26, 1991–1 C.B. 184.

284 See generally Eustice, "Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)," 39 Tax L. Rev. 345 (1984); Schwidetzky, "Integrating Subchapters K and S—Just Do It," 62 Tax Lawyer 749 (2009).

42 Eliminating the two-tier corporate tax system, perhaps through some form of corporate integration, could also minimize the need for multiple sets of rules for pass-through entities, but is beyond the scope of this discussion.

the partnership agreement (or in accordance with the partners' interest in the partnership if the agreement does not provide for an allocation) so long as such allocation has substantial economic effect.[43] Because of the one-class-of-stock rule for S corporations (sec. 1361(b)(1)(D)), the items of income, gain, loss, deduction or credit of an S corporation cannot be separately allocated to a particular shareholder, but are taken into account by all the shareholders on a per-share, per-day basis. Thus, partnerships generally are considered to be a more flexible vehicle for purposes of allocating particular entity-level items to investors.

Another important difference making partnerships more flexible than S corporations is the treatment of entity-level debt, for purposes of the owner's basis in his interest. A partner includes partnership-level debt in the basis of his interest (sec. 752), whereas an S corporation shareholder does not (sec. 1367). The amount of the partner's or S corporation shareholder's basis in his interest serves as a limit on the amount of losses that can be passed through (secs. 704(d), 1366(d)), which makes increases in basis for entity-level debt important.

The sale of stock in an S corporation generally results in capital gain or loss to the selling shareholder. The sale of an interest in a partnership also generally gives rise to capital gain or loss, but gives rise to ordinary income to the selling partner to the extent attributable to unrealized receivables and certain inventory items (sec. 751).

The distribution of appreciated property by an S corporation to a shareholder (as a dividend, in redemption of shares, or in liquidation) is treated as a taxable sale of such property. Any gain is allocated to all the shareholders on a per-share, per day basis and increases the shareholder's adjusted bases in their shares. The distributee shareholder then reduces his basis by the amount of the distribution (i.e., fair market value of the distributed property) and takes a fair market value basis in the property. By contrast, the distribution of appreciated property by a partnership to a partner generally is not treated as a taxable sale of the property (sec. 731).

An existing C corporation may elect to be treated as an S corporation on a tax-free basis, subject to certain special rules. Converting C corporations are subject to corporate-level tax on the recapture of LIFO benefits,[44] on certain built-in gains recognized within a 10-year period after conversion,[45] and on certain passive investment income earned

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[43] Sections 704(a) and (b). The determination of whether an allocation has substantial economic effect is complex (Treas. Reg. sec. 1.704–1(b)(2)).

[44] Section 1363(d).

[45] Section 1374. For a discussion of how section 1374 allows the conversion of a C corporation to S corporation to be treated more favorably than the liquidation of a C corporation into a sole proprietorship or a partnership, despite the economic equivalence of the transactions, see, letter to Chairman Dan Rostenkowski from Ronald A. Pearlman, Chief of Staff of the Joint Committee on Taxation, recommending several simplification proposals, reprinted in Committee on Ways and Means, Written Proposals on Tax Simplification (WMCP 101–27), May 25, 1990, p. 24. In his 1995 and 1997 budget messages to the Congress, President Clinton recommended that section 1374 be repealed for C corporations above a certain size. [Later

while the corporation retains its former C corporate earnings and profits.[46] The conversion of a C corporation to a partnership (or sole proprietorship) is treated as a liquidation of the entity, taxable to both the corporation and its shareholders.

The rules of subchapter C generally apply to an S corporation and its shareholders. Thus, for example, an S corporation may merge into a C corporation (or vice versa) on a tax-free basis. Similar rules do not apply to combinations of C corporations and partnerships.

Individual partners treated as general partners generally are subject to self-employment tax on their distributive shares of partnership income. Shareholders of an S corporation are not subject to self-employment tax on S corporation earnings, but are subject to payroll tax to the extent they receive salaries or wages from the corporation.

Partnerships, LLCs treated as partnerships, and S corporations may be treated differently for State income or franchise tax purposes.

Continuing utility of S corporations

If an LLC can provide limited liability to all owners and achieve pass-through status as a partnership under the check-the-box regulations (or under the Service's prior revenue rulings on LLCs), the need for S corporations could be questioned. Particularly in light of the growing use of LLCs, it could be argued that the great flexibility of the partnership tax rules outweigh the principal advantage of S corporations: relative simplicity. Thus, it is argued that the rules for S corporations could be repealed without detriment to taxpayers.[47]

Others say the continued existence of subchapter S is worthwhile. A corporate charter is a prerequisite imposed by regulators for some trades or businesses (e.g., for depository institutions or to hold certain licenses), and LLCs may not meet such regulatory requirements. Moreover, the corporate form is a familiar, time-tested format, while the LLC form is new and unfamiliar (particularly where a business undertakes interstate commerce). Subchapter S supporters further point out that the rules of subchapter S are much simpler than the rules of subchapter K.[48] Others point to specific advantages of subchapter S over the partnership tax rules (primarily the ability to convert from C to S corporation status

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proposals made by the Clinton administration would have repealed Section 1374 for C-to-S conversions of corporations with a value of more than $5 million at the time of conversion and treated the transaction as a taxable liquidation of the C corporation followed by a contribution of the assets to an S corporation by the recipient shareholders. Ed.]

[46] Section 1375.

[47] W. Schwidetzky, "Is It Time to Give the S Corporation a Proper Burial?" 15 Virginia Tax Review 591 (1996).

[48] However, it must be pointed out that partners of a partnership may opt for a simple, subchapter-S like structure if they so desire. It could be said that the check-the-box regulations expand the appeal of subchapter S, because prior to those regulations, only entities structured as corporations for State law purposes could elect S corporation status, whereas now, a State-law partnership or LLC can be classified as a corporation for tax purposes and elect S status (provided applicable requirements are met).

generally without current corporate tax on appreciation, and the availability of tax-free reorganization rules for business combinations and reorganizations). At least until LLC interests are as easily issued in capital markets as traditional corporate stock, the S corporation may continue to be an attractive vehicle in which to start a business, if it is anticipated that it will later go public. Finally, any repeal of subchapter S would require rules providing for the treatment of existing S corporations.[49]

Whether or not it is advisable to retain both the partnership rules and the S corporation rules, some argue that the complexity of either regime is excessive for small businesses, and a new, much simpler pass-through system should be provided for small businesses that would be consistent with the new simplicity for choice of entity under the check-the-box regulations.[50] A significant question, under such an approach, is the definition of a small business, which could depend on the number of owners, the value of the entity's assets, the amount of its gross or net income (if any), or some combination of these or other factors. Related questions involve the treatment of businesses that grow (or fluctuate in size), crossing the definitional line, and the treatment of tax attributes imported from a more complex tax regime. Weighing of simplicity against accuracy of income measurement and allocation would be a factor in designing a simpler regime.

Others would argue that there is nothing inherently complex in the application of the partnership tax rules to most small business transactions. Small businesses today can achieve the effect of a simplified partnership regime for most common business arrangements. Mandating the use of specific rules for small business would deny them the flexibility of present law partnership rules and, it could be argued, would represent a competitive disadvantage relative to larger businesses.

NOTE

The debate on how pass-through entities should be taxed comes and goes, with recurring themes and timeless arguments. The latest burst of energy was in 2013, when the House Ways and Means Committee released a provocative discussion draft with two reform options.[285] The less ambitious Option 1 would make a handful of specific changes to the S corporation rules, such as reducing the bite of the Section 1375 tax on excessive passive investment income, extending the time to make an S election, ameliorating

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[49] See, for example, the letter of July 25, 1995, from Leslie B. Samuels, Assistant Treasury Secretary (Tax Policy) to Senator Orrin Hatch, suggesting possible legislative proposals to allow S corporations to elect partnership status or to apply the check-the-box regulations to S corporations.

[50] American Law Institute, Federal Income Tax Project—Taxation of Pass-Through Entities, Memorandum No. 2 96–105 (Sept. 2, 1996) (G. Yin and D. Shakow, reporters).

[285] See House Comm. on Ways & Means, 113th Cong., Technical Explanation of the Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Small Businesses and Passthrough Entities (2013), available at https://www.pwc.com/us/en/law-firms/assets/2013/final_sm_bus_passthrough_technical_explanation_03_12_13.pdf.

penalties for inadvertent errors, and removing unnecessary complexity from the system. Two of the Option 1 proposals—to make permanent the reduction of the Section 1374 recognition period to five years and to limit a shareholder's downward basis adjustment resulting from an S corporation's charitable contribution of appreciated property to the adjusted basis of that property—were enacted into law in late 2015. The S corporation provisions in Option 1 were intended to encourage more C corporations to elect S status and provide greater flexibility to current S corporations in their day-to-day operations. Option 1 also included a list of far more controversial changes to the tax treatment of partnerships and partners in Subchapter K.

The more radical Option 2 would overhaul the current Subchapter K and S regimes by replacing them with a uniform set of rules available to most privately held business entities. Subchapter S would no longer exist, and a less flexible and somewhat more user-friendly Subchapter K would remain and apply to any legal form of closely held business entity if its owners elect pass-through tax treatment. Among the many changes affecting electing corporations would be elimination of the one-class-of-stock and shareholder eligibility restrictions; allowing entity debt to be included in a shareholder's basis; and permitting limited types of special allocations by agreement of the entity's owners.

In 2014, then House Ways and Means Committee chairman Dave Camp followed up with his sweeping discussion draft of The Tax Reform Act of 2014.[286] The provisions affecting pass-through entities were largely drawn from Option 1 of the 2013 proposals, reflecting a more incremental approach to reform rather than a radical overhaul. Chairman Camp's initiative stimulated much discussion when it was first released but, like so many earlier proposals, it has faded into the sunset where it has so far only gathered dust. Many of the S corporation proposals are uncontroversial, however, and could become law either as part of a targeted tax bill or if and when comprehensive business tax reform legislation is enacted. The 2014 proposals are in line with the view expressed by many practitioners and the small business community that Subchapter S continues to play a valuable role and should be expanded and improved rather than discarded in favor of a unified pass-through system.[287]

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[286] See Chapter 1H3, supra.

[287] See, e.g., Sicular, "Subchapter S at 55—Has Time Passed This Passthrough By? Maybe Not," 68 Tax Law. 185 (2014); Yin, Comments on the Taxation of Passthrough Entities, 140 Tax Notes 358 (July 22, 2013).

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