2020 National Income Tax Workbook

CHAPTER 4: S CORPORATION TAX ISSUES
Chapter Topics P. 101

- Issue 1: Entity Classification 102
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- Issue 3: Shareholder Stock and Debt Basis 117 *
- Issue 4: Distributions to Shareholders 129 *
- Issue 5: Compensation of Shareholders 135
- Issue 6: S Corporation Built-In Gains Tax 141
- Issue 7: Net Passive Investment Income 147
In the 2019 fiscal year there were 5,186,557 S corporation returns filed.

S corporation returns constituted 45.98% of the total returns filed by all C corporations, S corporations, and partnerships.
FIGURE 4.1 Classification of Business Entities  P. 103

- Incorporated Entity?
  - Yes
  - Qualify for S Status?
    - Yes
    - C corporation
    - No
    - Elect S status?
      - Yes
      - S corporation
      - No
      - Elect corporate status?
        - Yes
        - Partnership
        - No
        - More than one member?
          - Yes
          - Disregarded Entity
          - No
An LLC is generally not eligible to be a shareholder in an S corporation.

- However, the owner of an SMLLC that is disregarded as an entity separate from its owner is treated as owning the LLC’s assets directly, including its shares in an S corporation.

- If the LLC’s sole owner is a US citizen or resident or another eligible S corporation shareholder, the LLC can be a shareholder in an S corporation.

- However, if the LLC elects to be a C corporation or an S corporation for federal income tax purposes, or if one or more additional persons acquires an interest in the LLC, it is ineligible to own shares in an S corporation.
Each share of stock must confer identical rights to all current and liquidating distributions.

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on:

- the corporate charter
- articles of incorporation
- Bylaws
- applicable state law
- binding agreements relating to distribution and liquidation proceeds
Evidence of Filing

- When the IRS receives and processes Form 2553, it sends CP261, Notice of Acceptance as an S corporation.

- If the corporation does not receive this notice within 60 days of filing the S corporation election, it should contact the IRS.
Thornton Corporation is a calendar year taxpayer.

1. On November 8, 2019, it issued its first shares.
2. On December 9, 2019, the assets contributed by the shareholders were titled to the corporation.

Thornton must file Form 2553 on or before January 23, 2020, (2 months + 15 days from November 8, 2019.)
FIGURE 4.3 Form 2553 Shareholder Consent  P. 108

<table>
<thead>
<tr>
<th>J</th>
<th>Name and address of each shareholder or former shareholder required to consent to the election. (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>K</td>
<td>Shareholder’s Consent Statement Under penalties of perjury, I declare that I consent to the election of the above-named corporation (entity) to be an S corporation under section 1362(a) and that I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I understand my consent is binding and may not be withdrawn after the corporation (entity) has made a valid election. If seeking relief for a late filed election, I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the S corporation election for the year for which the election should have been filed (see beginning date entered on line E) and for all subsequent years.</td>
</tr>
<tr>
<td>L</td>
<td>Stock owned or percentage of ownership (see instructions)</td>
</tr>
<tr>
<td>M</td>
<td>Social security number or employer identification number (see instructions)</td>
</tr>
<tr>
<td>N</td>
<td>Shareholder’s tax year ends (month and day)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Employer identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

**Part I** Election Information (continued) Note: If you need more rows, use additional copies of page 2.
I.R.C. § 1362(b)(5) instructs the IRS to treat late S corporation elections as timely filed if:

- Reasonable cause for the delinquency.

Under Rev. Proc. 2013-30:

- Service centers can grant relief if
  - The corporation files Form 2553 no more than 3 years and 75 days after the day the election was intended to become effective.
  - The corporation must explain the reasonable cause for failure to timely file the election and its diligent actions to correct the mistake upon discovery.
  - This information can be provided on line 1 of Form 2553 or on an attached statement.
By default, an SMLLC is classified as a disregarded entity.

For tax purposes, the entity’s:
- assets,
- liabilities,
- income, and
- deductions
are treated as belonging directly to the owner.

If the sole owner is an individual, ordinary income or loss on Schedule C, E, or F

An SMLLC’s income is generally SE income
Passes through its items of income, gain, losses, deductions, and credits to partners
- The partners are taxed on their distributive share of partnership income.
- A partner (other than a limited partner) must also pay SE tax.
- Guaranteed payments from a partnership are not wages; SE income.

Have more flexibility in allocating income and loss to owners than S corporations.
- S corporations generally must allocate all items on a per-share, per-day basis.
- Partnership allocations may differ from capital ownership if they meet the requirements of I.R.C. § 704(b).
- However, partnership must allocate built-in gains and losses on contributed property to the contributing partner.
A partner’s share of partnership loss is allowed only
- To the extent of the adjusted basis of the partner’s interest in the partnership at the end of the partnership year in which the loss occurred.

Basis is increased by a partner’s share of the partnership liabilities.
- The risk of economic loss is enough to give a partner debt basis.
- Only economic outlay (discussed later) gives an S corporation shareholder debt basis.
Partners do not receive wages from the partnership (self employed)

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

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

- allocation of profits or
- guaranteed payments.

Guaranteed payments are not QBI and may reduce a partner’s QBI deduction.
C Corporations vs. Pass Through Entities

- Because of the lower tax rate on corporate income, C corporations that retain earnings may pay less taxes than a partnership or S corporation.

- However, if the C corporation makes distributions, the combined corporate level tax and tax on shareholder distributions is usually higher than the tax on a partnership or S corporation.

- But what about health insurance, sale of small business stock, etc. What can you think of that would make the C Corporation attractive?
Again......choose wisely.....

- State and local income tax, which would be fully deductible for a C corporation, but limited to $10,000 on an individual tax return.
- Plans to sell the corporation at a future date.
- §1202 exclusion potential.
- §105 plans to pay for shareholder health costs, if otherwise qualifying.
- Plans to reinvest the profits and not distribute dividend income, where individuals may not wish to pay tax on income they will not receive.
- Multiple classes of stock are desired, which cannot be done with an S corporation.
- The company has foreign investors.
NO COOKIE CUTTER FORMULA

KNOW YOUR CLIENT!!
A great opportunity is surely the permanent reduction in corporation income tax rates from a graduated 15%, 25% and 35% to a single flat rate of 21%.

The corporation tax rate reduction principally assists businesses that can, or do, keep the majority of income within the company rather than distribute that income to shareholders.

Excess business loss limitations for Non-Corporate taxpayers.
QBI deduction at the entity levels allowed

CQBI deduction limitations

CQBI 20% deduction sunset in 2025

Losses affect CQBI 20% deduction for all non-C Corp

SSTB limitations based on income
TALKING POINTS

- Whether business profits need to be or will be distributed; or could profits stay invested within the business.
- Filing Status of the owners
- Prior year losses if any
- How much other taxable income does the owner (and their spouse) have from sources other than the business being evaluated?
An S corporation is not subject to federal income tax on its earnings.


Income, loss, deduction, and credits pass through to the shareholders who report these items on their individual income tax returns.

Losses that exceed the shareholder’s basis in the S corporation stock and basis in indebtedness to the S corporation shareholder are not currently deductible.

Corporate liabilities (other than those owed to its shareholders) are not included in a shareholder’s basis.
The S corporation must pay its shareholders reasonable compensation for services provided to the corporation.

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

Also, distributions to materially participating S corporation shareholders are not subject to the NIIT.

An S corporation with C corporation history may be subject to tax at the entity level. It may pay tax on built-in gains and excess net passive investment income.
Initial Stock Basis

- **Purchase:** cost of the shares.
- **C electing S:** basis in C stock at any time of the conversion.
- **Gift:** generally the donor's basis.
- **Exchange for services:** Basis is measured by the stock's FMV, rather than by the value of the services.
- **Inheritance:** generally its FMV at the date of death or, if elected, the alternate valuation date.
- **When S Corp is capitalized:** equal to the basis of the property transferred, reduced by property received and increased by gain recognized on transfer.
**Stock Basis Adjustments**

**Increases**
- All income items of the S Corp
- Non-separately stated income of the S Corp
- Excess depletion deduction
- Cancellation of debt income
- Additional capital contributions

**Decreases**
- Distributions not includible in SH income
- The SH's share of the S Corp separately and non-separately stated loss, items of loss and deductions
- The SH's share of non-includable expense
- Never below zero
Ordering Rule and Election

Annually on the Last Day

- Increased for income items and excess depletion
- Decreased for distributions
- Decreased for nondeductible, noncapital expenses and depletion
- Decreased for items of loss and deduction

Election

- There is an election to reduce basis by items of loss or deduction before nondeductible, noncapital expenses.
- Made by attaching a statement to the return.
- Must be timely filed original or amended return.
- Once made, election is used for future years.
DISTRIBUTIONS

- Distributions reduce stock basis
- Not taxable if enough stock basis before losses or deductions
- If distributions exceed stock basis, capital gain is reported on Schedule D
Debt Basis

- Must be ‘bonafide’ loans
- Provisions are not the same as for Partnerships
- Not reduced by distributions
- Loan repayments to reduced debt basis create taxable gain
FIGURE 4.10
SUBSTITUTION OF PROMISSORY NOTE FOR GUARANTEE

P. 122
At-Risk Passive Schedule K-1

- 2nd loss limitation
- At-Risk – Form 6198, At-Risk Limitations
- 3rd loss limitation
- Passive Activity Rules
- Form 8582, Passive Activity Loss Limitations
Simple One

The sole shareholder of an S Corp has stock basis of $500. His K-1 increases for the year were $2,000 and interest income $100. Distributions were $800. What is his basis at the end of the year?

<table>
<thead>
<tr>
<th>Stock &amp; Debt Basis Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Beginning</strong></td>
</tr>
<tr>
<td>Stock: $500</td>
</tr>
<tr>
<td>Debt:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Profit &amp; Int</strong></td>
</tr>
<tr>
<td>Stock: $2,000 + 100</td>
</tr>
<tr>
<td>Debt: $2,100</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
</tr>
<tr>
<td>Stock: $2,600</td>
</tr>
<tr>
<td>Debt:</td>
</tr>
<tr>
<td><strong>Distribution</strong></td>
</tr>
<tr>
<td>Stock: (800)</td>
</tr>
<tr>
<td>Debt:</td>
</tr>
<tr>
<td><strong>End of Year Balance</strong></td>
</tr>
<tr>
<td>Stock: $1,800</td>
</tr>
<tr>
<td>Debt:</td>
</tr>
</tbody>
</table>

His distribution will not be taxable.
Now, with Debt Basis

A shareholder has a beginning basis in his stock of $1,000 and debt basis of $500. His K-1 shows: ordinary loss of $1,200 and interest income of $50. What is the ending debt basis?

<table>
<thead>
<tr>
<th></th>
<th>STOCK</th>
<th>DEBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning</td>
<td>$1,000</td>
<td>$500</td>
</tr>
<tr>
<td>Interest</td>
<td>$50</td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td>$1,050</td>
<td>$500</td>
</tr>
<tr>
<td>K-1 loss</td>
<td>$1,200</td>
<td>$(1,050)</td>
</tr>
<tr>
<td>End of Year Balance</td>
<td>$-0-</td>
<td>$350</td>
</tr>
</tbody>
</table>

His loss on Schedule K-1 will be allowed to flow onto the Schedule E, Pg 2 in full with no suspended carry overs.
Loan, Losses and Distributions

The sole shareholder of an S Corp has stock basis of $7,500 and unreduced loan basis of $5,000. During the year, cash of $8,500 and a computer within FMV of $500 was distributed to the shareholder. Her K-1 decreases for the year were $1,000. What is this shareholder’s stock and loan basis at the end of the year?

### Stock & Debt Basis Balances

<table>
<thead>
<tr>
<th></th>
<th>STOCK</th>
<th>DEBT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning</strong></td>
<td>$7,500</td>
<td>$5,000</td>
</tr>
<tr>
<td><strong>Distribution</strong></td>
<td>8,500 (8,000)</td>
<td>$(7,500) XXXXX</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$ -0-</td>
<td>$ 5,000</td>
</tr>
<tr>
<td><strong>Net Loss From K-1</strong></td>
<td>$ -0-</td>
<td>$(1,000)</td>
</tr>
<tr>
<td><strong>End of Year Balance</strong></td>
<td>$ -0-</td>
<td>$ 4,000</td>
</tr>
</tbody>
</table>

The $1,500 of distribution that exceeds basis will flow to Sch D. The $1,000 net loss will be allowed to flow to page 2 of the Sch E.
Basis Question

An S Corp passed through a loss of $1,500 to its sole shareholder. The shareholder also received a distribution of $5,000 during the year. The stock basis as of the beginning of the year was $2,500 and his loan basis was $5,000. What are the balances of Stock and Loan Basis at the end of the year?

<table>
<thead>
<tr>
<th></th>
<th>Stock Basis</th>
<th>Debt Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Basis</td>
<td>$2,500</td>
<td>$5,000</td>
</tr>
<tr>
<td>Distribution</td>
<td>$ (2,500)</td>
<td>XXXX</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$ -0-</td>
<td>$5,000</td>
</tr>
<tr>
<td>Ordinary Loss</td>
<td><em>-0-</em></td>
<td>$ (1,500)</td>
</tr>
<tr>
<td>Ending Basis</td>
<td>$ -0-</td>
<td>$ 3,500</td>
</tr>
</tbody>
</table>
Basis Question

After you determine Stock and Loan Basis - what are the entries from the K-1 that flow to the Form 1040?

<table>
<thead>
<tr>
<th></th>
<th>Stock Basis</th>
<th>Debt Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Basis</strong></td>
<td>$2,500</td>
<td>$5,000</td>
</tr>
<tr>
<td><strong>Distribution</strong></td>
<td>$(2,500)</td>
<td>XXXX</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$ -0-</td>
<td>$5,000</td>
</tr>
<tr>
<td><strong>Ordinary Loss</strong></td>
<td><em>-0-</em></td>
<td>$(1,500)</td>
</tr>
<tr>
<td><strong>Ending Basis</strong></td>
<td>$ -0-</td>
<td>$3,500</td>
</tr>
</tbody>
</table>

The distribution that exceeds stock basis flows to 1040 - Sch D, Capital Gain.

Since there is enough debt basis, the loss is allowed to flow to the 1040 - Sch E, Pg. 2, Ordinary Loss.
I am a sole shareholder of an S Corp and my beginning stock basis is $10,000. My unreduced Debt Basis is $25,000. I guaranteed a $50,000 loan for my S Corp this year and took a cash distribution of $20,000. The S Corp losses were $45,000. What is my stock and debt basis at the end of the year?

<table>
<thead>
<tr>
<th></th>
<th>STOCK BASIS</th>
<th>DEBT BASIS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning of Year</td>
<td>$ 10,000</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Distribution</td>
<td>($10K excess to Sch D)</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Sub-Total</td>
<td>$ -0-</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Net Losses</td>
<td>K-1 Loss $45K</td>
<td>-0-</td>
</tr>
<tr>
<td>Ending Balance</td>
<td>$ -0-</td>
<td>$ -0-</td>
</tr>
</tbody>
</table>

Entries for the 1040: Sch E = $25K loss on page 2
Sch D = $10K capital gain
Carryover Worksheet = $20K suspended loss
(The loan guarantee does not increase debt basis)
**FIGURE 4.11 Schedule E Basis Reporting**

P. 124

Schedule E (Form 1040 or 1040-SR) 2019

<table>
<thead>
<tr>
<th>Name(s) shown on return. Do not enter name and social security number if shown on other side.</th>
<th>Your social security number</th>
</tr>
</thead>
</table>

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

| Part II | Income or Loss From Partnerships and S Corporations — Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which any amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach Form 6198 (see instructions). |

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered “Yes,” see instructions before completing this section.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>28</th>
<th>(a) Name</th>
<th>(b) Enter P for partnership; S for S corporation</th>
<th>(c) Check if foreign partnership</th>
<th>(d) Employer identification number</th>
<th>(e) Check if basis computation is required</th>
<th>(f) Check if any amount is not at risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Both S and C corporations deduct expenses for wages paid, even if those payments are made to shareholder-employees. Because wages are deductible, but dividends paid are not, there is an incentive for a C corporation to disguise distributions to owners as wages to claim a deduction.
On the contrary, S corporation wages are subject to employment taxes, which creates an incentive to characterize payments as a share of earnings instead of wages.

To prevent the treatment of wages as earnings that are not subject to employment taxes, an S corporation must pay its shareholders reasonable compensation for services that they provide to the corporation.

If the salary paid to an S corporation shareholder is not reasonable, the IRS can recharacterize a shareholder distribution as wages that are subject to employment taxes.

For newly electing S corporations, the CP261 notice contains a statement that the corporation should compensate its shareholders, and that the IRS will be enforcing this rule.
The I.R.C. § 199A qualified business income (QBI) deduction applies to qualified business income.

Wages reduce qualified business income, which may reduce the QBI deduction.

However, for taxpayers who are above the QBI phase-in range, the deduction may be limited if the corporation does not pay enough W-2 wages.

For purposes of the QBI deduction, reasonable compensation of an S corporation shareholder includes any amounts (including distributions) paid by the S corporation to the shareholder, up to the amount that would constitute reasonable compensation.

See the “Qualified Business Income Deduction Issues” chapter in this book for a discussion of calculation of the QBI deduction, and limitations on that deduction.
**JUDICIAL FACTORS**

*Mayson Manufacturing factors:*
- The employee’s qualifications
- The nature, extent, and scope of the employee’s work
- The size of the business
- The complexities of the business
- Comparison of the salaries paid/ER’s gross and net income
- The prevailing general condition of the economy
- Comparison of the salaries paid/distributions to the SH
- Salaries paid for similar positions in similar businesses
- Salary policy of the corporation
- Compensation paid to EE in previous years
- Approval by the board of directors

*Herold Marketing factors:*
- Whether the employer and the employee dealt at arm’s length
- Whether the employee guaranteed the employer’s debt
- Whether the employer offered a pension plan or profit-sharing plan to its employees
- Whether the employer reimbursed the employee for business expenses that the employee paid personally
No single factor is decisive of the question, and courts consider and weigh the totality of the facts and circumstances in determining reasonable compensation.

For example, prior-year compensation may not be indicative if the corporation paid the shareholder-employee a lower salary during years when the business was not profitable, or if the employee took on increased duties or responsibilities.
The *IRS Reasonable Compensation Job Aid for IRS Valuation Professionals* describes three valuation methods for IRS agents and field personnel to determine reasonable compensation:

1. market approach
2. income approach
3. cost approach

- Although standard appraisal practice requires the consideration of all 3 approaches, the Job Aid states that reasonable compensation will generally rest *heavily on the market approach* (comparison to compensation for similar positions in similar companies).

- The income and cost approaches are then used to refine the reasonable compensation amount.
The market approach compares the shareholder-employee’s compensation with typical compensation in the industry.

It asks how much compensation would be paid for the same position, held by a non-owner in an arms-length employment relationship, at a similar company.

List of sources of information for the market approach
### Average hourly wages for selected occupational groups and areas by job characteristic, civilian workers, 2018

<table>
<thead>
<tr>
<th>Selected occupational groups and areas</th>
<th>Job characteristic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Union</td>
</tr>
<tr>
<td><strong>13-0000 Business and financial operations</strong></td>
<td></td>
</tr>
<tr>
<td>Atlanta-Sandy Springs-Roswell, GA</td>
<td>–</td>
</tr>
<tr>
<td>Boston-Cambridge-Nashua, MA-NH</td>
<td>$35.86</td>
</tr>
<tr>
<td>Chicago-Naperville-Elgin, IL-IN-WI</td>
<td>$33.25</td>
</tr>
<tr>
<td>Dallas-Fort Worth-Arlington, TX</td>
<td>–</td>
</tr>
<tr>
<td>Detroit-Warren-Dearborn, MI</td>
<td>–</td>
</tr>
<tr>
<td>Houston-The Woodlands-Sugar Land, TX</td>
<td>–</td>
</tr>
<tr>
<td>Los Angeles-Long Beach-Anaheim, CA</td>
<td>$35.27</td>
</tr>
<tr>
<td>Miami-Fort Lauderdale-West Palm Beach, FL</td>
<td>–</td>
</tr>
<tr>
<td>Minneapolis-St. Paul-Bloomington, MN-WI</td>
<td>$34.17</td>
</tr>
<tr>
<td>New York-Newark-Jersey City, NY-NJ-PA</td>
<td>$37.69</td>
</tr>
<tr>
<td>Philadelphia-Camden-Wilmington, PA-NJ-DE-MD</td>
<td>$35.07</td>
</tr>
<tr>
<td>Phoenix-Mesa-Scottsdale, AZ</td>
<td>–</td>
</tr>
<tr>
<td>San Jose-Sunnyvale-Santa Clara, CA</td>
<td>$43.36</td>
</tr>
<tr>
<td>Seattle-Tacoma-Bellevue, WA</td>
<td>$39.57</td>
</tr>
<tr>
<td>Washington-Arlington-Alexandria, DC-VA-MD-WV</td>
<td>$34.49</td>
</tr>
</tbody>
</table>
The Job Aid directs agents and other IRS personnel to use the income approach only when the FMV of the company is available for each year that compensation is being examined.

The income approach is based on an independent investor test that seeks to determine whether an independent investor would be satisfied with his or her return on investment.

The independent investor test creates a rebuttable presumption that an employee’s compensation is reasonable if investors obtain a far higher return than they had any reason to expect.
A high rate of return indicates that the assets’ value increased, and that the employee provided valuable services.

Thus, if investors obtain returns above what they should reasonably expect, an employee’s salary is presumptively reasonable.

The presumption is rebutted if the high rate of return is attributable to an extraneous event rather than the employee’s efforts.
The Cost Approach  P. 137

- The cost approach breaks the duties of the employee into components such as company administration, accounting, finance, marketing, advertising, engineering, and purchasing.

- It apportions the total hours worked by the employee to the job functions, uses salary surveys to determine the cost of each job duty that the employee performs, and compares the employee’s salary to market compensation for comparable positions.

- The Job Aid notes that a weakness of the cost approach is that an employee might perform many tasks to some degree.
Reclassification of Payments as Wages  Pp. 137-138

- If an S corporation distributes profits and fails to pay its shareholder-employees reasonable compensation, the excess distributions are disguised compensation and the corporation is responsible for FICA, FUTA, and income tax withholding on that compensation.
- The IRS may also assess interest and penalties.
- In Radtke v. U.S., the S corporation paid its sole shareholder dividends, but no salary for the services that he provided to the corporation. The court reclassified the payments as wages, which were subject to FICA and FUTA.
What about the health insurance S Corp paid for Shareholder?
FIGURE 4.25 Form 1125-E  P. 140

When is this form required to be filed?

<table>
<thead>
<tr>
<th>(a) Name of officer</th>
<th>(b) Social security number (see instructions)</th>
<th>(c) Percent of time devoted to business</th>
<th>(d) Percent of stock owned</th>
<th>(e) Percent of Preferred</th>
<th>(f) Amount of compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
</tbody>
</table>

2 Total compensation of officers

3 Compensation of officers claimed on Form 1125-A or elsewhere on return

4 Subtract line 3 from line 2. Enter the result here and on Form 1120, page 1, line 12 or the appropriate line of your tax return.

For Paperwork Reduction Act Notice, see separate instructions.
C corporations that convert to S corporations are subjected to the Built-in Gains tax (BIG) if they have a net unrealized built-in gain and sell assets within 5 years after the conversion.

This tax is assessed to the S corporation.

LB&I has found that S corporations are not always paying this tax when they sell the C corporation assets after the conversion.

LB&I has developed comprehensive technical content for this campaign that will aid revenue agents as they examine the issue.

The goal of this campaign is to increase awareness and compliance with the law as supported by several court decisions.

Treatment streams for this campaign will be issue-based examinations, soft letters, and outreach to practitioners.
In general, S corporation shareholders pay tax on the gain from the sale of the corporation’s assets, including a sale of substantially all the assets.

The gain increases the shareholders’ basis, thus allowing the shareholders to avoid double tax.

However, an S corporation that is subject to the BIG tax pays a flat rate of 21% (the maximum C corporation tax rate) in addition to the tax imposed on the shareholders.

This tax may reduce, or even negate, the benefits of the S election.
Built-In Gains Tax

The BIG tax applies only to assets that have appreciated in value in a C corporation.

Thus, if the corporation has always been an S corporation, or has been an S corporation for at least 5 years after it converted from a C corporation or acquired assets from a C corporation in certain reorganizations, the BIG tax does not apply.
The BIG tax applies to built-in gains of a former C corporation for the first 5 years following conversion to S corporation status.

This 5-year period is called the recognition period.

- Any assets sold before or during the recognition period are subject to the BIG tax, regardless of when the proceeds are received.

- Thus, the sale of assets in an installment sale will be subject to the BIG tax, even if no sale proceeds are received during the recognition period.
Net unrealized built-in gain (NUBIG) is the net unrealized appreciation in the C corporation assets at the time the S election is made.

- NUBIG limits the amount of taxable built-in gain that the corporation must report during the recognition period.

NUBIG is computed at the time the S election is effective.

- NUBIG is the net gain that the corporation would have recognized if it had liquidated on the first day it became an S corporation.
- In general, NUBIG equals the FMV of all the corporation’s assets, less the adjusted bases of these assets.
**FIGURE 4.28 LGU’S SCHEDULE B (FORM 1120-S)**

<table>
<thead>
<tr>
<th>Schedule B</th>
<th>Other Information (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Check accounting method: a ✔ Cash b □ Accrual</td>
</tr>
<tr>
<td></td>
<td>c □ Other (specify)</td>
</tr>
<tr>
<td>2</td>
<td>See the instructions and enter the:</td>
</tr>
<tr>
<td></td>
<td>a Business activity ▶ 541600</td>
</tr>
<tr>
<td></td>
<td>b Product or service ▶ Consulting</td>
</tr>
<tr>
<td>3</td>
<td>At any time during the tax year, was any shareholder of the corporation a disregarded entity, a trust, an estate, or a nominee or similar person? If “Yes,” attach Schedule B-1, Information on Certain Shareholders of an S Corporation.</td>
</tr>
<tr>
<td>4</td>
<td>At the end of the tax year, did the corporation:</td>
</tr>
<tr>
<td>8</td>
<td>If the corporation (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years. See instructions.</td>
</tr>
<tr>
<td></td>
<td>$ 339,500</td>
</tr>
<tr>
<td>9</td>
<td>Did the corporation have an election under section 163(j) for any real property trade or business or any farming business</td>
</tr>
</tbody>
</table>

Page 2
NET RECOGNIZED BUILT-IN GAIN

- The base for the BIG tax is derived from the corporation’s net recognized built-in gain for each year in the recognition period.
- The net recognized built-in gain is the lowest of the following three amounts:
  1. The pre-limitation amount (PLA)
  2. The taxable income limitation (TIL)
  3. The net unrealized built-in gain limitation (NUL)
C Corporation Carryforwards

- In general, an S corporation cannot claim a deduction for any carryforward arising in a year in which it was a C corporation.

- However, the BIG tax rules do permit the use of NOL and net capital loss carryforwards, for the limited purpose of reducing the BIG tax.
• I.R.C. § 1375 imposes a tax on S corporations with AE&P from C corporation years and excess net passive income.
  ◦ If an S corporation has AE&P at the end of the year,
  ◦ **and**
    ◦ the corporation’s passive investment income for the tax year exceeds 25% of gross receipts for the year,
• there is a corporate-level tax on the excess net passive income.
• If the corporation exceeds the 25% limit for 3 consecutive tax years, the corporation’s S status will terminate on the first day of the next tax year.
The tax is calculated by multiplying the excess net passive investment income by the highest corporate income tax rate, which is currently 21%.

Excess net passive income is:

\[
\frac{\text{Passive Gross Receipts} - 25\% \text{ Gross Receipts}}{\text{Passive Gross Receipts}} \times \text{Net Passive Income}
\]

It is limited to the corporation’s taxable income, with some adjustments.
QUESTIONS?