<table>
<thead>
<tr>
<th>Issue</th>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Entity Classification</td>
<td>102</td>
</tr>
<tr>
<td>2</td>
<td>Choice of Entity</td>
<td>111</td>
</tr>
<tr>
<td>3</td>
<td>Shareholder Stock and Debt Basis</td>
<td>117</td>
</tr>
<tr>
<td>4</td>
<td>Distributions to Shareholders</td>
<td>129</td>
</tr>
<tr>
<td>5</td>
<td>Compensation of Shareholders</td>
<td>135</td>
</tr>
<tr>
<td>6</td>
<td>S Corporation Built-In Gains Tax</td>
<td>141</td>
</tr>
<tr>
<td>7</td>
<td>Net Passive Investment Income</td>
<td>147</td>
</tr>
</tbody>
</table>
OUR APPROACH TO THE CHAPTER.....

• This chapter is very comprehensive and well defined.

• In reality, this chapter easily contains enough material for a four-hour course.

• The accompanying slides are also well defined.

• The chapter and the accompanying slides should be kept as an excellent reference works.
However, for our purposes we will emphasize the enforcement issues announced by the IRS after discussing some basics involving S corporations since the enforcement issues are the main areas of contention in an audit.
S CORPORATION ISSUES – IRS FOCUS –
AN OVERVIEW.....WHY WE NEED THIS CHAPTER....
S CORPORATION ENFORCEMENT – NOT IN BOOK

• As part of the LMSB “campaigns”, the IRS has announced a vigorous enforcement program regarding S corporations.
• This could have been predicted and is long overdue.
• The IRS has announced three areas of new audit enforcement:
S CORPORATION ENFORCEMENT – NOT IN BOOK - CONTINUED

1. Distributions by an S corporation:

- Focus is on the failure to report the gain on distributions of appreciated property to shareholders.

- Failure to report dividends from accumulated earnings and profits that resulted from a C corporation that had converted to an S corporation.
• Cash or property distributions that exceed the shareholder’s basis in the corporation:

• My thoughts are....

2. The existence of the applicability of the Built-In Gains Tax (BIG):
This is no surprise concerning the overemphasis on the existence of the qualified business income deduction for S corporation qualified income and the many pressures for clients to convert from a C corporation to an S corporation.

The built-in gains tax is 21% (new corporate rate) on the net profit from sales of assets owned before the conversion and five years after the conversion.
I would especially be careful with this computation because of the severity of the tax consequences and, when consulting with a client, have them sign a representation letter that they were advised on the consequences.

The IRS plans to issue “safe harbor” guidance in this area.
3. Basis in the S corporation – whether the client has sufficient basis in the S corporation

- Beginning in 2018, we were required to attach to the client’s form 1040 a computation of the basis to those who are in the following situations:

A. Reported a loss.
S CORPORATION ENFORCEMENT – NOT IN BOOK - CONTINUED

B. Dispositions of stock.

C. Received a distribution.

D. Received a loan repayment from the company.

➢ My recommendation is to do it on all S corporate shareholders forms 1040 because....
The audits in this new enforcement campaign are supposed to happen at the shareholder level with each individual shareholder’s returns being subject to examination.

How this is supposed to happen without auditing the related S corporation is a….
S CORPORATION ENFORCEMENT – NOT IN BOOK - CONTINUED

- Also, the IRS had previously announced that the Large Business & International Division would soon be examining partnerships as well as S corporations.

- Furthermore, Doug O’Donnel of the IRS stated that “obviously, some of those will be controlled by high-wealth individuals, so that will touch on our global high-wealth program as well, and we’ll understand better the linkages to what those individuals may be up to. We are going to collect this examination information and using a very robust feedback mechanism to do this. We put in place a number of subject matter experts to keep in touch with the teams to understand what they are seeing”.
The IRS announced enforcement campaign regarding S corporation will focus on:

1. Losses in excess of shareholder’s basis
2. Distributions in excess of basis.
3. Built-In Gains (BIG) tax computation.
4. All of the above.
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.
This section reviews the classification of business entities and how an entity makes the S corporation election.
• Unincorporated domestic entity with more than one owner is, by default, a partnership.
  ◦ However, it can elect to be treated as an association (a corporation) for federal tax purposes.

• A single-member LLC (SMLLC) is, by default, a disregarded entity.
  ◦ It too can elect to be taxed as a corporation for federal tax purposes.
An unincorporated entity can typically change its tax status without changing its nontax business form.

An unincorporated entity makes the election to be taxed as a corporation on the following form(s):
- Form 8832, Entity Classification Election, to be taxed as a C corporation
- Form 2553, Election by a Small Business Corporation, to be taxed as an S corporation
• To become an S corporation starting with the effective date of its election to be taxed as a corporation, an eligible unincorporated entity can file only Form 2553.

• An entity that elects to be taxed as an S corporation must meet the eligibility requirements of I.R.C. § 1361 and file the I.R.C. § 1362 election.
FIGURE 4.1 CLASSIFICATION OF BUSINESS ENTITIES
P. 103

Flowchart diagram showing the classification process:

1. Incorporated Entity? Yes → C corporation
   No → Elect corporate status?
2. Elect corporate status? Yes → More than one member?
   No → Quality for S Status?
3. Quality for S Status? Yes → S corporation
   No → Elect S status?
4. Elect S status? Yes → Disregarded Entity
   No → Partnership
S CORPORATION ELIGIBILITY

1. It does not have more than 100 shareholders.
2. All its owners are US citizens or resident alien individuals, estates, certain trusts, or certain tax-exempt organizations.
3. It does not have more than one class of stock.
An S corporation cannot have more than 100 shareholders at any time.
  ◦ A husband and wife are treated as one shareholder.
  ◦ In addition, extended family attribution rules treat all members of a family as a single shareholder for purposes of the 100-shareholder limit.
  ◦ A family includes six generations of descendants from a common ancestor, including spouses, former spouses, eligible foster children, and adopted children.
POLLING QUESTION #2

An S corporation may have:

1. More than 100 shareholders.
2. Multiple classes of stock.
3. All of the above.
4. None of the above.
The ONLY eligible shareholders are:

- Individuals who are US citizens or residents
  - If a spouse is a nonresident alien who has a current ownership interest (e.g., community property law), the corporation does not qualify
- Decedent and bankruptcy estates
- Certain trusts (described later)
- I.R.C. § 501(c)(3) tax-exempt entities
- I.R.C. § 401(a) qualified plans
• Only certain specified trusts qualify as S corporation shareholders.

• Some trusts must make an election to qualify as an S corporation shareholder.
  ✓ Grantor Trusts (Including Deemed Grantor Trusts)
  ✓ Testamentary Trusts
TRUSTS – CONTINUED

✓ Voting Trusts
✓ Electing Small Business Trusts (need election)
✓ Qualified Subchapter S Trusts (need election)
A trust is an eligible S corporation shareholder if the trust is treated as owned by a US citizen or resident individual.

The deemed owner of the trust may be the grantor (e.g., a section 676 revocable trust) or another person (a section 678 trust). The deemed owner is treated as the shareholder.
• If the trust was an eligible grantor trust immediately before the death of the deemed owner, it continues to be eligible for the 2-year period beginning on the day of the deemed owner’s death.
  ◦ The estate of the deemed owner is treated as the shareholder.
A grantor trust may be a shareholder if:

1. The trust is treated as owned by a US citizen or resident individual.
2. The deemed owner of the trust may be the grantor.
3. The trust was an eligible grantor trust immediately before the death of a deemed owner.
4. All of the above.

POLLING QUESTION #3
• A testamentary trust is created by a will and funded after the owner’s death.
  ◦ A testamentary trust is an eligible S corporation shareholder for 2 years after it receives the stock.
  ◦ The estate of the testator is treated as the shareholder.
A voting trust is an eligible S corporation shareholder.

A voting trust holds the voting power of stock, but no other beneficial interest, such as the right to distributions.

- The shareholders transfer their stock certificates to the trustee and receive voting trust certificates, which evidence their legal ownership in the trust.
A voting trust typically must terminate at a specific time or on the occurrence of a specific event.

Each beneficiary of the trust is treated as a shareholder.
An electing small business trust (ESBT) is an eligible S corporation shareholder. This trust can have more than one potential current income beneficiary. All beneficiaries must be individuals, estates, or certain tax-exempt organizations.
Generally, the trustee of the ESBT must file the ESBT election within 2 months and 16 days beginning on the day that the stock is transferred to the trust.

- If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of the tax year in which the S election is made, the trust must file the ESBT election within the 2-month-and-16-day period beginning on the day that the S election is effective.
Foreign Beneficiaries

- A potential current beneficiary of an ESBT may be a foreign person.
- However, if the foreign person has the powers granted in section 672(f)(2), the trust is not an eligible S corporation shareholder.
A QSST meets the following requirements:

- During the life of the Current Income Beneficiary there is only one income beneficiary who is a US citizen or resident.
- Distributions of trust principal are made to only the income beneficiary.
The income interest terminates on the beneficiary’s death or termination of the trust, whichever is earlier.

If the trust terminates during the current income beneficiary’s lifetime, the trust distributes all trust assets to that beneficiary.

The trustee makes annual distributions of income if the trust instrument does not require all trust income to be distributed annually.
QUALIFIED SUBCHAPTER S TRUSTS (CONTINUED)
P. 105

- The current income beneficiary must file a QSST election.
  ◦ The QSST election treats the trust as a grantor trust and the beneficiary as the owner of the part of the trust that consists of S corporation stock.
  ◦ The QSST and ESBT election deadlines are the same (2 months + 16 days).
Relief for Late Elections (RP 2013-30)

- The failure to properly file an ESBT or QSST election may result in an inadvertently invalid S corporation election, or in an inadvertent termination of an S corporation election.
- The taxpayer can make a late ESBT or QSST election within 3 years and 75 days after the date on which the trust election should have been effective.
- If that period has expired, the taxpayer can request a letter ruling.
• 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.
• Certain tax-exempt organizations can be S corporation shareholders.

• An eligible shareholder is an organization described in
  ◦ I.R.C. § 501(c)(3) (organizations organized and operated for charitable, religious, educational, and other specified purposes)
  ◦ I.R.C. § 401(a) (qualified pension, profit sharing, and stock bonus plans)
An S corporation must have a single class of stock.

This rule applies only to outstanding shares.

Differences in voting rights do not create multiple classes of stock.
The presence of a second class of stock is an emerging issue with the IRS.

In the last ten years the IRS has made over a dozen separate rulings on whether a second class of stock existed or not.

This is indicative of their emerging focus on the issue.
SECOND CLASS OF STOCK
NOT IN BOOK - CONTINUED

• The second class of stock can be intentional or UNINTENTIONAL.

• The greatest threat lies in the unintentional second class of stock.

• The basic rule is that each shareholder must have uniform distributions and no special preferences unlike a partnership.
• Each share of stock must confer identical rights to all current and liquidating distributions.

• This is a critical area that requires monitoring.

• No controlling shareholder can exercise their control by taking a disproportionate distribution of either cash or property.

• The S status will be in peril.
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
POLLING QUESTION #4

A second class of stock may exist:

1. Intentionally or unintentionally.
2. When one shareholder is allowed preferences in distributions.
3. When preferences exist in the organization’s documents.
4. All of the above.
• If an LLC elects to be taxed as an S corporation, the operating agreement may need to be amended
  ◦ to remove special income allocations, and
  ◦ provide for equal distributions of liquidation proceeds, per unit (share)
Buy-sell agreements, shareholder agreements that restrict the transfer of stock, and redemption agreements are disregarded unless:
  ◦ a principal purpose of the agreement is to circumvent the one class of stock requirement; and
  ◦ the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the FMV of the stock.
• Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded.
If restricted stock is issued in connection with the performance of services and is substantially nonvested, the stock is generally not treated as outstanding unless the holder makes an I.R.C. § 83(b) election.

- Certain call options, warrants, or similar instruments may be a second class of stock if
  - the exercise price is substantially below the FMV of the stock on the date of issue, and
  - they are substantially certain to be exercised.
• Call option issued to an employee or independent contractor in connection with services is not treated as stock if:
  ◦ the option is nontransferable, and
  ◦ has no readily ascertainable FMV when it is issued.

• Call options issued to a commercial lender in connection with a commercially reasonable loan are not treated as a second class of stock.
EQUITY ARRANGEMENTS (CONTINUED) P. 106

• However, if the call option is transferred without the transfer of a corresponding portion of the loan, the option must again be tested to determine if it constitutes a second class of stock.
POLLING QUESTION

#5

An agreement between shareholders that restricts minority shareholders from selling their stock to the S corporation at below fair market value:

1. Is a second class of stock.
2. Would probably revoke the S status of the corporation.
3. Both 1 and 2 above.
4. None of the above.
A company electing S corporation status must file Form 2553, Election by a Small Business Corporation, with the IRS Service Center (Kansas City or Ogden) where the company files (or will file) its tax returns.

- If an unincorporated entity is electing S corporation status as of the first day it is seeking entity classification as a corporation, the entity can file only Form 2553 and does not have to also file Form 8832.
The corporation can file Form 2553 by mail or by fax.

Figure 4.2 (P. 107) shows page 1 of Form 2553.
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.
• Form 2553 is due on or before:
  ◦ the fifteenth day of the third month of the tax year for which the election is to take effect; or
  ◦ If the company is in existence as a C corporation, it may file this election in the tax year preceding the tax year the status is to take effect.
POLLING QUESTION #6

In general, an election to an S corporation must be:

1. On or before the fifteenth day of the third month of the first year in which the election is to take effect.
2. Any time in the first year the election is to take effect.
3. Does not have to be filed.
4. None of the above.
For a new corporation, the tax year commences on the earliest of the following:
1. Issuance of shares
2. Acquisition of assets
3. Commencement of business
TIME FOR FILING (CONTINUED)  P. 108

• If the first tax year is less than 2 months and 15 days, the 2-month-and-15-day period may extend to the second tax year.
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.)
• Each shareholder who owns shares at the time of filing the S corporation election must consent to the election.
• Shareholders consent by signing Form 2553, or they can attach a separate consent statement.
• Figure 4.3 shows the Form 2553 consent.
• Figure 4.4 shows who must consent to the S election (P. 109).
FIGURE 4.3 FORM 2553 SHAREHOLDER CONSENT

P. 108

Form 2553 (Rev. 12-2017)

<table>
<thead>
<tr>
<th>Part I</th>
<th>Election Information (continued) Note: If you need more rows, use additional copies of page 2.</th>
</tr>
</thead>
<tbody>
<tr>
<td>K</td>
<td>Shareholder’s Consent Statement&lt;br&gt;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>

J Name and address of each shareholder or former shareholder required to consent to the election (see instructions)
### Figure 4.4 Required Consents for S Election

<table>
<thead>
<tr>
<th>If shares are held by</th>
<th>Person who must sign</th>
<th>Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Community property, tenants in common, joint tenants, tenants by the entirety</td>
<td>Each person holding an interest</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(i)</td>
</tr>
<tr>
<td>Minor</td>
<td>Self, parent, or legal representative</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(ii)</td>
</tr>
<tr>
<td>Estate</td>
<td>Executor or administrator, or other fiduciary appointed by testamentary instrument of the court</td>
<td>Treas. Reg. §1.1362-6(b)(2)(iii)</td>
</tr>
<tr>
<td>Trust</td>
<td>Person treated as the shareholder</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(iv)</td>
</tr>
<tr>
<td>QSST</td>
<td>Deemed owner (beneficiary)</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(iv)</td>
</tr>
<tr>
<td>ESBT</td>
<td>Trustee and, if a grantor trust, the deemed owner</td>
<td>Treas. Reg. § 1.1362-6(b)(2)(iv)</td>
</tr>
</tbody>
</table>
EXAMPLE 4.2 SHAREHOLDER CONSENT (CONTINUED)  

P. 109

FIGURE 4.5 Thornton Corporation Shares

<table>
<thead>
<tr>
<th>Date</th>
<th>Number of Shares</th>
<th>Shareholder</th>
<th>Shareholder Residence</th>
</tr>
</thead>
<tbody>
<tr>
<td>11/08/2019</td>
<td>100</td>
<td>Steve Thompson</td>
<td>California</td>
</tr>
<tr>
<td>12/15/2019</td>
<td>100</td>
<td>Lorraine Miles</td>
<td>Montana</td>
</tr>
<tr>
<td>01/10/2020</td>
<td>100</td>
<td>Susan Terry Revocable Trust</td>
<td>Ohio</td>
</tr>
</tbody>
</table>

- Thornton Corporation cannot file Form 2553 before November 8, 2019 (the date of incorporation).
EXAMPLE 4.2 SHAREHOLDER CONSENT (CONTINUED)  P. 109

Filing date of 2553

- November 8 - December 14, 2019
- December 15 - December 31, 2019
- January 1 – January 23, 2020

Required Consent

- Steve (and spouse if married: community property state)
- Steve (and spouse) and Lorraine
- Steve (and spouse) and Lorraine and Susan (deemed owner)
The IRS will accept a late consent if
1. filed within a reasonable period
2. reasonable cause
3. the interests of the government would not be jeopardized
• Inadvertently defective elections
• Late elections
• Different rules
DEFECTIVE ELECTION RELIEF  

- I.R.C. § 1362(f) provides relief for a corporation that filed a timely S election, but
  - inadvertently failed to meet the eligibility requirements, or
  - inadvertently neglected to include or misstated information on Form 2553.
- Within a reasonable time after discovery of the error, the corporation must become an eligible small business corporation.
- The taxpayer requests defective election relief (except for relief due to a late ESBT or QSUB election) by requesting a letter ruling.
I.R.C. § 1362(b)(5) instructs the IRS to treat late S corporation elections as timely filed if:
- Reasonable cause for the delinquency.
• Service centers can grant relief if
  ◦ The corporation files Form 2553 no more than 3 years and 75 days after the day the election was intended to become effective.
  ◦ The corporation must explain the reasonable cause for failure to timely file the election and its diligent actions to correct the mistake upon discovery.
  ◦ This information can be provided on line I of Form 2553 or on an attached statement.
Letter Ruling Request

If the corporation does not meet the requirements for relief from a late election from the service center, the corporation may file a request for a letter ruling from the IRS National Office and pay a user fee (currently $30,000).
A corporation can revoke its S election at any time.
- Revocation terminates the election
- Entity becomes a C corporation (even if it is unincorporated)
• To revoke the election, the corporation files a statement with the IRS service center where the S election was filed indicating the effective date of the revocation.
  ◦ Signed by any person authorized to sign income tax returns
  ◦ A statement of consent must be attached
  ◦ Consent signed by the holders of more than 50% of the stock (including nonvoting stock) on the date that the revocation is filed
ELECTION AFTER REVOCATION

• There is a general prohibition against making a new S corporation election if the corporation terminated an S election within 5 years.
  ◦ Thus, if a corporation decides to terminate its S status and become a C corporation, it must remain a C corporation for at least 5 years.
  ◦ If the corporation then decides to reelect S status, it may be subject to tax at the entity level (such as the built-in gains tax), discussed in Issue 6.
The IRS can reduce the reelection period to 1 year if the corporation meets the following two criteria:

1. There was a change in ownership of more than 50% of the corporation’s shares since termination of the prior election. and
2. The prior termination was beyond the control of the current shareholders.
This section reviews the classification of business entities and how an entity makes the S corporation election.

My opinion in advance on the selection of the S corporation versus choosing another form of entity.
Numerous other tax and nontax factors:
- Liability protection
- Step-up in basis of appreciated property after the death of an owner or sale of an owner’s interest
- Allowable type and number of owners
PRACTITIONER NOTE:
OTHER FACTORS TO CONSIDER - CONTINUED P. 111

- New partnership audit regime
- Tax rules that apply to entities with foreign income
- Availability of employee benefits
• 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.
Partnership Allocations

• 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 pay a flat 21% tax rate.

Distribution of earnings and profits is taxed to the shareholder.

Qualified dividends are taxed at the reduced tax rate of 0%, 15%, or 20%.

C corporation income is not eligible for the QBI deduction.

Dividends received from a C corporation are subject to the 3.8% NIIT.
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.
• 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.

• 2% or more shareholders of S corporations are singled out for what can be argued as discriminatory taxation.
• Figure 4.6 compares the attributes of partnerships, S corporations, C corporations, and disregarded entities.
FIGURE 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
<th>Partnerships</th>
<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity classification</td>
<td>Default status for multimember LLC</td>
<td>Elective status for multimember LLC or SMLLC if qualified for S corporation status and filing Form 2553</td>
<td>Elective status for multimember LLC or SMLLC filing Form 8832</td>
<td>Default status for SMLLC</td>
</tr>
<tr>
<td>Maximum number of equity interests</td>
<td>No maximum number</td>
<td>Maximum 100 shareholders (family members may be treated as one shareholder for this purpose)</td>
<td>No limitation</td>
<td>1</td>
</tr>
<tr>
<td>Classes of equity interests</td>
<td>No limitation</td>
<td>One class of stock (voting rights are disregarded in making this determination)</td>
<td>No limitation</td>
<td>N/A</td>
</tr>
</tbody>
</table>
FIGURE 4.6 (CONTINUED)  

FIGURE 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
<th>Partnerships</th>
<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ineligible entities</td>
<td>Generally, partnerships with equity interests that are publicly traded. Banks and certain insurance companies must use the corporate form</td>
<td>Foreign corporations; financial institutions using reserve method of accounting; insurance companies; DISCs and former DISCs</td>
<td>None</td>
<td>N/A</td>
</tr>
<tr>
<td>Eligible owners</td>
<td>All persons and entities eligible to be partners</td>
<td>Individuals, estates, and certain trusts, charities, and qualified retirement plans</td>
<td>All persons eligible</td>
<td>Individual</td>
</tr>
</tbody>
</table>
### FIGURE 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
<th>Partnerships</th>
<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign taxpayers</td>
<td>Eligible to be a partner; certain income subject to withholding tax</td>
<td>Ineligible to be a shareholder</td>
<td>Eligible to be a shareholder; dividends subject to withholding tax with possible reduced treaty rate</td>
<td>Eligible</td>
</tr>
<tr>
<td>Item</td>
<td>Partnerships</td>
<td>S Corporations</td>
<td>C Corporations</td>
<td>Disregarded Entity</td>
</tr>
<tr>
<td>--------------------</td>
<td>--------------</td>
<td>--------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------</td>
<td>------------------------------</td>
</tr>
<tr>
<td>Tax-exempt taxpayers</td>
<td>Eligible to be a partner; income subject to generally applicable unrelated business income tax</td>
<td>Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder. All items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of income and loss of ESOPs not included in unrelated business taxable income</td>
<td>Eligible to be a shareholder; dividend generally not subject to unrelated business income tax</td>
<td>Eligible to be an owner; income subject to generally applicable unrelated business income tax</td>
</tr>
<tr>
<td>Item</td>
<td>Partnerships</td>
<td>S Corporations</td>
<td>C Corporations</td>
<td>Disregarded Entity</td>
</tr>
<tr>
<td>--------------------</td>
<td>------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------</td>
<td>--------------------</td>
</tr>
<tr>
<td>Trusts</td>
<td>Eligible to be a partner; usual trust taxation rules apply</td>
<td>Only grantor trusts, testamentary trusts, qualified subchapter S trusts, and electing small business trusts</td>
<td>Eligible to be a shareholder; usual trust taxation rules apply</td>
<td>Eligible</td>
</tr>
<tr>
<td>Allocation of Income and losses</td>
<td>Allocation in accordance with partnership agreement if allocation is in accordance with each partner's interest in the partnership, or the allocation has substantial economic effect</td>
<td>Pro rata among shares on a daily basis</td>
<td>Not applicable (Income and losses do not pass through)</td>
<td>All to owner</td>
</tr>
</tbody>
</table>
### FIGURE 4.6 (CONTINUED)

#### FIGURE 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
<th>Partnerships</th>
<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limitation on losses</td>
<td>Losses limited to basis in partnership interest, which includes partner’s share of partnership debt. Subject to amount at risk, passive activity loss, and excess business loss limits</td>
<td>Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis. Subject to amount at risk, passive activity loss, and excess business loss limits</td>
<td>Losses deductible against corporate income; NOLs generally can be carried forward; capital losses generally can be carried back 3 years and forward 5 years</td>
<td>Subject to amount at risk, passive activity loss, and excess business loss limits</td>
</tr>
</tbody>
</table>
### Figure 4.6 (Continued)

#### Figure 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
<th>Partnerships</th>
<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions of unencumbered</td>
<td>Tax-free; built-in gain or loss allocated to contributing partner</td>
<td>Tax-free if contributors are in control of the corporation after the exchange;</td>
<td>Tax-free if contributors are in control of the corporation after the exchange;</td>
<td>N/A</td>
</tr>
<tr>
<td>property to entity</td>
<td></td>
<td>no special rules allocating built-in gain or loss to contributor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distributions of property</td>
<td>Generally tax-free; carryover or substituted basis to partner; partnership</td>
<td>Any gain in distributed property is recognized by the corporation and allocated to the shareholders; FMV basis to the shareholder</td>
<td>Any gain in distributed property taxable to the corporation; shareholder taxed if amount of distribution exceeds stock basis</td>
<td></td>
</tr>
<tr>
<td>(liquidating or otherwise)</td>
<td>may elect to make basis adjustment in partnership property to reflect adjustments to distributee partner</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>All business property treated as property of owner</td>
<td></td>
</tr>
</tbody>
</table>
FIGURE 4.6 (CONTINUED)

### FIGURE 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
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<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer of equity interests</td>
<td>Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price</td>
<td>Gain treated as capital; no adjustments to basis of corporate property</td>
<td>Gain treated as capital</td>
<td>Fully taxable as asset sale, unless contributed to partnership or controlled corporation</td>
</tr>
<tr>
<td>Termination of entity</td>
<td>Termination if not more than one owner, or ceases to carry on any business or investment</td>
<td>No provision</td>
<td>No provision</td>
<td>Generally, nontaxable</td>
</tr>
</tbody>
</table>
### FIGURE 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
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<th>C Corporations</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Treatment of C corporation converting to partnership or S corporation</td>
<td>Corporation must liquidate and gain or loss is recognized to corporation and shareholders</td>
<td>Generally no taxation upon election; corporate tax is imposed on built-in gain if assets sold during 5-year period after election effective; distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>
### FIGURE 4.6 (CONTINUED)  

**FIGURE 4.6 Comparison of Business Entities**

<table>
<thead>
<tr>
<th>Item</th>
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<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treatment of disregarded entity or partnership converting to C corporation or S corporation</td>
<td>Tax-free if transferors are in control of the corporation after the exchange; possible exception where contributed property is subject to debt</td>
<td>N/A</td>
<td>N/A</td>
<td>Tax-free if transferor is in control of the corporation after the exchange; possible exception where contributed property is subject to debt</td>
</tr>
</tbody>
</table>
FIGURE 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
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<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mergers and other reorganizations with corporations</td>
<td>Not eligible to engage in tax-free reorganization with corporation</td>
<td>Eligible party to a tax-free corporate reorganization</td>
<td>Eligible party to a tax-free corporate reorganization</td>
<td>Not eligible to engage in tax-free reorganization with corporation</td>
</tr>
</tbody>
</table>
## FIGURE 4.6 (CONTINUED)

**FIGURE 4.6 Comparison of Business Entities**

<table>
<thead>
<tr>
<th>Item</th>
<th>Partnerships</th>
<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate tax rules of subchapter C</td>
<td>Rules inapplicable</td>
<td>Rules generally applicable, with certain exceptions</td>
<td>Rules applicable</td>
<td>Rules inapplicable</td>
</tr>
<tr>
<td>Wholly owned corporate subsidiary</td>
<td>Corporation treated as separate entity</td>
<td>Parent corporation may elect to treat wholly owned subsidiary as disregarded entity</td>
<td>Not subject to tax on dividends or liquidating distributions paid between wholly owned subsidiaries. May be eligible to file consolidated returns</td>
<td>Corporation treated as separate entity</td>
</tr>
<tr>
<td>Federal income tax rates</td>
<td>All income is allocated to owners and taxed at their rates</td>
<td>All income that exceeds reasonable compensation to owner employees is allocated to owners and taxed at their rates</td>
<td>All income that exceeds reasonable compensation to owner employees is taxed at a flat 21% rate</td>
<td>All income is taxed to the individual owner</td>
</tr>
</tbody>
</table>
**FIGURE 4.6 Comparison of Business Entities**

<table>
<thead>
<tr>
<th>Item</th>
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<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Application of employment and SE taxes</td>
<td>Except in certain cases involving a limited partner, each partner’s share of net business income is net earnings from SE</td>
<td>Amounts paid as reasonable compensation to a shareholder-employee are wages subject to employment tax; no amount of shareholder’s share of S corporation income is net earnings from SE</td>
<td>Amounts paid as compensation are wages subject to employment tax; no amounts are net earnings from SE</td>
<td>Net business income is net earnings from SE</td>
</tr>
</tbody>
</table>
### FIGURE 4.6 Comparison of Business Entities

<table>
<thead>
<tr>
<th>Item</th>
<th>Partnerships</th>
<th>S Corporations</th>
<th>C Corporations</th>
<th>Disregarded Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treatment of earnings as investment income for purposes of the net investment income tax (NIIT)</td>
<td>Business income of limited partners who are not active in the business and that is not net earnings from SE is treated as investment income for the NIIT</td>
<td>Business income of shareholders not active in the business is treated as investment income for the NIIT</td>
<td>Dividends paid to individuals are treated as investment income for the NIIT</td>
<td>Subject to NIIT unless section 1231 gain or income subject to SE tax</td>
</tr>
<tr>
<td>Qualified business income</td>
<td>QBI, W-2 wages, and qualified property passed through to eligible partners</td>
<td>QBI, W-2 wages, and qualified property passed through to shareholders</td>
<td>Not eligible for QBI deduction</td>
<td>QBI, W-2 wages, and qualified property used to calculate the owner’s QBI deduction</td>
</tr>
</tbody>
</table>
SHAREHOLDER BASIS IN S CORPORATIONS
This section explains how to determine, adjust, and report shareholder stock and debt basis.
The shareholder has an initial basis in his or her stock at the time of acquisition.

The shareholder then increases basis each year for his or her share of the corporation’s income and decreases basis for the shareholder’s share of deductions and losses.

Distributions (other than dividends from accumulated earnings and profits) also reduce basis.
Recordkeeping

• An S corporation shareholder must maintain adequate books and records to substantiate his or her basis.

• IRS can impose penalties for a failure to maintain books and records to substantiate basis.
In reality, the penalty that the IRS will impose is to simply disallow the basis of the shareholders and any according losses that they claimed.
SHAREHOLDER BASIS - GENERAL RULE

- Essentially, the computation of the basis of a given shareholder is an “off the books” separate analysis that usually cannot be readily calculated from a review of the tax balance sheet.

- The taxpayer is responsible for calculating the current basis and the IRS requires that you calculate the change from the first day. Otherwise, ...........
BASIS – COMPUTATION
NOT IN BOOK

Barnes

➢ A precedential case that involves the lack of accurate basis computations from year to year.

➢ In a nine year span, the S corporation had one year of profit (sixth one) and losses for the remaining eight years in this period.

➢ The corporation made a mistake and reported a gain in the second year instead of a substantial loss which was actually incurred.
In the third year following the mistake in the second year, the corporation did not reduce their basis by a loss as required and deduct the same.

The effect of these “mistakes” was to totally alter the true basis computation for the shareholders.

This resulted in a “rolling” mistake that naturally affected every subsequent year.
The IRS audited the S corporation, determined the errors by analyzing the nine years, and produced a corrected at risk basis for the corporation applying to the shareholders.

The IRS then disallowed the losses claimed in the most recent years.
The taxpayers argued this was wrong since they had claimed income rather than a loss, even though it was erroneous, resulting in an increased basis to allow the disallowed losses.

Also, the taxpayers argued that the statute was expired on that year thus making the income inclusion “locked” and not subject to being removed.
The Court made an important ruling regarding these computations in stating that “basis may not be adjusted on an erroneous inclusion, omission, or computation.”

The Court stated that the IRS had the statutory power in absence of accepting the taxpayer’s basis calculation to compute the taxpayer’s true basis for the entire period regardless of statute expirations as it affected open years.
This resulted in the IRS disallowing losses in open years, suspending same, and producing a much larger negative basis to overcome.

This was a very significant conclusion reached by the Court.
The irony of this case, which is also statutory, is that the taxpayers had reported the erroneous income from the S corporation on their forms 1040 from the second year but because the statute was closed, could not receive a refund resulting from amending their returns to reflect the IRS victory.

Thus, they lost the tax benefits of losses in subsequent open years and could not receive a compensating refund from the IRS calculation doing so.
This case establishes a clear precedent as to an agent examining basis in this detail and my thoughts are....
RECREATING A SHAREHOLDER’S BASIS – WHAT TO DO? NOT IN BOOK

In light of the requirement of the IRS in an examination that the shareholder must prove the basis from the first day of his or her ownership which has been unanimously supported by the courts, what should the practitioner do when he or she is confronted by a new client that has an S corporation and no record of a basis computation or one that is poorly maintained?
Obtain copies of all prior forms 1120S and keep them in your open files for a period of at least 3 years after you have ceased preparing the S corporate return or shareholder’s return.

Obtain copies of all prior forms 1040 and reconcile them to each year of the client’s ownership of an interest in the S corporation.
RECREATING A SHAREHOLDER’S BASIS – WHAT TO DO? – NOT IN BOOK - CONTINUED

- Keep copies of the form 1040 for all years of the client’s ownership interest in the S corporation in your open files until at least 3 years after you cease preparing the client’s returns or when they no longer have ownership in the S corporation.

- Try to complete the basis to the extent that you can and...amend prior errors in the computation that you detect that were done by someone else and...
Keep your fingers crossed and hope that.......!!
POLLING QUESTION #7

With regards to an individual shareholder’s basis in an S corporations, he or she is required to maintain a computation:

1. From the beginning of his or her ownership.
2. Not required to maintain the computation.
3. Prove the entries to the computation of basis.
4. Numbers 1 and 3 only.
BASIS AT TIME OF ACQUISITION  

- **How Acquired**
  - §351 Incorporation
  - Purchase
  - Decedent
    - Except imputed IRD
    - Imputed IRD
  - Gift
    - Before 1977
    - After 1976
    - Any if FMV < donor basis
  - Compensation

- **Beginning Basis**
  - Basis in property contributed to corporation
  - Cost
  - FMV or zero
    - FMV on date of death or alternate valuation date
    - Zero
  - Generally donor basis
    - Add gift tax (≤ FMV)
    - Add gift tax on appreciation
    - Limit to FMV for loss
  - Gross income on receipt
In 2020, Jeannie Bird inherited all the stock in Jayco.

Jayco is a cash method S corporation.

FMV of the stock on the date of death was $1,000,000

Accounts receivable on the date of death $450,000

Jeannie’s initial basis in the Jayco stock is

FMV $1,000,000

Less cash method receivable ( 450,000)

Basis $550,000

Jeannie includes the accounts receivable in income when Jayco collects the receivables, and Jeannie’s basis increases to $1,000,000 [550,000 + 450,000].
Stock Inherited in 2010

• Stock inherited from a decedent who died in 2010 may have a modified carryover basis if the executor elected to have no estate tax imposed.
• A shareholder’s basis is adjusted annually for the shareholder’s allocable portion of the S corporation’s income and loss, and for distributions.
  ◦ An income item increases stock basis.
  ◦ A loss, deduction, or distribution decreases stock basis.

• If there is more than one shareholder, the corporation must generally allocate each income and loss item on a per-day, per-share basis.
• An exception applies if a shareholder’s entire interest in the S corporation terminates and the corporation elects to treat the tax year as two short tax years.

• An election to terminate the year may also be allowed if there is a substantial disposition or issuance of stock.

• The first tax year ends at the end of the day on which the shareholder’s entire interest terminates.
• Adjustments to basis are made annually on the last day of the S corporation year (or immediately before the disposition of S corporation stock).

• Under the general rules, adjustments are made in the following order:
  1. Income items, including tax-exempt income and separately stated income, and excess depletion increase basis.
  2. Distributions (other than dividends from the corporation’s accumulated earnings and profits) decrease basis, but not below zero.
  3. Nondeductible, noncapital expenses and depletion decrease basis, but not below zero.
  4. Items of loss and deduction decrease basis, but not below zero.
EXAMPLE 4.4 ADJUSTING SHAREHOLDER BASIS
PP. 118-119

- Cheryl Sims is the sole shareholder of Sims Corporation.
- On January 1, 2020, Cheryl’s basis in the corporation was $15,000
- In 2020, the corporation had:
  - Ordinary loss $20,000
  - Net section 1231 gain $4,000
  - Cash contribution to a charity $5,000
  - Nondeductible expenses $1,000
  - Distributed to Cheryl $12,000
### FIGURE 4.7 SCHEDULE K-1

#### Part I: Information About the Corporation
- A. Corporation's employer identification number: 00-0000000
- B. Corporation's name, address, city, state, and ZIP code: Siens Corporation
  100 Pine Street
  Seattle, WA 98107
- C. IRS Center where corporation filed return: Otho

#### Part II: Information About the Shareholder
- D. Shareholder's identifying number: 000-00-0000
- E. Shareholder's name, address, city, state, and ZIP code: Cheryl Siens
  500 Primacy Avenue
  Seattle, WA 98103
- F. Shareholder's percentage of stock ownership for tax year: 100%

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

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Ordinary business income/loss</td>
<td>0.000</td>
</tr>
<tr>
<td>2</td>
<td>Net rental real estate income/loss</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Other rental income/loss</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Interest income</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Ordinary dividends</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Qualified dividends</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Foreign transactions</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Royalties</td>
<td></td>
</tr>
<tr>
<td>9a</td>
<td>Net short-term capital gain/loss</td>
<td></td>
</tr>
<tr>
<td>9b</td>
<td>Net long-term capital gain/loss</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Dividends received deduction</td>
<td>4,000</td>
</tr>
<tr>
<td>11</td>
<td>Other income</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Alternative minimum tax (AMT) tax</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Credits</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Item affecting shareholder basis</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Other deductions</td>
<td></td>
</tr>
</tbody>
</table>

| A. | 5,000 | D. | 12,000 |
Beginning stock basis $15,000
Increase for income items 4,000
Basis before distribution $19,000
Distribution (12,000)
Basis before loss items $ 7,000
Decrease for nondeductible expenses (1,000)
Basis before loss and deduction items $ 6,000
Allowable ordinary business loss* (4,800)
Allowable cash contributions* (1,200)
Ending stock basis $ 0

* The $6,000 allowed loss items must be allocated between the $5,000 charitable contribution deduction and the $20,000 ordinary loss.

Of the total $25,000 loss items,
- 80% ($20,000 ÷ $25,000) is the ordinary loss
- 20% ($5,000 ÷ $25,000) is the charitable contribution deduction.

$4,800 ($6,000 × 80%) of the allowed loss is ordinary
$1,200 ($6,000 × 20%) is charitable contribution
Cheryl’s 2020 loss is limited to $4,800.
- She can carry over the suspended $15,200 ($20,000 − $4,800) loss to 2021, which may again be limited by Cheryl’s basis in the corporation.

- Cheryl can claim a $1,200 cash contribution on Schedule A (Form 1040), subject to the contribution limitations.

- If she does not itemize deductions, she can claim a $300 above-the-line charitable contribution deduction.

- She can carry over the remaining $3,800 ($5,000 − $1,200) to 2021.
Other Loss Limitations

• In addition to the basis limitations, a shareholder’s loss may be limited by the at-risk rules and the passive activity loss limitations.

• See pages 85–107 in the 2017 National Income Tax Workbook for a discussion of these rules.
Under the general ordering rule:

1. Nondeductible expense items, such as the 50% disallowed meal expense, reduce basis before other items of loss and deduction.

2. If the nondeductible items exceed available basis, the shareholder’s basis is reduced to zero.

3. There is no carryforward of excess nondeductible items.
At the beginning of 2020, Joanna’s basis in her stock was $5,000.

In 2020, LTB had
- $4,500 ordinary loss,
- $1,500 disallowed meals

The corporation had no income items, and Joanna received no distributions.

Under the general rule,
- Beginning basis $5,000
- Disallowed meal expenses (1,500)
- Joanna’s basis before loss $3,500
- She can deduct $3,500 of the corporation’s ordinary loss.
- The $1,000 loss ($4,500 loss less $3,500 deduction) that exceeds her basis is carried forward.
A shareholder can elect to decrease basis by items of loss or deduction before the nondeductible expenses.

If a shareholder makes this election, any amount of nondeductible expenses that exceeds the shareholder’s basis in stock and indebtedness is treated, for purposes of calculating basis, as nondeductible expenses in the next tax year.
EXAMPLE 4.6
ELECTIVE ORDERING IS ADVANTAGEOUS  P. 120

- At the beginning of 2020, Joanna’s basis in her stock was $5,000.
- In 2020, LTB had
  - $4,500 ordinary loss,
  - $1,500 disallowed meals
- The corporation had no income items, and Joanna received no distributions.

Under the elective rule,

- Beginning basis $5,000
- Ordinary loss (4,500)
- Joanna’s basis before ND $ 500
- Less ND expense ( 500)
- Basis $ 0

She can deduct all the ordinary loss.

The remaining $1,000 nondeductible expense ($1,500 - $500) is carried forward.
EXAMPLE 4.7
ELECTIVE ORDERING IS NOT ADVANTAGEOUS P. 121

• The facts are the same as in Example 4.6 except that
  ◦ the 2020 nondeductible expense was a $50,000 fine
  ◦ fine was nondeductible and the ordinary loss was still $4,500

• Figure 4.9 compares Joanna’s basis calculations with the general rule and the elective ordering rule.
<table>
<thead>
<tr>
<th>General Rule</th>
<th>Elective Ordering Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Beginning basis</td>
<td>• Beginning basis</td>
</tr>
<tr>
<td></td>
<td>$ 5,000</td>
</tr>
<tr>
<td>• Nondeductible expense</td>
<td>• Allowable ordinary business loss</td>
</tr>
<tr>
<td></td>
<td>(4,500)</td>
</tr>
<tr>
<td>• Adjusted basis</td>
<td>• Adjusted basis</td>
</tr>
<tr>
<td></td>
<td>$ 500</td>
</tr>
<tr>
<td>• Allowable ordinary business loss</td>
<td>• Allowable nondeductible expense</td>
</tr>
<tr>
<td></td>
<td>(500)</td>
</tr>
<tr>
<td>• Ending basis</td>
<td>• Ending basis</td>
</tr>
<tr>
<td></td>
<td>$ 0</td>
</tr>
<tr>
<td>• Carryforward to next year</td>
<td>• Carryforward to next year</td>
</tr>
<tr>
<td>• Nondeductible expense</td>
<td>• Non deductible expense</td>
</tr>
<tr>
<td></td>
<td>$ 0</td>
</tr>
<tr>
<td>• Ordinary loss</td>
<td>• Ordinary loss</td>
</tr>
<tr>
<td></td>
<td>$ 4,500</td>
</tr>
<tr>
<td></td>
<td>$ 49,500</td>
</tr>
<tr>
<td></td>
<td>$ 0</td>
</tr>
</tbody>
</table>
SHAREHOLDER BASIS AND DEBT

LOANS
• A shareholder obtains debt basis by loaning the S corporation money or property in which the shareholder has basis.

• There must be *bona fide indebtedness* from the corporation to the shareholder.
In addition to what we have just discussed, a shareholder’s basis is increased by their loans to the corporation.

Despite repeated court challenges, the basic rule is that a shareholder has basis in the corporation ONLY to the extent that they are the DIRECT creditor. This is different than the rule for partnerships in which the partner has basis to the extent of their DIRECT or INDIRECT (e.g., guarantees) position as a creditor.
This rule is absolute despite repeated attempts to challenge the increase in basis by a number of indirect strategies to increase basis.

This is an issue that the IRS has a zero tolerance in accepting and requires a strict compliance with the requirement to increase basis by a loan that must include a DIRECT ECONOMIC OUTLAY.

The converse is true that the repayment of a loan that qualifies to increase basis decreases basis as it is repaid.
• A shareholder does not obtain basis of indebtedness in the S corporation merely by
  ◦ Guaranteeing a loan
  ◦ Acting as a surety, accommodation party
  ◦ Acting in a similar capacity relating to a loan

• When a shareholder makes a payment on bona fide indebtedness of the S corporation the shareholder may increase the basis of his or her indebtedness to the extent of that payment.
POLLING QUESTION #8

A shareholder may increase their basis in an S corporation with a loan as long as:

1. They guarantee the loan.
2. They make a direct economic outlay to the corporation.
3. They are a co-guarantor with the S corporation.
4. None of the above.
• Claire Conrad is the sole shareholder of Glacier, Inc., an S corporation.
  ◦ In 2018, Claire guaranteed a $100,000 bank loan made to Glacier.
  ◦ In 2020, Glacier was unable to make the loan payments,
  ◦ Claire used her personal funds to pay $20,000 of loan principal on
    Glacier’s behalf.

• The loan guarantee does not affect Claire’s basis in 2018.

• Her $20,000 principal payment increases her basis by $20,000 in 2020.
The IRS ruled that the shareholder’s execution of a promissory and bank’s acceptance of the note caused the indebtedness of the corporation to accrue to the shareholder.

- Created a basis in the indebtedness
FIGURE 4.10
SUBSTITUTION OF PROMISSORY NOTE FOR GUARANTEE P. 122
S CORPORATION DEBT BASIS

- Ltr. Rul. 8747013
- S corporation pledged its assets to the lender as security for a loan.
  - The shareholders guaranteed the loan.
- The shareholders then borrowed money from the lender and loaned the funds to the corporation so that it could pay the loan.
- The S corporation’s assets secured the loan to the shareholders.
- The IRS ruled that the shareholders had debt basis in their loan to the corporation.
• In *Gilday v. Commissioner*, the shareholders initially guaranteed a loan to an S corporation.
  ◦ The shareholders later gave the bank a promissory note in satisfaction of the corporation’s indebtedness.
  ◦ The corporation gave the shareholders a promissory note for the amount owed to the bank.

• The court found that the shareholders moved from the position of guarantors to primary obligors on the loan from the bank.
Most courts have held that there is no attributed basis for loans made by related parties.

- See *Prashker v. Commissioner*
- In Rev. Rul. 69-125, the IRS ruled that a loan from a partnership to an S corporation where the partners and S corporation shareholders were the same persons did not constitute indebtedness of the corporation to the shareholders.
In *Culnen v. Commissioner*, a shareholder owned controlling interests in two S corporations.

One corporation advanced funds to another, so that the shareholder could claim basis in the recipient corporation.

- The corporation advancing the funds recorded the advances as distributions to the shareholder.
The recipient corporation recorded the funds as loans from the shareholder.

- Both corporations recorded and reported the transactions consistently.
- The court found that the shareholder had debt basis in the recipient corporation.
- See also Yates v. Commissioner.
• Treas. Reg. § 1.1366-2(a)(2)(iii), Example 1, provides that a shareholder can make a loan to an S corporation through an entity that is disregarded as separate from the shareholder.

  ◦ For example, an SMLLC is a disregarded entity, and a loan by the LLC to the S corporation is treated as a loan from the LLC’s sole member to the S corporation, which creates debt basis.
• Under Treas. Reg. § 1.1366-2, back-to-back loans create basis.
• In a back-to-back loan,
  1. shareholder borrows money (possibly from a related entity)
  2. shareholder lends the money to the S corporation
• The arrangement must constitute bona fide indebtedness from the S corporation to the shareholder.
EXAMPLE 4.9 BACK-TO-BACK LOAN

P. 123

- Andy Bennett owns all the stock of two S corporations
  - Andy Co.
  - Bennett Co.
- Andy borrowed $50,000 from Andy Co. and loaned the $50,000 to Bennett Co.
- If the loan from Andy to Bennett Co. constitutes bona fide indebtedness from Bennett Co. to Andy, Andy’s back-to-back loan increases his basis of indebtedness in Bennett Co. by $50,000.
In Seven Sixty Ranch Co., the S corporation shareholder personally borrowed money from banks for the S corporation business operations.

Later, the S corporation gave the shareholder promissory notes for the amounts that the shareholder borrowed from the banks.
• The court found that the notes from the corporation to the shareholder evidenced money borrowed from a commercial lending institution on behalf of the corporation and were bona fide debts.

• Thus the shareholder had basis.
In *Oren v. Commissioner*, the S corporation shareholder borrowed from one controlled entity and loaned the funds to other controlled entities, which then loaned the money back to the corporation that was the original source of funds.

The court found that the circular lending arrangement between a shareholder and his wholly owned corporations had no actual economic outlays or amounts at risk.
Similarly, in Kaplan v. Commissioner, the court found that loans to the S corporation lacked economic substance.

1. S corporation shareholder borrowed money from a bank.
2. The shareholder pledged bank accounts of two wholly owned S corporations as security for the loan.
3. The shareholder loaned the borrowed funds to the two S corporations and deposited the funds in the pledged bank accounts.
4. The corporations returned the funds to the shareholder.
5. He repaid the bank loan 11 days after the original loan.

- The court found that the various disbursements between the taxpayer and his S corporations were the equivalent of offsetting bookkeeping entries, and the shareholder made no economic outlay.
ADJUSTMENTS TO S CORPORATION DEBT BASIS
PP. 123-124

- If a shareholder’s portion of an S corporation’s losses does not exceed his or her stock basis, there will never be an adjustment to debt basis.

- If, however, the shareholder’s portion of losses exceeds the stock basis, debt basis must be adjusted as follows:
  - In the year of the loss, after the stock basis is reduced to zero, the shareholder reduces debt basis.
  - In a subsequent year when the corporation reports income, the shareholder will restore debt basis before increasing stock basis.
• Bigtime, Inc. is an S corporation.

• 2019, Bigtime $100,000 ordinary loss
  ◦ Beginning of 2019, stock basis of $60,000 and debt basis of $50,000
  ◦ The 2019 loss reduced Jimmy’s stock basis to $0 and his debt basis to $10,000

• In 2020, Bigtime $140,000 ordinary income
  ◦ Restores Jimmy’s debt basis to $50,000
  ◦ Increases Jimmy’s stock basis to $100,000

---

### Example 4.10 Debt Basis Adjustments

#### 2019

<table>
<thead>
<tr>
<th>Stock Basis</th>
<th>Debt Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>$60,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>1. (60,000)</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>(40,000)</td>
</tr>
<tr>
<td>End</td>
<td>$0</td>
</tr>
</tbody>
</table>

#### 2020

| 1.  | 40,000 |
| 2.  | 100,000 |
| End | $100,000 | $50,000 |
As previously discussed, the IRS LB&I Division compliance campaign is focusing on S corporation basis reporting, and S corporation shareholders may be required to file basis calculations with their tax returns.

- There is a box on Schedule E (Form 1040), Supplemental Income and Loss, to indicate whether basis reporting is required.
Schedule E (Form 1040 or 1040-SR) 2019

Name(s) shown on return. Do not enter name and social security number if shown on other side.

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

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

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered “Yes,” see instructions before completing this section.

<table>
<thead>
<tr>
<th>Line</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>28</td>
<td>A</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>B</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>C</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>D</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**Worksheet for Figuring a Shareholder's Stock and Debt Basis**

**Part I—Shareholder Stock Basis**

1. Stock basis at the beginning of the corporation's tax year
   
2. Basis from any capital contributions made or additional stock acquired during the tax year

3a. Ordinary business income (losses go on Part III)

3b. Net rental real estate income (losses go on Part III)

3c. Other net rental income (losses go on Part III)

3d. Interest income

3e. Ordinary dividends

3f. Royalties

3g. Net capital gains (losses go on Part III)

3h. Net section 1231 gain (losses go on Part III)

3i. Other income (losses go on Part III)

3j. Excess depletion adjustment

3k. Tax-exempt income

3l. Recapture of business credits

3m. Other items that increase stock basis

4. Add lines 3a through 3m

5. Stock basis before distributions. Add lines 1, 2, and 4

6. Distributions (excluding dividend distributions)

   Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.

7. Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0, skip lines 8 through 14, and enter -0 on line 15

8a. Nondeductible expense

8b. Depletion for oil and gas

9. Add lines 8a and 8b

10. Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0, skip lines 11 through 14, and enter -0 on line 15

11. Allowable loss and deduction items. Enter the amount from Part III, line 1, column (d)

12. Debt basis restoration (see net increase in instructions for Part III, line 6)

13. Other items that decrease stock basis

14. Add lines 11, 12, and 13

15. Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0.
### Figure 4.12
Worksheet for Figuring Basis

**Part II—Shareholder Debt Basis**

<table>
<thead>
<tr>
<th>Amount of Debt</th>
<th>Debt 1</th>
<th>Debt 2</th>
<th>Debt 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Loan balance at the beginning of the corporation's tax year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Additional loans (see instructions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Loan balance before repayment. Combine lines 1 and 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Principal portion of debt repayment (this line doesn't include interest)</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td></td>
</tr>
<tr>
<td>5. Loan balance at the end of the corporation's tax year. Combine lines 3 and 4</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>

**Adjustments to Debt Basis:**

<table>
<thead>
<tr>
<th></th>
<th>Debt 1</th>
<th>Debt 2</th>
<th>Debt 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Debt basis at the beginning of the corporation's tax year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Enter the amount, if any, from line 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Debt basis restoration (see instructions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Debt basis before repayment. Combine lines 6, 7, and 8</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Divide line 9 by line 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Nonreimbursable debt repayment. Multiply line 10 by line 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Debt basis before nonreimbursable expenses and losses. Subtract line 11 from line 9</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Nonreimbursable expenses and oil and gas depletion deductions in excess of stock basis</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14. Debt basis before losses and deductions. Subtract line 13 from line 12. If the result is zero or less, enter 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15. Allowable losses in excess of stock basis. Enter the amount from Part III, line 13, column (b)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16. Debt basis at the end of the corporation's tax year. Subtract line 15 from line 14. If the result is zero or less, enter 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Gains on Loan Repayment:**

<table>
<thead>
<tr>
<th></th>
<th>Debt 1</th>
<th>Debt 2</th>
<th>Debt 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17. Repayment. Enter the amount from line 4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18. Nonreimbursable repayments. Enter the amount from line 11</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19. Reportable gains. Subtract line 18 from line 17</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**FIGURE 4.12 WORKSHEET FOR FIGURING BASIS P. 127**

Part III—Allowable Loss and Deduction Items

<table>
<thead>
<tr>
<th></th>
<th>(a) Current year losses and deductions</th>
<th>(b) Carryover amounts (column (a) from the previous year)</th>
<th>(c) Allowable loss from stock basis</th>
<th>(d) Allowable loss from debt basis</th>
<th>(e) Carryover amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Ordinary business loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Net rental real estate loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Other net rental loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Net capital loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Net section 1231 loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Other loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Section 179 deductions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>Charitable contributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9.</td>
<td>Investment interest expense</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10.</td>
<td>Section 59(e)(2) expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11.</td>
<td>Other deductions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12.</td>
<td>Foreign taxes paid or accrued</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13.</td>
<td><strong>Total Loss. Combine lines 1 through 12 for each column. Enter the total loss in column (c) on line 11 of Part I and enter the total loss in column (d) on line 15 of Part II.</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Dear [Taxpayer],

Our research indicates you may have claimed pass-through loss or deduction items in excess of your basis in stock and debt in [S CORPORATION, TIN].

Section 1366(d)(1) of the Internal Revenue Code (IRC) states that the loss and deduction items taken into account by an S corporation shareholder cannot exceed the shareholder's basis in stock and debt. Generally, loss or deduction items not allowed because of the basis limitation can be carried forward and deducted in a later year, depending on the basis limitation for that later year.

Our records indicate you didn't attach an adjusted basis computation schedule to your federal income tax return. You are required to compute and attach an adjusted basis computation schedule under IRC Section 1367 and Treasury Regulation Section 1.1367-1(b). You must attach the schedule to your return as directed in the instructions to Form 1040, Schedule K-1, Supplemental Income and Loss.

Please provide your adjusted basis computation schedule at the address above, along with a copy of this letter, by the response due date. You can refer to the Shareholder's Instructions for Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., at www.irs.gov/forms-pubs for more information.

If you claimed loss or deduction items in excess of your basis in stock and debt, file Form 1040X, Amended U.S. Individual Income Tax Return or amend Form 1041, U.S. Income Tax Returns for Estates and Trust, whichever is applicable, to correct your errors for the tax periods listed above. Mail the amended form to the address above. You can find Forms 1040X and 1041 at www.irs.gov/forms-pubs.

Please remember that after applying the basis limitation, the deduction amount of your aggregated losses and deductions may be further reduced by the at-risk rules and the passive activity loss rules. For more information, see Publication 925, Passive Activity and At-Risk Rules, at www.irs.gov/forms-pubs.

We enclosed a copy of this letter for your records. This letter is not an audit of your tax return.

If you have questions, contact the person listed at the top of this letter.
DISTRIBUTIONS
This section explains the tax treatment of distributions from S corporations to their shareholders.
S corporations may distribute cash to their shareholders. The tax treatment of those distributions depends on the taxpayer’s basis in his or her S corporation stock, and whether the S corporation has accumulated earnings and profits (AE&P) from a prior year when it was a C corporation. An S corporation may also distribute noncash assets to its shareholders.
• Once again, the IRS LB&I Division has undertaken a campaign to educate S corporations and their shareholders about the following distribution issues:
  1. Failure to report tax on nondividend distributions that exceed stock basis
  2. Failure to determine that a distribution, whether in cash or in property, is taxable as a dividend
1. Failure to report gain on the distribution of appreciated property to a shareholder
2. Computation of distributions from S corporations with accumulated earnings and profits
If the S corporation does not have AE&P, the tax treatment of cash distributions depends on the shareholder’s stock basis.

- If the distributions do not exceed adjusted stock basis, the shareholder receives the distribution tax-free and reduces basis by the amount of the distribution.
NONDIVIDEND DISTRIBUTIONS – CONTINUED - P. 129

• The calculation is made at the end of the year, and the shareholder’s pro rata share of the corporation’s income items increases basis before basis is reduced by distributions.
  ◦ See the earlier discussion of basis adjustments, PP. 118-122.

• Debt basis is not considered when determining the taxability of a distribution.
• Distributions from an S corporation that exceed the shareholder’s basis are treated as a gain from a deemed sale of the stock.
  ◦ Stock is a capital asset for most taxpayers, and the gain is a capital gain.
  ◦ It is a long-term capital gain if the stock has been held for longer than one year.
• Nondividend distributions are reported on
  ◦ Schedule K-1 (Form 1120-S box 16 with code “D.”)
• Dividend distributions (discussed later) are reported on Form 1099-DIV.
EXAMPLE 4.11 NONTAXABLE DISTRIBUTION

P. 129

• Deborah Burke is the sole shareholder in Medco, Inc., an S corporation.
• Medco has no AE&P.
• In 2020, Medco had
  ◦ $90,000 of section 1231 gains
  ◦ $50,000 ordinary loss
  ◦ $120,000 distribution to Deborah
• Her stock basis was $150,000 on January 1, 2020.
• Figure 4.14 shows Deborah’s 2020 basis adjustments.
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis at beginning of year</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>Current-year income</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Basis before distribution</td>
<td>$240,000</td>
<td>The $120,000 distribution to Deborah did not exceed her $240,000 basis.</td>
</tr>
<tr>
<td>Distribution</td>
<td>(120,000)</td>
<td>Deborah does not include the distribution in her income.</td>
</tr>
<tr>
<td>Basis before loss</td>
<td>$120,000</td>
<td>She reduces her basis by the amount of the distribution.</td>
</tr>
<tr>
<td>Loss</td>
<td>(50,000)</td>
<td></td>
</tr>
<tr>
<td>Ending basis</td>
<td>$70,000</td>
<td></td>
</tr>
</tbody>
</table>
**EXAMPLE 4.12 TAXABLE DISTRIBUTION**  

- Same except basis at beginning of year was $10,000

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis at beginning of year</td>
<td>$10,000</td>
</tr>
<tr>
<td>Current-year income</td>
<td>90,000</td>
</tr>
<tr>
<td>Basis before distribution</td>
<td>$100,000</td>
</tr>
<tr>
<td>Distribution</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Basis before loss</td>
<td>$ 0</td>
</tr>
<tr>
<td>Loss</td>
<td>( 0)</td>
</tr>
<tr>
<td>Ending basis</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

- The $120,000 distribution reduces her basis to $0.
- Deborah has a $20,000 ($120,000 − $100,000) gain.
- She cannot deduct any of the $50,000 loss in the current year.
• An S corporation does not accumulate E&P.
• If the S corporation was previously a C corporation (or acquired assets from a C corporation in a reorganization) it may have AE&P.
• The distribution of AE&P creates a taxable dividend.
• Thus, an S corporation that has E&P must maintain an accumulated adjustments account (AAA) and an AE&P account to determine the tax effect of distributions during years as an S corporation.
ACCUMULATED ADJUSTMENTS ACCOUNT P. 130

• Distributions from an S corporation are generally treated as if they were made first from the S corporation’s income, and then from AE&P.

• The AAA tracks the income that the S corporation has earned but not yet distributed.
• Distributions that do not exceed the balance in the AAA reduce a shareholder’s basis (and result in capital gain if the distribution exceeds the shareholder’s basis) in the same manner as a distribution from an S corporation that does not have AE&P.

• The AAA is an account of the S corporation and is not apportioned among the shareholders.

• The corporation reports the AAA on Schedule M-2 (Form 1120-S).
A new S corporation (or a corporation that has newly elected S corporation status) starts with a zero balance in its AAA.

Each year, the corporation must adjust its AAA.

All taxable (but not tax-exempt) items of S corporation income increase AAA.
• AAA is decreased by items of loss or deduction
  ◦ except for nondeductible expenses related to tax-exempt income and federal taxes attributable to any tax year in which the corporation was a C corporation.
  ◦ These items may decrease AAA below zero.
• Distributions reduce AAA (but not below zero).
• Different from the ordering rules for basis adjustments

• Generally,
  ◦ Income items first increase AAA
  ◦ Losses reduce AAA to the extent of income items for the year
Distributions reduce AAA

- Net negative adjustment in a year that the corporation has a net loss

- Net negative adjustment = excess of loss items over income items
Acme, Inc. is an S corporation that was formerly a C corporation.

Acme had $250,000 AE&P at the beginning of 2020.

In 2020, Acme had
- $90,000 section 1231 gains
- $150,000 ordinary loss
- $120,000 distribution to Diana

Diana’s basis in her S corporation stock at the beginning of 2020 was $150,000.
She has no debt basis.

Figure 4.15 shows the adjustments to Acme’s AAA.
<table>
<thead>
<tr>
<th>FIGURE 4.15 Acme, Inc.'s AAA Adjustments</th>
<th>FIGURE 4.16 Diana Miller’s Basis Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>• AAA at beginning of year</td>
<td>• Beginning of year</td>
</tr>
<tr>
<td></td>
<td>$150,000</td>
</tr>
<tr>
<td>• Income items</td>
<td>• Income items</td>
</tr>
<tr>
<td></td>
<td>90,000</td>
</tr>
<tr>
<td>• Losses, limited to the income items</td>
<td>• Basis before distributions</td>
</tr>
<tr>
<td></td>
<td>(90,000)</td>
</tr>
<tr>
<td>• AAA before distributions</td>
<td>• Distributions from AAA</td>
</tr>
<tr>
<td></td>
<td>(110,000)</td>
</tr>
<tr>
<td>• Nondividend distribution*</td>
<td>• Basis before losses</td>
</tr>
<tr>
<td></td>
<td>$130,000</td>
</tr>
<tr>
<td></td>
<td>• Losses allowable ($150,000 total)</td>
</tr>
<tr>
<td></td>
<td>(130,000)</td>
</tr>
<tr>
<td>• Net negative adjustment</td>
<td>• Basis at end of year</td>
</tr>
<tr>
<td></td>
<td>$0</td>
</tr>
<tr>
<td>• ($150,000 – $90,000)</td>
<td>◦ Diana’s loss deduction is limited by her</td>
</tr>
<tr>
<td></td>
<td>basis.</td>
</tr>
<tr>
<td>• AAA at end of year</td>
<td>◦ She must carry forward $20,000 ($150,000 –</td>
</tr>
<tr>
<td></td>
<td>$130,000) of the loss.</td>
</tr>
<tr>
<td></td>
<td>◦ She must also report $10,000 of dividend</td>
</tr>
<tr>
<td></td>
<td>income.</td>
</tr>
</tbody>
</table>

* The $10,000 distribution that exceeds AAA is a dividend and does not reduce AAA.
# FIGURE 4.17 ACME INC.’S SCHEDULE M-2P.

**Schedule M-2**

Analysis of Accumulated Adjustments Account, Shareholders’ Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account

(see instructions)

<table>
<thead>
<tr>
<th></th>
<th>(a) Accumulated adjustments account</th>
<th>(b) Shareholders’ undistributed taxable income previously taxed</th>
<th>(c) Accumulated earnings and profits</th>
<th>(d) Other adjustments account</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Balance at beginning of tax year</td>
<td>110,000</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Ordinary income from page 1, line 21</td>
<td>90,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Other additions</td>
<td>150,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Loss from page 1, line 21</td>
<td>( )</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Other reductions</td>
<td>( )</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Combine lines 1 through 5</td>
<td>50,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Distributions</td>
<td>110,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Balance at end of tax year. Subtract line 7 from line 6</td>
<td>(60,000)</td>
<td>240,000</td>
<td></td>
</tr>
</tbody>
</table>

Form 1120-S (2019)
The AE&P account is the maximum amount of distributions that may be taxed as dividends while the S election is in effect.

Adjustments to this account are reported on Schedule M-2, column (c).
ELECTION TO DISTRIBUT E&P FIRST  P. 131

• If the corporation has AE&P and wants to distribute from this account before making distributions from the AAA, it may elect to do so with the consent of all its affected shareholders.
  ◦ Election is irrevocable
  ◦ Applies only for the tax year for which it is made
An S corporation that has AE&P and passive investment income may be subject to the corporate level tax on excess net passive investment income (discussed later) and lose its S corporation status.

That corporation may elect to make distributions first from AE&P to avoid the corporate level tax and loss of its S corporation status.
Sidney Gunderson is the sole shareholder in an S corporation that was formerly a C corporation.
- $50,000 of AAA and $30,000 of AE&P on December 31, 2020
- $10,000 distribution to Sidney
- Sidney has large losses from other businesses in 2020.

If the corporation elects to treat the distribution as having been made first from AE&P, the $10,000 is a taxable dividend, which will be offset by Sidney’s other losses.
- The corporation reduces its AE&P to $20,000.
A deemed dividend is treated as if
1. it were a pro rata distribution of money to the shareholders
2. received by the shareholders
3. immediately contributed back to the corporation
4. all on the last day of the tax year

• This election is irrevocable and applies only for the tax year for which it is made.
DEEMED DIVIDEND ELECTION – CONTINUED

P. 132

• The corporation will be treated as also having elected to distribute AE&P first.

• The AE&P at the end of the year is first reduced by any actual distributions of AE&P made during the tax year, and the amount of the deemed dividend equals the AE&P at the end of the tax year.

• Thus, the election eliminates the AE&P.
• To make either of the previous elections the corporation must attach a statement to a timely filed original or amended Form 1120-S. The corporation must identify the election and must state that each shareholder consents.

• The statement of election to make a deemed dividend must include the amount deemed distributed to each shareholder.
Previously Taxed Income

• Schedule M-2, column (b), reports shareholders’ undistributed taxable income previously taxed.

• This is the previously taxed income (PTI) of a shareholder that accumulated between 1958 and 1982.

• Distributions that exceed AAA come from PTI before AE&P.
OTHER ADJUSTMENTS ACCOUNT  

• The other adjustments account (OAA) is reported on Schedule M-2, column (d).

• It is a catchall account for items of income and loss that do not fit into any other categories.

• OAA can include life insurance proceeds, exempt bond interest income, expenses related to tax-exempt income, and federal taxes attributable to a C corporation tax year.
• After these adjustments, the account is reduced for any distributions made during the year.
• Under the ordering rules, distributions reduce the OAA after they reduce the AE&P.
### FIGURE 4.18 SUMMARY OF DISTRIBUTIONS FROM S CORPORATIONS P. 133

<table>
<thead>
<tr>
<th>General Order</th>
<th>Source</th>
<th>Description</th>
<th>Taxability</th>
<th>Effect on Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>AAA (including current-year income and loss items) Not taxable unless exceed shareholder’s basis</td>
<td>All S corporations to the extent of AAA Reduce basis to the extent thereof</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>PTI</td>
<td>Shareholders with pre-1983 PTI accumulations Not taxable unless exceed shareholder’s basis</td>
<td>Not taxable unless exceed shareholder’s basis Reduce basis to the extent thereof</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>AE&amp;P</td>
<td>S corporations with AE&amp;P Dividends</td>
<td>No effect on basis</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>OAA, then paid-in capital</td>
<td>All remaining distributions Not taxable unless exceed shareholder’s basis</td>
<td>Reduce basis to the extent thereof</td>
<td></td>
</tr>
</tbody>
</table>
DISTRIBUTIONS OF NONCASH PROPERTY P. 133

• An S corporation is subject to the same general rules as a C corporation and must recognize gain on distributions of appreciated property (FMV exceeds adjusted basis) as if it sold the property for its FMV.

• It generally does not recognize losses on distributions of property with FMV that is less than its adjusted basis.

• Gain recognized on distributions of depreciable property may be characterized as ordinary income.
• When an S corporation distributes appreciated property to its shareholders, it is treated as if it
  1. sold the property for its FMV
  2. distributed the proceeds to the shareholders

• If the distributed property is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, the deemed FMV is reduced by the assumed liability, but cannot be less than the liability.
The corporation does not pay tax on the gain on distributed property unless it is subject to the built-in-gains tax (discussed later).

Instead, any gain recognized by the S corporation is taken into account by the shareholders, in the same manner as other income from the S corporation.
Thus, for an S corporation with no C corporation history, the shareholder’s share of the gain increases basis and is not taxable to the extent that it does not exceed the shareholder’s basis in his or her shares.
DISTRIBUTION OF APPRECIATED PROPERTY
P. 133

• For an S corporation with AE&P, under the general ordering rules, the distribution reduces AAA (but not below zero) and then is a dividend distribution that reduces the AE&P.

• I.R.C. § 312 limits the reduction to the adjusted basis of the distributed property even though the FMV is included in the shareholder’s income as a dividend.

• The shareholder’s basis in distributed property is its FMV.
In general, if the S corporation distributes property with an adjusted basis that is less than its FMV, the corporation does not recognize a loss.

The shareholder’s basis is the FMV of property less any liabilities that the shareholder assumes.

The corporation may recognize a loss on a pro rata distribution to a qualified person, in complete liquidation of the corporation.
Under I.R.C. § 1239, any gain recognized by a seller on the sale of distributed property must be treated as ordinary income if the property is, in the hands of a related buyer, depreciable under I.R.C. § 167.

I.R.C. § 1239 defines related persons to include a corporation and any person who actually or constructively owns more than 50% of the outstanding stock.

Constructive ownership rules apply (I.R.C. §267).
EXAMPLE 4.15 DISTRIBUTION OF NONCASH PROPERTY P. 134

- Handcraft has always been an S corporation and has no AE&P.
- Sally, Will, and Tom are unrelated.
  - Sally owns 40%
  - Will owns 35%
  - Tom owns 25%
- In 2020, Handcraft had $350,000 taxable income before any distributions.
- Handcraft plans to make the distributions shown in Figure 4.19 at the end of 2020.
<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Asset</th>
<th>FMV</th>
<th>Adjusted Basis</th>
<th>Liabilities Assumed</th>
<th>Net Distributed Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sally</td>
<td>Cash</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$0</td>
<td>$200,000</td>
</tr>
<tr>
<td>Will</td>
<td>Building</td>
<td>$255,000</td>
<td>$85,000</td>
<td>$80,000</td>
<td>$175,000</td>
</tr>
<tr>
<td>Tom</td>
<td>Securities</td>
<td>$125,000</td>
<td>$190,000</td>
<td>$0</td>
<td>$125,000</td>
</tr>
</tbody>
</table>
### FIGURE 4.20 Handcraft, Inc.’s Gain on Distributions

<table>
<thead>
<tr>
<th>Asset</th>
<th>Gain Recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$0</td>
</tr>
<tr>
<td>Building ($255,000 FMV – $85,000 basis)</td>
<td>$170,000</td>
</tr>
<tr>
<td>Securities ($125,000 FMV – $190,000 basis)</td>
<td>$0</td>
</tr>
</tbody>
</table>

* S corporations do not recognize loss on distributed assets
Handcraft’s 2020 taxable income is $520,000.

It allocates
- $208,000 ($520,000 × 40%) to Sally
- $182,000 ($520,000 × 35%) to Will
- $130,000 ($520,000 × 25%) to Tom

Each shareholder takes his or her share of income into account as an addition to basis, and then reduces basis by the FMV (less liabilities assumed) of the distributed property.

Figure 4.21 shows the shareholders’ bases in the distributed assets.
**FIGURE 4.21 SHAREHOLDERS’ BASES IN DISTRIBUTION ASSETS P. 134**

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Asset</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sally</td>
<td>Cash</td>
<td>$200,000</td>
</tr>
<tr>
<td>Will</td>
<td>Building</td>
<td>$255,000</td>
</tr>
<tr>
<td>Tom</td>
<td>Securities</td>
<td>$125,000</td>
</tr>
</tbody>
</table>
The distributions reduce each shareholder’s basis in his or her shares.

If a shareholder’s basis before the distribution was less than the distribution amount, the shareholder would recognize gain on the excess amount.

<table>
<thead>
<tr>
<th></th>
<th>Sally</th>
<th>Will</th>
<th>Tom</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning basis</td>
<td>$40,000</td>
<td>$35,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Increase for current-year income</td>
<td>208,000</td>
<td>182,000</td>
<td>130,000</td>
</tr>
<tr>
<td>Basis before distribution</td>
<td>$248,000</td>
<td>$217,000</td>
<td>$155,000</td>
</tr>
<tr>
<td>Distribution (see Figure 4.19)</td>
<td>(200,000)</td>
<td>(175,000)</td>
<td>(125,000)</td>
</tr>
<tr>
<td>Ending basis</td>
<td>$48,000</td>
<td>$42,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>
COMPENSATION
This section explains the compensation of S corporation shareholder-employees.
• 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.

Frankly, the above statement by the author is wrong.

No regulations or other guidance has been issued on the definition of wages for QBID purposes.
Indeed, the author’s definition is one that is too strict and does not even qualify, according to court decisions, in the definition of reasonable compensation for S corporations for employment tax purposes.

The author’s statement should be ignored and the approach should be to argue the reasonableness of the S shareholder’s salary based upon multiple factors.
CROSS-REFERENCE
QBI DEDUCTION – CONTINUED  P. 135

• 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.

• The above chapter does not give any cite as the authority such as regulations, etc. regarding the author’s position or the position of the author for that chapter.
Reasonable compensation is determined by facts and circumstances and the burden of proof is on the taxpayer to substantiate that the compensation is reasonable.
**JUDICIAL FACTORS**

**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
MARKET APPROACH
NOT IN BOOK

• Practitioners Note: Be very careful with the IRS’s usage of the market approach as they will make extreme market comparisons such as the wages paid in an given industry in London in the U.K. or New York City with Columbus or Akron, Ohio as an example.

• This is obviously wrong and reflects the lack of common sense as to the differing economics by the IRS examiners.
### FIGURE 4.23 2018 BLS MWE TABLE

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>13-0000 Business and financial operations</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 INCOME APPROACH  P. 137

- 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 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.
RECLASSIFICATION OF PAYMENTS AS WAGES – CONTINUED - PP. 137-138

• 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.
Lucy Granger is an interior decorator who operated her business as a sole proprietorship.

In 2019, Lucy earned $120,000, and she paid approximately $17,000 SE tax on that income.

In 2020, Lucy incorporated her business and elected S corporation status.

She is the sole shareholder and president of the corporation.
• Lucy works full-time in her decorating business.
• In 2020, the corporation earned $125,000 and distributed $100,000 to Lucy.
  ◦ The corporation did not pay Lucy a salary for the year.
  ◦ Lucy reported her income from the S corporation on Schedule E
The IRS determined that a comparable decorator would be paid a $75,000 salary.

The IRS reclassified $75,000 of the distributions as wage income, and the corporation was responsible for FICA, FUTA, and income tax withholding on that income.
• David Watson was a practicing CPA with considerable experience in business taxation.

• He formed a professional corporation (PC) that elected to be taxed as an S corporation.

• He was the sole shareholder in his PC and its sole employee.

• In both 2002 and 2003, Mr. Watson’s salary was $24,000 per year.

• The PC distributed approximately $200,000 to him in 2002 and $175,000 in 2003.
The IRS determined that the PC underpaid employment taxes, and assessed tax, penalties, and interest.

At trial, the IRS expert testified that the value of the services that Mr. Watson provided to the PC was $91,044 per year, for the years at issue.

The court ruled that $67,044 ($91,044 – $24,000 salary paid) should be recharacterized and subject to employment tax.
Compensation Study

An S corporation that is trying to establish reasonable compensation for its shareholder-employees may consider hiring a consulting firm to conduct a compensation study.
COMPENSATION REPORTING REQUIREMENTS  P. 138

• An S corporation must file Form W-2 to report the compensation of its employees, including shareholder-employees.

• S corporations report the deduction for officer compensation on Form 1120-S, line 7.

• A corporation determines who is an officer under the laws of the state where it is incorporated.

• Figure 4.24 shows the reporting of officer compensation on Form 1120-S.
Figure 4.24 Form 1120S, Line 7

U.S. Income Tax Return for an S Corporation

Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.

Go to www.irs.gov/Form1120S for instructions and the latest information.

For calendar year 2019 or tax year beginning, 2019, ending, 2020

<table>
<thead>
<tr>
<th>A</th>
<th>S election effective date</th>
<th>TYPE OR PRINT</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Business activity code number (see instructions)</td>
<td>Name</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Number, street, and room or suite no. If a P.O. box, see instructions.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>City or town, state or province, country, and ZIP or foreign postal code</td>
</tr>
<tr>
<td>C</td>
<td>Check if Sch. M-3 attached</td>
<td></td>
</tr>
<tr>
<td>G</td>
<td>Is the corporation electing to be an S corporation beginning with this tax year?</td>
<td>Yes</td>
</tr>
<tr>
<td>H</td>
<td>Check if:</td>
<td>Final return</td>
</tr>
<tr>
<td>I</td>
<td>Enter the number of shareholders who were shareholders during any part of the tax year</td>
<td></td>
</tr>
<tr>
<td>J</td>
<td>Check if corporation:</td>
<td>Aggregated activities for section 465 at-risk purposes</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Income</th>
<th>1a</th>
<th>Gross receipts or sales</th>
<th>1b</th>
<th>Returns and allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2c</td>
<td>Balance. Subtract line 1b from line 1a</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>Cost of goods sold (attach Form 1125-A)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>Gross profit. Subtract line 2 from line 1c</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>Net gain (loss) from Form 4797, line 17 (attach Form 4797)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>Other income (loss) (see instructions—attach statement)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>Total income (loss). Add lines 2 through 5</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>Compensation of officers (see instructions—attach Form 1125-E)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>Salaries and wages (less employment credits)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>Repairs and maintenance</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
In addition, if the corporation has gross receipts of $500,000 or more and deducts compensation of officers, it must list the compensation of each of its officers on Form 1125-E, Compensation of Officers.

Figure 4.25 shows Form 1125-E.
Total gross receipts include the following amounts:

- Form 1120-S, page 1, line 1a, gross receipts or sales
- Form 1120-S, page 1, line 4, net gain (loss) from Form 4797
- Form 1120-S, page 1, line 5, other income (loss)
- Schedule K, line 3a, gross rental income (loss)
- Schedule K, line 4, interest income
- Schedule K, line 5a, ordinary dividends
- Schedule K, line 6, royalties
- Schedule K, line 7, net short-term capital gain (loss)
- Schedule K, line 8a, net long-term capital gain (loss)
- Schedule K, line 9, net section 1231 gain (loss)
- Schedule K, line 10, other income (loss)
- Form 8825, line 2, gross rents
- Form 8825, line 19, net gain (loss) from the disposition of rental real estate property
- Form 8825, line 20a
FIGURE 4.25 FORM 1125-E  P. 140

Form 1125-E
(Rev. October 2016)
Department of the Treasury
Internal Revenue Service

Compensation of Officers

attachment Form 1120, 1120-C, 1120-F, 1120-REIT, 1120-RIC, or 1120S.
Information about Form 1125-E and its separate instructions is at www.irs.gov/form1125e.

Name

Employer identification number

Note: Complete Form 1125-E only if total receipts are $500,000 or more. See instructions for definition of total receipts.

<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>Percent of stock owned</th>
<th>(f) Amount of compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>(d) Common</td>
<td>(e) Preferred</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<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.

Cat. No. 55999C

Form 1125-E (Rev. 10-2016)
Officers

- Many of the cases involving undercompensation of S corporation shareholders involve compensation of officers.

- In general, an officer of the corporation is an employee for FICA tax purposes unless the officer performs no more than minor services and is not entitled to any compensation.

- A director of a corporation in his or her capacity as a director is not an employee of the corporation.
THE HIDDEN TRAP OF THE BIG (BUILT-IN GAINS TAX) TAX
The built-in gains tax is a corporate-level tax on S corporations with C corporation history.
An S corporation that was formerly a C corporation may be taxed on its built-in gains (BIG).

The IRS LB&I Division has undertaken a campaign to educate S corporations and their shareholders about the need to properly calculate and document built-in gains.
As we had previously discussed, the BIG tax is part of the IRS campaign involving the examination of S corporations.

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.

• This issue has come to the forefront because of the overstated advantages of conversion from a C corporation to an S corporation.
GENERAL RULES
NOT IN BOOK - CONTINUED

• Practitioner Note: This is an area in which the client should be closely advised as to the negative factors and the practitioner should have the client sign a representation letter attesting to this.
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.
• NUBIG also includes certain income and deduction items that are attributable to the C corporation but not yet taken into account at the time of the S election.
  ◦ It includes any item that would be treated as a built-in gain, even if it is not on the balance sheet
  ◦ It is reduced for any amount allowable as a deduction (such as accounts payable of a cash basis corporation), which would be treated as a built-in loss, even though the item is not reflected on the corporation’s balance sheet.
Leon Lewis, Ginger Grace, and Ursula Underhill have developed a successful consulting firm, LGU, Inc.

- LGU has been a professional C corporation for over 30 years.
- The three principals are considering selling their practice in the future.
- They understand that a potential purchaser will likely prefer to purchase the LGU assets rather than the LGU shares.
• The corporation uses the cash method and carries a large balance in receivables from year to year.
  ◦ Each shareholder has a $5,000 basis in his or her shares.
LGU has substantial goodwill, which will be subject to double tax on a sale of the assets.

Accordingly, the corporation elected to become an S corporation effective January 1, 2020.

On January 1, 2020, LGU has $70,000 accounts payable.
### FIGURE 4.26 LGU Assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$18,500</td>
<td>$18,500</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>0</td>
<td>124,000</td>
</tr>
<tr>
<td>Office furniture and equipment</td>
<td>72,000</td>
<td>104,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>253,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$90,500</strong></td>
<td><strong>$500,000</strong></td>
</tr>
</tbody>
</table>

### FIGURE 4.27 LGU’S NUBIG Calculation

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of assets</td>
<td>$500,000</td>
</tr>
<tr>
<td>Adjusted basis of assets</td>
<td>(90,500)</td>
</tr>
<tr>
<td>NUBIG</td>
<td>$339,500</td>
</tr>
</tbody>
</table>
FIGURE 4.28 LGU’S SCHEDULE B (FORM 1120-S) P. 143

<table>
<thead>
<tr>
<th>Schedule B Other Information (see instructions)</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Check accounting method:</td>
<td>a ☑ Cash</td>
<td>b ☐ Accrual</td>
</tr>
<tr>
<td>2. See the instructions and enter the:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Business activity ▶ 541600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Product or service ▶ Consulting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. 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>
<td></td>
<td>☑</td>
</tr>
<tr>
<td>4. At the end of the tax year, did the corporation:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. 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>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$ 339,500</td>
<td></td>
</tr>
<tr>
<td>9. Did the corporation have an election under section 163(j) for any real property trade or business or any farming business</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Appraisal Recommended

- All gains recognized by an S corporation during the recognition period are presumed to be recognized built-in gains.

- The taxpayer can rebut this presumption by establishing that an asset was not held before conversion or that the appreciation resulting in the gain occurred after conversion.

- Thus, a C corporation converting to an S corporation should obtain an appraisal of its assets immediately prior to the conversion to document the gain at that time.
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)
THE PRE-LIMITATION AMOUNT

- The PLA is a calculation of the S corporation’s taxable income using the C corporation rules.
  - This calculation includes only recognized built-in gains, recognized built-in losses, and recognized built-in gain carryover.
  - The corporation must use the method of accounting that it uses for tax purposes as an S corporation.
Examples are collection of a cash method receivable, sale of inventory, or the taxable disposition of other property.

The built-in portion of these gains is limited to the amount of gain attributable to years before the S election took effect.

The corporation has the burden of proof to demonstrate that any gain, or portion of a gain recognized is not a recognized built-in gain.
• Any recognized built-in gains may be offset by recognized built-in losses.

• These are losses that are both recognized in the current year (by the S corporation’s method of accounting) and had economically accrued before the S election took effect.

• The corporation has the burden of proof to demonstrate that any losses recognized in the current year are built-in losses.
In 2020, LGU collected $124,000 of its receivables from 2019.

The corporation paid all its $70,000 accounts payable.

FIGURE 4.29 LGU’s PLA Calculation

- Revenue $124,000
- Operating expenses (70,000)
- Net PLA $54,000

The corporation prepares Form 1120, U.S. Corporation Income Tax Return, and completes lines 1 through 28 on page 1, including only recognized built-in gains and allowable recognized built-in losses.

It then enters this total on Form 1120-S, Schedule D, Part III, line 16, and attaches a computation statement.
• To calculate the TIL, the corporation reports all its current-year income and deductions using the C corporation rules.

• The C corporation rules are modified by the limit on excess net passive income, which allows no deductions for NOLs or special corporate deductions, except for §248.
EXAMPLE 4.19 CALCULATING THE TIL  P. 144

FIGURE 4.30 LGU’s Total 2020 Income and Expenses

- Revenue $1,560,000
- Operating expenses (725,000)
- Shareholder compensation (820,000)
- Net income $15,000

- The corporation prepares another dummy Form 1120 and completes lines 1 through 28 on page 1, including income and gains and all allowable deductions and losses.
- It then enters this total on Form 1120S, Schedule D, Part III, line 17, and attaches a computation statement.
NET UNREALIZED BUILT-IN GAIN LIMITATION
P. 145

- A corporation’s initial NUL is its NUBIG on the day the S election takes effect. If the NUL is less than either the PLA or the TIL, it limits the built-in gains tax.

- After the first year in the recognition period, the NUL is reduced by any net recognized built-in gains from prior S years.
The facts are the same as in Example 4.19. LGU calculates its $15,000 net recognized built-in gain, which is the lowest of the following three amounts:

1. $54,000 PLA (Example 4.18)
2. $15,000 TIL (Example 4.19)
3. $339,500 NUL (Example 4.17)
The corporation calculates the tax on its net recognized built-in gain at the highest C corporation rate (currently 21%).
The facts are the same as in Example 4.20.

LGU has no unused C corporation net operating loss (NOL) carryforward.

LGU’s BIG tax is $3,150 ($15,000 × 21%).

Figure 4.31 shows LGU’s Schedule D, Part III.
**FIGURE 4.31 LGU’S SCHEDULE D, PART III P. 145**

Schedule D (Form 1120-S) 2019

**Part III**  
**Built-in Gains Tax** (See instructions **before** completing this part.)

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>Excess of recognized built-in gains over recognized built-in losses (attach computation statement)</td>
<td>16</td>
</tr>
<tr>
<td>17</td>
<td>Taxable income (attach computation statement)</td>
<td>17</td>
</tr>
<tr>
<td>18</td>
<td>Net recognized built-in gain. Enter the smallest of line 16, line 17, or line 8 of Schedule B</td>
<td>18</td>
</tr>
<tr>
<td>19</td>
<td>Section 1374(b)(2) deduction</td>
<td>19</td>
</tr>
<tr>
<td>20</td>
<td>Subtract line 19 from line 18. If zero or less, enter -0- here and on line 23</td>
<td>20</td>
</tr>
<tr>
<td>21</td>
<td>Enter 21% of line 20</td>
<td>21</td>
</tr>
<tr>
<td>22</td>
<td>Section 1374(b)(3) business credit and minimum tax credit carryforwards from C corporation years</td>
<td>22</td>
</tr>
<tr>
<td>23</td>
<td><strong>Tax.</strong> Subtract line 22 from line 21 (if zero or less, enter -0-). Enter here and on Form 1120-S, page 1, line 22b</td>
<td>23</td>
</tr>
</tbody>
</table>

Schedule D (Form 1120-S) 2019

See p. 143
j1  jamison.robert@gmail.com, 9/15/2020
The BIG tax is treated as a loss, which corresponds to the gain that created the tax.

To the extent that this tax is attributable to ordinary income, the tax is included in “Taxes and licenses” on Form 1120-S, page 1, line 12.

If any of this tax is allocated to income of another character, such as a capital gain, it is treated as an offsetting loss of the same character.
EXAMPLE 4.22 BIG TAX REDUCES SHAREHOLDER INCOME - P. 146

- Each shareholder includes his or her share of the income on Schedule E (Form 1040), Supplemental Income and Loss.
- If LGU did not distribute any money or property to the shareholders in 2020, each shareholder adds $3,950 to his or her stock basis.
- LGU adds $11,850 to its AAA at the end of 2020.
- Because 2020 was its first year as an S corporation, $11,850 is the AAA balance at the beginning of 2021.
• An S corporation that is subject to the BIG tax must subtract the year’s net recognized built-in gain from the NUBIG as of the beginning of the current tax year. The reduced balance is the NUBIG limitation for the next tax year.
If the corporation’s TIL is the lowest measure of the corporation’s net recognized built-in gain in any of the first 4 years of the recognition period, the corporation must compute the difference between this limitation and the other two limitations (the PLA or NUL, whichever is less). The result is the recognized built-in gain carryforward, which is treated as part of next year’s PLA.

If the corporation had any unused NOL or NOL carryforwards from C corporation years, it may use these to offset its net recognized built-in gain. The corporation must keep track of unused carryforwards for possible use in future years.
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.
LGU must calculate its recognized built-in gain carryforward because its TIL was the lowest limitation used to calculate net recognized built-in gain.

- The lower of its PLA and its NUL is $54,000.
- Its TIL was $15,000.
- LGU’s recognized built-in gain carryforward is $39,000 ($54,000 − $15,000).
• The $39,000 carryforward becomes a recognized built-in gain, which is part of the PLA for 2021.
  ◦ If LGU continues to limit its net recognized built-in gain with the TIL, the recognized built-in gain carryforward will carry forward to each year until the recognition period expires.
  ◦ After 5 years as an S corporation, any remaining disappears.
LGU must adjust its NUBIG by the built-in gains recognized in the current year. It must make this adjustment for each of the first 4 years in the recognition period, so that the total net recognized built-in gain in the 5-year period does not exceed the initial NUBIG.
EXAMPLE 4.23 YEAR-END CALCULATIONS – CONTINUED - P. 146

• LGU’s NUBIG on January 1, 2021, is $324,500 ($339,500 − $15,000).
  ◦ $339,500 was the original NUBIG.
  ◦ See Figure 4.27, p. 142.
  ◦ $15,000 was the NRBIG for this year.
  ◦ See Figure 4.30, p. 144.
This section discusses the tax on excess net passive income.
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.
Gross receipts are defined as the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income.
• Passive investment income includes gross receipts from the following:
  ◦ Royalties
  ◦ Rents
  ◦ Dividends
  ◦ Interest (except interest on the sale of a capital asset in the corporation’s ordinary trade or business)
  ◦ Annuities
Net passive income is limited to the taxable income that the corporation calculates as if it were a C corporation, except NOL deductions and corporate deductions allowed under I.R.C. §§ 241–250.
• High Country, Inc. is a C corporation with AE&P.
• It made a valid election to be classified as an S corporation as of January 1, 2020.
• Figure 4.32 shows High Country’s income and expenses.

FIGURE 4.32 High Country’s 2020 Income and Expenses

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating gross receipts</td>
<td>$450,000</td>
</tr>
<tr>
<td>Investment interest income</td>
<td>200,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>(350,000)</td>
</tr>
<tr>
<td>Investment interest expenses</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$200,000</td>
</tr>
</tbody>
</table>
EXAMPLE 4.24 (CONTINUED)  P. 147

• High Country’s net passive investment income is $100,000.
  ◦ $200,000 investment interest income − $100,000 investment interest expenses

• Its gross receipts are $650,000.
  ◦ $450,000 operating gross receipts + $200,000 investment interest income

• Its taxable income is $200,000.

• High Country’s excess net passive investment income is $18,750 ($100,000 × 18.75%). Its tax is $3,938 ($18,750 × 21%).
QUESTIONS?