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Advisers guide to S corporations : tax compliance and planning

Gregory B. McKeen

The Adviser's Guide to S Corporations Tax Compliance and Planning Strategies

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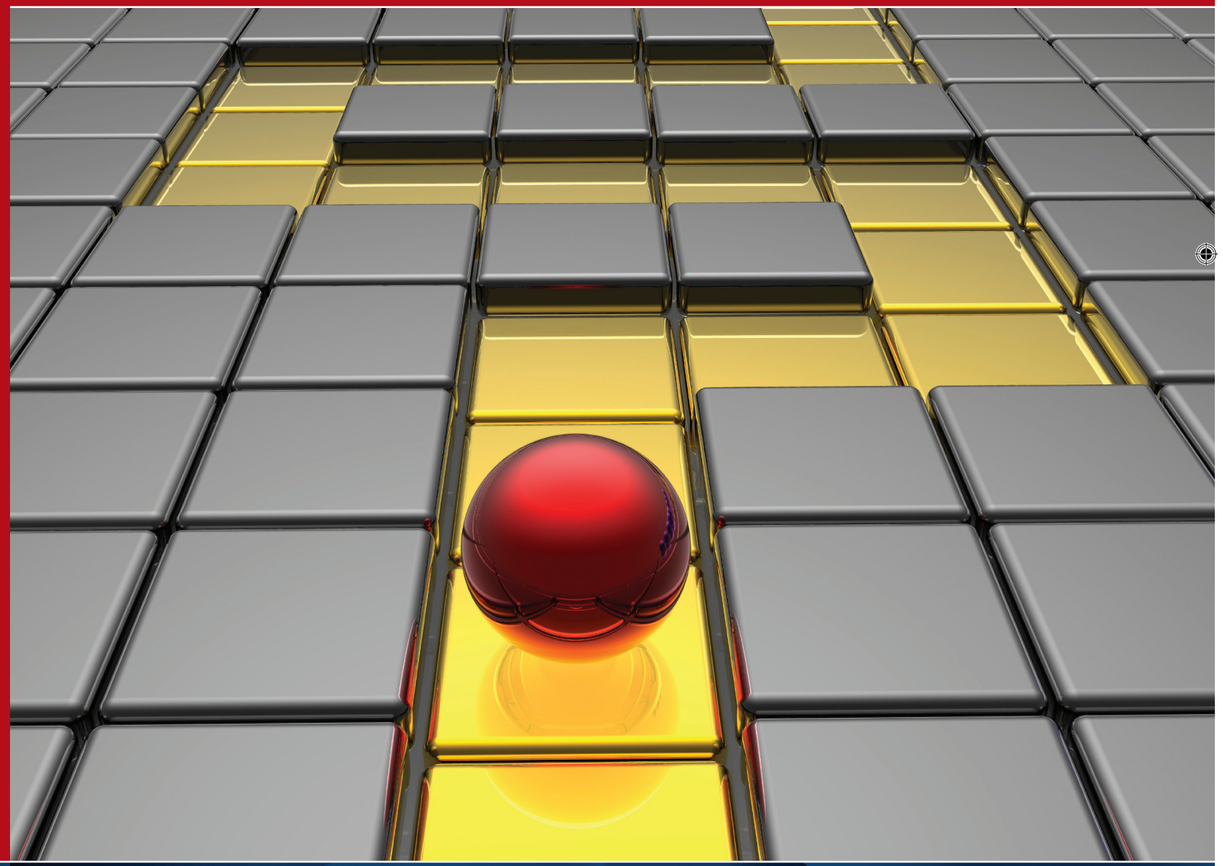

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Chapter 1

Why Subchapter S?

Introduction

In this chapter, we will discuss the following:

- Limited liability
- Advantages of S corporations over C corporations
- Advantages of C corporations over S corporations

Choosing the most favorable type of business entity can be a difficult task. Owners of a new business can, depending on the circumstances, decide to operate as a proprietorship, partnership, C corporation, or S corporation. Furthermore, if a limited liability company (LLC) is formed, it may operate as any one of those types of entity, as long as it meets the applicable requirements.

In this Guide, we will examine some of the advantages and disadvantages of incorporation and then go through the requirements for electing to be an S corporation, as well as the rules for operating an S corporation.

We will also address practical situations that occur in the operations of S corporations and will examine some tax return issues. A copy of the S corporation tax return, Form 1120S, and Schedule K-1 can be found at the end of chapter 10.

Our discussion starts with a question—why should your client consider being an S corporation, or even a C corporation, at all? Why not operate as a proprietorship, if there is one owner, or as a partnership, if there is more than one owner?

Advantages of Corporations

Limited Liability

Most corporations are formed because the corporate entity offers some protection against personal liability. Unlike a general partner or proprietor, shareholders are generally liable for loss only to the extent of their investment. As a practical matter, however, before making a loan, a lending institution will usually insist that individual shareholders in a closely held corporation agree in writing to be personally liable for the debt. Although a professional person normally cannot protect himself from liability arising from personal negligence, he or she may be able to protect him or herself from lawsuits arising from the negligence of other professionals in the corporation.

Limited liability can also be obtained by forming a limited liability company (LLC) or limited liability partnership (LLP), discussed later.

Continuity of Organization

A corporation's existence depends on its charter and its outstanding stock, rather than circumstances relating to the owners of the stock. Therefore, the death, insanity, bankruptcy, retirement, resignation or expulsion of any shareholder will not, in itself, cause dissolution of the corporation.

Transfer of Interest

Shares of stock in a corporation can be transferred with relative ease. This provides gift and estate planning opportunities that are not so readily achievable in other forms of doing business. It also makes it easier to give a "piece of the action" to key employees or relatives who are moving into the business. If real estate is held outside of the corporation, or in a separate corporation, shareholders can sell or transfer stock in the business, while still retaining their ownership of the real estate.

Ordinary Deduction for Stock Losses

Under Sec. 1244, a loss realized because of the sale or worthlessness of C or S corporation stock may qualify as an ordinary loss, rather than a capital loss. A loss arising from disposition of a partnership interest is generally a capital loss.

Disadvantages of Corporations

Double Taxation

Both regular corporations and, to a much lesser extent, S corporations pay tax at the corporate level. There can also be tax at the shareholder level when the income is distributed or passed through. There is *never* a tax at the partnership level.

Cost of Organization

Generally, the cost of incorporating is more than the cost of forming a partnership. Certain formalities and technicalities such as state filings, writing up bylaws, issuing stock, changing title to assets, and holding organizational meetings are all required. And attorneys' fees are also a normal expense of incorporating.

Rigidity of Operation

A partnership has more flexibility in its operation than a corporation. A partnership can make special allocations of certain income and expense items, if there is substantial economic effect for the allocations. Corporations must keep minutes of formal meetings, deal with complex payroll records, and file additional tax returns. Furthermore, S corporation items of income, loss, deduction, and credit must be allocated to shareholders based on the number of shares held by each shareholder.

Liquidation

The complexity of liquidation is another disadvantage of the corporate form. Liquidation must be formal, and many potential tax traps exist. Both the corporation and the shareholders may incur tax when the corporation liquidates.

Payroll Taxes

Sole proprietors or partners are not considered to be employees of their companies. However, in a corporation, persons who perform employee services for a corporation are employees even if they are shareholders and that means their wages are subject to withholding and payroll taxes.

Remember, the IRS has the power to reclassify or reallocate income to ensure that salaries to shareholders are "reasonable."

Advantages of S Corporations

Number of S Corporations Continues to Grow

S corporations are the second most common type of business in the United States, according to a General Accounting Office (GAO) report issued in December 2009. (Sole proprietorships are first, then S corporations, partnerships, and C corporations, in that order.)

The report states that the growth rate of S corporations from 2000 to 2006 was 35 percent, compared to a 23 percent growth rate for all business types. Furthermore, most S corporations are held by three or fewer shareholders. In 2006, 60 percent of S corporations were owned by one shareholder, 89 percent had two or fewer shareholders, and 94 percent had three or fewer shareholders.

> **Note**: Because of the advantages of operating an S corporation, this type of entity is subject to continuing scrutiny by the Congress and the IRS. For example, Congress has at various times considered making all or a certain portion (or a certain type) of S corporation income subject to self-employment tax. So far, however, S corporation income passed through to shareholders has escaped being classified as earnings from self-employment.

Reasons for Forming an S Corporation

The overwhelming majority of S corporations are formed because of one or more of the following four factors:

1. Limited liability (discussed earlier).
2. No double taxation (generally).
3. Passthrough of losses and credits.
4. Passthrough and distributions from S corporations are not subject to self-employment tax.

BASIS

One important fact to remember at this point is that partners have an advantage over S corporation shareholders when it comes to the passthrough of losses, which are deductible to the extent of basis.

A partner is considered to have basis in any partnership indebtedness for which the partner is personally liable, and in certain nonrecourse debt. An S corporation shareholder has basis only in any indebtedness of the S corporation *to the shareholder*.

Therefore, S corporation treatment would probably not be favorable to a company that was generating losses caused by depreciation of heavily mortgaged business property, such as real property rented to outsiders.

Escape Double Taxation

In an S corporation, income is generally taxed only at the shareholder level. In a C corporation, income is taxed at the corporate level, and taxed again to the shareholders when distributed. However, in certain situations an S corporation and its shareholders can face double taxation of built-in gains and passive investment income.

LIQUIDATION

An S corporation that has never been a C corporation is not subject to corporate level tax on liquidation.[1] A C corporation, on the other hand, is taxed at the corporate level on gains that occur during liquidation.

Passthrough of Losses and Credits

Within limits, an S corporation passes through losses and credits to be used on the shareholder's personal return. Therefore, corporate losses can offset other noncorporate gains and corporate credits can offset personal tax. C corporation losses and credits can only be offset against corporate income and tax.

This passthrough feature can be an advantage when a company needs the corporate liability shield, but expects losses or large credits at the beginning of its existence. When the financial picture turns around and the company shows significant income, the election can be terminated, if C corporation treatment is more favorable to the shareholders.

Self-employment Tax and Reasonable Compensation

Passthrough and distributions from S corporations are not subject to self-employment tax. This may cause less FICA tax to be assessed to an S corporation and its shareholders than would apply to a partnership or proprietorship.

In either a C or an S corporation, the IRS has the power to reclassify corporate income or stockholder's salary to reflect the value of services rendered by the shareholders to the

[1] The corporate-level built-in gains tax can apply upon liquidation of an S corporation, however, under two conditions: (1) the corporation operated as a C corporation during the preceding 120 months, or (2) the S corporation received appreciated property from a C corporation.

corporation. If a C corporation pays "excessive compensation" to its shareholder-employees, the IRS can classify the excess as a dividend, depriving the corporation of the deduction. In an S corporation, however, the IRS can classify excessive salary as a corporate distribution, but distributions from an S corporation may represent a nontaxable return of capital, rather than a dividend. Furthermore, the IRS has the authority to increase wage expense if the S corporation has been paying *less* than reasonable salaries to its employee or shareholders (to reduce payroll taxes, for example).

Income Splitting

The passthrough feature of an S corporation allocates income among the shareholders. Therefore, an S corporation can be used as a vehicle to split business income with related parties. Income splitting can be accomplished without loss of control of the corporation by using a voting trust or by issuing nonvoting shares. For example, nonvoting shares could be issued to a child. The child would then report his or her share of the income passed through by the corporation, but would not have the power to make management decisions. (The effects of the kiddie tax must be considered if the child is under age 18 or a full-time student age 19-23.)

Income, however, may be reallocated by the IRS to reflect the value of services rendered or capital contributed.[2]

Personal Holding Company Income

Receipt of passive income in a C corporation can result in the personal holding company tax being assessed. Therefore, some personal holding companies may elect to become S corporations, which are not subject to the personal holding company tax. An S corporation with C corporation accumulated earnings and profits, however, can be subject to the tax on excess net passive income.

Accumulated Earnings Tax

An S corporation is not subject to the accumulated earnings tax, because all income is currently passed through to shareholders.

Cash Method

An S corporation[3] that qualifies (for example, because it provides only services) can use the cash method of accounting. A C corporation (other than a personal service corporation or farming business) must use the accrual method of accounting if it has gross receipts of more than $5 million.

Alternative Minimum Tax

An S corporation is not subject to the corporate alternative minimum tax (AMT). Rather, the S corporation passes through adjustment and preference items to its shareholders, who are subject to AMT.

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[2] Sec. 1366(e).
[3] Other than a tax shelter under Sec. 448(d)(3).

Tax Rates

The top individual rate is 35 percent and the C Corporation tax rates are shown below. However, the fact that S corporation income is generally taxed only once (at the shareholder level) remains a favorable factor for S corporations.

The C corporation tax rates are as follows:

Taxable Income Over	Not Over	Tax Rate
$0	$50,000	15%
50,000	75,000	25%
75,000	100,000	34%
100,000	335,000	39%
335,000	10,000,000	34%
10,000,000	15,000,000	35%
15,000,000	18,333,333	38%
18,333,333	—	35%

The lower brackets are not available to C corporation personal service corporations.[4] Thus, a personal service corporation pays tax at a flat 35 percent.

Advantages of C Corporations

Of course, there are also compelling reasons for forming a C corporation. Among them are the following:

- *Two Sets of Lower Tax Brackets*—Most businesses cannot distribute all their net income currently. Often, the funds need to stay with the company for working capital, to maintain inventory, or for plant improvement, among other reasons. In a C corporation, undistributed profits are taxed at the corporate level. In an S corporation, all the income is passed through, thereby increasing shareholders' personal income and potentially pushing the shareholder into a higher tax bracket. S corporation income passed through to the shareholders is taxed at a maximum rate of 35 percent. C corporation rates are shown in the preceding chart.

- *No Double Tax until Income Is Distributed*—C corporation income is not subject to double tax until it is actually distributed. Therefore, operating as a C corporation can be the most favorable way to do business if the corporation can, or must, retain income in the business, and the shareholders do not plan on liquidating the corporation in the foreseeable future.

  If a corporation will be distributing all of its net income currently, then it might be better to operate as an S corporation.

[4] Sec. 11(b).

- *Carryovers of Losses or Credits*—A C corporation carries over allowable losses and credits at the corporate level. However, if a C corporation elects to become an S corporation, carryovers are suspended and cannot be used while the company remains an S corporation. There are exceptions if the S corporation is subject to the built-in gains rules and if passive activity losses carry into the S corporation.

- *Fiscal Year*—A C corporation has more flexibility in choosing a fiscal year that is different from that of its shareholders. This means, for example, that a C corporation can accelerate or hold back a dividend distribution to drop it into the owner's tax year where it incurs the least tax cost. This flexibility results in some ability to manipulate income. Generally, an S corporation is restricted in its use of a fiscal year.

- *Passive Activity Gains and Losses*—S corporation shareholders who do not materially participate in the activities of an S corporation are subject to the passive activity loss rules. Certain C corporations are not subject to the passive activity rules.

- *Fringe Benefits*—C corporations can furnish certain fringe benefits to shareholder-employees. The corporation deducts the cost of the benefits, and the employee does not include the value of the benefits in income. S corporation shareholder-employees owning more than 2 percent of the corporation's stock must include the cost of certain fringe benefits in income.

- *Shareholder Restrictions*—Restrictions on the number and type of shareholders are imposed on S corporations, but not on C corporations.

- *No Risk of Involuntary Termination*—An S corporation runs the risk of committing an act that terminates the S election. The C corporation runs no such risk.

- *Qualified Small Business Stock*—An S corporation, cannot issue Qualified Small Business Stock (QSBS), but can hold such stock and pass the exclusion through to its qualified shareholders. For QSBS issued after August 10, 1993, a noncorporate taxpayer who has held the stock for more than five years can exclude from income 50 percent of the gain when the stock is sold or exchanged. (The exclusion is 75 percent of the gain for stock acquired after February 17, 2009, and before September 28, 2010. The exclusion is 100 percent of the gain for stock acquired after September 27, 2010, and before January 1, 2012, applicable to both regular tax and AMT.) The taxable portion of the gain is subject to a maximum capital gains rate of 28 percent, and a percentage of the *less-than-100 percent* excluded portion is treated as an AMT preference. Furthermore, under certain circumstances, a taxpayer can elect to roll over capital gain from disposition of QSBS if the stock was held more than six months and qualified replacement stock is acquired within 60 days.[5]

- *State Tax Treatment*—Some states do not recognize any tax difference between an S corporation and a C corporation. This means that there can be a corporate tax at the state level as well as a state income tax to the shareholder when dividends are received. Some states, on the other hand, recognize S corporations as passthrough entities and do not tax S corporation income. Other states treat an S corporation as a hybrid entity and assess a

[5] See Secs. 1202 and 1(h)(4).

state tax at the corporate level, while allowing passthrough treatment of the corporation's income and loss items. The state tax problem is compounded if the S corporation does business in more than one state.

- *Built-In Gains*—When a C corporation elects S corporation status, there are possible disadvantages relating to built-in gains rules and the LIFO inventory recapture rules. We will talk about these issues in later chapters.

Limited Liability Company (LLC)

A limited liability company that is treated as a partnership combines certain benefits of S corporation status (for example, limited liability and passthrough of losses) with classification as a partnership for federal income tax purposes. Partnership treatment provides advantages such as maximum tax flexibility in allocating partnership items of income, gain, deduction, and credit. However, LLC income may be subject to the self-employment tax if the LLC is treated as a proprietorship or partnership. An LLC can elect to be taxed as a corporation and, if eligible, can elect S status.

Summary

Most S Corporations are formed

- As a corporate shield against personal liability.
- To escape double taxation.
- Because of the passthrough of losses.
- Because passthrough and distributions from S corporations are not subject to self employment tax.

Chapter 2
Qualifications

Introduction

In this chapter, we will discuss the following:

- Characteristics of an S corporation
- Eligible and ineligible shareholders
- Qualified Subchapter S Subsidiaries

Eligibility for S Corporation Status

This chapter looks closely at the rules that define which entities are eligible to be S corporations. The basic rules center on how many shareholders an S corporation may have and who are the eligible shareholders. There are also considerations related to classes of stock and subsidiary corporations.

An S corporation is a *small business corporation* for which an S election under Sec. 1362(a) is in effect.[1] An S corporation differs from a "regular" C corporation in the way that its shareholders are taxed on corporate income and distributions.

A small business corporation is an eligible domestic corporation with a maximum of 100 shareholders.[2]

Other criteria for small business corporations:

- The shareholders must be individuals, estates, certain trusts, or charitable organizations under Sec. 501(c)(3).
- Nonresident aliens may not be shareholders and may not have a current ownership interest in stock owned by a spouse who is a qualified shareholder.
- There can be only one class of stock.

  Practice Tip: A limited liability company (LLC) that meets the eligibility rules can elect to be taxed as an S corporation.

[1] Sec. 1361(a)(1).
[2] Sec. 1361(b)(1)(A).

Number of Shareholders

An S Corporation can have no more than 100 shareholders. When computing the number of shareholders, a spouse and family members (and their estates) are treated as a single shareholder.[3] If stock is owned by joint tenants or by tenants in common (who are not husband and wife or family members), each party owning an interest in the stock is counted as one shareholder.

Treating Family Members as One Shareholder

Family members (and their estates) are treated as one shareholder for purposes of the 100 shareholder limit.[4]

A child who is adopted or a foster child is treated as a natural child if the provisions under Sec. 1361(c)(1)(C) are met.

> **Practice Tip:** Significantly more than 100 individuals can own stock in an S corporation because spouses, family members, and their estates are counted as one shareholder for purposes of the 100-shareholder limit.

Definition of Family Member

A family member for these purposes includes the lineal descendants of a "common ancestor," and the spouses (or former spouses) of the common ancestor and lineal descendants. An individual is not considered a common ancestor if, on the "applicable date," the individual is more than six generations removed from the youngest generation of shareholders who would (but for this provision) be members of the family. The applicable date is the latest of (1) the date the S election is effective; (2) the first date that a family member holds stock in the S corporation; or (3) October 22, 2004.[5]

A spouse or former spouse is treated as being of the same generation as the person to whom the spouse is (or was) married.

> **Practice Tip:** The rule limiting family members to six-generations does not seem to be much of a practical limitation on the number of family members eligible to hold S corporation stock. Regulations provide that the six-generation limitation is effective on the applicable date only. Lineal descendents (and spouses) more than six generations removed from the common ancestor will be treated as members of the family if they acquire stock in the corporation after the applicable date.[6]

Example 2-1

ABC Inc., an S corporation, has 100 shareholders who are neither married nor related to one another. One of the shareholders, Jack Martin, marries Jill and transfers half of his shares to her. He also transfers stock to his two children and two grandchildren.

[3] Sec. 1361(c)(1)(A); Reg. Sec. 1.1361-1(e).
[4] Sec. 1361(c)(1); Reg. Sec. 1.1361-1(e).
[5] See Sec. 1361(c)(1)(B) and Reg. Sec. 1.1361-1(e)(3).
[6] Reg. Sec. 1.1361-1(e)(3).

As husband and wife, Jack and Jill are considered one shareholder. This is also true of family members—Jack and his children and grandchildren. Jack is the common ancestor in the Martin family, so the corporation is still considered to have 100 shareholders for purposes of the shareholder limitation. If Jack and Jill divorce, they will still be considered to be one shareholder under the "former spouse" provisions of the family member rules.

Even though the corporation now has more than 100 shareholders for passthrough and other purposes, it is considered to have only 100 shareholders when determining whether it meets the no-more-than-100-shareholder test.

Richard Williams, also a shareholder, dies during July and his stock is transferred to his estate. Shareholders and their estates are considered to be one shareholder for purposes of the shareholder limitation, so the corporation is considered to have 100 shareholders during the year.

Partnership of S Corporations Can Avoid the 100-Shareholder Limitation

An S corporation can be a partner in a partnership. (A partnership, however, cannot own S corporation stock.) Partnerships with S corporation partners provide a popular technique for avoiding the 100 shareholder limitation. The IRS has ruled that it will not apply the shareholder limit to a partnership with S corporations as partners, as long as each S corporation has no more than the allowable number of shareholders.

Example 2-2

A group of 105 unrelated individuals form three S corporations, each with 35 shareholders. The three S corporations then form a partnership to operate a single business. The corporations are treated separately for eligibility purposes. Thus each corporation retains its S status and is considered to have 35 shareholders (Rev. Rul. 94-43, 1994-2 CB 198).

Eligible Shareholders

Only individuals, estates, certain trusts (including certain tax-exempt qualified retirement plan trusts), and charitable organizations under Sec. 501(c)(3) may own shares in an S corporation. Nonresident aliens, corporations, and partnerships, limited liability partnerships (LLPs), and multiple-member limited liability companies (LLCs) are not qualified shareholders.[7] Trusts are qualified shareholders only if they are specifically recognized by the statute.[8] Beneficial ownership, rather than ownership of record, is controlling.[9]

> **Practice Tip:** The beneficial owner is the person or entity that controls the stock or carries the responsibility, receives the benefits, and takes the risks of stock ownership.

S corporation shares can be owned by minors (and others incapable of entering into a legal contract). Usually such stock is registered in the name of a custodian but, since the minor is

[7] Unless the entity is a charitable organization under 501(c)(3).
[8] Sec. 1361(b)(1).
[9] Reg. Sec. 1.1361-1(e)(1).

regarded as the beneficial owner, the shareholder of record can be a corporation or nonqualified trust acting as custodian for the minor.

> **Practice Tip:** Corporations[10] and partnerships cannot own S corporation stock. The S corporation itself, however, is not restricted in the investments it can hold. Thus, an S corporation can own the shares of another corporation, be a partner in a partnership, or hold an interest in an LLC.

Estates

Certain estates are eligible to hold S corporation shares.

Estate of a Decedent

The estate of a decedent is a qualified shareholder.[11]

Bankruptcy Estate

A qualified shareholder includes the estate of an individual in a bankruptcy case.[12]

The S election does not terminate when an S corporation files a Chapter 7 or Chapter 11 bankruptcy petition. Also, a new or separate taxable entity is not created by an S corporation's bankruptcy, so the S corporation continues to pass through items of income, loss, deduction, and credit to the shareholders, and not the bankruptcy trust.[13]

On the other hand, the Tax Court has ruled that when an *individual shareholder* files for bankruptcy and transfers S corporation shares to a bankruptcy estate, the bankruptcy estate is treated as if it were a shareholder who held the stock for the entire year. The Court stated that, under Sec. 1398(f)(1), a transfer of an asset from the bankrupt debtor to the bankruptcy estate is not a disposition triggering tax consequences, and the estate is treated as the debtor would be treated relating to that asset. Therefore, the bankrupt stockholder's share of passthrough items for the entire year passes through to the bankruptcy estate. This is true even if the bankruptcy estate held the shares for only a short time before the S corporation's tax year ended. In this case,[14] the corporation passed through losses for the year but, theoretically at least, passthrough allocable to a bankrupt shareholder's stock should also be passed through to the bankruptcy estate if the corporation were generating income or gain.

Trusts as Shareholders

Under Sec. 1361(c)(2), certain trusts qualify as shareholders in S corporations. Foreign trusts do not qualify.

Eligible trusts are limited to

[10] Other than Section 501(c)(3) charitable organizations.
[11] Sec. 1361(b)(1)(B).
[12] Sec. 1361(c)(3).
[13] *Alphonse Mourad*, 94 AFTR 2d 2004-6440 (2004, CA1) *aff'g* 121 TC 1 (2003).
[14] *Lawrence G. Williams*, 123 TC 144 (2004).

- Trusts created primarily to exercise the voting power of the stock. In determining whether the limitation on the number of qualifying shareholders has been exceeded, each beneficiary of the trust is treated as a separate shareholder; in other words, the trust veil is pierced to determine the number of shareholders.
- Trusts in which either the grantor (grantor trust) or individual other than the grantor (Sec. 678 trust) is treated as the complete owner of the trust. The individual must be a U.S. citizen or resident. For purposes of the 100-shareholder rule, the deemed owner is considered to be the shareholder.
- A trust described in the preceding item that continues after the deemed owner's death, but only for two years after the deemed owner dies. For purposes of the 100-shareholder rule, the estate is considered to be the shareholder.
- Qualified Subchapter S Trusts (QSSTs).
- Electing Small Business Trusts (ESBTs).
- Trusts to which stock is transferred under the terms of a will, but only for two years after the stock is transferred to the trust. The estate is considered to be the shareholder. (The two-year period does not apply if the trust is a QSST or ESBT.)
- Tax-exempt qualified retirement plan trusts under Sec. 401(a), which are employer's qualified pension, profit-sharing, or stock bonus plans, including an employee stock ownership plan (ESOP). A plan (other than an ESOP) that holds S corporation stock, however, may be subject to the tax on unrelated business taxable income (UBTI) under Sec. 512(e).

IRAs, SEPs, and Certain Charitable Trusts Generally Cannot Hold S Corporation Shares

IRAs and SEPs are not eligible to hold S corporation shares.[15] Neither are charitable remainder annuity trusts and charitable remainder unitrusts.[16] For exceptions to the rule, see the following paragraphs.

IRA Can Hold S Stock of Certain Banks and Certain ESOP Rollovers

An IRA (including a Roth IRA) is allowed to hold S stock in extremely limited circumstances.

An IRA can hold shares of a bank (as defined by Sec. 581) if the bank elects S status and the shares were held in the IRA on October 22, 2004.[17]

Another limited exception allows an ESOP to make a direct rollover of S corporation stock to an IRA if three conditions are met. First, the terms of the ESOP must require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to the IRA. Second, the S corporation must actually repurchase the S corporation stock on the same day as the

[15] Rev. Rul.92-73, 1992-2 CB 244.
[16] Sec. 1361(e)(1)(B).
[17] See Secs. 1361(c)(2)(A)(vi), 1361(c)(2)(B)(vi), and 4975(d)(16).

distribution. Third, items of income, loss, deduction, or credit cannot be passed through by the S corporation to the IRA.[18]

Charitable Organizations

Section 501(c)(3) charitable organizations are eligible shareholders.[19] When computing the charitable organization's unrelated business taxable income (UBTI), you must take into account all items of income, loss, and deduction passed through by the S corporation, as well as any gain or loss from the disposition of the S corporation's stock.[20]

A Single-Member LLC Can Be an Eligible Shareholder

Normally, an LLC cannot hold S corporation stock. However, Ltr. Ruls. 200008015 and 9745017 state that a single-member LLC can be an S corporation shareholder. The LLC must be disregarded as an entity separate from its owner, and must be a domestic entity that is not classified as a corporation.[21]

Certain Corporations are Ineligible to Elect S Status

The following are ineligible corporations under Sec. 1361(b)(2) and Reg. Sec. 1.1361-1(d), and thus cannot elect S corporation status:

- A domestic international sales corporation (DISC) or former DISC
- A financial institution that uses the reserve method of accounting for bad debts
- An insurance company taxable under Subchapter L
- A corporation electing the possessions tax credit under Sec. 936
- A taxable mortgage pool (TMP) under Sec. 1361(b)(2)(E).[22]

Certain Banks and LLCs Can Be Eligible Corporations

A corporation that fits the qualifications described under "Eligibility for S Corporation Status" earlier can elect to be an S corporation if it is not specifically ineligible. Banks and LLCs may not fit clearly into these categories, and are discussed in the following paragraphs.

Banks

A bank (as described in Sec. 581) can elect S status if it does not use the reserve method of accounting for bad debts.[23] When a bank files an S election Form 2553, it is agreeing to change

[18] Rev. Proc. 2004-14, 2004-1 CB 489.
[19] Secs. 1361(b)(1)(B) and (c)(6)(A).
[20] Sec. 512(e).
[21] Reg. Sec. 301.7701-3(a) and (b)(1) set out the entity classification options for an entity not otherwise classified as a corporation.
[22] See Reg. Sec. 301.7701(i)-3 and 301.7701(i)-4(c)(1).
[23] Sec. 1362(b)(2).

its method of accounting for bad debts from the Section 585 reserve method to the Section 166 specific charge-off method.[24]

LLCs

An LLC (or other entity) that has filed a check-the-box election to be taxed as a corporation can elect S status, if the entity and the shareholders meet the eligibility rules.[25] The entity generally makes the check-the-box election by filing Form 8832, *Entity Classification Election*.

An LLC that is both electing to be treated as a corporation and making the S election can bypass Form 8832 and instead use Form 2553. If such an LLC timely files a proper S election (Form 2553), the entity is considered to have made the election to be taxed as a corporation.[26] The entity is classified as a corporation on the date the S election is effective.[27]

Once an entity changes its classification (for example, to a corporation), it cannot change its classification again for 60 months.[28]

Completing Form 2553 when an LLC Elects S Status

Completing the S election Form 2553 when an LLC is electing S status can be troublesome because an LLC is not a formal corporation that issues shares. The instructions to the S election Form 2553 do provide some guidance, however. According to the instructions, the effective date of the election is the earliest date on which the entity (1) first had owners; (2) first had assets; or (3) began doing business. (These criteria are also applied to corporations electing S status.) Each member's percentage of ownership is entered in the number-of-shares sections of Form 2553. You may want to enter the effective date of the Form 8832 or the S election as the date incorporated on Form 2553 because the instructions are silent on this matter. Also, you should evidently enter the state in which the entity is formed as the state of incorporation.

> **Practice Tip:** Changing an entity classification can cause tax consequences that should be fully researched before the change is made. For example, a change in classification from an LLC treated as a partnership to treatment as a corporation is considered to be a liquidation of the partnership.

Relief from Late Filing of Form 8832 or Form 2553

An entity that intended to be classified as an association taxable as a corporation on the date the S election became effective, but did not timely file Form 8832, Form 2553, or both can apply for relief using simplified methods under Rev. Procs. 2004-48, or 2007-62.

RELIEF UNDER REV. PROC. 2004-48

Under Rev. Proc. 2004-48, 2004-2 CB 72, an entity that meets the S corporation requirements can be an S corporation from the date the S election was originally intended to be effective, even though the Forms 8832 or 2553 were not timely filed. The request for relief is made by filing the

[24] Rev. Proc. 2008-52, 2008-52, 2008-36 IRB 587, Appendix Sec. 24.01.
[25] Reg. Secs. 1.1361-1(c) and 301.7701-3.
[26] Reg. Sec. 301.7701-3(c)(1)(v)(C).
[27] Reg. Sec. 301.7701-3(c)(1)(v)(C).
[28] Reg. 301.7701-3(c)(1)(iv).

S election Form 2553 with the appropriate IRS service center no later than six months after the due date of the tax return, excluding extensions, for the first year the entity intended to be an S corporation. Reasonable cause must be given for the failure to file the forms. Anyone who was a shareholder during the period beginning on the first day of the tax year for which the election is to be effective and ending on the day the election is made must consent to the election. No user fee is required when applying for relief under the provisions set out in Rev. Proc. 2004-48.

RELIEF UNDER REV. PROC. 2007-62

Under Rev. Proc. 2007-62, 2007-41 IRB 786, an entity that meets the S corporation requirements can be an S corporation from the date the S election was originally intended to be effective, even though the Forms 8832 or 2553 were not timely filed. The request for relief is made by filing the S election Form 2553 with the entity's first tax return, Form 1120S. The tax return must be filed no later than six months after its due date, excluding extensions, for the first year the entity intended to be treated as an S corporation. Reasonable cause must be given for the failure to file the forms. Anyone who was a shareholder during the period beginning on the first day of the tax year for which the election is to be effective and ending on the day the election is made must consent to the election. No user fee is required when applying for relief under the provisions set out in Rev. Proc. 2007-62.

> **Practice Tip:** The primary differences between the two revenue procedures can be summarized like this:
>
> - Rev. Proc. 2004-48 is submitted to an IRS service center, while Rev. Proc. 2007-62 is attached to the entity's first tax return, Form 1120S.
> - The explanation as to why the Forms 8832 or 2553 were not timely filed is submitted as an attachment to the Form 2553 under Rev. Proc. 2004-48. Under Rev. Proc. 2007-62, the explanation is made in the space provided on the face of Form 2553.
>
> When using either of these relief provisions, you should study the specific revenue procedure and follow the procedures set out in the revenue procedure.

LLC ELECTING S STATUS MUST FOLLOW S CORPORATION RULES

An LLC that elects S status and its shareholders must be eligible for S status and must follow the S corporation rules once the S election is made. Therefore, the S corporation can have only one class of stock and the S corporation passthrough and distribution rules will apply. This also means that the LLC members who have effectively become S corporation shareholders are not subject to self-employment tax on passthrough or distributions received from the S corporation. If a member provides services to the corporation, that member or shareholder must be paid a reasonable salary, subject to payroll taxes and W-2 reporting.

One Class of Stock

An S corporation can have only one class of stock.[29] Regulations indicate that the one class of stock rules apply only to outstanding shares of stock.[30] In other words, the existence of other

[29] Sec. 1361(b)(1)(D).
[30] Reg. Sec. 1.1361-1(b).

classes of stock either authorized and unissued or held as treasury stock does not bar an S election. However, rights provided by governing provisions may be considered a second class of stock.

Voting and Nonvoting Shares

Different voting rights among shares of common stock do not violate the one class of stock rule.[31]

The issuance of nonvoting shares may provide a means of transferring an ownership interest to, say, children. The new shareholders would then enjoy an equity interest, but would not have the power to make management decisions. However, it is important to remember that if the corporation elects to revoke the S election, shareholders holding more than 50 percent of the outstanding shares (whether voting or nonvoting) can consent to the revocation and cause the S election to terminate.

Straight Debt

Certain loans from shareholders may be determined to actually represent equity in the corporation. If corporate debt to shareholders is deemed to be equity, is it also a second class of stock?

Not if you are careful.

In general, an instrument, obligation, or arrangement will be treated as a second class of stock, if

- It constitutes equity or otherwise results in the holder being treated as the owner of the stock, and
- One of its principal purposes is to circumvent the rights to distribution or liquidation proceeds or to circumvent the 100-shareholder limit.[32]

Section 1361(c)(5) provides a safe harbor wherein straight debt in an S corporation will not be treated as a second class of stock. *Straight debt* is defined[33] as

> [A] written unconditional promise to pay on demand or on a specified date a certain sum in money if
>
> a. The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, payment of dividends with respect to common stock, or similar factors;
>
> b. There is no direct or indirect convertibility to stock or any other equity interest of the S corporation; and
>
> c. The creditor is (1) an individual, estate or trust eligible to hold S corporation stock, or (2) a bank or other entity (not including an individual) that is actively and regularly engaged in the business of lending money.

[31] Sec. 1362(c)(4); Reg. Sec. 1.1361-1(l)(1).
[32] Reg. Sec. 1.1361-1(l)(4)(ii).
[33] Reg. Sec. 1.1361-1(l)(5).

There is no express requirement that the debt bear interest. If it does not carry a fair market interest rate, however, it will be subject to the below-market interest rules of Sec. 7872.

The Subchapter S Revision Act of 1982 Senate Finance Committee Report provides that tying the interest rate to the prime rate or similar factor will not remove the instrument from the safe harbor boundaries.

> **Practice Tip:** Even though loans from shareholders are not required to bear interest, in the author's opinion, all such notes should carry a fair market interest rate. Payment of fair market interest is a strong indicator that the loan from the shareholder is bona fide corporate debt.
>
> **Practice Tip:** The straight debt provisions should make it relatively easy to avoid an IRS argument that debt is a disguised second class of stock. Generally, the corporation is only required to produce documentation showing that the loan is bona fide. And the terms of the document should be complied with; for example, interest should be paid when due.

SAFE HARBORS

The regulations provide two safe harbors in addition to the straight debt rules. Under the regulations, debt to shareholders will not constitute a second class of stock if either of two conditions is met:

1. Unwritten advances from a shareholder are not more than $10,000 in the aggregate at any time during the corporation's taxable year, are treated as debt by the corporation and shareholder, and are expected to be repaid within a reasonable time.
2. Obligations are held by a sole shareholder or obligations are owned only by the shareholders and are held in the same proportion as the corporation's outstanding stock.[34] This means that debt held by shareholders in the same proportions as their stock ownership will not be considered a second class of stock. Furthermore, debt held by an S corporation's sole shareholder is considered to be proportionately held debt and therefore is not a second class of stock.

These safe harbors do not apply if the debt is considered to be equity and a principal purpose of the debt is to circumvent the rights to distribution or liquidation proceeds or to circumvent the 100-shareholder limit.

The regulations also contain rules relating to debt that is convertible to stock, options and warrants, and other provisions.

Governing Provisions

The regulations generally provide that an S corporation has only one class of stock if all outstanding shares carry identical rights to distribution and liquidation proceeds.[35]

Only rights given in *governing provisions* will be considered when determining if there is more than one class of stock. Governing provisions are those found in the corporate charter, articles of

[34] Reg. Sec. 1.1361-1(l)(4)(ii)(B).
[35] Reg. Sec. 1.1361-1(l)(1).

incorporation, bylaws, applicable state law, and "binding agreements" that apply to distribution and liquidation proceeds.

A routine commercial contract is not a binding agreement for these purposes, and will not cause a second class of stock unless it is designed to circumvent the second class of stock rules or contravene the 100-shareholder limitation. Routine commercial contracts include contractual arrangements such as a lease, employment agreement, or loan agreement.[36] Also disregarded when determining whether stock confers identical rights are agreements to redeem stock on death, disability, divorce, or termination of employment.[37]

Buy-Sell Agreements

A buy-sell agreement among shareholders will not create a second class of stock unless

- A principal purpose of the agreement is to circumvent the one class of stock rule, and
- The agreement establishes a purchase price that is significantly above or below the fair market value of the stock (measured at the time the agreement is entered into).[38]

If the purchase price is between fair market value and book value, the price is *not* considered to be significantly above or below fair market value.

Buy-sell agreements, agreements restricting the transfer of stock, and redemption agreements are not under the preceding rules if entered into before May 28, 1992, and not materially modified after that date.

Restricted Bank Director Shares

Restricted bank director shares are not considered to be outstanding S corporation stock, and, therefore, are (1) not counted when determining whether the 100-shareholder limit has been exceeded, and (2) not considered to be a second class of stock.[39]

Qualified Subchapter S Trust

A *Qualified Subchapter S Trust* (QSST) may be a shareholder.[40] The individual beneficiary of the trust must elect to be treated as the owner of the trust. The election is irrevocable and it must apply from the date of the trust's election until the trust ceases to be a Subchapter S trust. The election may apply retroactively for a period of no more than 2 months and 15 days.

A *Qualified Subchapter S Trust* is one which

- Owns stock in one or more S corporations;
- Has as its sole beneficiary a U.S. citizen or resident; and

[36] Reg. Sec. 1.1361- 1(l)(2)(i).
[37] Reg. Sec. 1.1361-1(l)(2)(iii)(B).
[38] Reg. Sec. 1.1361-1(l)(2)(iii)(A).
[39] See Sec. 1361(f).
[40] Sec. 1361(d); Reg. Sec. 1.1361-1(j).

- Has trust terms stating that
    - During the life of the current beneficiary, there will be only one income beneficiary;
    - Any corpus distributed during the term of the trust must be distributed to the current income beneficiary;
    - The income interest of the current income beneficiary terminates on the earlier of the income beneficiary's death or the date the trust terminates; and
    - Upon trust termination during the life of the income beneficiary all corpus and income must be distributed to that beneficiary.

If the income beneficiary dies, and the trust continues to meet the QSST requirements, the successor beneficiary is deemed to have elected qualified trust treatment, unless an affirmative refusal is made.[41]

If a QSST ceases to qualify after the death of the income beneficiary, the trust will continue to be an eligible shareholder for the two-year period following the death of the current beneficiary.[42]

Beneficiary Includes S Corporation Passthrough Items on Form 1040

S corporation items of income, gain, loss, deduction, or credit passed through to the trust are reported by the trust's current income beneficiary on the beneficiary's personal income tax return, Form 1040 (Ltr. Rul. 9035048).

Income Distribution Requirement

The QSST must distribute (or be required to distribute) all of its income[43] currently to the trust's beneficiary.[44]

Income for purposes of the current distribution does not include the trust's *pro rata* share of the S corporation's passthrough items of income, gain loss, deduction, or credit.[45] Income for these purposes, however, does include distributions from the S corporation. Therefore, amounts passed through to the trust by the S corporation do not have to be distributed currently. Distributions from the S corporation, however, are under the current distribution rule.

Example 2-3

Jan is the beneficiary of a QSST that holds stock in ABC, an S corporation. During the year, the corporation makes a nontaxable distribution of $12,000 to the trust. At the end of the year, ABC passes through $23,000 of trade or business income to the QSST. The trust is required to distribute $12,000 to Jan currently.

[41] Sec. 1361(d) (2)(B)(ii); Reg. Sec. 1.1361-1(j)(9).
[42] Sec. 1361(c)(2)(A)(ii).
[43] As defined in Sec. 643(b).
[44] See Sec. 1361(d)(3)(B) and also Rev. Rul. 92-20, 1992-1 CB 301.
[45] Sec. 1361(d)(1)(B); Reg. Sec. 1.1361-1(j)(1)(i).

Jan reports the $23,000 of income on her Form 1040, but that amount is not under the current distribution rule and does not have to be distributed to her.

Sale of S Corporation Stock by a QSST

When a QSST sells S corporation stock, the QSST, rather than the income beneficiary, recognizes gain or loss on the sale.[46] The trust reports the transaction on Schedule D of Form 1041.

For purposes of the at-risk and passive activity loss rules only, however, a QSST's disposition of S stock is treated as if it were a disposition by the QSST beneficiary.[47] This allows the QSST beneficiary to deduct losses previously suspended under the at-risk or passive activity loss rules when the QSST disposes of its S corporation stock. This is true even though the gain is reported at the trust level.

QSST Election

The QSST election must be signed by the trust's income beneficiary and filed within the 2-month and 16-day period beginning on the date the stock of the S corporation is transferred to the trust.[48]

The QSST election can be made on the S election form, Form 2553, if (1), the S election and the QSST election are effective on the same date, and (2), the corporation's stock is transferred to the trust on or before the date on which the S election is made. Regulations Sec. 1.1361-1(j) provides detailed instructions for electing and revoking a Qualified Subchapter S Trust, and gives examples of trusts that qualify.

If the QSST fails to file a timely election and this failure causes the corporation's S election to terminate, the corporation may qualify for a waiver from inadvertent termination under the provisions set out in Rev. Proc. 2003-43, 2003-1 CB 998.

Once a QSST election is made, it can be revoked only if the IRS consents to the revocation.[49]

> **Practice Tip:** If loss of S corporation status is to be avoided, care will have to be exercised to ensure that the trust continues to be an eligible S shareholder. The trust's disqualification terminates the S election as of the date the trust becomes disqualified.[50]

Electing Small Business Trust

An *Electing Small Business Trust* (ESBT) is an eligible S corporation shareholder.[51] An ESBT can provide that income will be distributed to (or accumulated for) one or more beneficiaries. The trust (not the beneficiary) is taxed on income related to the S corporation stock at the highest

[46] Reg. Sec. 1.1361-1(j)(8).
[47] Sec. 1361(d)(1); Reg. Sec. 1.1361-1(j)(8).
[48] Reg. Sec. 1361-1(j)(6)(iii).
[49] Sec. 1361(d)(2)(C).
[50] Sec. 1361(d)(4).
[51] Sec. 1361(c)(2)(A)(v) and (e).

individual rate (35 percent on ordinary income), unless the income qualifies as long-term capital gain, in which case a maximum 15 percent rate generally applies.[52]

> **Practice Tip:** An ESBT can have more than one current beneficiary, which allows S corporation income to be distributed to or accumulated for the benefit of family members or other beneficiaries.

ESBT beneficiaries must be individuals, estates or charitable organizations qualified to be S shareholders. Also, political entities defined in Sec. 170(c)(1) can be contingent beneficiaries if they are not potential current income beneficiaries, as defined below.[53] If a disqualified person becomes a potential current beneficiary, the ESBT has one year to dispose of its S corporation stock before the S election terminates.[54]

No interest in the trust can be acquired by purchase (that is, with a cost basis determined under Sec. 1012, *Basis of Property—Cost*). This means that an interest in the trust must generally be acquired by gift, bequest, or transfer in trust. Under this provision, a beneficiary is prohibited from purchasing an interest in the trust, but the trust itself is allowed to buy S corporation shares and hold them in the trust.[55]

Potential Current Beneficiaries

Any person who is entitled to (or at the discretion of any person may receive) a distribution from the principal or income from an ESBT is a *potential current beneficiary*. When making this determination, unexercised powers of appointment are disregarded.[56] If the person is not entitled to receive a distribution until a specified time or specified event (upon another person's death, for example), the person is not a potential current beneficiary until the time arrives or the event takes place.[57]

For purposes of the 100-shareholder limit, each potential current beneficiary, and the beneficiary's family members, count as one shareholder. The trust itself is treated as the shareholder if the trust has no potential current beneficiaries.[58]

Taxable Income

The taxable income of an ESBT consisting solely of stock in one or more S corporations includes

- The S corporation items of income, loss, or deduction allocated to it (that is, passed through on Schedule K-1 of Form 1120S) as an S corporation shareholder;
- Gain or loss from the sale of the S corporation stock; and
- To the extent provided in the regulations, any state or local income taxes and administrative expenses.

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[52] Sec. 641(c)(2)(A).
[53] Sec. 1361(e)(1)(A).
[54] Sec. 1361(e)(2).
[55] Sec. 1361(e)(1)(A)(ii); Reg. Sec. 1.1361-1(m).
[56] Sec. 1361(e)(2); Reg. Sec. 1.1361-1(m)(4).
[57] Reg. Sec. 1.1361-1(m)(1)(ii)(C).
[58] Sec. 1361(c)(2)(B)(v); Reg. Sec. 1.1361-1(m)(1)(i); Reg. Sec. 1.1361-1(e)(3)(ii).

Capital losses are allowed only to the extent of capital gains.[59]

Sale of S Corporation Stock by ESBT

When an ESBT sells its S corporation stock, gain or loss is recognized at the trust level.[60] Remember, though, that an ESBT can recognize capital losses only to the extent of capital gains, as stated in the preceding paragraph.

Interest Deduction for Debt Used to Acquire S Shares

An ESBT can deduct interest expense on debt that is used to acquire S corporation shares when determining the trust's taxable income attributable to its S corporation ownership.[61]

ESBT Election

The trustee of an ESBT makes the ESBT election by signing and filing a statement with the service center where the corporation files its income tax return.[62] If the S corporation is electing S status, the ESBT election statement may be attached to the S election Form 2553.

The ESBT election must be filed within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust or, if later, the first day of the S corporation's first tax year.

Once an ESBT election is made, it can be revoked only if the IRS consents to the revocation.[63]

Relief from Termination of the S Election When QSST or ESBT Election Is Not Timely Filed

The IRS will grant relief (that is, allow the corporation to retain its S status) if the QSST or ESBT election is not timely filed. Without this relief, the S election would terminate or not become effective at all because the corporation would have an ineligible trust as a shareholder. See Rev. Proc. 2003-43, 2002-1 CB 998.

S Corporation Can Hold Stock of Another Corporation

An S corporation can own up to 100 percent of another corporation. However, a corporation[64] is not eligible to hold S corporation stock. Thus, if, for example, S corporation ABC acquires stock of S corporation GHI, S corporation GHI's election will terminate. If ABC holds 100 percent of GHI's shares, ABC can elect to treat GHI as a Qualified Subchapter S Subsidiary, as discussed in the following topic.

> **Practice Tip:** An S corporation can hold an ownership interest in a partnership or LLC. If these entities own S corporation stock, however, the S election will terminate because the entities are not eligible S shareholders.

[59] Secs. 641(c)(2)(C) and 1361; Reg. Sec. 1.641(c)-1(d).
[60] Sec. 641(c)(2)(C)(ii); Reg. Sec. 1.641(c)-1(d)(3)(i).
[61] Sec. 641(c)(2)(C).
[62] Reg. Sec. 1.1361-1(m)(2), 1.1362-6(b)(2)(iv).
[63] Sec. 1361(e)(3).
[64] Other than a charitable organization under Sec. 501(c)(3).

Qualified Subchapter S Subsidiary

An S corporation is allowed to hold a "Qualified Subchapter S Subsidiary" (QSub).[65] A QSub is a domestic corporation that is 100 percent owned by an S corporation that is not treated as a separate corporation for federal tax purposes.

> **Example 2-4**
>
> Robot, Inc., an S corporation, acquires all the stock of a C corporation, Arm, Inc., and an S corporation, Legg Corp. Robot can
>
> 1. Treat both Arm and Legg as separate C corporations,
> 2. Treat Arm as a separate C corporation and elect to treat Legg as a QSub,
> 3. Treat Legg as a separate C corporation and elect to treat Arm as a QSub, or
> 4. Elect to treat both Arm and Legg as QSubs.
>
> As discussed earlier in this chapter, a corporation cannot hold S corporation stock. So, Legg's S status terminates when its stock is acquired by Robot. This fact does not affect Robot's ability to make the QSub election.

The QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the S corporation parent company and are reflected on the parent corporation's tax return.[66] Therefore, only the parent company files a tax return, Form 1120S, and transactions between the S corporation parent and the QSub are not taken into account.

Items of the QSub (including debt basis, accumulated earnings and profits, passive investment income, and built-in gains) are considered to be items of the parent S corporation.

Even though the parent S corporation and QSub are treated as one entity, the QSub is treated as a separate entity for purposes of certain taxes, refunds, and credits.[67] Included in these provisions is a requirement that a QSub must report its FICA, FUTA, and wage withholding separately from the parent corporation.[68]

A QSub cannot be an ineligible corporation such as a DISC or former DISC.

Filing the QSub Election

The S corporation parent elects QSub status for the subsidiary by filing Form 8869, *Qualified Subchapter S Subsidiary Election*. The parent specifies the effective date of the QSub election on the Form 8869. The effective date cannot be more than 2 months and 15 days prior to the date of filing the form or more than 12 months after that date.

> **Practice Tip:** If the QSub election is to become effective on the date the subsidiary is acquired, the Form 8869 must be filed by the 15th day of the third month after the

[65] Sec. 1361(b)(3); Reg. Secs. 1.1361-2, -3, -4, -5.
[66] Reg. Sec. 1.1361-4(a).
[67] See Sec. 1361(b)(3)(A); Reg. Sec. 1.1361-4(a)(6), (7), and (8).
[68] Reg. Sec. 1.1361-4(a)(7).

acquisition date. For example, if the QSub election is to be effective on January 7, it must be made before March 22.[69]

Relief from Late or Invalid QSub Elections

If a timely QSub election is not filed or is otherwise invalid, the S corporation may qualify for inadvertent invalid election.[70] Under certain conditions, the effects of an invalid election can be waived and the QSub election will become effective as originally planned.

QSub Election Form 8869

A Form 8869 can be found at the end of this chapter.

Termination of QSub Status

A QSub election will terminate if the subsidiary fails to qualify or the parent revokes the election. If this happens, another QSub election cannot be made for the subsidiary by the parent for five years without the consent of the IRS.[71]

Electing QSub Status Is a Deemed Liquidation

When an S corporation makes a QSub election for a subsidiary corporation, the subsidiary generally is deemed to have engaged in a *tax-free liquidation* (under Secs. 332 and 337) into the S corporation.[72] Making the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation takes place, unless a formal plan of liquidation relating to the QSub election is adopted on an earlier date.

If the deemed liquidation results in a gain and does not qualify as a tax-free parent or subsidiary liquidation under Secs. 332 and 337, the subsidiary generally recognizes the gain. (For example, Rev. Rul. 68-602, 1968-2 CB 135, provides that the Sec. 332 tax-free provisions do not apply where the wholly-owned subsidiary owes the acquiring corporation more than the fair market value of the subsidiary's assets.) The related-party loss rules of Sec. 267 generally prohibit the recognition of losses on such liquidations.

Built-in Gains Tax and LIFO Recapture Tax

If the QSub election is made for a subsidiary that was a C corporation before the QSub election, the subsidiary's assets are subject to the built-in gains tax rules beginning on the date the QSub election becomes effective. Also, a subsidiary's assets remain subject to the built-in gains tax provisions if the subsidiary was an S corporation subject to the built-in gains tax before the QSub election.[73]

The built-in gains rules do not apply to a QSub's assets if the subsidiary was an S corporation that was not subject to the built-in gains tax.

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[69] Reg. Secs. 1.1361-3(a)(4), 1.1362-6(a)(2)(ii)(C).
[70] Sec. 1362(f); Rev. Proc. 2003-43, 2003-1 CB 998.
[71] Secs. 1361 and 1362; Reg. Sec. 1.1365-5.
[72] Reg. Sec. 1.1361-4(a)(2).
[73] Sec. 1374(d)(8); Reg. Sec. 1.1374-8(b); Reg. Sec. 1.1374-3(b) and (c).

The LIFO recapture tax applies to a QSub if the subsidiary was a C corporation using the LIFO method for inventory prior to the QSub election.[74]

Summary

To be an S corporation, a corporation must

- Be a small business corporation.
- Not be ineligible.

[74] Sec. 1363(d).

Form **8832**
(Rev. January 2011)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

OMB No. 1545-1516

Type or Print	Name of eligible entity making election	Employer identification number
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.	

► Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41

Part I Election Information

1 **Type of election** (see instructions):

a ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

a Name of owner ► _____
b Identifying number of owner ► _____

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

a Name of parent corporation ► _____
b Employer identification number ► _____

Part I **Election Information** (Continued)

6 **Type of entity** (see instructions):

a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
b ☐ A domestic eligible entity electing to be classified as a partnership.
c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
e ☐ A foreign eligible entity electing to be classified as a partnership.
f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ▶ _____

8 Election is to be effective beginning (month, day, year) (see instructions) . . . . . ▶ _____

9 Name and title of contact person whom the IRS may call for more information	**10** Contact person's telephone number

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

Signature(s)	Date	Title

Part II Late Election Relief

11 Provide the explanation as to why the entity classification election was not filed on time (see instructions).

Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I (we) further declare that I (we) have personal knowledge of the facts and circumstances related to the election. I (we) further declare that the elements required for relief in Section 4.01 of Revenue Procedure 2009-41 have been satisfied.

Signature(s)	Date	Title

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

What Is New:

A checkbox was added to allow for the late election under Rev. Proc. 2009-41, 2009-39 I.R.B. 439.

Also, foreign entities that meet the requirements of Rev. Proc. 2010-32, 2010-36 I.R.B. 320 and that elect to be classified as a partnership rather than a disregarded entity or a disregarded entity rather than a partnership will be classified as the appropriate flow through entity depending on its actual number of owners instead of an association taxable as a corporation.

Purpose of Form

An eligible entity uses Form 8832 to elect how it will be classified for federal tax purposes, as a corporation, a partnership, or an entity disregarded as separate from its owner. An eligible entity is classified for federal tax purposes under the default rules described below unless it files Form 8832 or Form 2553, Election by a Small Business Corporation, to elect a classification or change its current classification. See Who Must File below.

The IRS will use the information entered on this form to establish the entity's filing and reporting requirements for federal tax purposes.

A new eligible entity should not file Form 8832 if it will be using its default classification (see Default Rules *below).*

Eligible entity. An eligible entity is a business entity that is not included in items 1, or 3 through 9, under the definition of **corporation** provided under *Definitions.* Eligible entities include limited liability companies (LLCs) and partnerships.

Generally, corporations are not eligible entities. However, the following types of corporations are treated as eligible entities:

1. An eligible entity that previously elected to be an association taxable as a corporation by filing Form 8832. An entity that elects to be classified as a corporation by filing Form 8832 can make another election to change its classification (see the *60-month limitation rule* discussed below in the instructions for lines 2a and 2b).

2. A foreign eligible entity that became an association taxable as a corporation under the foreign default rule described below.

Default Rules

Existing entity default rule. Certain domestic and foreign entities that were in existence before January 1, 1997, and have an established federal tax classification generally do not need to make an election to continue that classification. If an existing entity decides to change its classification, it may do so subject to the 60-month limitation rule. See the instructions for lines 2a and 2b. See Regulations sections 301.7701-3(b)(3) and 301.7701-3(h)(2) for more details.

Domestic default rule. Unless an election is made on Form 8832, a domestic eligible entity is:

1. A partnership if it has two or more members.

2. Disregarded as an entity separate from its owner if it has a single owner.

A change in the number of members of an eligible entity classified as an **association** (defined below) does not affect the entity's classification. However, an eligible entity classified as a partnership will become a disregarded entity when the entity's membership is reduced to one member and a disregarded entity will be classified as a partnership when the entity has more than one member.

Foreign default rule. Unless an election is made on Form 8832, a foreign eligible entity is:

1. A partnership if it has two or more members and at least one member does not have limited liability.

2. An association taxable as a corporation if all members have limited liability.

3. Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

However, if a qualified foreign entity (as defined in section 3.02 of Rev. Proc. 2010-32) files a valid election to be classified as a partnership based on the reasonable assumption that it had two or more owners as of the effective date of the election, and the qualified entity is later determined to have a single owner, the IRS will deem the election to be an election to be classified as a disregarded entity provided:

1. The qualified entity's owner and purported owners file amended returns that are consistent with the treatment of the entity as a disregarded entity;

2. The amended returns are filed before the close of the period of limitations on assessments under section 6501(a) for the relevant taxable year; and

3. The corrected Form 8832 is filed and attached to the amended tax return. Corrected Form 8832 must include across the top the statement "FILED PURSUANT TO REVENUE PROCEDURE 2010-32;"

Also, if the qualified foreign entity (as defined in section 3.02 of Rev. Proc. 2010-32) files a valid election to be classified as a disregarded entity based on the reasonable assumption that it had a single owner as of the effective date of the election, and the qualified entity is later determined to have two or more owners, the IRS will deem the election to be an election to be classified as a partnership provided:

1. The qualified entity files information returns and the actual owners file original or amended returns consistent with the treatment of the entity as a partnership;

2. The amended returns are filed before the close of the period of limitations on assessments under section 6501(a) for the relevant taxable year; and

3. The corrected Form 8832 is filed and attached to the amended tax returns. Corrected Form 8832 must include across the top the statement "FILED PURSUANT TO REVENUE PROCEDURE 2010-32"; see Rev. Proc. 2010-32, 2010-36 I.R.B. 320 for details.

Definitions

Association. For purposes of this form, an association is an eligible entity taxable as a corporation by election or, for foreign eligible entities, under the default rules (see Regulations section 301.7701-3).

Business entity. A business entity is any entity recognized for federal tax purposes that is not properly classified as a trust under Regulations section 301.7701-4 or otherwise subject to special treatment under the Code regarding the entity's classification. See Regulations section 301.7701-2(a).

Corporation. For federal tax purposes, a corporation is any of the following:

1. A business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic.

2. An association (as determined under Regulations section 301.7701-3).

3. A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association.

4. An insurance company.

5. A state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S. C. 1811 et seq., or a similar federal statute.

6. A business entity wholly owned by a state or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in Regulations section 1.892-2T.

7. A business entity that is taxable as a corporation under a provision of the Code other than section 7701(a)(3).

8. A foreign business entity listed on page 7. See Regulations section 301.7701-2(b)(8) for any exceptions and inclusions to items on this list and for any revisions made to this list since these instructions were printed.

9. An entity created or organized under the laws of more than one jurisdiction (business entities with multiple charters) if the entity is treated as a corporation with respect to any one of the jurisdictions. See Regulations section 301.7701-2(b)(9) for examples.

Disregarded entity. A disregarded entity is an eligible entity that is treated as an entity not separate from its single owner for income tax purposes. A "disregarded entity" is treated as separate from its owner for:

- Employment tax purposes, effective for wages paid on or after January 1, 2009; and
- Excise taxes reported on Forms 720, 730, 2290, 11-C, or 8849, effective for excise taxes reported and paid after December 31, 2007.

See the employment tax and excise tax return instructions for more information.

Limited liability. A member of a foreign eligible entity has limited liability if the member has no personal liability for any debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law under which the entity is organized (and, if relevant, the entity's organizational documents). A member has personal liability if the creditors of the entity may seek satisfaction of all or any part of the debts or claims against the entity from the member as such. A member has personal liability even if the member makes an agreement under which another person (whether or not a member of the entity) assumes that liability or agrees to indemnify that member for that liability.

Partnership. A partnership is a business entity that has at least two members and is not a corporation as defined above under *Corporation.*

Who Must File

File this form for an eligible entity that is one of the following:

- A domestic entity electing to be classified as an association taxable as a corporation.
- A domestic entity electing to change its current classification (even if it is currently classified under the default rule).
- A foreign entity that has more than one owner, all owners having limited liability, electing to be classified as a partnership.
- A foreign entity that has at least one owner that does not have limited liability, electing to be classified as an association taxable as a corporation.
- A foreign entity with a single owner having limited liability, electing to be an entity disregarded as an entity separate from its owner.
- A foreign entity electing to change its current classification (even if it is currently classified under the default rule).

Do not file this form for an eligible entity that is:

- Tax-exempt under section 501(a);
- A real estate investment trust (REIT), as defined in section 856; or
- Electing to be classified as an S corporation. An eligible entity that timely files Form 2553 to elect classification as an S corporation and meets all other requirements to qualify as an S corporation is deemed to have made an election under Regulations section 301.7701-3(c)(v) to be classified as an association taxable as a corporation.

All three of these entities are deemed to have made an election to be classified as an association.

Effect of Election

The federal tax treatment of elective changes in classification as described in Regulations section 301.7701-3(g)(1) is summarized as follows:

- If an eligible entity classified as a partnership elects to be classified as an association, it is deemed that the partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.
- If an eligible entity classified as an association elects to be classified as a partnership, it is deemed that the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.
- If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, it is deemed that the association distributes all of its assets and liabilities to its single owner in liquidation of the association.
- If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the association in exchange for the stock of the association.

Note. For information on the federal tax consequences of elective changes in classification, see Regulations section 301.7701-3(g).

When To File

Generally, an election specifying an eligible entity's classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed. An eligible entity may be eligible for late election relief in certain circumstances. For more information, see *Late Election Relief*, later.

Where To File

File Form 8832 with the Internal Revenue Service Center for your state listed below.

In addition, attach a copy of Form 8832 to the entity's federal tax or information return for the tax year of the election. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the federal tax returns of all direct or indirect owners of the entity for the tax year of the owner that includes the date on which the election took effect. An indirect owner of the electing entity does not have to attach a copy of the Form 8832 to its tax return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. Failure to attach a copy of Form 8832 will not invalidate an otherwise valid election, but penalties may be assessed against persons who are required to, but do not, attach Form 8832.

Each member of the entity is required to file the member's return consistent with the entity election. Penalties apply to returns filed inconsistent with the entity's election.

If the entity's principal business, office, or agency is located in:	Use the following Internal Revenue Service Center address:
Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, Wisconsin	Cincinnati, OH 45999

If the entity's principal business, office, or agency is located in:	Use the following Internal Revenue Service Center address:
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, Wyoming	Ogden, UT 84201
A foreign country or U.S. possession	Ogden, UT 84201-0023

Note. Also attach a copy to the entity's federal income tax return for the tax year of the election.

Acceptance or Nonacceptance of Election

The service center will notify the eligible entity at the address listed on Form 8832 if its election is accepted or not accepted. The entity should generally receive a determination on its election within 60 days after it has filed Form 8832.

Care should be exercised to ensure that the IRS receives the election. If the entity is not notified of acceptance or nonacceptance of its election within 60 days of the date of filing, take follow-up action by calling 1-800-829-0115, or by sending a letter to the service center to inquire about its status. Send any such letter by certified or registered mail via the U.S. Postal Service, or equivalent type of delivery by a designated private delivery service (see Notice 2004-83, 2004-52 I.R.B. 1030 (or its successor)).

If the IRS questions whether Form 8832 was filed, an acceptable proof of filing is:

- A certified or registered mail receipt (timely postmarked) from the U.S. Postal Service, or its equivalent from a designated private delivery service;
- Form 8832 with an accepted stamp;
- Form 8832 with a stamped IRS received date; or
- An IRS letter stating that Form 8832 has been accepted.

Specific Instructions

Name. Enter the name of the eligible entity electing to be classified.

Employer identification number (EIN). Show the EIN of the eligible entity electing to be classified.

Do not put "Applied For" on this line.

Note. Any entity that has an EIN will retain that EIN even if its federal tax classification changes under Regulations section 301.7701-3.

If a disregarded entity's classification changes so that it becomes recognized as a partnership or association for federal tax purposes, and that entity had an EIN, then the entity must continue to use that EIN. If the entity did not already have its own EIN, then the entity must apply for an EIN and not use the identifying number of the single owner.

A foreign entity that makes an election under Regulations section 301.7701-3(c) and (d) must also use its own taxpayer identifying number. See sections 6721 through 6724 for penalties that may apply for failure to supply taxpayer identifying numbers.

If the entity electing to be classified using Form 8832 does not have an EIN, it must apply for one on Form SS-4, Application for Employer Identification Number. The entity must have received an EIN by the time Form 8832 is filed in order for the form to be processed. An election will not be accepted if the eligible entity does not provide an EIN.

Do not apply for a new EIN for an existing entity that is changing its classification if the entity already has an EIN.

Address. Enter the address of the entity electing a classification. All correspondence regarding the acceptance or nonacceptance of the election will be sent to this address. Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the entity has a P.O. box, show the box number instead of the street address. If the electing entity receives its mail in care of a third party (such as an accountant or an attorney), enter on the street address line "C/O" followed by the third party's name and street address or P.O. box.

Address change. If the eligible entity has changed its address since filing Form SS-4 or the entity's most recently-filed return (including a change to an "in care of" address), check the box for an address change.

Note. If a change of address occurs after the later of the filing of Form SS-4 or the most recently-filed return, use Form 8822, Change of Address, to notify the IRS of the new address. A new address shown on Form 8832 will not update the entity's address of record with the IRS.

Late-classification relief sought under Revenue Procedure 2009-41. Check the box if the entity is seeking relief under Rev. Proc. 2009-41, 2009-39 I.R.B. 439, for a late classification election. For more information, see *Late Election Relief*, later.

Part I. Election Information

Complete Part I whether or not the entity is seeking late-election relief under Rev. Proc. 2009-41.

Line 1. Check box 1a if the entity is choosing a classification for the first time (i.e., the entity does not want to be classified under the applicable default classification). Do not file this form if the entity wants to be classified under the default rules.

Check box 1b if the entity is changing its current classification.

Lines 2a and 2b. 60-month limitation rule. Once an eligible entity makes an election to *change* its classification, the entity generally cannot change its classification by election again during the 60 months after the effective date of the election. However, the IRS may (by private letter ruling) permit the entity to change its classification by election within the 60-month period if more than 50% of the ownership interests in the entity, as of the effective date of the election, are owned by persons that did not own any interests in the entity on the effective date or the filing date of the entity's prior election.

Note. The 60-month limitation does not apply if the previous election was made by a newly formed eligible entity and was effective on the date of formation.

Line 4. If an eligible entity has only one owner, provide the name of its owner on line 4a and the owner's identifying number (social security number, or individual taxpayer identification number, or EIN) on line 4b. If the electing eligible entity is owned by an entity that is a disregarded entity or by an entity that is a member of a series of tiered disregarded entities, identify the first entity (the entity closest to the electing eligible entity) that is not a disregarded entity. For example, if the electing eligible entity is owned by disregarded entity A, which is owned by another disregarded entity B, and disregarded entity B is owned by partnership C, provide the name and EIN of partnership C as the owner of the electing eligible entity. If the owner is a foreign person or entity and does not have a U.S. identifying number, enter "none" on line 4b.

Line 5. If the eligible entity is owned by one or more members of an affiliated group of corporations that file a consolidated return, provide the name and EIN of the parent corporation.

Line 6. Check the appropriate box if you are changing a current classification (no matter how achieved), or are electing out of a default classification. Do not file this form if you fall within a default classification that is the desired classification for the new entity.

Line 7. If the entity making the election is created or organized in a foreign jurisdiction, enter the name of the foreign country in which it is organized. This information must be provided even if the entity is also organized under domestic law.

Line 8. Generally, the election will take effect on the date you enter on line 8 of this form, or on the date filed if no date is entered on line 8. An election specifying an entity's classification for federal tax purposes can take effect no more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date on which the election is filed. If line 8 shows a date more than 75 days prior to the date on which the election is filed, the election will default to 75 days before the date it is filed. If line 8 shows an effective date more than 12 months from the filing date, the election will take effect 12 months after the date the election is filed.

Consent statement and signature(s). Form 8832 must be signed by:

1. Each member of the electing entity who is an owner at the time the election is filed; or

2. Any officer, manager, or member of the electing entity who is authorized (under local law or the organizational documents) to make the election. The elector represents to having such authorization under penalties of perjury.

If an election is to be effective for any period prior to the time it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, must sign.

If you need a continuation sheet or use a separate consent statement, attach it to Form 8832. The separate consent statement must contain the same information as shown on Form 8832.

Note. Do not sign the copy that is attached to your tax return.

Part II. Late Election Relief

Complete Part II only if the entity is requesting late election relief under Rev. Proc. 2009-41.

An eligible entity may be eligible for late election relief under Rev. Proc. 2009-41, 2009-39 I.R.B. 439, if **each** of the following requirements is met.

1. The entity failed to obtain its requested classification as of the date of its formation (or upon the entity's classification becoming relevant) or failed to obtain its requested change in classification solely because Form 8832 was not filed timely.

2. Either:

a. The entity has not filed a federal tax or information return for the first year in which the election was intended because the due date has not passed for that year's federal tax or information return; or

b. The entity has timely filed all required federal tax returns and information returns (or if not timely, within 6 months after its due date, excluding extensions) consistent with its requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years. If the eligible entity is not required to file a federal tax return or information return, each affected person who is required to file a federal tax return or information return must have timely filed all such returns (or if not

timely, within 6 months after its due date, excluding extensions) consistent with the entity's requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed during any of the tax years.

3. The entity has reasonable cause for its failure to timely make the entity classification election.

4. Three years and 75 days from the requested effective date of the eligible entity's classification election have not passed.

Affected person. An affected person is either:

• with respect to the effective date of the eligible entity's classification election, a person who would have been required to attach a copy of the Form 8832 for the eligible entity to its federal tax or information return for the tax year of the person which includes that date; or

• with respect to any subsequent date after the entity's requested effective date of the classification election, a person who would have been required to attach a copy of the Form 8832 for the eligible entity to its federal tax or information return for the person's taxable year that includes that subsequent date had the election first become effective on that subsequent date.

For details on the requirement to attach a copy of Form 8832, see Rev. Proc. 2009-41 and the instructions under *Where To File*.

To obtain relief, file Form 8832 with the applicable IRS service center listed in *Where To File,* earlier, within 3 years and 75 days from the requested effective date of the eligible entity's classification election.

If Rev. Proc. 2009-41 does not apply, an entity may seek relief for a late entity election by requesting a private letter ruling and paying a user fee in accordance with Rev. Proc. 2011-1, 2011-1 I.R.B. 1 (or its successor).

Line 11. Explain the reason for the failure to file a timely entity classification election.

Signatures. Part II of Form 8832 must be signed by an authorized representative of the eligible entity and each affected person. See *Affected Persons*, earlier. The individual or individuals who sign the declaration must have personal knowledge of the facts and circumstances related to the election.

Foreign Entities Classified as Corporations for Federal Tax Purposes:

American Samoa—Corporation
Argentina—Sociedad Anonima
Australia—Public Limited Company
Austria—Aktiengesellschaft
Barbados—Limited Company
Belgium—Societe Anonyme
Belize—Public Limited Company
Bolivia—Sociedad Anonima
Brazil—Sociedade Anonima
Bulgaria—Aktsionerno Druzhestvo
Canada—Corporation and Company
Chile—Sociedad Anonima
People's Republic of China—Gufen Youxian Gongsi
Republic of China (Taiwan)—Ku-fen Yu-hsien Kung-szu
Colombia—Sociedad Anonima
Costa Rica—Sociedad Anonima
Cyprus—Public Limited Company
Czech Republic—Akciova Spolecnost
Denmark—Aktieselskab
Ecuador—Sociedad Anonima or Compania Anonima
Egypt—Sharikat Al-Mossahamah
El Salvador—Sociedad Anonima
Estonia—Aktsiaselts
European Economic Area/European Union—Societas Europaea
Finland—Julkinen Osakeyhtio/Publikt Aktiebolag
France—Societe Anonyme
Germany—Aktiengesellschaft
Greece—Anonymos Etairia
Guam—Corporation
Guatemala—Sociedad Anonima
Guyana—Public Limited Company
Honduras—Sociedad Anonima
Hong Kong—Public Limited Company
Hungary—Reszvenytarsasag
Iceland—Hlutafelag
India—Public Limited Company
Indonesia—Perseroan Terbuka
Ireland—Public Limited Company
Israel—Public Limited Company
Italy—Societa per Azioni
Jamaica—Public Limited Company
Japan—Kabushiki Kaisha
Kazakstan—Ashyk Aktsionerlik Kogham
Republic of Korea—Chusik Hoesa
Latvia—Akciju Sabiedriba
Liberia—Corporation
Liechtenstein—Aktiengesellschaft
Lithuania—Akcine Bendroves
Luxembourg—Societe Anonyme
Malaysia—Berhad
Malta—Public Limited Company
Mexico—Sociedad Anonima
Morocco—Societe Anonyme
Netherlands—Naamloze Vennootschap
New Zealand—Limited Company
Nicaragua—Compania Anonima
Nigeria—Public Limited Company
Northern Mariana Islands—Corporation
Norway—Allment Aksjeselskap
Pakistan—Public Limited Company
Panama—Sociedad Anonima
Paraguay—Sociedad Anonima
Peru—Sociedad Anonima
Philippines—Stock Corporation
Poland—Spolka Akcyjna
Portugal—Sociedade Anonima
Puerto Rico—Corporation
Romania—Societe pe Actiuni
Russia—Otkrytoye Aktsionernoy Obshchestvo
Saudi Arabia—Sharikat Al-Mossahamah
Singapore—Public Limited Company
Slovak Republic—Akciova Spolocnost
Slovenia—Delniska Druzba
South Africa—Public Limited Company
Spain—Sociedad Anonima
Surinam—Naamloze Vennootschap
Sweden—Publika Aktiebolag
Switzerland— Aktiengesellschaft
Thailand—Borisat Chamkad (Mahachon)
Trinidad and Tobago—Limited Company
Tunisia—Societe Anonyme
Turkey—Anonim Sirket
Ukraine—Aktsionerne Tovaristvo Vidkritogo Tipu
United Kingdom—Public Limited Company
United States Virgin Islands—Corporation
Uruguay—Sociedad Anonima
Venezuela—Sociedad Anonima or Compania Anonima

See Regulations section 301.7701-2(b)(8) for any exceptions and inclusions to items on this list and for any revisions made to this list since these instructions were printed.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping . . . . . 1 hr., 49 min.

Learning about the law or the form . . . . . 2 hr., 25 min.

Preparing and sending the form to the IRS . . . . . 23 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. Do not send the form to this address. Instead, see *Where To File* above.

Form **8869**
(Rev. December 2008)
Department of the Treasury
Internal Revenue Service

Qualified Subchapter S Subsidiary Election

(Under section 1361(b)(3) of the Internal Revenue Code)

OMB No. 1545-1700

Part I Parent S Corporation Making the Election

1a Name of parent	**2 Employer identification number** (EIN)
b Number, street, and room or suite no. If a P.O. box, see instructions.	**3** Tax year ending (month and day)
c City or town, state, and ZIP code	**4** Service center where last return was filed
5 Name and title of officer or legal representative whom the IRS may call for more information	**6** Telephone number of officer or legal representative ( )

Part II Subsidiary Corporation for Which Election is Made (For additional subsidiaries, see instructions.)

7a Name of subsidiary	**8** EIN (if any)
b Number, street, and room or suite no. If a P.O. box, see instructions.	**9** Date incorporated
c City or town, state, and ZIP code	**10** State of incorporation

11 Date election is to take effect (month, day, year) (see instructions) . . . . . ▶ / /

12 Did the subsidiary previously file a federal income tax return? If "Yes," complete lines **13a, 13b,** and **13c** . . . . . ▶ ☐ Yes ☐ No

13a Service center where last return was filed	**13b** Tax year ending date of last return (month, day, year) ▶ / /	**13c** Check type of return filed: ☐ Form 1120 ☐ Form 1120S ☐ Other ▶

14 Is this election being made in combination with a section 368(a)(1)(F) reorganization described in Rev. Rul. 2008-18, where the subsidiary was an S corporation immediately before the election and a newly formed holding company will be the subsidiary's parent? . . . ▶ ☐ Yes ☐ No

15 Was the subsidiary's last return filed as part of a consolidated return? If "Yes," complete lines **16a, 16b,** and **16c** . . . . . ▶ ☐ Yes ☐ No

16a Name of common parent	**16b** EIN of common parent	**16c** Service center where consolidated return was filed

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer of parent corporation ▶	**Title ▶**	**Date ▶**

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

A parent S corporation uses Form 8869 to elect to treat one or more of its eligible subsidiaries as a qualified subchapter S subsidiary (QSub).

The QSub election results in a deemed liquidation of the subsidiary into the parent. Following the deemed liquidation, the QSub is not treated as a separate corporation and all of the subsidiary's assets, liabilities, and items of income, deduction, and credit are treated as those of the parent.

Because the liquidation is a deemed liquidation, do not file Form 966, Corporate Dissolution or Liquidation. *However, a final return for the subsidiary may have to be filed if it was a separate corporation prior to the date of the deemed liquidation. No final return is required if this election is being made pursuant to a reorganization under section 368(a)(1)(F) and Rev. Rul. 2008-18. See Rev. Rul. 2008-18, 2008-13 I.R.B. 674, for details.*

Eligible Subsidiary

An eligible subsidiary is a domestic corporation whose stock is owned 100% by an S corporation and is not one of the following ineligible corporations.

- A bank or thrift institution that uses the reserve method of accounting for bad debts under section 585.
- An insurance company subject to tax under subchapter L of the Code.
- A corporation that has elected to be treated as a possessions corporation under section 936.
- A domestic international sales corporation (DISC) or former DISC.

See sections 1361(b)(3), 1362(f), and their related regulations for additional information.

When To Make the Election

The parent S corporation can make the QSub election at any time during the tax year. However, the requested effective date of the QSub election generally cannot be more than:

1. Twelve months after the date the election is filed, or
2. Two months and 15 days before the date the election is filed.

An election filed more than 12 months before the requested effective date will be made effective 12 months after the date it is filed. An election filed more than two months and 15 days after the requested effective date generally is late and will be made effective two months and 15 days before the date it is filed. However, an election filed more than two months and 15 days after the requested effective date will be accepted as timely filed if the corporation can show that the failure to file on time was due to reasonable cause.

To request relief for a late election, the corporation generally must request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2009-1, 2009-1 I.R.B. 1 (or its successor). However, relief from the ruling and user fee requirements is available. See Rev. Proc. 2003-43, 2003-23 I.R.B. 998, for details.

Where To File

File Form 8869 with the service center where the subsidiary filed its most recent return. However, if the parent S corporation forms a subsidiary, and makes a valid election effective upon formation, submit Form 8869 to the service center where the parent S corporation filed its most recent return.

Acceptance of Election

The service center will notify the corporation if the QSub election is (a) accepted, and when it will take effect, or (b) not accepted.

The corporation should generally receive a determination on its election within 60 days after it has filed Form 8869. However, if the corporation is not notified of acceptance or nonacceptance of its election within 2 months of the date of filing (date mailed), take follow-up action by calling 1-800-829-4933.

If the IRS questions whether Form 8869 was filed, an acceptable proof of filing is (a) a certified or registered mail receipt (timely postmarked) from the U.S. Postal Service, or its equivalent from a designated private delivery service (see Notice 2004-83, 2004-52 I.R.B. 1030 (or its successor)); (b) a Form 8869 with an accepted stamp; (c) a Form 8869 with a stamped IRS received date; or (d) an IRS letter stating that Form 8869 has been accepted.

End of Election

Once the QSub election is made, it remains in effect until it is terminated. If the election is terminated, IRS consent generally is required for another QSub election with regard to the former QSub (or its successor) for any tax year before the 5th tax year after the first tax year in which the termination took effect. See Regulations section 1.1361-5 for details.

Specific Instructions

Address

Include the suite, room, or other unit number after the street address. If the Post Office does not deliver to the street address and the corporation has a P.O. box, show the box number instead.

If the subsidiary has the same address as the parent S corporation, enter "Same as parent" in Part II.

Additional Subsidiaries

If the QSub election is being made for more than one subsidiary, attach a separate sheet for each subsidiary. Use the same size, format, and line numbers as in Part II of the printed form. Put the parent corporation's name and employer identification number at the top of each sheet.

If the QSub elections are being made effective on the same date for a tiered group of subsidiaries, the parent S corporation may specify the order of the deemed liquidations on an attachment. If no order is specified, the deemed liquidations will be treated as occurring first for the lowest tier subsidiary and proceeding successively upward. See Regulations section 1.1361-4(b)(2).

Caution. *A QSub election for a tiered group of subsidiaries may, in certain circumstances, result in the recognition of income. A primary example is excess loss accounts (see Regulations section 1.1502-19).*

Reorganizations

Line 14. This box should be checked "Yes" if this election is being made pursuant to a reorganization under section 368(a)(1)(F) and Rev. Rul. 2008-18. This occurs when a newly formed parent holding company holds the stock of the subsidiary that was an S corporation immediately before the transaction and the transaction otherwise qualifies as a reorganization under section 368(a)(1)(F). No Form 2553, Election by a Small Business Corporation, is required to be filed by the parent. See Rev. Rul. 2008-18, 2008-13 I.R.B. 674, for details.

Employer Identification Number (EIN)

A QSub may not be required to have an EIN for federal tax purposes. If the QSub does not have an EIN, enter "N/A" on line 8.

However, if the QSub has previously filed a return, separately or as part of a consolidated return, and used an EIN, enter that EIN on line 8 and (if applicable) the EIN of its common parent on line 16b. If this election is being made pursuant to a reorganization under section 368(a)(1)(F) and Rev. Rul. 2008-18, the old S corporation for which this QSub election is being made will retain its EIN. The newly formed parent must get a new EIN. See Rev. Rul. 2008-18, 2008-13 I.R.B. 674, for details.

Note. Failure to enter the subsidiary's EIN may result in the service center sending a notice of delinquent filing to the QSub.

If the QSub wants its own EIN, but does not have one, see Form SS-4, Application for Employer Identification Number, for details on how to obtain an EIN.

If the QSub has not received its EIN by the time the election is made, write "Applied for" on line 8. See the Instructions for Form SS-4 for details.

Effective Date of Election

Form 8869 generally must be filed no earlier than 12 months before or no later than 2 months and 15 days after the effective date requested on line 11. For details and exceptions, see When To Make the Election *on page 1.*

A parent S corporation that forms a new subsidiary and wants the election effective upon formation should enter the formation date. A parent corporation that wants to make the election for an existing subsidiary should enter the requested effective date. For details about the effect of a QSub election, see Regulations section 1.1361-4.

Signature

Form 8869 must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer (such as tax officer) authorized to sign the parent's S corporation return.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	6 hr., 13 min.
Learning about the law or the form	53 min.
Preparing, copying, assembling, and sending the form to the IRS	1 hr., 2 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send the form to this address. Instead, see *Where To File* on page 1.

Chapter 3

Election

Introduction

In this chapter, we will discuss the following:

- Time for making the S election
- Making the S election
- How to waive the effect of an invalid election
- C corporation carryovers

A corporation must elect to become an S corporation.

The election can be made by a newly formed corporation or an existing corporation changing its status. In either case, the consent of all shareholders on the date the election is made is required.

Time for Making the Election

The dates during which the S election must be made depend on two conditions:

1. Whether the corporation already exists
2. Whether the election is for the current or the subsequent year

Existing Corporations

An existing corporation must make the election

- At any time during the current year for the election to become effective on the first day of the following tax year, or
- On or before the 15th day of the third month of the year for which S status is sought, if the election is to become effective at the beginning of the current tax year.[1] Consequently, the election may be retroactive for a period of two months and 15 days or less.

If the election is to be retroactive, and is therefore to become effective at the beginning of the tax year in which the election is made, the following requirements must be met:

[1] Sec. 1362 (b)(1).

- All shareholders on the day the election is made must consent.[2]
- The corporation must have been eligible to make the election on all days from the beginning of the taxable year until the election is made.[3]
- All persons who were shareholders at any time from the beginning of the tax year until the election is made must consent (even if they are no longer shareholders at the time the S election is made).[4]

If the requirements for the second and third points above are not met, the election will be effective for the following taxable year.[5]

An election made more than 2½ months after the beginning of the taxable year is effective for the following taxable year.[6]

> **Practice Tip:** Care will have to be exercised by those existing corporations that make an election within the first 2½ months (on or before the 15th day of the third month) of their taxable year to correctly indicate the year for which the election is to be effective. An election within the first 2½ months of a corporation's taxable year can be effective for either
>
> - The year in which it is made, if all the requirements are met, or
> - The following taxable year.

Newly Formed Corporations

To be an S corporation from inception, a newly formed corporation must elect within the first 2½ months (on or before the 15th day of the third month) of the corporation's first taxable year. For example, if a corporation begins its first year on January 7, the election must be made within the period beginning January 7, and ending before March 22.[7]

Where the period in the first taxable year is less than 2½ months, the election can be valid for the first taxable year, if the election is made within two months and fifteen days after the first day of the taxable year.[8]

Example 3-1

A calendar year corporation begins its first year on November 8 and intends to be an S corporation beginning on that date. It can make the election before January 23 of the next year, and be an S corporation from November 8. The first short taxable year begins November 8 and ends December 31. The second taxable year covers the next full calendar year.

[2] Sec. 1362(b)(1)(B).
[3] Sec. 1362(b)(2)(B)(i).
[4] Sec. 1362(b)(2)(B)(ii).
[5] Sec. 1362(b)(2).
[6] Sec. 1362(b)(3).
[7] Reg. Sec. 1.1362-6(a)(2)(ii)(C), 1.1362-6(a)(2)(iii) Example 1.
[8] Sec. 1362 (b)(4).

When first taxable year begins. The date on which the first taxable year begins is the first date on which the corporation (a) had shareholders, (b) acquired assets, or (c) began doing business, whichever is the first to occur.[9]

> **Practice Tip:** Where state law provides that a corporation comes into existence on the day the articles of incorporation are filed, the IRS has asserted the corporation automatically has shareholders on that date.[10] Also, a corporation cannot make a valid election until it actually becomes a corporation under state law.[11]

Therefore, the taxpayer should exercise caution in determining the appropriate date. It may make sense to *start business* or acquire assets concurrently with the date the articles of incorporation are filed, and to elect S corporation status within 2½ months thereafter.

Shareholder's Consent

In general, all shareholders at the time of the election must consent to the election. New shareholders added after the election is made are not required to consent to the election. The corporation continues to be an S corporation unless terminated.

According to Reg. Sec. 1.1362-6(b)(2), the following are the proper persons required to sign the consent:

- *Husband and Wife*—Each spouse holding an interest in S corporation stock must sign the consent even though a husband and wife are regarded as a single shareholder under the rules limiting the number of shareholders an S corporation can have. Thus, consents are required from each person having a community interest in the stock (or in the income from the stock), and from each person who has an interest in the stock as a tenant in common, joint tenant, or tenant by the entirety.

- *Family Members*—Each family member holding an interest in S corporation stock must sign the consent even though family members are regarded as a single shareholder under the 100 shareholder rules.[12]

- *Minors*—The consent of a minor is made by the minor or the minor's legal representative. If no legal representative has been appointed, a natural or adoptive parent of the minor signs the consent form.[13]

- *Estates*—The executor or administrator signs the consent. Also, the consent can be signed by any other fiduciary appointed by testamentary instrument or appointed by the court.

- *Qualified Trusts*

    - For a grantor trust, the grantor must sign.

    - For a trust with designated owner, the deemed owner should sign.

[9] Reg. Sec. 1.1362-6(a)(ii)(c).
[10] Rev. Rul. 72-257, 1972-1 CB 270.
[11] *Frentz*, (1965) 44 TC 485, *aff'd*. (1967, CA-6, 375 F.2d 662).
[12] Sec. 1361 (c)(1); Reg. Sec.1.1362-62-6(b)(2)(i).
[13] Reg. Sec. 1.1362-6(b)(2)(ii).

- For a Qualified Subchapter S Trust (QSST), the consent should be signed by the beneficiary.
- For an Electing Small Business Trust (ESBT), the trustee consents to the election.
- For a voting trust, each individual beneficiary of the trust should sign the consent.

A trust (other than a QSST, ESBT, or other qualifying trust) receiving shares through inheritance is a qualified shareholder for a limited period of two years. The estate of the deceased shareholder is considered the shareholder.[14]

- *Beneficial Owner*—In some cases the stock may be held in the name of a person (nominee) who has no beneficial interest in the stock. If so, the beneficial owner, rather than the owner of record, is the proper person to sign the consent.[15]

How to Make the Election

The S election is made on Form 2553, Election by a Small Business Corporation.

1. The form must be filed by the corporation and may be used to indicate the shareholders' consent to the election.

   However, the consent of the shareholders may be evidenced by one or more statements signed by the shareholders under penalties of perjury and attached to Form 2553.[16]

2. A Form 2553 and instructions can be found at the end of this chapter.
3. Part II of the form relates to fiscal years.
4. Form 2553 and any accompanying consent of shareholders must be filed with the Cincinnati or Ogden Service Center, depending on the corporation's principal place of business.
5. The month and day of the corporation's year end must be indicated on the Form 2553. IRS permission will normally be required to use a year other than a calendar year.

The election is effective for the taxable year and all subsequent taxable years unless the election is voluntarily or involuntarily terminated.[17]

Filing the S Election

FILING BY MAIL

When an S election Form 2553 is mailed, it is considered filed on the date the envelope is postmarked. An S election sent by certified or registered mail is considered to be filed on the date stamped on the receipt issued by the post office.[18]

[14] Sec. 1361(c)(2)(B).
[15] Reg. Sec. 1.1361-1(e)(1).
[16] Reg. Sec. 1.1362-6(b)(3).
[17] Sec. 1362(c).

> **Practice Tip:** Mailed S elections should *always* be sent certified or registered. The receipt received from the post office is *prima facie* evidence that the election was delivered to the IRS.[19] This means that the IRS carries the burden of proof to show that you did not mail the election, if you can provide a date-stamped receipt from the post office for certified or registered mail addressed to the IRS. The regulation does not require that you send the election with a return receipt requested, but doing so is highly recommended.

If the IRS claims they did not receive the election and it was not sent by certified or registered mail, the S election can be denied by the IRS even if you can prove that the election was mailed or otherwise sent on time.[20]

PRIMA FACIE EVIDENCE OF DELIVERY APPLIES ONLY TO MAILED ELECTIONS

The IRS has issued proposed regulations providing that sending documents by certified or registered mail (or actually delivering the documents to the IRS) is the only way for the taxpayer to provide *prima facie* evidence that the document was delivered.[21] Thus, the evidence-of-delivery rule does *not* apply to S elections and other documents sent by private delivery service or fax.

When published as final regulations, the rule providing that *prima facie* evidence only applies to documents sent by certified or registered mail will apply to documents mailed after September 21, 2004.[22]

The author strongly recommends that the S election form be sent by certified or registered mail, return receipt requested. Alternatively, the form can be delivered to an IRS office. If this is done, have the IRS stamp a copy of the form and retain that copy in your files.

FILING BY PRIVATE DELIVERY SERVICE

S elections and other filings with the IRS may be made by using a "designated private delivery service."[23] If the IRS actually receives the election, the delivery service's receipt showing the date and time the delivery service picks up or otherwise receives the document is proof of the date the election was filed. IRS Notice 2004-83, 2004-2 CB 1030, provides that the following private delivery services and types of services are approved by the IRS:

- DHL Express (DHL)—DHL Same Day Service, DHL Next Day 10:30 am, DHL Next Day 12:00 pm, DHL Next Day 3:00 pm, and DHL 2nd Day Service.
- Federal Express (FedEx)—FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2 Day, FedEx International Priority, and FedEx International First.

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[18] Sec. 7502; Reg. Sec. 301.7505-1(c)(2).
[19] Reg. Sec. 301.7502-1 (d)(1).
[20] For example, see *James R. Carroll v. Com*., (1995, CA6) 76 AFTR 2d 95-8115, 71 F3d 1228, 96-1 USTC 50010, affg. (1994) TC Memo 1994-229, 67 CCH TCM 2995, cert. den. (1996, S Ct).
[21] Prop. Reg. Sec. 301.7502-1(e)(1).
[22] Prop. Reg. Sec. 301.7502-1(g)(4).
[23] IRS Sec. 7502(f); Rev. Proc. 97-19, 1997-1, CB 644.

- United Parcel Service (UPS)—UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

FILING BY FAX

According to the instructions to the S election Form 2553, the form can be faxed to the appropriate IRS service center by using the fax number given in the instructions. If you fax the form, keep the original Form 2553 in the files.

NOTIFICATION OF ELECTION ACCEPTANCE BY IRS

The IRS generally notifies the corporation within 60 days whether or not the S election has been accepted. If you have not received notice from the IRS within three months from the date the election is filed, you should contact the IRS service center where the election was sent.

> **Practice Tip:** If the S election is filed late or is inadvertently not filed, the election may still become effective if the IRS waives the effect of an invalid election, as discussed in the next topic.

Invalid Elections

An invalid election may still become effective if the IRS waives the effect of an invalid election.

For example, the IRS may waive the effect of an invalid election if the corporation inadvertently fails to

- Qualify as a small business corporation;
- Obtain the required shareholder consents, including elections regarding Qualified Subchapter S Trusts (QSSTs) or Electing Small Business Trusts (ESBTs); or
- Make the S election on time, if there was reasonable cause for the delay in filing. The IRS may even exercise this authority if the taxpayer did not actually file an election.[24]

> **Practice Tip:** When applying for relief from an invalid election, be sure to study the applicable IRS ruling and carefully follow the requirements and procedures set out in that ruling.

The IRS has provided the following ways to request relief from an invalid election.

Extension of Time to File Consents

The corporation may request the IRS to grant an extension of time to file stockholder consents, if (a) a timely election was filed, (b) reasonable cause is given, (c) the interests of the government are not jeopardized, (d) proper consent is filed by the affected shareholder within an extension period granted by the IRS, and (e) all shareholders during the period from the beginning of the tax year to the end of the extension period have filed consents.[25] No user fee is assessed.

[24] Sec. 1362.
[25] Reg. Sec. 1.1362-6(b)(3)(iii).

Relief When Consent of Community Property Spouse is Omitted

The corporation can obtain automatic relief from an invalid election if the consent of a community property spouse was omitted from the election. Details for obtaining such relief are set out in Rev. Proc. 2004-35, 2004-1 CB 1029.

Filing the S Election Late under Rev. Proc. 2003-43

If the corporation has not filed its S election Form 2553 and the deadline for filing has passed, the corporation can file its S election late and the IRS will accept it if the following requirements are met:[26]

- The corporation fails to qualify as an S corporation solely because of the failure to file a timely S election Form 2553;
- Less than 24 months have passed since the original due date of the S election;
- The corporation has reasonable cause for its failure to make the timely S election; and
- All taxpayers whose tax liability or tax returns would be affected by the S election (including all shareholders of the S corporation) have reported consistently as if the corporation were an S corporation on all affected returns for the year the S election was intended, as well as for any subsequent years.

The deadline for filing late S election relief differs depending on whether the corporation has filed a Form 1120S tax return.

If the corporation has not filed a Form 1120S, the S election (Form 2553) must be filed by the earlier of

- Eighteen months after the original due date for the S corporation election, or
- Six months after the due date of the Form 1120S (excluding extensions) for the first year the election was intended.

If the corporation has filed a Form 1120S for the first year in which the election was intended, the Form 2553 must be filed within 24 months of the original due date for the S election. The Form 1120S must have been filed within six months of the due date of the Form 1120S (excluding extensions).

To qualify for relief from an invalid election under Rev. Proc. 2003-43, the corporation files a properly completed Form 2553 with the Service Center where the original S election would have been filed. The space at the top of the Form 2553 should contain the words "FILED PURSUANT TO REV. PROC. 2003-43." The Form 2553 must be signed by an authorized corporate officer and by all persons who were shareholders at any time during the period beginning on the first day of the taxable year for which the election is to be effective and ending on the day the election is made.

The following information should be attached to the Form 2553:

[26] Rev. Proc. 2003-43, 2003-1 CB 998.

- A statement establishing reasonable cause for the failure to file a timely S election;
- Statements from all shareholders during the period between the date the S corporation election was to have become effective and the date the completed election was filed that they have reported their income on all affected returns consistent with the S election for the year the election should have been made and for all subsequent years; and
- A dated declaration signed by an officer of the corporation authorized to sign which states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

The IRS will determine whether the requirements for granting additional time to file the S election have been satisfied and will notify the corporation whether the late S election has been accepted. If it is accepted, the corporation will be an S corporation from the date that it originally intended to become an S corporation.

No user fee is assessed.

Relief for Late Election under Rev. Proc. 2007-62

Under Rev. Proc. 2007-62, 2007-41 IRB 786, relief from a late S corporation election can be obtained by filing Form 2553 with the S corporation's first income tax return, Form 1120S. Relief under Rev. Proc. 2007-62 is available if

- The corporation does not qualify as an S corporation solely because of the failure to file a timely S election Form 2553;
- The corporation has reasonable cause for its failure to make a timely S election;
- The corporation has not filed a tax return, Form 1120S; and
- All taxpayers whose tax liability or tax returns would be affected by the S election (including all shareholders of the S corporation) have reported consistently as if the corporation were an S corporation on all affected returns for the year the S election was intended, as well as for any subsequent years.

Relief is requested by filing the S election Form 2553 along with Form 1120S for the first taxable year the entity intended to be an S corporation. The forms must be filed together no later than six months after the tax return's due date, excluding extensions, for the first year the entity intended to be treated as an S corporation. Reasonable cause must be given for the failure to file the forms.

Anyone who was a shareholder during the period beginning on the first day of the tax year for which the election is to be effective and ending on the day the election is made must consent to the election.

No user fee is required when applying for relief under the provisions set out in Rev. Proc. 2007-62.

> **Practice Tip:** The primary differences between Rev. Procs. 2003-43 and 2007-62 can be summarized like this:

- Rev. Proc. 2004-48 is submitted to an IRS service center, while Rev. Proc. 2007-62 is attached to the entity's first tax return, Form 1120S.
- The explanation as to why the Form 2553 was not timely filed is submitted as an attachment to the Form 2553 under Rev. Proc. 2004-48. Under Rev. Proc. 2007-62, the explanation is made in the space provided on the face of Form 2553.

Filing the S Election Late under Rev. Proc. 97-48

Under some conditions, a corporation may have filed one or more S corporation returns, Form 1120S, even though the S election was not properly filed. In that case, the corporation may be able to continue to remain in S status under the provisions of Rev. Proc. 97-48, 1997-2 CB 521.

If the corporation has been filing Form 1120S, and the shareholders have been reporting as if the corporation were in S status, the corporation can file its S election late and the IRS will *automatically* accept it if the requirements are met.[27] This procedure cannot be used if the corporation received notice from the IRS concerning its S status within six months of when it filed its first tax return, Form 1120S. No user fee is assessed.

> **Practice Tip:** This situation may occur when the shareholders believed that the S election had been properly filed, but the IRS has no record of it.

Obtaining a Letter Ruling

The corporation may request waiver of an invalid election by obtaining a letter ruling.[28] A user fee must accompany the request. User fees are set out in the first revenue procedure issued each year. The current user fee is $14,000 for corporations with gross receipts of $1 million or more; $2,000 for a corporation with gross receipts of $250,000 or more but less than $1 million; and $625 for a corporation with gross receipts of less than $250,000.[29]

LLC Electing to be Treated as a Corporation

An entity that intended to be classified as an association taxable as a corporation on the date the S election became effective, but did not timely file Form 8832, Form 2553, or both can apply for relief from the invalid elections.

Electing S Corporation Status after Termination

When the corporation's S election terminates, a new election, generally, cannot be made for five years without IRS consent.

C Corporation Carryovers

Carryovers from a C corporation year generally cannot be carried to an S corporation year.[30] The corporation can use them if the S corporation reverts to a C corporation. However, the

[27] Rev. Proc. 97-48.
[28] IRS Ann. 97-4, 1997-3 IRB 14; Rev. Proc. 2003-43, 2003-1 CB 998.
[29] Rev. Proc. 2011-1, 2011-1 IRB 1.
[30] Sec. 1371(b)(1).

intervening S corporation years do count as elapsed years for purposes of determining when the carryovers expire.[31]

There are exceptions to the C corporation carryover rules for S corporations that are subject to the built-in gains rules of Sec. 1374. Certain C corporation carryovers can offset built-in gains and the built-in gains tax. Further, certain passive activity losses may be carried into an S year.

When First S Corporation Year Begins

New Corporation

When an entity incorporates and immediately becomes an S corporation, the first S corporation year begins, as discussed earlier in this chapter, when the corporation first had shareholders, acquired assets, or began doing business. This will normally (but not always) be the date that the company becomes a corporation under state law. The first S year runs until the end of the corporation's taxable year, and may be for a period of less than twelve months.

> **Example 3-2**
>
> Newcorp first has shareholders on July 13 and elects S status on that date. The corporation shows on its S election Form 2553 that it will use a calendar year. The first short taxable year begins July 13 and ends December 31. The second taxable year covers the next full calendar year.

Existing Corporation

An existing corporation begins its first S corporation year at the end of the C corporation's year. Thus, any short year will generally be for the S corporation's first year, rather than the C corporation's last taxable year.

> **Example 3-3**
>
> Oldco is using a July 31 year end and elects S status beginning August 1. The corporation shows on its S election Form 2553 that it will use a calendar year. The first S year will be for a five-month short period, that is, it begins August 1 and ends December 31 of that year. The second S year covers the following calendar year.

C Corporation Can Change Its Fiscal Year Prior to Making the S Election

Rev. Proc. 2006-45, 2006-45 IRB 851 allows a C corporation that intends to elect S status to automatically change its tax year to a calendar year, or other year that an S corporation is permitted to use.

> **Example 3-4**
>
> Midco Inc. is using a July 31 year end. Midco meets the requirements of Rev. Proc. 2006-45. Therefore, it can change to a calendar year and elect S status. If Midco changes to a calendar year and elects S status, its final C corporation year

[31] Sec. 1371(b)(3).

will be for a five-month short period, that is, it begins August 1 and ends December 31. The first S year will then be for the following full calendar year.

Summary

- Corporations must properly elect to become S corporations.
- To be retroactive, the election must be made within 2½ months of the beginning of the year.
- All shareholders at the time of the election must consent to the election.
- When a corporation's S election terminates, a new election generally may not be made for five years without IRS consent.
- The IRS has power to waive the effect of an invalid election retroactively.

Form **2553**
(Rev. December 2007)
Department of the Treasury
Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)

► **See Parts II and III on page 3 and the separate instructions.**
► **The corporation can fax this form to the IRS (see separate instructions).**

OMB No. 1545-0146

Note. This election to be an S corporation can be accepted only if all the tests are met under **Who May Elect** on page 1 of the instructions; all shareholders have signed the consent statement; an officer has signed below; and the exact name and address of the corporation and other required form information are provided.

Part I Election Information

Type or Print		
	Name (see instructions)	**A** Employer identification number
	Number, street, and room or suite no. (If a P.O. box, see instructions.)	**B** Date incorporated
	City or town, state, and ZIP code	**C** State of incorporation

D Check the applicable box(es) if the corporation, after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) . . . . . ► / /

Caution. A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:

(1) ☐ Calendar year
(2) ☐ Fiscal year ending (month and day) ► _____
(3) ☐ 52-53-week year ending with reference to the month of December
(4) ☐ 52-53-week year ending with reference to the month of ► _____

If box (2) or (4) is checked, complete Part II

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under **Who May Elect** in the instructions) ► ☐

H Name and title of officer or legal representative who the IRS may call for more information	**I** Telephone number of officer or legal representative ( )

If this S corporation election is being filed with Form 1120S, I declare that I had reasonable cause for not filing Form 2553 timely, and if this election is made by an entity eligible to elect to be treated as a corporation, I declare that I also had reasonable cause for not filing an entity classification election timely. See below for my explanation of the reasons the election or elections were not made on time (see instructions).

Sign Here

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer	**Title**	**Date**

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 18629R Form **2553** (Rev. 12-2007)

Part I Election Information (continued)

J Name and address of each shareholder or former shareholder required to consent to the election. (See the instructions for column K.)	**K** Shareholders' Consent Statement. Under penalties of perjury, we declare that we consent to the election of the above-named corporation to be an S corporation under section 1362(a) and that we have examined this consent statement, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete. We understand our consent is binding and may not be withdrawn after the corporation has made a valid election. (Sign and date below.)		**L** Stock owned or percentage of ownership (see instructions)		**M** Social security number or employer identification number (see instructions)	**N** Shareholder's tax year ends (month and day)
	Signature	Date	Number of shares or percentage of ownership	Date(s) acquired		

Part II Selection of Fiscal Tax Year (see instructions)

Note. All corporations using this part must complete item O and item P, Q, or R.

O Check the applicable box to indicate whether the corporation is:

1. ☐ A new corporation **adopting** the tax year entered in item F, Part I.

2. ☐ An existing corporation **retaining** the tax year entered in item F, Part I.

3. ☐ An existing corporation **changing** to the tax year entered in item F, Part I.

P Complete item P if the corporation is using the automatic approval provisions of Rev. Proc. 2006-46, 2006-45 I.R.B. 859, to request **(1)** a natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) or **(2)** a year that satisfies the ownership tax year test (as defined in section 5.08 of Rev. Proc. 2006-46). Check the applicable box below to indicate the representation statement the corporation is making.

1. Natural Business Year ► ☐ I represent that the corporation is adopting, retaining, or changing to a tax year that qualifies as its natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) and has attached a statement showing separately for each month the gross receipts for the most recent 47 months (see instructions). I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

2. Ownership Tax Year ► ☐ I represent that shareholders (as described in section 5.08 of Rev. Proc. 2006-46) holding more than half of the shares of the stock (as of the first day of the tax year to which the request relates) of the corporation have the same tax year or are concurrently changing to the tax year that the corporation adopts, retains, or changes to per item F, Part I, and that such tax year satisfies the requirement of section 4.01(3) of Rev. Proc. 2006-46. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

Note. If you do not use item P and the corporation wants a fiscal tax year, complete either item Q or R below. Item Q is used to request a fiscal tax year based on a business purpose and to make a back-up section 444 election. Item R is used to make a regular section 444 election.

Q Business Purpose—To request a fiscal tax year based on a business purpose, check box Q1. See instructions for details including payment of a user fee. You may also check box Q2 and/or box Q3.

1. Check here ► ☐ if the fiscal year entered in item F, Part I, is requested under the prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046. Attach to Form 2553 a statement describing the relevant facts and circumstances and, if applicable, the gross receipts from sales and services necessary to establish a business purpose. See the instructions for details regarding the gross receipts from sales and services. If the IRS proposes to disapprove the requested fiscal year, do you want a conference with the IRS National Office?

☐ Yes ☐ No

2. Check here ► ☐ to show that the corporation intends to make a back-up section 444 election in the event the corporation's business purpose request is not approved by the IRS. (See instructions for more information.)

3. Check here ► ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event (1) the corporation's business purpose request is not approved and the corporation makes a back-up section 444 election, but is ultimately not qualified to make a section 444 election, or (2) the corporation's business purpose request is not approved and the corporation did not make a back-up section 444 election.

R Section 444 Election—To make a section 444 election, check box R1. You may also check box R2.

1. Check here ► ☐ to show that the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item F, Part I. To make the election, you must complete **Form 8716,** Election To Have a Tax Year Other Than a Required Tax Year, and either attach it to Form 2553 or file it separately.

2. Check here ► ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event the corporation is ultimately not qualified to make a section 444 election.

Part III Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)*

Income beneficiary's name and address	Social security number
Trust's name and address	Employer identification number

Date on which stock of the corporation was transferred to the trust (month, day, year) . . . . . ► / /

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under section 1361(d)(2). Under penalties of perjury, I certify that the trust meets the definitional requirements of section 1361(d)(3) and that all other information provided in Part III is true, correct, and complete.

Signature of income beneficiary or signature and title of legal representative or other qualified person making the election | Date

*Use Part III to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. The QSST election must be made and filed separately if stock of the corporation is transferred to the trust **after** the date on which the corporation makes the S election.

Instructions for Form 2553

Department of the Treasury
Internal Revenue Service

(Rev. December 2007)

Election by a Small Business Corporation

Section references are to the Internal Revenue Code unless otherwise noted.

What's New

For tax years ending on or after December 31, 2007, certain corporations (entities) with reasonable cause for not timely filing Form 2553 can request to have the form treated as timely filed by filing Form 2553 as an attachment to Form 1120S, U.S. Income Tax Return for an S Corporation. An entry space for an explanation of reasonable cause was added to page 1 of the form. See *Relief for Late Elections*.

General Instructions

Purpose of Form

A corporation or other entity eligible to elect to be treated as a corporation must use Form 2553 to make an election under section 1362(a) to be an S corporation. An entity eligible to elect to be treated as a corporation that meets certain tests discussed below will be treated as a corporation as of the effective date of the S corporation election and does not need to file Form 8832, Entity Classification Election.

The income of an S corporation generally is taxed to the shareholders of the corporation rather than to the corporation itself. However, an S corporation may still owe tax on certain income. For details, see *Tax and Payments* in the Instructions for Form 1120S.

Who May Elect

A corporation or other entity eligible to elect to be treated as a corporation may elect to be an S corporation only if it meets all the following tests.

1. It is (a) a domestic corporation, or (b) a domestic entity eligible to elect to be treated as a corporation, that timely files Form 2553 and meets all the other tests listed below. If Form 2553 is not timely filed, see *Relief for Late Elections* on page 2.

2. It has no more than 100 shareholders. You can treat a husband and wife (and their estates) as one shareholder for this test. You can also treat all members of a family (as defined in section 1361(c)(1)(B)) and their estates as one shareholder for this test. For additional situations in which certain entities will be treated as members of a family, see Notice 2005-91, 2005-51 I.R.B. 1164. All others are treated as separate shareholders. For details, see section 1361(c)(1).

3. Its only shareholders are individuals, estates, exempt organizations described in section 401(a) or 501(c)(3), or certain trusts described in section 1361(c)(2)(A).

For information about the section 1361(d)(2) election to be a qualified subchapter S trust (QSST), see the instructions for Part III. For information about the section 1361(e)(3) election to be an electing small business trust (ESBT), see Regulations section 1.1361-1(m). For guidance on how to convert a QSST to an ESBT, see Regulations section 1.1361-1(j)(12). If these elections were not timely made, see Rev. Proc. 2003-43, 2003-23 I.R.B. 998.

4. It has no nonresident alien shareholders.

5. It has only one class of stock (disregarding differences in voting rights). Generally, a corporation is treated as having only one class of stock if all outstanding shares of the corporation's stock confer identical rights to distribution and liquidation proceeds. See Regulations section 1.1361-1(l) for details.

6. It is not one of the following ineligible corporations.

a. A bank or thrift institution that uses the reserve method of accounting for bad debts under section 585.

b. An insurance company subject to tax under subchapter L of the Code.

c. A corporation that has elected to be treated as a possessions corporation under section 936.

d. A domestic international sales corporation (DISC) or former DISC.

7. It has or will adopt or change to one of the following tax years.

a. A tax year ending December 31.
b. A natural business year.
c. An ownership tax year.
d. A tax year elected under section 444.
e. A 52-53-week tax year ending with reference to a year listed above.
f. Any other tax year (including a 52-53-week tax year) for which the corporation establishes a business purpose.

For details on making a section 444 election or requesting a natural business, ownership, or other business purpose tax year, see the instructions for Part II.

8. Each shareholder consents as explained in the instructions for column K.

See sections 1361, 1362, and 1378, and their related regulations for additional information on the above tests.

A parent S corporation can elect to treat an eligible wholly-owned subsidiary as a qualified subchapter S subsidiary. If the election is made, the subsidiary's assets, liabilities, and items of income, deduction, and credit generally are treated as those of the parent. For details, see Form 8869, Qualified Subchapter S Subsidiary Election.

When To Make the Election

Complete and file Form 2553:

- No more than two months and 15 days after the beginning of the tax year the election is to take effect, or
- At any time during the tax year preceding the tax year it is to take effect.

For this purpose, the 2 month period begins on the day of the month the tax year begins and ends with the close of the day before the numerically corresponding day of the second calendar month following that month. If there is no corresponding day, use the close of the last day of the calendar month.

Example 1. No prior tax year. A calendar year small business corporation begins its first tax year on January 7. The two month period ends March 6 and 15 days after that is March 21. To be an S corporation beginning with its first tax year, the corporation must file Form 2553 during the period that begins January 7 and ends March 21. Because

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the corporation had no prior tax year, an election made before January 7 will not be valid.

Example 2. Prior tax year. A calendar year small business corporation has been filing Form 1120 as a C corporation but wishes to make an S election for its next tax year beginning January 1. The two month period ends February 28 (29 in leap years) and 15 days after that is March 15. To be an S corporation beginning with its next tax year, the corporation must file Form 2553 during the period that begins the first day (January 1) of its last year as a C corporation and ends March 15th of the year it wishes to be an S corporation. Because the corporation had a prior tax year, it can make the election at any time during that prior tax year.

Example 3. Tax year less than 2 1/2 months. A calendar year small business corporation begins its first tax year on November 8. The two month period ends January 7 and 15 days after that is January 22. To be an S corporation beginning with its short tax year, the corporation must file Form 2553 during the period that begins November 8 and ends January 22. Because the corporation had no prior tax year, an election made before November 8 will not be valid.

Relief for Late Elections

A late election to be an S corporation generally is effective for the tax year following the tax year beginning on the date entered on line E of Form 2553. However, relief for a late election may be available if the corporation can show that the failure to file on time was due to reasonable cause.

To request relief for a late election when the tax year beginning on the date entered on line E ends on or after December 31, 2007, a corporation that meets the following requirements can explain the reasonable cause in the designated space on page 1 of Form 2553.

- The corporation fails to qualify to elect to be an S corporation (see *Who May Elect* on page 1) solely because of the failure to timely file Form 2553.
- The corporation has reasonable cause for its failure to timely file Form 2553.
- The corporation has not filed a tax return for the tax year beginning on the date entered on line E of Form 2553.
- The corporation files Form 2553 as an attachment to Form 1120S no later than 6 months after the due date of Form 1120S (excluding extensions) for the tax year beginning on the date entered on line E of Form 2553.
- No taxpayer whose tax liability or tax return would be affected by the S corporation election (including all shareholders of the S corporation) has reported inconsistently with the S corporation election on any affected return for the tax year beginning on the date entered on line E of Form 2553.

Similar relief is available for an entity eligible to elect to be treated as a corporation (see the instructions for Form 8832) electing to be treated as a corporation as of the date entered on line E of Form 2553. For more details, see Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

To request relief for a late election when the above requirements are not met, the corporation generally must request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2008-1, 2008-1 I.R.B. 1 (or its successor). However, the ruling and user fee requirements may not apply if relief is available under the following revenue procedures.

- If an entity eligible to elect to be treated as a corporation (a) failed to timely file Form 2553, and (b) has not elected to be treated as a corporation, see Rev. Proc. 2004-48, 2004-32 I.R.B. 172.
- If a corporation failed to timely file Form 2553, see Rev. Proc. 2003-43, 2003-23 I.R.B. 998.
- If Form 1120S was filed without an S corporation election and neither the corporation nor any shareholder was notified by the IRS of any problem with the S corporation status within 6 months after the return was timely filed, see Rev. Proc. 97-48, 1997-43 I.R.B. 19.

Where To File

Generally, send the original election (no photocopies) or fax it to the Internal Revenue Service Center listed below. If the corporation files this election by fax, keep the original Form 2553 with the corporation's permanent records. However, certain late elections can be filed attached to Form 1120S. See *Relief for Late Elections* above.

If the corporation's principal business, office, or agency is located in:	Use the following address or fax number:
Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, Wisconsin	Department of the Treasury Internal Revenue Service Center Cincinnati, OH 45999 Fax: (859) 669-5748
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, Wyoming	Department of the Treasury Internal Revenue Service Center Ogden, UT 84201 Fax: (801) 620-7116

Acceptance or Nonacceptance of Election

The service center will notify the corporation if its election is accepted and when it will take effect. The corporation will also be notified if its election is not accepted. The corporation should generally receive a determination on its election within 60 days after it has filed Form 2553. If box Q1 in Part II is checked, the corporation will receive a ruling letter from the IRS that either approves or denies the selected tax year. When box Q1 is checked, it will generally take an additional 90 days for the Form 2553 to be accepted.

Care should be exercised to ensure that the IRS receives the election. If the corporation is not notified of acceptance or nonacceptance of its election within 2 months of the date of filing (date faxed or mailed), or within 5 months if box Q1 is checked, take follow-up action by calling 1-800-829-4933.

If the IRS questions whether Form 2553 was filed, an acceptable proof of filing is (a) a certified or registered mail receipt (timely postmarked) from the U.S. Postal Service, or its equivalent from a designated private delivery service (see Notice 2004-83, 2004-52 I.R.B. 1030 (or its successor)); (b) Form 2553 with an accepted stamp; (c) Form 2553 with a stamped IRS received date; or (d) an IRS letter stating that Form 2553 has been accepted.

Do not file Form 1120S for any tax year before the year the election takes effect. If the corporation is now required to file Form 1120, U.S. Corporation Income Tax Return, or any other applicable tax return, continue filing it until the election takes effect.

End of Election

Once the election is made, it stays in effect until it is terminated or revoked. IRS consent generally is required for another election by the corporation (or a successor corporation) on Form 2553 for any tax year before the 5th tax year after the first tax year in which the termination or revocation took effect. See Regulations section 1.1362-5 for details.

Specific Instructions

Part I

Name and Address

Enter the corporation's true name as stated in the corporate charter or other legal document creating it. If the corporation's mailing address is the same as someone else's, such as a shareholder's, enter "C/O" and this person's name following the name of the corporation. Include the suite, room, or other unit number after the street address. If the Post Office does not deliver to the street address and the corporation has a P.O. box, show the box number instead of the street address. If the corporation changed its name or address after applying for its employer identification number, be sure to check the box in item D of Part I.

Item A. Employer Identification Number (EIN)

Enter the corporation's EIN. If the corporation does not have an EIN, it must apply for one. An EIN can be applied for:

- Online–Click on the EIN link at *www.irs.gov/businesses/small*. The EIN is issued immediately once the application information is validated.
- By telephone at 1-800-829-4933.
- By mailing or faxing Form SS-4, Application for Employer Identification Number.

If the corporation has not received its EIN by the time the return is due, enter "Applied For" and the date you applied in the space for the EIN. For more details, see the Instructions for Form SS-4.

Item E. Effective Date of Election

Form 2553 generally must be filed no later than 2 months and 15 days after the date entered for item E. For details and exceptions, see When To Make the Election *on page 1.*

A corporation (or entity eligible to elect to be treated as a corporation) making the election effective for its first tax year in existence should enter the earliest of the following dates: (a) the date the corporation (entity) first had shareholders (owners), (b) the date the corporation (entity) first had assets, or (c) the date the corporation (entity) began doing business.

When the corporation (entity) is making the election for its first tax year in existence, it will usually enter the beginning date of a tax year that begins on a date other than January 1.

A corporation (entity) not making the election for its first tax year in existence that is keeping its current tax year should enter the beginning date of the first tax year for which it wants the election to be effective.

A corporation (entity) not making the election for its first tax year in existence that is changing its tax year and wants to be an S corporation for the short tax year needed to switch tax years should enter the beginning date of the short tax year. If the corporation (entity) does not want to be an S corporation for this short tax year, it should enter the beginning date of the tax year following this short tax year and file Form 1128, Application To Adopt, Change, or Retain a Tax Year. If this change qualifies as an automatic approval request (Form 1128, Part II), file Form 1128 as an attachment to Form 2553. If this change qualifies as a ruling request (Form 1128, Part III), file Form 1128 separately. If filing Form 1128, enter "Form 1128" on the dotted line to the left of the entry space for item E.

Item F

Check the box that corresponds with the S corporation's selected tax year. If box (2) or (4) is checked, provide the additional information about the tax year, and complete Part II of the form.

Signature

Form 2553 must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer (such as tax officer) authorized to sign.

If Form 2553 is not signed, it will not be considered timely filed.

Column K. Shareholders' Consent Statement

For an election filed before the effective date entered for item E, only shareholders who own stock on the day the election is made need to consent to the election.

For an election filed on or after the effective date entered for item E, all shareholders or former shareholders who owned stock at any time during the period beginning on the effective date entered for item E and ending on the day the election is made must consent to the election.

If the corporation timely filed an election, but one or more shareholders did not timely file a consent, see Regulations section 1.1362-6(b)(3)(iii). If the shareholder was a community property spouse who was a shareholder solely because of a state community property law, see Rev. Proc. 2004-35, 2004-23 I.R.B. 1029.

Each shareholder consents by signing and dating either in column K or on a separate consent statement. The following special rules apply in determining who must sign.

- If a husband and wife have a community interest in the stock or in the income from it, both must consent.
- Each tenant in common, joint tenant, and tenant by the entirety must consent.
- A minor's consent is made by the minor, legal representative of the minor, or a natural or adoptive parent of the minor if no legal representative has been appointed.
- The consent of an estate is made by the executor or administrator.
- The consent of an electing small business trust (ESBT) is made by the trustee and, if a grantor trust, the deemed owner. See Regulations section 1.1362-6(b)(2)(iv) for details.
- If the stock is owned by a qualified subchapter S trust (QSST), the deemed owner of the trust must consent.
- If the stock is owned by a trust (other than an ESBT or QSST), the person treated as the shareholder by section 1361(c)(2)(B) must consent.

Continuation sheet or separate consent statement. If you need a continuation sheet or use a separate consent statement, attach it to Form 2553. It must contain the name, address, and EIN of the corporation and the information requested in columns J through N of Part I.

Column L

Enter the number of shares of stock each shareholder owns on the date the election is filed and the date(s) the stock was acquired. Enter -0- for any former shareholders listed in column J. An entity without stock, such as a limited liability company (LLC), should enter the percentage of ownership and date(s) acquired.

Column M

Enter the social security number of each individual listed in column J. Enter the EIN of each estate, qualified trust, or exempt organization.

Column N

Enter the month and day that each shareholder's tax year ends. If a shareholder is changing his or her tax year, enter the tax year the shareholder is changing to, and attach an explanation indicating the present tax year and the basis for the change (for example, an automatic revenue procedure or a letter ruling request).

Part II

Complete Part II if you checked box (2) or (4) in Part I, Item F.

Note. Corporations cannot obtain automatic approval of a fiscal year under the natural business year (box P1) or ownership tax year (box P2) provisions if they are under examination, before an appeals (area) office, or before a federal court without meeting certain conditions and attaching a statement to the application. For details, see section 7.03 of Rev. Proc. 2006-46, 2006-45 I.R.B. 859.

Box P1

A corporation that does not have a 47-month period of gross receipts cannot automatically establish a natural business year.

Box Q1

For examples of an acceptable business purpose for requesting a fiscal tax year, see section 5.02 of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046, and Rev. Rul. 87-57, 1987-2 C.B. 117.

Attach a statement showing the relevant facts and circumstances to establish a business purpose for the requested fiscal year. For details on what is sufficient to establish a business purpose, see section 5.02 of Rev. Proc. 2002-39.

If your business purpose is based on one of the natural business year tests provided in section 5.03 of Rev. Proc. 2002-39, identify which test you are using (the 25% gross receipts, annual business cycle, or seasonal business test). For the 25% gross receipts test, provide a schedule showing the amount of gross receipts for each month for the most recent 47 months. For either the annual business cycle or seasonal business test, provide the gross receipts from sales and services (and inventory costs, if applicable) for each month of the short period, if any, and the three immediately preceding tax years. If the corporation has been in existence for less than three tax years, submit figures for the period of existence.

If you check box Q1, you will be charged a user fee of $3,200 ($1,500 if your request is received before February 2, 2008) (subject to change by Rev. Proc. 2009-1 or its successor). Do not pay the fee when filing Form 2553. The service center will send Form 2553 to the IRS in Washington, DC, who, in turn, will notify the corporation that the fee is due.

Box Q2

If the corporation makes a back-up section 444 election for which it is qualified, then the section 444 election will take effect in the event the business purpose request is not approved. In some cases, the tax year requested under the back-up section 444 election may be different than the tax year requested under business purpose. See Form 8716, Election To Have a Tax Year Other Than a Required Tax Year, for details on making a back-up section 444 election.

Boxes Q3 and R2

If the corporation is not qualified to make the section 444 election after making the item Q2 back-up section 444 election or indicating its intention to make the election in item R1, and therefore it later files a calendar year return, it should write "Section 444 Election Not Made" in the top left corner of the first calendar year Form 1120S it files.

Part III

In Part III, the income beneficiary (or legal representative) of certain qualified subchapter S trusts (QSSTs) may make the QSST election required by section 1361(d)(2). Part III may be used to make the QSST election only if corporate stock has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. However, a statement can be used instead of Part III to make the election. If there was an inadvertent failure to timely file a QSST election, see the relief provisions under Rev. Proc. 2003-43.

Note. Use Part III only if you make the election in Part I. Form 2553 cannot be filed with only Part III completed.

The deemed owner of the QSST must also consent to the S corporation election in column K of Form 2553.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will depend on individual circumstances. The estimated average time is:

Recordkeeping	9 hr., 48 min.
Learning about the law or the form	2 hr., 33 min.
Preparing, copying, assembling, and sending the form to the IRS	4 hr., 1 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send the form to this address. Instead, see *Where To File* on page 2.

Chapter 4

Termination

Introduction

In this chapter, we will discuss

- Causes of voluntary and involuntary termination
- Revocation of the Election
- Events causing involuntary termination
- The tax effect of termination
- Two methods of allocating income for the short years
    - *Pro rata* method
    - Normal tax accounting rules
- New election

Length of Election

An election to be an S corporation, once effective, remains in force until the election is terminated.[1] Once the S election becomes effective, it is not affected when a new qualified shareholder acquires stock. The new shareholder is not required to consent to the S election. Involuntary, as well as voluntary, events can terminate the election. According to Sec. 1362(d), termination can occur

- By revocation;
- By the corporation ceasing to be a small business corporation; or
- By receiving passive investment income in excess of the limit, under certain conditions.

Now, we will look at each terminating event more closely.

[1] Sec. 1362(c).

Voluntary Termination (Revocation)

An S corporation voluntarily terminates its S election if shareholders owning more than 50 percent of the shares (including nonvoting shares) consent to the revocation.[2]

Revocation Effective Date

If a revocation is filed on or before the 15th day of the third month of the taxable year, the revocation is retroactively effective on the first day of the taxable year, unless a prospective effective date is specified.[3] A prospective date is any date that is on or after the day the revocation is filed.

If the revocation is filed after the 15th day of the third month of the taxable year, it is effective on the first day of the following taxable year, unless a prospective date is specified.[4]

Consequently, the corporation can choose the date the termination election is to be effective, provided the termination is to take place on or after the date on which the revocation is filed.[5]

Revocation can occur during the first taxable year.[6] Further, an S election can be revoked prior to the election's effective date.[7] In that event, the corporation would not become an S corporation.

How a Revocation Is Filed

There is no specific form required for filing a revocation of the S election, but the information which must be provided to accomplish revocation is set out in Reg. Sec. 1.1362-6(a)(3).

The corporation files a statement that the corporation revokes the election made under Sec. 1362(a). The statement is signed by any person authorized to sign the corporate tax return, and is filed with the service center with which the election was filed. The Notice of Revocation must show

- The number of shares of stock (including nonvoting shares) issued and outstanding at the time the revocation is made, and
- The date the revocation is to be effective.

A statement of consent must be attached to the Notice of Revocation. The statement must be signed under penalties of perjury by each shareholder who consents to the revocation, and must state the number of shares held by each shareholder, including shareholders who are not consenting to the revocation.[8]

Exhibits 4-1 and 4-2 at the end of this chapter are examples of a revocation and the related consents. These examples fit the criteria set forth in the Regs.

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[2] Sec. 1362(d)(1)(B); Reg. Sec. 1.1362-6(a)(3).
[3] Sec. 1362(d)(1)(C)(i); Reg. Sec. 1.1362-2(a)(2).
[4] Sec. 1362(d)(1)(C)(ii).
[5] Sec. 1362(d)(1)(D); Reg. Sec. 1.1362-2(a)(2).
[6] Reg. Sec. 1.1362-2(a).
[7] Reg. Sec. 1.1362-2(a)(2).
[8] Reg. Sec. 1.1362-6(a)(3), 1.1362-6(b)(1).

Rescission of Revocation

Once made, a revocation can be rescinded, so that the S election does not terminate. The rescission must be filed before the revocation becomes effective.[9] The rescission is made by filing a statement that the corporation rescinds the revocation made under Sec. 1362(d)(1). The statement should contain the name, address, and taxpayer identification number of the corporation, and should be signed by any person authorized to sign the corporate tax return.

Each person who consented to the revocation and each person who became a shareholder after the date the revocation was made must consent to the rescission. The consent must be signed under penalty of perjury and must contain the information required by Reg. Sec. 1.1362-6(b)(1).

Involuntary Termination

Cessation of Small Business Corporation

The S election terminates when the corporation ceases to be a small business corporation.[10] Events causing disqualification under this provision include

- Exceeding the permitted number of shareholders;
- Transfer of stock to a corporation, partnership, ineligible trust, or nonresident alien; and
- Creation of a class of stock other than voting and nonvoting common stock.

Termination Effective Date

When an event causes the corporation to no longer be a small business corporation, termination of the election occurs on the date the disqualifying event takes place.[11] This means that the last day of the S corporation's year is the day before the event takes place, and the first day of the resulting C corporation's year begins on the day that the event occurs. (See Example 4-1.)

New Shareholders

The election is not affected when a new qualified shareholder acquires stock, and the new shareholder is not required to consent to the S election. A new shareholder may not cause the election to be revoked unless the shareholder owns more than 50 percent of the shares of the corporation. Thus, a new shareholder acquiring a minority of the stock is locked into the election whether or not S corporation treatment is beneficial.

> **Practice Tip**: Does this mean that a minority shareholder does not have the power to terminate the S election? Not really. The shareholder can transfer shares to an ineligible shareholder (for example, a corporation) and thereby cause loss of the election on the date the transfer takes place. The corporation may want to have proper agreements drawn up to prevent this type of transfer.

[9] Reg. Sec. 1.1362-6(a)(4).
[10] Sec. 1362(d)(2)(A).
[11] Sec. 1362(d)(2)(B).

Passive Investment Income

This topic deals with income earned by investments made by the S corporation, and how that income can cause the S election to terminate. It should not be confused with the passive activity rules, which determine how a shareholder treats income and losses from passive activities.

Corporations with Accumulated Earnings and Profits

An S corporation does not generate earnings and profits. However, an S corporation can have accumulated earnings and profits (AE&P) that were generated when the company was a C corporation. If the S corporation has AE&P, passive investment income can cause the S election to terminate.

A corporation's S election terminates if

- It has C corporation AE&P at the end of three consecutive taxable years, and
- More than 25 percent of its gross receipts for each of the three years is from passive investment income.[12]

The termination is effective with the first day of the taxable year following such third consecutive taxable year.[13]

> **Practice Tip:** Passive investment income has no effect on the S election of S corporations that do not have AE&P.

Definition of Passive Investment Income

For these purposes, passive investment income consists of gross receipts from rents, royalties, dividends, interest, and annuities.[14]

Exceptions to this rule include interest and other gross receipts received in the ordinary course of certain trades or businesses. Also, rents are not passive investment income if they are derived in the active trade or business of renting property.

Passive investment income and the calculation of gross receipts are discussed in more detail in chapter 5, where we cover the tax on excess net passive income.

> **Practice Tip:** Remember that there is no threat to the S election no matter how much passive investment income the S corporation receives, if the corporation does not have AE&P. Therefore, if a corporation is formed, immediately elects S status, and does not acquire another corporation, passive investment income is not, and will never be, a problem at the corporate level. Likewise, if the corporation was a C corporation but had no earnings and profits at the date of the S corporation election, passive investment income is not a problem. However, if the corporation was a C corporation that had AE&P, no matter how small, at the date of the S corporation election, there is potentially a tax at the corporate level. Also, the S election is terminated if the corporation has AE&P and the passive income test is "failed" for three consecutive tax years.

[12] Sec. 1362(d)(3)(A)(i).
[13] Sec. 1362 (d)(3)(A)(ii).
[14] Sec. 1362(d)(3)(D); Reg. Sec. 1.1362-2(c)(5).

The tax on passive investment income and the threat of termination of S status because of passive investment income are both eliminated if the S corporation distributes all of its AE&P to shareholders.

Notification of Termination

The IRS must be notified if the S corporation election terminates. The notice is filed with the Form 1120S for the year in which the termination occurred, and must state the date of the termination.[15] The "S election termination or revocation" box near the top of the first page of Form 1120S should be checked. Evidently, the "Final return" box should be checked only if the corporation is liquidating and will no longer be filing either Form 1120 or 1120S.

Allocation between Taxable Years

Terminations can, and will, occur on dates other than the first of the tax year. Shareholders holding a majority of the shares can select the day on which a voluntary termination becomes effective, and involuntary terminations occur on the day the disqualifying event takes place.

So the question arises—If an S corporation terminates at a date other than year-end, how is the income or loss determined for the short S and short C corporation year?

The answer is found in Sec. 1362(e) and in Reg. Sec. 1.1362-3.

The short S corporation year ends on the day before the first day that the termination is effective.[16] The short C year begins the next day, on the day that the termination is effective.[17]

> **Example 4-1**
>
> Jones, a shareholder of X Corp., a calendar year S corporation, transfers stock to a nonqualifying trust on September 3. X Corp. is an S corporation for the short year January 1 through September 2 and a C corporation for the short year September 3 through December 31 and thereafter.

Notice that if a corporation revokes its S election so that the termination is effective on, say, April 1, the last day of the S corporation's short year would be the preceding day, March 31.

Methods of Allocation

There are two ways to allocate income between the short S and C corporation years:

1. *Pro rata* method
2. Normal tax accounting rules method

Pro Rata *Allocation*

The *pro rata* method is used unless

[15] Reg. Sec. 1.1362-2(b)(1).
[16] Sec. 1362(e)(1)(A).
[17] Sec. 1362 (e)(1)(B).

- The shareholders elect to use normal tax accounting rules,
- 50 percent or more of the stock was sold or exchanged during the year, or
- 80 percent or more of the S corporation's shares is purchased and a Sec. 338 election to treat the stock purchase as an asset acquisition is made.[18]

Where the *pro rata* method is available and is used, it is not necessary to close the books at the termination date. The allocation is made by assigning each short year its *pro rata* share of the entire year's income, losses, deductions, and credits.

The following amounts for the entire taxable year are allocated on a *pro rata* basis:

- Ordinary income or loss, which, technically, is the nonseparately computed income or loss.[19] It shows up as the bottom line income or loss on page 1 of Form 1120S.
- The amounts of income, loss, deduction or credit that are separately reported by the shareholder under Sec. 1366(a)(1)(A). Examples of these items would be capital gains, tax-exempt interest, contributions, and credits.[20]

The items are then allocated based on the number of days in each short year.[21]

Got it?

Maybe it would help to look at an example.

Example 4-2

Assume X Corp., in Example 4-1, had ordinary income of $40,000 for the year in which the termination took place.

Using the pro rata method, X Corp. would allocate the income like this:

	S Corporation Year	C Corporation Year	Total
Dates	1/1–9/2	9/3–12/31	–
Number of days	245	120	365
Ratio $\left(\frac{\text{No. of Days}}{365}\right)$	.6712	.3288	1.00
Ordinary income	$26,848	$13,152	$40,000

Remember, the *pro rata* method cannot be used if 50 percent or more of the corporation's stock was sold or exchanged during the year the termination took place.[22]

Election to Use Normal Tax Accounting Rules

Instead of using the *pro rata* method of determining each short year's income, the corporation may elect to use normal tax accounting rules to assign the items to each short year.[23] Anyone

[18] Sec. 1362(e)(6)(D); Reg. Secs. 1.1362-3(a), 1.1362-3(b), 1.1362-3(c)(1).
[19] Sec. 1362(e)(2)(A)(ii).
[20] Sec. 1362(e)(2)(A)(i).
[21] Sec. 1362(e)(2); Reg. Sec. 1.1362-3(a).
[22] Sec. 1362(e)(6)(D).

who was a shareholder at any time during the S short year and anyone who was a shareholder on the first day of the C short year must consent to the election.[24] If the election is made, items of income, loss, deduction, and credit are attributable to the short taxable year in which they were incurred or realized using the corporation's normal method of accounting.[25]

Okay, here we tackle our X Corp. example again.

Example 4-3

X Corp. in Example 4-2 elects to allocate between the short tax years by using normal tax accounting rules, and all shareholders consent. (Note that the nonqualifying trust, which caused the S corporation election to terminate, must also consent to this election, since it will be a shareholder on the first day of the C short year.)

X Corp.'s records show that the corporation earned ordinary income of $1,300 through September 2, and $38,700 from September 3 through December 31. Therefore, the income is allocated between the short years as follows:

	S Corporation Year	C Corporation Year	Total
Ordinary Income	$1,300	$38,700	$40,000

The election to allocate based on normal tax accounting rules may be made regardless of whether termination is voluntary or involuntary.

HOW TO MAKE ELECTION

The election to allocate (between S and C short years in a termination year) based on normal tax accounting rules is filed with the C corporation's short year return. The election should state that the corporation elects under Sec. 1362(e)(3) to have the rules in Sec. 1362(e)(2) *not* apply. Also, the statement must state the cause and the date of termination. It must be signed by any person authorized to sign the corporate tax return.[26]

Each person who was a shareholder at any time during the S short year and anyone who was a shareholder on the first day of the C short year must state under penalties of perjury that the shareholder consents to the corporation making the election under Sec. 1362(e)(3). The consents are attached to the election.[27]

> **Practice Tip:** The election to use normal tax accounting rules can be made by the due date (including extensions) of the C return, which is due at the end of the regular tax year.

Exhibits 4-3 and 4-4 at the end of this chapter provide examples of the election and consents.

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[23] Sec. 1362(e)(3)(A).
[24] Sec. 1362(e)(3).
[25] Reg. Sec. 1.1362-3(a).
[26] Reg. Sec. 1.1362-6(a)(5), 1.1362-6(a)(1).
[27] Reg. Sec. 1.1362-6(a)(5), 1.1362-6(b)(1).

Mandatory Use of Normal Tax Accounting Rules

If 50 percent or more of the shares of the corporation are sold or exchanged during the year, allocations to each short year must be based on normal tax accounting rules.[28] In that case, no election is required.

Tax Planning Pointers

The provisions relating to revocation of the S corporation election give your S corporation clients unprecedented tax planning opportunities. The provisions work in the taxpayer's favor because of three factors:

1. The revocation can be effective at any time in the future.
2. The corporation can elect to use normal tax accounting rules.
3. The decision of whether to use the *pro rata* method or normal tax accounting rules does not have to be made until the end of the tax year (including both the S corporation's and C corporation's *short* years).

Along with the tax planning opportunities, however, there are dangers and pitfalls. If the S election is to be revoked, the accountant *must* be aware of the most favorable time to have the revocation become effective.

- As soon as revocation is considered, you should start tracking the corporation's income and expenses. When conditions are right, *revoke*. *The date revocation occurs should not be happenstance*. To the extent possible, it should be the date that provides the best tax treatment for your client!
- The revocation should occur at the date on which you think the conditions are right—but if conditions change during the last portion of the year, and the *pro rata* method works out to be the best method to use, it is still available.
- Therefore, the timing of the revocation should be based on actual books and records. The *pro rata* method should *never* be used *UNLESS it provides the best tax result*.

Computing Short Year's Tax

For purposes of computing the C corporation's tax for the short year, the income must be annualized.[29]

- Annualizing is required so that the corporation can be taxed at higher brackets than would be applicable if the tax were computed on only the short year's income.
- Annualizing applies regardless of whether the *pro rata* allocation method or the normal tax accounting rules method is used. However, as we will see in the example, since the *pro rata* allocation method is computed using the same fractions as the annualizing

[28] Sec. 1362(e)(6)(D); Reg. Sec. 1.1362-3(b)(3).
[29] Sec. 1362(e)(5)(A).

formula, the *annualized* amount of net income is the same as the net income *for the entire year*, if the *pro rata* allocation method is used.

The annualization is accomplished by multiplying the taxable income by the number of days in the entire year and dividing the result by the number of days in the short year. The tax for the total year is then apportioned according to the number of days in the C corporation short year as compared to the number of days in the entire year.[30] Confusing, isn't it? Here are examples that illustrate the tax computation:

Example 4-4

Assume the same data as Example 4-2. Under the pro rata allocation method, X Corp. computes its C corporation tax this way:

Ordinary income for entire year, per Example 4-2		$40,000
You would get this same $40,000 answer by running the amounts through the annualization process:		
C corporation allocated ordinary income, per Example 4-2	$13,152	
Multiply by ratio of number of days in entire year over number of days in C corporation short year (365/120)	3.0417	
Annualized income	$40,004	
There is a small difference due to rounding		
Corporate tax on $40,000		
$40,000 at 15%		$6,000
Multiply by ratio of number of days in short year over number of days in entire year (120/365)		.3288
Income tax		$1,973

Now, what if the corporation has made the election to apportion the income based on normal tax accounting rules?

Example 4-5

Computation of annualized income when the election to use normal tax accounting rules is made:

[30] Sec. 1362(e)(5)(A); Reg. Sec. 1.1362-3(c)(2).

Ordinary income for the C corporation year, per Example 4-3	$38,700
Multiply by number of days in entire year over number of days in C corporation short year (365/120)	3.0417
Annualized income	$117,714
Tax on $117,714:	
$50,000 at 15%	$7,500
$25,000 at 15%	6,250
$25,000 at 34%	8,500
$17,714 at 39%[1]	6,908
Total	$29,158
Multiply by number of days in short year over number of days in entire year (120/365)	.3288
Income tax	$9,587

A comparison of the results follows:

	***Pro rata* Allocation Method**	**Normal Tax Accounting Rules**
Ordinary income passed through to shareholders	$26,848	$ 1,300
C corporation income	13,152	38,700
Total income	$40,000	$40,000
Tax:		
Shareholder (assuming 28% rate)	$7,517[2]	$ 364[3]
Corporation (per calculations above)	1,973	9,587
	$9,490	$9,951

Even though the total tax results appear similar in this example, bear in mind that distribution of the C corporation income to the shareholders will result in taxable income to them.

[1] 34% tax rate plus 5% surtax to phase out benefit of lower brackets
[2] $26,848 x 28% = $7,517
[3] $1,300 x 28% = $364

ALTERNATIVE MINIMUM TAX EXCLUSION

The alternative minimum tax (AMT) exclusion for corporate tax preferences[31] must also be annualized in accordance with Sec. 443(d)(2).[32]

> **Practice Tip:** The AMT can apply to the C corporation year only. S corporations are not subject to the AMT. Rather, the AMT items pass through to the shareholders to be reported on their personal income tax returns.

[31] Sec. 55(d)(2).
[32] Sec. 1362(e)(5)(B).

CARRYOVERS

The short S corporation and C corporation years will be treated as one year for purposes of carryforwards and carrybacks, but are treated as two separate years for other purposes.[33]

DUE DATE OF RETURNS

Both short year returns are due on the date the S corporation return would have been due (including extensions) if the election had not terminated.[34]

> **Example 4-6**
>
> X Corporation's return (Form 1120S) for the short year, January 1 through September 2, is due the following March 15—2½ months after the normal December 31 year-end. The C corporation return (Form 1120) for the short year, September 3 through December 31, is also due on March 15. The due date of both returns can be extended by filing extension requests.

When Short-Year Passthrough Occurs

Passthrough to shareholders occurs at the end of the entire taxable year, rather than at the date the S short year ends.[35]

> **Example 4-7**
>
> S Corp. uses a fiscal year ending on August 31. Jane, the sole shareholder, reports on a calendar-year basis. S Corp. terminates its S election on November 1, 2011. The S Corporation tax return for the short year ending October 31, 2011, is not due until November 15, 2012, two-and-a-half months after the normal August 31 year-end. Furthermore, the decision of whether to use the pro rata allocation method or normal tax accounting rules does not have to be made until the due date of the tax return. Accordingly, income or loss from the S Corporation is reported on Jane's 2012 Form 1040 (that is, the year in which the S corporation tax year normally ends).

New Election

A corporation whose S election has been terminated cannot make another S corporation election for any tax year before the fifth taxable year that begins after the first taxable year in which the election is terminated. The rule also applies to a successor corporation under Reg. Sec. 1.1362-5(b). A corporation is a successor corporation for these purposes if

1. 50 percent or more of the stock of a new corporation is owned, directly or indirectly, by the same persons who, on the date of termination, owned 50 percent or more of the stock of the terminated S corporation, and

[33] Sec. 1362(e)(6)(A); Reg. Sec. 1.1362-3(c)(4).
[34] Sec. 1362(e)(6)(B); Reg. Sec. 1.1362-3(c)(5).
[35] Sec. 1362(e)(1), 1362(e)(4); Reg. Sec. 1.1362-3(c)(6).

2. The new corporation either acquires a substantial portion of the assets of the old corporation, or a substantial portion of the assets of the new corporation were assets of the terminated S corporation.

The five-year waiting period applies regardless of whether termination was voluntary or involuntary. However, the IRS has the power to allow an earlier election.[36]

IRS May Allow New S Election before End of Five-year Period

Reg. Sec. 1.1362-5 states that the corporation has the burden of persuading the IRS to consent to a new election before 5 years have elapsed. However, the fact that more than half of the corporation's stock is owned by persons who did not own stock on the date of the termination provides good grounds for IRS consent. This makes sense; the new controlling shareholders could, presumably, have organized a new corporation eligible to make the election. Such a new corporation would not be considered a *successor corporation* under Reg. Sec. 1.1362-5(b) since more than 50 percent of the shares are owned, directly or indirectly, by shareholders who did not own shares in the terminated S corporation.

Example 4-8

On December 30, a 50 percent shareholder of an S corporation sold some shares to a nonresident alien. Several days later, he learned that the sale caused the corporation to lose its S corporation status for the year of the sale. He repurchased the shares on January 15. The IRS granted a new election, even though the event causing the termination was within the shareholder's control.[37]

The IRS has also granted a new election when a depressed economy caused the corporation to have excess net passive income for three consecutive years.[38]

> **Practice Tip:** When a client's S corporation election *inadvertently* terminates, it may be better to request a termination waiver, rather than requesting a waiver of the five-year period in which to make a new S election. If the termination waiver is granted, the S election is treated as if it did not terminate, and the corporation's S status continues unbroken.

New Election Normally Not Allowable if Termination was Voluntary

Ordinarily, consent will not be given for a new S election within the five-year waiting period unless the event causing termination was not reasonably within the control of the shareholders, and was not part of a plan to terminate the election. The IRS may allow new elections when the election terminated because the shareholders were not aware of the consequences of the terminating event.[39]

[36] Sec. 1362(g).
[37] Rev. Rul. 78-274, 1978-2 CB 220.
[38] Rev. Rul. 78-275, 1978-2 CB 221.
[39] Reg. Sec. 1.1362-5(a).

New Election within Five-year Period Requires Letter Ruling

The taxpayer must request an IRS letter ruling to determine whether the IRS will consent to a new S election within the five-year waiting period. A user fee must accompany such ruling requests. User fees are set out in the first revenue procedure issued each year. The current user fee can be found in chapter 3 of this course under the heading *Obtaining a Letter Ruling*.

New Election Allowable if S Election Never Became Effective

The corporation can reelect S status without reference to the five-year waiting period if the corporation's original S election did not become effective.[40] This situation can occur when (1) the corporation was not eligible for S status when the original election was filed (for example, because it had a nonresident alien as a shareholder), or (2) the corporation filed a valid S election, but the election was revoked or terminated before it became effective. If the corporation fits either of these two scenarios, it is not subject to the five-year waiting period because the S election never became effective. Such a corporation can elect S status before five years has elapsed. No letter ruling or user fee is required.

Termination Waiver

The IRS has authority to waive termination of the S election if all of the following criteria are met:

1. The termination occurred because the corporation
    a. Ceased to be a small business corporation (as previously discussed), or
    b. Passive income exceeded the 25 percent limit for 3 consecutive tax years.
2. The termination was inadvertent.
3. Steps are taken within a reasonable time to make the corporation eligible again.
4. The corporation and anyone who was a shareholder during the waiver period agree to make any adjustments required so that they are treated as if the election had remained in effect during the waiver period.[41]

If the waiver is granted, the corporation may be treated as an S corporation for the *entire period*, as if the termination did not occur, or it may only apply back to the period in which the corporation again became eligible for S corporation treatment, depending on the facts. Before the waiver can be granted, the corporation must have completed the steps necessary to again qualify as an S corporation.

> **Practice Tip:** The IRS will not grant a termination waiver if the S election was voluntarily revoked.

Details regarding waiver requests are provided in Reg. Sec. 1.1362-4.

[40] Reg. Sec. 1.1362-5(c).
[41] Sec. 1362(f); Reg. Sec. 1.1362-4(a).

IRS Rulings on Termination Waivers

The IRS consented to waive the termination caused when shares of the corporation's stock were transferred to a trust that did not qualify as an S corporation shareholder because the beneficiaries had not filed the required elections. Further, the trust was not a Qualified Subchapter S Trust because it granted someone other than the beneficiary the right to alter the trusts' estate. The beneficiaries' elections were mailed about a year after the shares were transferred to the trust, and six months after the date for timely filing had expired. The trust instrument was changed so that corpus could not be diverted from the trust. The IRS allowed the corporation to be an S corporation without interruption, even though the trust was not a qualified shareholder for almost 19 months. In effect, the IRS said that the trust was a proper shareholder because the flaws were caused inadvertently.[42]

This and other favorable rulings show that it may pay to request a waiver (or a request for a new election) when it is advantageous to retain S status and the termination or disqualification was inadvertent.[43]

The IRS decides on a case-by-case basis whether the S corporation's passthrough items of income, loss deduction, or credit during the termination waiver period are allocated only to the eligible shareholders or to all shareholders, including those who were ineligible.

User Fee

The taxpayer must request an IRS letter ruling to have the termination waived. A user fee must accompany such ruling requests. User fees are set out in the first revenue procedure issued each year. The current user fee can be found in chapter 3 of this course under the heading *Obtaining a Letter Ruling*.

Post-Termination Transition Period

Tax-free distributions can be made from the Accumulated Adjustments Account (AAA) and unused losses can be deducted (subject to basis limitations) for a certain period of time after termination of the S election occurs. This *post-termination transition period* (generally a one-year period following the termination of the S election) is discussed in chapters 7 and 8.

[42] Ltr. Rul. 8535068.
[43] See Rev. Rul. 86-110, 1986-2 CB 150, and Ltr. Ruls. 9527017, 9628005, 200007024, 200205024, 200223003, and 200906019.

Exhibit 4-1

Notice of Revocation of S Corporation Election

Name:	L&M Manufacturing Co., Inc.
Address:	6350 Sunset Blvd. Beverly Hills, CA 90129
Employer Identification Number:	94-2386197
Service Center:	Ogden, UT

Voting shares issued and outstanding—1,500

Nonvoting shares issued and outstanding—none

The above corporation, L&M Manufacturing Co., Inc., hereby revokes its election made under Sec. 1362(a) to be taxed as an S corporation. It is intended that this revocation shall be effective on January 15, 2011.

At the date of filing this election, the corporation has the following number of shares issued and outstanding:

Voting shares:	1,500
Nonvoting shares	0
Total shares	1,500

Mortimer Gregory
President

Dated: January 10, 2011

Author's Note: January 15, 2011, is the first day of the short C corporation taxable year, in this example. Requirements and procedures for revoking an S election are set out in Reg. Secs. 1.1362-2(a), 1.1362-6(a)(3), and 1.1362-6(b).

Exhibit 4-2

Shareholders' Consent to Revocation of S Corporation Election

Corporation:	L&M Manufacturing Co., Inc.
Address:	6350 Sunset Blvd. Beverly Hills, CA 90129
Employer Identification Number:	94-2386197
Service Center:	Ogden, UT

We, the undersigned, constituting shareholders holding more than one-half of the shares of stock of L&M Manufacturing Co., Inc., on January 10, 2011, the date on which the aforementioned corporation filed its revocation of the Sec. 1362(a) S corporation election, hereby consent to the aforementioned corporation's revocation.

Under penalties of perjury, we, the undersigned, declare that we have examined this election, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct and complete.

Name, Address, I.D. Number, and Taxable Year End of Shareholder	**Number of Shares Owned**		**Date(s) Acquired**	**Signature of Shareholder**
	Voting	**Non-Voting**		
Mortimer Gregory 211 Third St. San Jose, CA 90001 100-10-1000 December 31	700	0	2/10/2004	
Bernard Fish 11 Oak Lane Malibu, CA 90002 200-22-2222 December 31	300	0	5/31/2007	

Dated: January 10, 2011

Exhibit 4-3

Election to Have Items Assigned under Normal Tax Accounting Rules

Name:	L&M Manufacturing Co., Inc.
Address:	6350 Sunset Blvd. Beverly Hills, CA 90129
Employer Identification Number:	94-2386197
Service Center:	Ogden, UT

The above corporation, L&M Manufacturing Co., Inc., hereby elects under Sec. 1362(e)(3) to have the rules in Sec. 1362(e)(2) not apply.

Date corporate year ends:	December 31, 2011
Cause of termination:	Revocation, filed on January 10, 2011
Date of Termination:	January 15, 2011

Mortimer Gregory
President

Dated: February 15, 2012

Exhibit 4-4

Consent to Election to Have Items Assigned under Normal Tax Accounting Rules

Corporation:	L&M Manufacturing Co., Inc.
Address:	6350 Sunset Blvd. Beverly Hills, CA 90129
Employer Identification Number:	94-2386197
Service Center:	Ogden, UT

We, the undersigned, constituting all of the shareholders in L&M Manufacturing Co., Inc., at any time during the S short year beginning January 1, 2011, and all shareholders on the first day of the C short year, beginning January 15, 2011, hereby consent to the aforementioned corporation's election under Sec. 1362(e)(3) to have the rules in Sec. 1362(e)(2) not apply.

Under penalties of perjury, we, the undersigned, declare that we have examined this election, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete.

Name, Address, I.D. Number, and Taxable Year End of Shareholder	**Number of Shares Owned**	**Date(s) Acquired**	**Signature of Shareholder**
Mortimer Gregory 211 Third St. San Jose, CA 90001 100-10-1000 December 31	700	2/10/2004	
Bernard Fish 11 Oak Lane Malibu, CA 90002 200-22-2222 December 31	300	5/31/2006	
John Jackson 13 Oak Lane Malibu, CA 90002 300-33-3333 December 31	500	3/20/2005	

Dated: February 15, 2012

Chapter 5

Taxation of S Corporations

Introduction

In this chapter, we will discuss

- Taxes for which an S corporation can be liable.

One of the primary advantages of operating as an S corporation is the escaping of income tax at the corporate level. Income of a C corporation is taxed to the corporation, then the shareholders pay tax on it again when it is distributed as dividends. Generally, there is no tax to an S corporation. The income or loss passes through and is taxed, or deducted, at the shareholder level.

However, there are three types of taxes that an S corporation that was once a C corporation may generate at the corporate level:

1. Tax on built-in gains
2. Tax on excess net passive income
3. Business credit recapture

> **Practice Tip:** Be aware that none of these taxes will normally apply unless the corporation has previously been a C corporation. The general rule is that a company that has been an S corporation since inception will not pay a tax. (We will discuss the exceptions to the rule in this chapter, but they occur in situations where a C corporation is involved—such as when the corporation acquires a corporation that was a C corporation or when transferred basis property is received from a company that was a C corporation.)

A copy of the S corporation tax return, Form 1120S, and Schedule K-1 can be found at the end of chapter 10.

OTHER PAYMENTS MADE AT S CORPORATION LEVEL

LIFO Recapture

If a C corporation is using the LIFO inventory method at the date the S election is effective, it is subject to LIFO recapture. The LIFO recapture is recognized on the last C corporation return. The LIFO recapture tax, however, is payable in four installments. One-fourth of the tax is paid by the unextended due date of the C corporation's last return, and one-fourth is payable by the unextended due dates of the S corporation's first three returns.

Fiscal Years

An S corporation may also have to make *required payments* if it elects to adopt or retain a fiscal year.[1]

Estimated Tax Payments

An S corporation that incurs tax at the corporate level must make estimated tax payments, as discussed at the end of this chapter.

Now we will investigate each potential tax separately.

Tax on Built-in Gains

Both the corporation and the shareholders in a C corporation are taxed on gains that occur during liquidation. S corporations, though, are generally not subject to double tax upon liquidation, because gains are passed through to shareholders. To discourage C corporations from electing S status to avoid the double tax on liquidation, the tax on *built-in gains* was imposed at the corporate level for C corporations that made the S election after December 31, 1986.

The built-in gains tax, however, does not apply only to liquidating corporations. Rather, an S corporation that was previously a C corporation is generally subject to the built-in gains rules for a 10-year recognition period, beginning with the date the S election becomes effective. Built-in gain is triggered by the disposition (or other type of income recognition) from an asset with a fair market value that exceeded its adjusted basis on the effective date of the S election. The tax rate is presently 35 percent, the highest rate of corporate tax.

A temporary built-in gains tax exemption applies to built-in gains recognized in an S corporation's tax years beginning in 2009 and 2010, if the *seventh tax year* of the recognition period has elapsed before the beginning of the tax year beginning in 2009 or 2010. A built-in gains tax suspension period also applies to the tax year beginning in 2011, if the *fifth year* of the recognition period has elapsed before the beginning of the tax year beginning in 2011. These suspension periods are discussed later in this chapter.

A worksheet for computing built-in gains tax is included as Exhibit 5-1 at the end of this chapter.

Recognition Period

When a C corporation elects S status, the S corporation is subject to the built-in gains tax for the 10-year period beginning with the day the S election becomes effective. In the words of the Code, "The term 'recognition period' means the 10-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation."[2]

[1] Secs. 444, 7519.
[2] Sec. 1374(d)(7); Reg. Sec. 1.1374-1(d).

Example 5-1

Ceecorp is a C corporation that has an October 31 year-end. On November 1, 2011, it becomes an S corporation. The S corporation reports on a calendar year, so its first tax year runs from November 1 through December 31. The corporation is subject to the built-in gain rules through October 31, 2021, the end of the 10-year recognition period. After that date, the corporation can dispose of assets or liquidate with no tax at the corporate level. (The corporation can, however, become subject to the built-in gains even after the expiration of the 10-year recognition period, if it acquires assets from a C corporation or from an S corporation subject to the built-in gains tax.)

Corporations Subject to the Built-in Gain Rules

The general rule is that only S corporations that have been C corporations are subject to the built-in gains tax.[3] Furthermore, an S corporation's total amount of built-in gain is limited to the *net unrealized built-in gain*. Thus, an S corporation that would otherwise be subject to the built-in gains tax will not be subject to the tax if the aggregate adjusted basis of the corporation's assets exceeds the fair market value of those assets on the date the S election becomes effective.

However, the built-in gains tax can apply when any S corporation acquires an asset from a C corporation or from an S corporation subject to the built-in gains tax rules.

Recognized Built-in Gain

Built-in gain is recognized when an asset is disposed of during the 10-year recognition period. The amount recognized is the difference between the asset's basis and its fair market value at the date the S corporation election became effective.[4] The recognized built-in gain attributable to an asset, however, is limited to the actual gain recognized when the asset is disposed of.

An asset, however, does not have to be actually disposed of to trigger built-in gain. The definition of items subject to the built-in gains tax includes any item of income that is taken into account during the recognition period, if the item is attributable to the period prior to the effective date of the S election.[5] The regulations provide that income recognized during the recognition period is recognized built-in gain if the income would have been included in gross income before the recognition period by a taxpayer using the accrual method.[6] This rule means that cash basis accounts receivable earned by the C corporation, but collected by the S corporation, cause built-in gains.

DISTRIBUTIONS OF APPRECIATED PROPERTY

Distributions of appreciated property are treated as if the property were sold to the shareholder at its fair market value. Therefore, these distributions cause the built-in gains tax to be applied in the same way it would be if the property were sold.

[3] Sec. 1374(c).
[4] Sec. 1374(d).
[5] Sec. 1374(d)(5)(A).
[6] Reg. Sec. 1.1374-4(b)(1).

SECTION 481 ADJUSTMENTS

Section 481 adjustments (relating to adjustments caused by a change in accounting method) taken into account during the recognition period represent built-in gain or loss to the extent the adjustments are attributable to the period that the company was a C corporation.[7]

Banks that change from the reserve method of accounting for bad debts to the specific charge-off method in the bank's first S corporation tax year can elect to take the income adjustment in full in its last C corporation year.[8] If the election is made, a Section 481(a) adjustment is avoided.

GOODWILL AND GOING CONCERN VALUE

Goodwill, going concern, and other intangible corporate assets are subject to the built-in gains tax, and must be appraised along with the other assets.

> **Practice Tip:** Two Tax Court cases illustrate circumstances under which certain goodwill is owned by the shareholders, rather than the S corporation. Under these circumstances, such goodwill is not subject to the built-in gains tax rules because it is not the corporation's asset. The Tax Court held that the corporation has no goodwill when the corporation's business is dependent upon its key shareholder-employees, unless they enter into a covenant not to compete, employment contract, or other agreement with the corporation that causes their personal relationships with clients to become property of the corporation.[9]

CERTAIN TIMBER, COAL, OR IRON ORE TRANSACTIONS

Certain transactions involving the disposal of timber, coal, or domestic iron ore under Sec. 631 are not subject to the built-in gains tax.[10]

Built-in Losses

Built-in losses can offset built-in gains. Two types of losses can be built-in.

First, there is built-in loss, to the extent that an asset's basis exceeds its fair market value at the S election's effective date.[11] This loss reduces the *net unrealized built-in gain* that limits the overall amount of built-in gain that an S corporation must recognize, as discussed later in this chapter. Also, when the asset is disposed of, the recognized built-in loss can offset built-in gain recognized in the same tax year.

Second, certain accounts payable and bonuses represent built-in losses that reduce net unrealized built-in gains and offset recognized built-in gains when the payable is deducted. Technically, any amount that is allowable as a deduction during the 10-year recognition period that is attributable to periods before the S election was effective is treated as a built-in loss in the year that it is

[7] See Reg. Sec. 1374-4(d); *Argo Sales Co Inc*. 105 TC 86 (1995); *Rondy, Inc*. TC Memo 1995-372 (1995); and *MMC Corp*., TC Memo 2007-354 (2007).
[8] Sec. 1361(g).
[9] See *Martin Ice Cream Co*. 110 TC 189 (1998) and *William Norwalk* TC Memo 1998-279 (1998).
[10] See Rev. Rul. 2001-50, 2001-2 CB 343.
[11] Sec. 1374(d)(4).

deductible by the S corporation.[12] The regulations provide that a deduction during the recognition period is a built-in loss if the deduction would have been allowed against gross income before the beginning of the recognition period by a taxpayer using the accrual method.[13] This means that cash basis accounts payable incurred by the C corporation, but paid (and deducted) by the S corporation, are built-in losses.

> **Practice Tip:** Liabilities incurred during the C corporation period must be deductible by the S corporation, if they are to create built-in losses. A liability for, say, the purchase of an asset does not cause a built-in loss.

If the liability is to a related party, and would not be deductible by an accrual basis taxpayer under Section 267(a)(2) until paid (such as a bonus or other expense payable to a shareholder), the liability represents a built-in loss if

- All events have occurred to establish the exact amount of the liability as of the beginning of the recognition period, and
- The amount is paid
  - In the first 2½ months of the recognition period, or
  - To a related party owning, under the attribution rules of Section 267, less than 5 percent of the corporation's stock.[14]

> **Practice Tip:** Assuming that *all events* have occurred to establish the exact amount of the liability for the bonus or deferred compensation payment at the date the S election becomes effective, the preceding discussion boils down to this:

- The bonus or deferred compensation payment to a more-than-5 percent shareholder represents a built-in loss only if it is paid within 2½ months after the S election becomes effective.
- The bonus or deferred compensation payment to a shareholder who owns less than 5 percent of the voting power and value of the stock represents a built-in loss regardless of when it is paid during the 10-year recognition period.

BUILT-IN LOSSES MAY BE LIMITED

Built-in losses offset built-in gain only to the extent that built-in gains are recognized in the same taxable year.

The amount of built-in loss that can offset built-in gain is limited to the actual loss recognized when the asset is disposed of.

Furthermore, built-in losses are not allowed if the built-in loss property is sold or otherwise transferred to a related party, including someone who, directly or indirectly, owns shares in the S corporation.[15]

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[12] Sec. 1374(d)(5)(B).
[13] Reg. Sec. 1.1374-4(b)(2).
[14] Reg. Sec. 1.1374-4(c)(1). See also Secs. 267(a)(2), 267(e)(1), and Ltr. Rul. 200925005.

Practice Tip: Built-in losses benefit the S corporation in two ways because they

1. Offset built-in gains and
2. Reduce net unrealized built-in gain which limits the total amount of built-in gains that must be reported during the 10-year recognition period.

Cumulative Recognized Built-in Gain Is Limited to Net Unrealized Built-in Gain

The amount of cumulative built-in gain that must be recognized is limited to the *net unrealized built-in gain*; that is, the amount (if any) that

- The fair market value of the corporation's assets at the beginning of its first S corporation year exceeds.
- The aggregate adjusted basis of the assets at that date.[16]

This means that the total amount of recognized built-in gain is limited to the net appreciation of assets on hand when the S corporation election becomes effective. As illustrated in Example 5-4, built-in losses can reduce net unrealized built-in gain.

Practice Tip: An S corporation is not subject to the built-in gains tax if it has no net unrealized built-in gain at the date the S election becomes effective. The S corporation can become subject to the tax, however, if it acquires (or receives transferred basis property from) a C corporation or an S corporation subject to the built-in gains tax.

Example 5-2

Seecorp, an accrual method C corporation, becomes an S corporation on January 1, 2011. On that date, it has assets as follows:

	Fair Market Value	Basis	Built-in Gain (Loss)
Cash	$ 15,000	$15,000	$ 0
Machine 1	25,000	22,000	3,000
Machine 2	120,000	75,000	45,000
Machine 3	15,500	11,000	4,500
Machine 4	22,000	39,000	(17,000)
Totals	$197,500	$162,000	$35,000

Net unrealized built-in gain is $35,500, the fair market value of the assets at the beginning of the first S year, less the aggregate bases of assets at that date.

Seecorp's taxable income, computed as if it were a C corporation is $50,000 each year.

During 2011, Machine 1 is sold at a gain of $4,000. The corporation is subject to tax on built-in gain of $3,000, based on the excess of the asset's fair market value over its basis on the date the S election became effective. The additional $1,000

[15] Sec. 267.
[16] Sec. 1374(d)(1).

gain had to arise from depreciation taken or appreciation that occurred after that date. That portion of the gain is not subject to the built-in gains rules, and it passes through to shareholders free of corporate tax.

In 2013, Machine 2 is sold at a gain of $35,000. The built-in gain on that asset was $45,000 on the date the S election became effective. Consequently, all of the gain would be built-in gain if it were not for the net unrealized built-in gain limitation. Under that limitation, the corporation does not have to recognize cumulative built-in gains in excess of $35,500, so the 2013 built-in gain is limited to $32,500.

The calculation is as follows:

Net unrealized built-in gain, as above	$35,500
Less: Built-in gain recognized in prior years	3,000
Limitation on recognized built-in gains	$32,500

The $32,500 is taxable at the corporate level, and the remaining $2,500 of the gain passes through to shareholders without being taxed at the corporate level.

Note: Since Seecorp has been taxed on its total built-in gains, any gain realized on the sale of Machine 3 would not be subject to the tax.

Built-in losses from payables also reduce net unrealized built-in gain.

Example 5-3

Assume the same facts as in Example 5-2, except that Machine 4 is also sold in 2011 to an unrelated party for $25,000. The machine's basis at the date of sale is $39,000, resulting in a loss of $14,000 ($39,000 - $25,000). The amount of built-in loss from the sale of the asset that can offset built-in gain for the year is limited to $14,000, the lesser of (1) the built-in loss at the date the S election was effective or (2) the actual loss. Thus, the built-in loss offsets the entire $4,000 built-in gain recognized in 2011, and the corporation has no net recognized built-in gain for that year. Passthrough of the loss to shareholders is not affected by the offset against built-in gains; that is, the full $14,000 loss passes through to the shareholders.

In 2013, when Machine 2 is sold at a gain of $35,000, all of the gain will be subject to the built-in gains tax, as shown in the following calculation:

Net unrealized built-in gain	$35,500
Less: Built-in gain recognized in prior years	0
Limitation on recognized built-in gains	35,500
Less: Built-in gain recognized in the current year	35,000
Remaining net unrealized built-in gain	$500

If Machine 3 is disposed of at a gain in a later year, the built-in gain is limited to the remaining net unrealized built-in gain of $500.

Practice Tip: If built-in losses during a year are more than built-in gains, the excess losses do not carry over to offset future gains. Thus, to the extent possible, built-in losses should be recognized in the same year as built-in gains.

Tax Trap—Inventory and Accounts Receivable Can Cause Built-in Gains

The corporation does not have to liquidate, sell, or otherwise dispose of assets to be subject to the built-in gains tax. Built-in gains are recognized when any item of income is taken into account by the S corporation, if the item is attributable to the period before the S election was effective. Obviously, gains on sales of inventory on hand at the date of conversion to S status would fit this description. So do collections of receivables by a cash basis taxpayer.

Therefore, you must also be on guard for potential built-in gains that can occur *in the first year that the S election is effective*.

The reportable built-in gains on accounts receivable will be the difference between the amount of the receivable at the date the S election is effective, and its zero basis to a cash basis corporation.

INVENTORY

Sales of inventory can trigger the built-in gains tax. The regulations provide that the fair market value of the inventory is the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer who expects to continue operating the S corporation's business.[17] The buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts. The preamble to the regulations states that the value of the inventory will "generally be less than its anticipated retail price, but greater than its replacement cost."

> **Practice Tip:** Do not forget that work in progress at the date the S election becomes effective is an asset, and its value at the date the S election becomes effective must be included when determining the corporation's net unrealized built-in gain.

FIFO AND LIFO INVENTORIES

The inventory method used by the taxpayer for tax purposes, such as FIFO or LIFO, will be used to determine what items of inventory were disposed of.[18] For example, a corporation using the LIFO inventory method will not be subject to the built-in gains tax related to sales of inventory, except to the extent that a LIFO layer existing at the time the S corporation election becomes effective is invaded after that date. (Corporations that use the LIFO inventory method and elect S status are subject to LIFO recapture provisions.)

> **Practice Tip:** The built-in gains tax on inventory may not present too large a hurdle when your C corporation client is considering whether to elect S status. In many cases, the inventory's cost will be the same as its basis, so there will be no built-in gain when the inventory is sold. If the corporation's inventory is slower moving and tends to appreciate while being held by the corporation before being sold, built-in gain might be a consideration. Farming corporations that are carrying raised crops or animals at zero basis may be especially vulnerable to the built-in gains tax on inventory.

[17] Reg. Sec. 1.1374-7(a).
[18] Reg. Sec. 1.1374-7(b).

CALCULATION

Calculation of recognized built-in gains on inventory and accounts receivable is illustrated in the following example:

Example 5-4

Seecorp, a C corporation, has $500,000 of average annual gross receipts. The corporation reports on a calendar year and uses the cash basis method of tax reporting. It becomes an S corporation on January 1, 2011. On that date, it has assets and accrued expenses as follows:

	Fair Market Value	Basis	Built-in Gain (Loss)
Cash	$ 15,000	$15,000	$ 0
Inventory	62,000	60,000	2,000
Accounts receivable	78,000	–	78,000
Equipment	80,000	70,000	10,000
Totals	$235,000	$145,000	90,000
Accounts payable	(13,000)		(13,000)
Net unrealized built-in gain			$77,000

Assuming that all of the inventory is sold, all of the receivables are collected and the accounts payable are paid and deducted in 2011, the corporation will have recognized built-in gains of $67,000 ($2,000 + $78,000 – $13,000) that will be taxed at the corporate level in 2011. The built-in gain will also pass through to shareholders. Consequently, both the corporation and the shareholders will be subjected to tax on those items. The built-in gains tax, however, is deductible at the corporate level and reduces each shareholder's portion of passthrough income.

Practice Tip: Many C corporations that might otherwise make the S corporation election will be discouraged from doing so because of the double tax imposed on the collection of accounts receivable.

Computation of Built-in Gains Tax

The tax on built-in gains is imposed at the highest rate of corporate tax (presently 35 percent). The tax is based on the lesser of

- The built-in gain recognized for the taxable year (that is, recognized built-in gains net of recognized built-in losses), or
- The taxable income that the corporation would have for the taxable year if it were a C corporation.[19]

[19] Sec. 1374 (a) and (d)(2)(A); Reg. Sec. 1.1374-2(a).

TAXABLE INCOME LIMITATION

In determining the taxable income in the second point above, the net operating loss deduction is not allowed (but see *Corporate Carryovers Offset Built-in Gains* later in this chapter). The special corporate deductions of Secs. 241 through 250 are not allowed either, except for amortization of organization expenditures under Sec. 248. (The special corporate deductions relate to the dividends-received deduction, bond premium deduction, and National Railroad Passenger Corporation payments.)

> **Practice Tip:** It may be helpful to use the C corporation tax return, Form 1120, to compute the corporation's taxable income under this provision.

Example 5-5

For the calendar year, Esscorp has built-in gains of $50,000. Its taxable income, computed as if it were a C corporation, is $60,000. The tax on built-in gain is $17,500 ($50,000 × 35%, the maximum corporate rate).

Assume that the taxable income is $20,000, and the built-in gain is $60,000. The built-in gains tax would be $7,000 ($20,000 × 35%). The $40,000 ($60,000 - $20,000) built-in gain that is not taxed because of the taxable income limitation will carry over to the following year.

If the S election was effective at a date other than the beginning of the corporation's regular tax year, the 10-year recognition period will end during a tax year, rather than at the end of the year. In that event, the taxable income limit is determined for the year as if the corporation closed its books at the end of the recognition period.[20]

Net Unrealized Built-in Gain Limitation

As we saw earlier, the built-in gain is also limited to the amount of net unrealized built-in gain at the date the election was effective. (Net unrealized built-in gain is generally the amount that the fair market value of the corporation's assets exceeds the aggregate adjusted bases of the assets at the date the S election becomes effective.) Thus, the built-in gain in any specific year cannot exceed

- The net unrealized built-in gain, reduced by
- The net recognized built-in gain for prior taxable years beginning in the recognition period.[21]

Example 5-6

Albon Inc., a C Corporation, elects S status on January 1, 2011. On that date, it has the following assets and incurred expenses:

[20] Reg. Sec. 1.1374-1(d).
[21] Sec. 1374(c)(2); Reg. Sec. 1.1374-2(a).

	Fair Market Value	Basis	Built-in Gain (Loss)
Cash	$ 15,000	$15,000	$ 0
Inventory	62,000	60,000	2,000
Accounts receivable	85,000	–	85,000
Machine One	22,000	12,000	10,000
Machine Two	21,000	28,000	(7,000)
Totals	$205,000	$115,000	90,000
Accounts payable	(13,000)		(13,000)
Net unrealized built-in gain			$77,000

In 2011, the inventory is sold, the accounts receivable are collected, and the accounts payable are paid and deducted. The corporation's taxable income is $100,000.

The recognized built-in gain for the year is $74,000 ($2,000 + $85,000 – $13,000).

In 2012, Machine One is sold at a $10,000 gain. The corporation's taxable income for the year is $100,000.

The recognized built-in gain for 2012 is limited to $3,000, calculated as follows:

Net unrealized built-in gain	$77,000
Less: Net recognized built-in gain for prior years	74,000
Remaining net unrealized built-in gain	$3,000

The corporation has now recognized $77,000 of built-in gain in total. The corporation is no longer subject to the built-in gains rules because cumulative recognized built-in gain is limited to the net unrealized built-in gain calculated at the date the S election becomes effective. However, the corporation can again become subject to the built-in gains tax if it acquires transferred basis property from a C corporation or an S corporation that is subject to the built-in gains tax.

Summary of Limitation on Built-in Gains

To summarize, the built-in gains tax is based on the smallest of

- The built-in gain recognized for the taxable year;
- The taxable income that the corporation would have for the taxable year, if it were a C corporation; or
- The net unrealized built-in gain, reduced by the net recognized built-in gain for prior taxable years, beginning in the recognition period.

Carryover of Built-in Gains

Any built-in gain that is not taxed because of the taxable income limitation will carry over until there is taxable income, at which time it will be subject to the tax. The gains carry forward,

however, only until the end of the 10-year recognition period, and built-in gains are not applicable after that time.[22]

Example 5-7

Jaycorp, an accrual basis C corporation, elects S status effective as of January 1, 2011, the beginning of its calendar year. A list of Jaycorp's assets on that date is shown below. Jaycorp had no unpaid expenses when the S election became effective.

	Fair Market Value	Basis	Built-in Gain (Loss)
Cash	$200,000	$200,000	$ 0
Asset A	225,000	0	225,000
Asset B	15,000	5,000	10,000
Asset C	20,000	100,000	(80,000)
Totals	$460,000	$305,000	$155,000

In 2011, the corporation sells asset A and realizes a $225,000 ordinary gain. Its total income (including the gain) is $350,000, but it has operating expenses in excess of income, so it shows taxable income (computed as if it were a C corporation) of zero.

The realized built-in gain for the year is $225,000, but it is limited to the lesser of the net unrealized built-in gain ($155,000) or the taxable income ($0). Consequently, there is no built-in gain recognized for the year, but the $155,000 of built-in gains carries over into the next year. The carryover is computed as follows:

(A)	Combined realized built-in gains and losses	$225,000
(B)	Net unrealized built-in gain	$155,000
(C)	Limitation (Lesser of A or B)	$155,000
(D)	Taxable income	0
(E)	Carryover C – D	$155,000

Example 5-8

Assume the same facts as Example 5-7. In 2012, Jaycorp has operating income of $320,000 and operating expenses of $245,000, so its taxable income (computed as if it were a C corporation) is $75,000.

The corporation has a recognized built-in gain of $155,000 in 2012, because the carryover is treated as a recognized built-in gain in the year to which it is carried.

The net recognized built-in gain in 2012 is limited to the taxable income for the year, $75,000.

[22] Sec. 1374(d)(2)(B); Reg. Sec. 1.1374-2(c).

The built-in gains tax is $26,250 calculated by applying the highest corporate rate (35 percent) to net recognized built-in gain ($75,000 in this case). Passthrough to the shareholders will be ordinary income of $75,000. The $26,250 built-in gains tax passes through as a loss, as discussed in the next topic.

The $80,000 excess of the combined realized built-in gains and losses ($155,000), over the corporation's taxable income ($75,000) will carry over to 2013. The built-in gain will continue to carry over until it is recognized because the corporation has taxable income, or until the expiration of the 10-year recognition period at the end of 2020.

A worksheet showing the step-by-step calculation of the built-in gains tax and carryover is reproduced at the end of this chapter.

Passthrough of Built-in Gains Tax

The built-in gains tax is treated as a loss that passes through with the same tax character as the recognized gains that created the tax.[23] This means that the built-in gains tax is treated as a deduction from the S corporation's income.

The built-in gains tax is reported on Form 1120S, Schedule D, Part III. The instructions to that form state that built-in gains tax resulting from ordinary gains are reported as a deduction on the "Taxes and licenses" line on page 1 of Form 1120S. The instructions also say that built-in gains tax resulting from short-term capital gains is reported as a loss in the short-term capital gain section of Form 1120S, Schedule D. Built-in gains tax resulting from the disposition of long-term capital gain property is reported as a long-term capital loss in the long-term capital gain section of Form 1120S, Schedule D.

Schedule D of Form 1120S states that the built-in gains tax is to be carried as a deduction to page 1 of Form 1120S. However, only the built-in gains tax attributable to ordinary income should be carried to page 1. Built-in gains tax attributable to short-term capital gains should be shown as a deduction from those gains on line 5, Part 1, of Schedule D. Built-in gains attributable to long-term capital gains should be shown as a deduction from those gains on line 12 of Part II of Schedule D.

The instructions to Schedule D of Form 1120S provide that the corporation must attach a statement showing its (1) built-in capital gains and losses, (2) built-in ordinary gains and losses, and (3) total net recognized built-in gain. In the author's opinion, the statement should also show how the built-in gains tax is divided among the various types of gain.

Example 5-9

Esscorp sells a machine, and recognizes Section 1245 ordinary gain of $30,000. Of that amount, $25,000 is built-in gain, and the corporation pays tax of $8,750 (35 percent of $25,000). The $30,000 of ordinary gain passes through to the shareholders, and the built-in gains tax passes through as an ordinary loss of $8,750. The $8,750 built-in gains tax arose from ordinary income, so it is reported as a deduction on the "Taxes and licenses" line on Form 1120S, page one. (See

[23] Sec. 1366(f)(2).

Schedule D of Form 1120S and its instructions. A copy of the S corporation tax return, Form 1120S, Schedule K-1, and Schedule D can be found at the end of chapter 10.)

The built-in gains tax paid at the corporate level passes through (as a loss) in the same year that the built-in gain is recognized (that is, the year the tax is assessed). This is true even though the built-in gains tax may actually be paid in the next year when the tax return is filed.

Built-in Gains Tax Rate—Capital Gain

Built-in gains are taxed at the maximum corporate tax rate for the type of income involved.[24] However, at this time, the maximum corporate tax rate and capital gains rate are the same (35 percent).

Corporate Carryovers Offset Built-in Gains

A net operating loss or capital loss carryover from a *C corporation* year may be used to offset income subject to the built-in gains tax.[25] The capital loss carryover from a C corporation can offset only the capital gain portion of built-in gain. Also, unused C corporation business and alternative minimum tax credit carryovers can apply against the built-in gains tax.

Example 5-10

Seecorp has a $100,000 net operating loss carryover when it becomes an S corporation on January 1. Three years later, Seecorp has realized built-in gain of $135,000. Its taxable income, computed as if it were a C corporation, is $150,000. Seecorp offsets the amount subject to built-in gains tax ($135,000) with the C corporation net operating loss carry-over ($100,000), so that only $35,000 will be taxed as built-in gain.

Any C corporation net operating loss or capital loss carryover remaining after the built-in gain taxable amount is offset can be carried over to later taxable years.

Example 5-11

Assume in Example 5-10 that the C corporation net operating loss carryover was $200,000, instead of $100,000. The built-in gain taxable amount ($135,000) will be offset in its entirety. There will be no tax on built-in gains, and $65,000 of the net operating loss can be carried over to be applied against future built-in gains, or to be used against C corporation income, if the S election terminates and the corporation again becomes a C corporation.

CREDITS

The only S corporation credit allowable against the built-in gains tax is the Sec. 34 credit for certain use of gasoline and special fuels.

[24] Sec. 1374(b)(4).
[25] Sec. 1374(b)(2); Reg. Sec. 1.1374-5.

However, the alternative minimum tax credit carryover and business credits that carryover under Sec. 39 from a C corporation year can be applied against the built-in gains tax, subject to the annual limitations on those credits.[26]

The application of C corporation business credit carryovers against the built-in gains tax can also be limited by the S corporation's tentative minimum tax.[27] The tentative minimum tax is determined using C corporation AMT tax rates, without regard to the AMT foreign tax credit. The corporation's alternative minimum taxable income for these purposes is the net recognized built-in gain, modified by the minimum tax adjustments and preferences that apply to C corporations.

The minimum tax carryover is subject to similar limitations under Sec. 55(e)(5).

These rules effectively limit the application of C corporation general business credit and minimum tax credit carryovers against built-in gains tax to the amount that could be used under the C corporation rules. Note that certain business credits (such as the rehabilitation credit) are not limited by the tentative minimum tax calculation because they offset both regular tax and AMT.

LIMITATIONS UNDER SECTIONS 382, 383, AND 384 CAN APPLY TO C CORPORATION CARRYOVERS

Use of C corporation carryovers can be limited by Secs. 382 (limitation on net operating loss carryforwards), 383 (limitation on certain credit and capital loss carryforwards), or 384 (limitation on use of preacquisition losses).[28]

Contribution of Built-in Loss Property under the "Anti-Stuffing" Rule

If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the built-in gains tax, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded when determining the S corporation's net unrealized built-in gain, net recognized built-in gain, and the amount of any net operating loss or credit carryforwards allowed to reduce or offset the built-in gains tax.[29]

Gains Will Be Presumed to Be Built-in

If an asset is disposed of at a gain, the presumption will be that any resulting gain is built-in[30]; it will be the S corporation's responsibility to prove that the gain (that is, the appreciation in value) occurred after the first day of the S corporation's first year.

If the gain is caused by subsequent depreciation deductions, it should be easy to prove, but if the gain is caused by subsequent appreciation, it may be difficult to substantiate when that appreciation took place.

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[26] Sec. 1374(b)(3); Reg. Sec. 1.1374-6.
[27] Reg. Sec. 1.1374-6(c).
[28] See, for example, Reg. Secs. 1.1374-1(b) and 1.1374-3.
[29] Reg. Sec. 1.1374-9.
[30] Sec. 1374(d)(3).

Example 5-12

Seecorp, a C corporation, became an S corporation on January 1, 2011. On that date, the corporation has a machine that has a basis of $35,000, and an estimated market value of $35,000. The machine was sold in 2012 for $41,000. Total depreciation of $15,000 was taken in 2011 and 2012, making the basis of the machine $20,000.

The entire $21,000 gain is presumed to be built-in gain unless the corporation can prove otherwise. It will not be difficult to show that $15,000 of the gain arose from depreciation taken after the election was effective, but proving that the additional $6,000 of appreciation occurred after the S election became effective may be a difficult matter indeed. Unless the corporation can come up with documents establishing the fair market value at January 1, 2011, the corporation will be subject to tax on $6,000 of built-in gains.

APPRAISALS SHOULD BE OBTAINED

It is in the taxpayer's very best interest to be able to substantiate net unrealized built-in gain. Therefore, appraisals of assets on hand when the S corporation election becomes effective should be obtained.

If appraisals are not made, all available documentation to support basis and fair market value should be retained.

Exchanged Basis Property

If an asset is carrying built-in gain (that is, its fair market value exceeded its basis on the date of the S election was effective) and the asset is exchanged for another asset whose basis is determined in whole or in part by the asset exchanged, the built-in gain transfers to the new asset.[31] Exchanged basis property is acquired, for example, in a Section 1031 tax-deferred exchange or a Section 1033 involuntary conversion.

Example 5-13

ABC, an S corporation, has an asset with a basis of $90,000 on January 1, 2011, the date the S election become effective. Built-in gain of $25,000 would result if the asset were sold. The asset is transferred in a Sec. 1031 like-kind exchange two years later. Under the Sec. 1031 rules, the new asset's basis is the same as that of the asset transferred, $90,000. The potential $25,000 built-in gain shifts to the new asset. Consequently, disposition of the new asset within the 10-year period beginning on January 1, 2011, can result in recognition of the $25,000 built-in gain. Gain recognized on the exchange can also trigger built-in gain.

Transferred Basis Property

Property is transferred (or substituted) basis property if its basis is determined in whole or in part by reference to its basis in the hands of the transferor.[32] To guard against transfers to the S

[31] Sec. 1374(d)(6).
[32] Sec. 7701(a)(42).

corporation that might result in avoidance of double taxation, the built-in gains tax will be imposed on any recognized built-in gain from transferred basis property received from a C corporation or from an S corporation that is subject to the built-in gains tax. If the property is transferred from a C corporation, the 10-year recognition period begins with the day the property is acquired by the S corporation. If the property is transferred from an S corporation subject to the built-in gains tax, the property's recognition period in the hands of the recipient S corporation is the *remainder* of the transferor S corporation's original 10-year period.[33]

Example 5-14

Esscorp elected S status eleven years ago, and is therefore generally not subject to the built-in gains tax rules because its 10-year recognition period has expired. Esscorp receives an asset from a C corporation on April 10 of the current year in a reorganization. The asset retains the same basis ($100,000) as it had in the hands of the C corporation. The asset's fair market value is $120,000 on the date of transfer. The $20,000 built-in gain will be recognized (subject to the net income limitation) if the asset is disposed of in the 10-year period beginning April 10.

Exchanged Basis Property

Property is exchanged basis property if its basis is determined in whole or in part by reference to other property held by the person for whom the basis is to be determined.[34] Examples would be property acquired in a Sec. 1031 like-kind exchange or a Sec. 1033 involuntary conversion. Any unrecognized built-in gain attributable to the asset given up in the exchange carries over to the property received in the exchange.[35] The 10-year recognition period for the asset received is the same as it was for the asset given up in the exchange. That is, the beginning of the acquired asset's recognition period is the date that the S election became effective, not the date the exchange took place.

Installment Sales

The regulations extend the 10-year recognition period for certain installment sales.[36]

The regulations are effective for installment sales occurring after March 25, 1990, unless a binding contract was in effect before that date.[37] The regulations apply when an S corporation sells an asset on the installment method before or during the recognition period.

The regulations affect the year in which the corporation recognizes the income on the installment sale. When the S corporation recognizes income on the sale (either during or after the recognition period) the income will be subject to the built-in gains tax to the extent it would have been taxed in prior years if the corporation had elected out of the installment method.

[33] Sec. 1374(d)(8); Reg. Secs. 1.1374-3(b)-(c) and 1.1374-8; IRS Ann. 86-128, 1986-51 IRB 22.
[34] Sec. 7701(a)(44).
[35] Sec. 1374(d)(6).
[36] Reg. Sec. 1.1374-4(h).
[37] Reg. Sec. 1.1374-10(b)(4); Notice 90-27, 1990-1 CB 336.

Example 5-15

In Year 1 of the recognition period, S Inc. sells an asset on the installment method. The asset's basis is $150,000 and the sales price (less expenses) is $250,000, resulting in $100,000 gain. The asset's fair market value at the date of the S election exceeded its basis by $125,000, and the corporation had net unrealized built-in gain on that date of $200,000. The corporation is to receive full payment for the asset in Year 11. In Year 1, the corporation has net income (without considering the installment sale and computed as if the company were a C corporation) of $40,000.

No payment is received on the installment sale in Year 1, so the regulations do not affect that year; there is no tax at the corporate level. For each of the remaining nine years of the recognition period, S Inc. shows net losses of $10,000.

When the installment note is collected during Year 11, you must look back to Year 1 to see what would have happened if S Inc. had elected out of the installment method. If it had, the income for Year 1 (including the installment sale) would have been $140,000. Therefore, the entire $100,000 of gain on the installment sale is subject to the built-in gains tax in Year 11, even though the original 10-year recognition has expired. Because the built-in gain on installment sales is calculated as if the corporation had elected out of the installment method, the built-in gains tax applies in Year 11 even if the S corporation has no net income in that year.

Example 5-16

Assume the same facts as in Example 5-15, except that S Inc. has a loss of $60,000 in Year 1 (without considering the installment sale and computed as if the company were a C corporation). In that case, the corporation would have recognized $40,000 of built-in gain in Year 1 if it had elected out of installment reporting. Therefore, it reports $40,000 of built-in gain when the note is collected in Year 11.

Income in more than one year during the recognition period may have to be used when determining the amount that would have been taxed in previous years. For example, assume that the S corporation showed $10,000 of net income in Year 2 of the recognition period. Now, S Inc. will recognize $50,000 ($40,000 + $10,000) of built-in gain in Year 11.

Note: The results in these examples would be the same if the installment sale occurred before the S election became effective (assuming there was $100,000 of unrecognized installment sale gain on the date that the C corporation became an S corporation).

Treatment of Charitable Contributions of Appreciated Property

Under Sec. 1374(d)(3), built-in gain arises when an asset is disposed of in a transaction in which gain is recognized during the 10-year recognition period. No gain is recognized when an S

corporation contributes appreciated property to charity. Therefore, such contributions do not trigger built-in gains tax.

Planning for Built-in Gains and Losses

REDUCE NET UNREALIZED GAIN BY GENERATING BUILT-IN LOSSES

If your client is a C corporation that is going to make an S election, it may be possible to create built-in losses, which reduce net unrealized built-in gain. For instance, the C corporation could declare reasonable bonuses to shareholder-employees but not pay them until after the S election is effective. (For this strategy to be effective for a shareholder who owns 5 percent or more of the stock, the bonus must be paid within 2½ months after the S election is effective, as discussed earlier.) Or a cash basis C corporation can hold off paying operating expenses until the company is an S corporation. Deciding whether or not to delay these payments into the S year will require careful study and planning, because the C corporation will lose the deductions for them. But these deductions might cause tax savings of only 15 percent in the C corporation, while offsetting a built-in gain will produce tax savings of 35 percent.

> **Practice Tip:** An S corporation is not subject to the built-in gains tax if it has no net unrealized built-in gain at the date the S election becomes effective. Net unrealized built-in gain is the amount by which the total fair market value of the corporation's assets exceeds the basis of those assets. This amount, however, can be reduced by built-in losses. Remember, though, that any S corporation can become subject to the tax if it receives transferred basis property from a C corporation or an S corporation subject to the built-in gains tax.

TIMING RECOGNITION OF BUILT-IN LOSSES

If your client is an S corporation with both potential built-in gains and losses, time the recognition of built-in losses to occur in the same year as built-in gains. Built-in losses will then reduce the net recognized built-in gain, the amount subject to the built-in gains tax. If a built-in loss is recognized in a year in which there are no built-in gains, the loss does not carry over to reduce future built-in gains.

REDUCE CURRENT INCOME TO UTILIZE THE TAXABLE INCOME LIMIT

As discussed earlier, the built-in gain recognized in any year is limited to the corporation's taxable income calculated as if it were a C corporation. It may be possible to pay bonuses or otherwise decrease taxable income in a year in which built-in gains would otherwise be recognized. However, for this strategy to effectively avoid the built-in gains tax, the income would have to be reduced each year throughout the remainder of the 10-year recognition period because of the built-in gain carryover provisions.

DELAY DISPOSITION OF ASSETS OR MAKE A TAX-DEFERRED EXCHANGE

The built-in gain can be avoided by delaying disposition of assets until the 10-year recognition period expires, but this strategy is impractical in many instances. Another possibility would be to negotiate a Section 1031 tax-deferred exchange in order to transfer the built-in gain into the new property, as covered in the earlier discussion of exchanged basis property.

DISPOSE OF ASSETS THAT CARRY NO NET UNREALIZED BUILT-IN GAIN

An asset is not subject to the built-in gains tax, unless (a) the asset was on hand at the date the S election became effective, and (b) on that date, the asset's fair market value exceeded its basis. Assets that do not fit this description can be disposed of without incurring built-in gains tax.

REVOKE S STATUS

The built-in gains tax applies to S corporations, so the tax is not assessed if assets are disposed of after S status is terminated. The S election should not be revoked, however, unless and until it is determined that revocation provides the most favorable results for the current and future years. If the assets are disposed of after the S election terminates, the C corporation's income will be subject to double taxation under the C corporation rules.

2009-2010 Built-in Gains Tax Suspension Period

The American Recovery and Reinvestment Act of 2009 (which we will call the 2009 Recovery Act, but which is also commonly called the Stimulus Bill) provides that the built-in gains tax will not be assessed on built-in gains recognized in an S corporation's tax years beginning in 2009 and 2010, if the seventh tax year of the recognition period has elapsed before the start of the S corporation's tax year.[38] The built-in gains will evidently be assessed, however, for built-in gains recognized after 2010, if the S corporation's 10-year recognition period has not expired at the end of that tax year.

COUNTING THE SEVENTH TAX YEAR OF THE RECOGNITION PERIOD FOR PURPOSES OF THE 2009-2010 SUSPENSION PERIOD

An S corporation that was previously a C corporation is generally subject to the built-in gains rules for a 10-year (that is, 120-month) recognition period, beginning with the date the S election becomes effective. However, Sec. 1374(d)(7)(B) provides that "In the case of any taxable year beginning in 2009 or 2010, no tax shall be imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year." The IRS has not clarified how the seven-year period is to be calculated. Based on the wording in the Code, *tax years* (rather than calendar years) are counted when determining whether seven years have elapsed before 2009 or 2010.

> **Note:** Evidently, the 10-year recognition period and the seven-year period for purposes of determining the built-in gains 2009-2010 suspension period are counted differently. The recognition period is based on 10 calendar years (that is, 120 months), beginning with the date the S election is effective. The seven-year period, however, is apparently based on taxable years.

Example 5-17

ABC Corp., a calendar-year C corporation, elected S status on January 1, 2002. On January 2, 2009, it sells an asset and recognizes $20,000 of built-in gain. On January 5, 2010, it sells an asset and recognizes built-in gain of $15,000. The 10-year recognition period expires on December 31, 2011. However, ABC is not

[38] Sec. 1374(d)(7).

subject to the built-in gains tax in 2009 or 2010, because seven years (that is, 2002 through 2008) elapsed before January 1, 2009. Therefore, the $20,000 and $15,000 of built-in gains recognized in 2009 and 2010 are not taxed at the corporate level.

ABC will no longer be subject to the built-in gains tax, unless it acquires transferred basis property from a C corporation or an S corporation subject to the built-in gains tax. That is, ABC is exempt from the built-in gains tax in 2009 and 2010 because of the 2009-1010 suspension. Furthermore, it is exempt from the built-in gains tax in 2011 because of the 2011 built-in gains suspension period (discussed later in this chapter). After 2011, ABC is not subject to the built-in gains tax, because the corporation's 10-year recognition period expires on December 31, 2011.

Example 5-18

Assume the same facts as in Example 5-17, except that ABC elected S status on July 1, 2002.

The 10-year recognition period expires on June 30, 2012. Here, it appears that ABC is still exempt from the built-in gains tax in 2009 and 2010, because seven *tax years* (that is, 2002 through 2008) have elapsed before January 1, 2009. This is evidently true, even though the seventh *calendar* year (12-month period) of the recognition period does not end until June 30, 2009 (that is, seven years beginning with the date the S election was effective).

ABC will also be exempt from the built-in gains tax for its 2011 calendar tax year because of the *2011* built-in gains suspension period, discussed later. However, ABC will again be subject to the built-in gains tax from January 1, 2012, through June 30, 2012 (that is, after the 2009-2010 and 2011 suspension periods through the end of the 10-year recognition period).

Caution: In the following discussion, it is assumed that the seven-year period will be counted in accordance with the current wording of Sec. 1374(d)(7)(B). That is, the first *tax year* will be counted as one year for purposes of determining the seven years preceding the 2009-2010 suspension period, even though that year may be less than 12 months. You should be aware that the instructions to *2009* Form 1120S, Schedule D (*see also* the 2010 form at the end of chapter 10), covering the 2009-2010 suspension period, say "...no tax is imposed if the S corporation's *7th year of the applicable recognition period* ended before the tax year." Compare this to Sec. 1374(d)(7)(B) that says "...no tax shall be imposed...if the *7th taxable year in the recognition perio*d preceded such taxable year" (italics added). In other words, the Form 1120S instructions change the Code's "taxable year" to "year." However, the wording in the Code should prevail unless the IRS issues authoritative guidance to the contrary or Congress changes the law, which seems unlikely at this late date.

S CORPORATIONS THAT CAN BENEFIT FROM THE 2009-2010 SUSPENSION PERIOD

The 2009-2010 built-in gains suspension period can potentially benefit corporations that elected S status in tax years beginning in 2001, 2002, and 2003.

Corporations that Elected S Status in 2001

A corporation that elected S status at the beginning of the corporation's tax year in 2001 will not be subject to the built-in gains tax after the close of its 2008 tax year.

Example 5-19

GHI Corp., a calendar-year C corporation, elected S status on January 1, 2001. On January 2, 2009, it sells an asset and recognizes $20,000 of built-in gain. On January 5, 2010, it sells an asset and recognizes built-in gain of $15,000. The 10-year recognition period expires on December 31, 2010. However, GHI is not subject to the built-in gains tax in 2009 and 2010, because more than seven years (that is, 2001 through 2008) elapsed before January 1, 2009.

GHI's 10-year recognition period expires on December 31, 2010, so the corporation will not be subject to the built-in gains tax after December 31, 2008, the beginning of the 2009-2010 suspension period.

Example 5-20

Assume the same facts as in Example 5-19, except that GHI elected S status on July 1, 2001.

The 10-year recognition period expires on June 30, 2011. Here, GHI is still not subject to the built-in gains tax in 2009 and 2010, because more than seven years have elapsed before January 1, 2009.

Even though the 2009-2010 suspension relating to GHI expires on December 31, 2010, the corporation will not be subject to the built-in gains tax from January 1, 2011, through June 30, 2011 (that is, after the suspension period through the end of the 10-year recognition period), because of the 2011 suspension period, discussed later.

Corporations that Elected S Status in 2002

A corporation that elected S status at the beginning of the tax year beginning in 2002 will be exempt from the built-in gains tax during the 2009-2010 suspension period.

Corporations that Elected S Status in 2003

A corporation that elected S status at the beginning of the tax year beginning in 2003 will be exempt from the built-in gains tax during 2010.

Example 5-21

JKL Corp., a calendar-year C corporation, elected S status on January 1, 2003. On January 2, 2009, it sells an asset and recognizes $20,000 of built-in gain. On January 5, 2010, it sells an asset and recognizes built-in gain of $15,000. The 10-year recognition period expires on December 31, 2012. JKL is subject to the built-in gains tax in 2009. However, the corporation is exempt from the built-in gains tax in 2010, because seven years (that is, 2003 through 2009) elapsed before January 1, 2010.

JKL's 10-year recognition period expires on December 31, 2012, so the corporation will again be subject to the built-in gains tax from January 1, 2012, through December 31, 2012 (that is, after the 2009-2010 and 2011 suspension periods through the end of the 10-year recognition period).

Example 5-22

Assume the same facts as in Example 5-21, except that JKL elected S status on July 1, 2003.

The 10-year recognition period expires on June 30, 2013. Here, it appears that JKL is still not subject to the built-in gains tax in 2010, because more than seven tax years (2003 through 2009) have elapsed before January 1, 2010.

JKL will again be subject to the built-in gains tax from January 1, 2012, through July 1, 2013 (that is, after the 2009-2010 and 2011 suspension periods through the end of the 10-year recognition period).

SPECIAL RULES APPLY TO TRANSFERRED BASIS PROPERTY

As discussed earlier in this chapter, a separate 10-year recognition period applies to transferred basis property received from a C corporation or from an S corporation that is subject to the built-in gains tax. If the property is acquired from a C corporation, the 10-year recognition period begins on the day the property is acquired by the S corporation.[39]

Example 5-23

MNO Corp., a calendar-year C corporation, elected S status on January 1, 2003. On January 1, 2008, it acquires transferred basis property from a C corporation. The transferred basis property has a FMV of $17,000 and basis of $9,000 on the date of transfer. On January 2, 2010, MNO sells an asset that was on hand on the date the S election became effective and recognizes $20,000 of built-in gain. On July 5, 2010, it sells the transferred basis property and recognizes built-in gain of $8,000. The 10-year recognition period for assets on hand at the date the S election was effective expires on December 31, 2012. However, MNO is not subject to the built-in gains tax on those assets in 2010, because seven years (that is, 2003 through 2009) elapsed before January 1, 2010.

[39] See Sec. 1374(d)(8); Reg. Secs. 1.1374-3(b)-(c) and 1.1374-8; IRS Ann. 86-128, 1986-51 IRB 22.

The 10-year recognition period for the transferred basis asset expires on December 31, 2017. MNO is subject to the $8,000 of built-in gain on the transferred basis asset because that asset had not been on hand for seven years before January 1, 2010.

NET RECOGNIZED BUILT-IN GAIN EXCLUSION

The S corporation's net unrealized built-in gain (that is, the excess of recognized built-in gains over recognized built-in losses) is reported on Line 14 of Form 1120S, Schedule D. The instructions to Schedule D say that built-in gains that are excludable because of the 2009-2010 suspension period should not be included in the amount on line 14. We will call this excluded amount the "net recognized built-in gain exclusion."

Example 5-24

ABC Corp., a calendar-year C corporation, elected S status on January 1, 2003. (This example is a variation on the facts in Example 5-17.) At that date, ABC has three assets with net unrealized built-in gain (that is, excess of FMV over adjusted basis) totaling $45,000, as follows:

Asset One	$20,000
Asset Two	15,000
Asset Three	10,000
Total net unrealized built-in gain	$45,000

On January 2, 2010, ABC sells Asset One and recognizes $20,000 of built-in gain. ABC is not subject to the built-in gains tax in 2010, because seven years (that is, 2003 through 2009) elapsed before January 1, 2010.

ABC has net recognized built-in gain of $20,000 for 2010, but that amount can be excluded under the 2009-2010 suspension period rules, so zero ($20,000 net recognized built-in gain less $20,000 net recognized built-in gain exclusion) is reported on ABC's 2010 Form 1120S, Schedule D.

TREATMENT OF NET UNREALIZED BUILT-IN GAIN, BUILT-IN GAIN CARRYOVER, AND OTHER ITEMS DURING SUSPENSION PERIOD

The instructions to Form 1120S, Schedule D, provide that the net recognized built-in gain exclusion does not apply for the following purposes:

- Calculating the net unrealized built-in gain limitation in any subsequent year (see Example 5-25).
- Calculating the carryover of net recognized built-in gain in excess of the taxable income limitation (see Example 5-25).
- Determining the character of the loss arising from the built-in gains tax.
- Calculating the deduction for C corporation NOLs that can offset built-in gains under Sec. 1374(b)(2).

This means that the items on the preceding list are treated as if the full amount of net recognized built-in gain had been reported, even though no built-in gains tax was assessed. Thus, the built-in gain, limitations, and carryovers during and after the 2009-2010 suspension period are calculated the same way they would be if the suspension period did not exist. The net recognized built-in gain during the suspension period, however, is not subject to the built-in gains tax.

Note that this carryover provision is unfavorable because the built-in gain can carry over into a year that is subject to the built-in gains tax, if the year is after the suspension period but before the end of the corporation's 10-year recognition period.

Example 5-25

Assume the same facts as in Example 5-24. ABC shows zero on line 14 of Form 1120S, Schedule D. Nevertheless, ABC's net unrealized built-in gain is calculated as if the full amount of net recognized built-in gain had been included on that line. Thus, the corporation's net unrealized built-in gain at the end of 2010 is $25,000 ($45,000 total net unrealized built-in gain less $20,000 recognized built-in gain for 2010). Note that this net unrealized built-in gain calculation is favorable because it reduces the net unrealized built-in gain and consequently reduces the amount of potential built-in gain that the S corporation may ultimately have to report.

Assume now that ABC's taxable income calculated as if it were a C corporation is $7,000 for 2010. The recognized built-in gain for a year is limited to the S corporation's taxable income, and the excess is subject to carryover to future years. This calculation is made during the suspension period as if the full amount of net recognized built-in gain had been included in line 14 of Form 1120S, Schedule D. Thus, $13,000 ($20,000 – $7,000) of built-in gain carries over to 2011, where it would again be exempt from built-in gains tax because of the 2011 suspension period. If the built-in gain is not recognized in 2011 (because, for example, the corporation had no income), the built-in gain *would* carry to 2012, because ABC's 10-year recognition period does not expire until December 31, 2012.

2011 Built-in Gains Suspension Period

The Small Business Jobs Act of 2010 provides that no built-in gains tax will be imposed on the net recognized built-in gain of an S corporation for the tax year beginning in 2011 if the *fifth year* in the recognition period precedes the tax year beginning in 2011.[40]

2011 SUSPENSION PERIOD USES TWELVE-MONTH PERIODS TO MEASURE PRECEDING YEARS

The years preceding the 2009-2010 suspension period and those preceding the 2011 suspension period are counted differently, according to the wording of the Code. The seven years preceding the 2009-2010 suspension period are measured in *taxable years* under Sec. 1374(d)(7)(B)(i) (see

[40] Sec. 1374(d)(7)(B)(ii).

Example 5-22). The five years preceding the 2011 suspension period, however, are measured in *calendar* years (that is, 12-month years) under Sec. 1374(d)(7)(B)(ii) (see Example 5-26).

Example 5-26

Bright, Inc., a C corporation that uses a calendar year, elects S status on June 1, 2005. Bright qualifies for the 2011 built-in gains tax suspension period, because the fifth year of its 10-year recognition period ends on May 31, 2010, that is, before the beginning of its 2011 tax year. Thus, built-in gain recognized by Bright in 2011 will not be subject to the built-in gains tax.

Bright's 10-year recognition period expires on May 31, 2015, so the corporation will again be subject to the built-in gains tax after 2011, unless Congress extends the suspension period beyond that year.

Practice Tip: If an S corporation's S election becomes effective on January 1, 2006, the fifth year of its 10-year recognition period will end on December 31, 2010. Therefore, a calendar-year S corporation will qualify for the 2011 suspension period if its S election became effective on January 1, 2006 or before.

TRANSFERRED BASIS PROPERTY

Built-in gain on the disposition of transferred basis property is not subject to the built-in gains tax in 2011 if the property was acquired by the S corporation at least five years before the beginning of the 2011 tax year.[41]

Tax on Excess Net Passive Income

A tax at the maximum corporate rate (presently 35 percent) is imposed at the corporate level on the *excess net passive income* of an S corporation which has C corporation accumulated earnings and profits (AE&P).[42] The tax applies if the corporation's passive investment income exceeds 25 percent of its gross receipts for the year.

Many C corporations that elect S status have AE&P that carries into the S corporation. A C corporation's taxable income that has not been distributed represents AE&P (although such income is not usually identical to AE&P, because certain items, such as tax-exempt income and accelerated cost recovery, affect E&P at different rates than they affect income).

Practice Tip: If an S corporation does not have C corporation AE&P, there is no corporate level tax on passive income at the corporate level. However, if the corporation was a C corporation that had AE&P at the date of the S corporation election, there is potentially tax on excess net passive income at the corporate level. Also, the S election is terminated if the passive investment income exceeds 25 percent of the corporation's gross receipts for three consecutive tax years. If the AE&P is distributed to shareholders, however, the tax and threat of termination of the S election disappear.

[41] Sec. 1374(d)(8).
[42] Sec. 1375(a); Reg. Sec. 1.1375-1.

Definitions

In order to understand the computation of the tax, we need some definitions:

- *Passive investment income* is, generally, gross receipts from royalties, rents, dividends, interest, and annuities.[43] Tax-exempt interest income is counted as passive investment income and it must be included in the passive income calculations, even though it is nontaxable for other purposes.

  Reg. Sec. 1.1362-2 (covering termination of the S election) generally excludes from the definition of passive investment income gross receipts derived in the ordinary course of certain trades or business. Thus, the following are *not* considered to be passive investment income:

  - Rents earned for the use of property if the amounts are derived in the active trade or business of renting property. Thus, income from hotels and motels is not passive investment income. Rents received by a corporation are derived in a trade or business if the corporation provides significant services or incurs substantial costs in the rental business. All facts and circumstances must be considered when applying the significant services and substantial costs tests.

  Practice Tip: The IRS has been relatively generous in ruling that rental of commercial property, apartment buildings, and other types of property, such as trailer parks, did not result in passive income. For example, see Ltr. Ruls. 200217045, 200217023, 200104010, 200002031, 9649028, 9615016, and 9404019.

  Generally, net leases are not considered to be received in the course of a trade or business, and would normally be considered passive investment income. Also, rents do not include produced film rents under Section 543(a)(5); nor do rents include income from property developed, manufactured, or produced by the taxpayer, if the taxpayer engages in substantial development, manufacture, or production of that type of property.

  - Interest earned from the sale of property or the performance of services in the ordinary course of a trade or business.
  - Gross receipts directly derived in the ordinary course of a trade or business of lending or financing, dealing in property, purchasing or discounting accounts receivable, notes or installment obligations, or servicing mortgages.
  - Royalties derived in the ordinary course of a trade or business of licensing property.
  - Copyright royalties as defined under Section 543(a)(4); mineral, oil and gas royalties as defined under Section 543(a)(3); amounts received upon disposal of timber, coal, or domestic iron ore to which Section 631(b) and (c) apply; or active business computer software royalties under Section 543(d) [without regard to paragraph (d)(5)].

[43] Sec. 1362(d)(3)(C); Reg. Sec. 1.1362-2.

> In addition, the Commissioner may by regulations, revenue ruling, or revenue procedure exclude from the definition of passive investment income other income derived in the ordinary course of a corporation's trade or business.

- *Net passive income* is passive investment income reduced by deductions directly connected with the production of that income, except for the Sec. 172 net operating loss deduction and the special corporate deductions of part VIII of Subchapter B (relating primarily to dividends received and the organization expense amortization deduction).[44]

- *Excess net passive income* is an amount computed by multiplying the net passive income by a fraction. The numerator of the fraction is the amount by which the passive investment income exceeds 25 percent of the gross income for the taxable year. The denominator is the passive investment income for the taxable year. Excess net passive income cannot exceed taxable income for the year, computed under the C corporation rules. Taxable income is computed without any net operating loss deduction under Sec. 172, and without the deductions allowable under Secs. 241 through 250 (relating to dividends received, bond premium deduction and payments to the National Railroad Passenger Corporation). The deduction for amortization of organization expense is allowable.[45]

STOCK AND SECURITIES

For tax years beginning before May 26, 2007, gains from the sale or exchange of stock or securities are considered to be passive investment income.[46] For tax years beginning on or after May 26, 2007, gains from the sale of exchange of stock or securities are *not* passive investment income. They are, however, considered in the calculation of gross receipts, as discussed below.

Gross Receipts

What are gross receipts for purposes of the 25 percent test?

- *Gross receipts* means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income without any reductions, except for gains from sale or exchange of stock or securities, or capital assets (as discussed in the following two paragraphs).[47]

- Only *gains* from the sale or exchange of stock and securities are taken into account in computing gross receipts.[48]

- Also, only *capital gain* from the sale or exchange of capital assets (except for stock and securities) is considered.[49] This is to prevent the so-called churning of assets.

Think about that for a minute.

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[44] Sec. 1375(b)(2).
[45] Sec. 1375(b)(1).
[46] Prior Sec. 1362(d)(3)(C)(i).
[47] Reg. Sec. 1.1362-2(c)(4).
[48] Sec. 1362(d)(3)(B)(ii).
[49] Sec. 1362(d)(3)(B)(i).

Assume a corporation was approaching the passive income limit. If gross receipts included the total amount realized from the disposition of capital assets, the corporation could sell or exchange some of its investment property at no tax cost (assuming the amount realized equaled the basis) and could nonetheless increase its gross receipts by the amount realized. By having gross receipts include only the capital gains from such sales or exchanges, the ability to inflate gross receipts in that manner is eliminated.

> **Practice Tip:** The capital gain rule (the third item in the preceding list) applies to capital assets only. It does not apply to Section 1231 assets (that is, depreciable assets and real property used in a trade or business). The sales price of Section 1231 assets is fully included in gross receipts, even though all or part of the gain may be capital gain.

Calculating the Tax on Excess Net Passive Income

The instructions to Form 1120S set out a worksheet for computing the tax on excess net passive income, requesting that the calculation be done in that format and attached to the return. The numbers down the left side of our calculation correspond to the IRS worksheet format.

Example 5-27

For the calendar year, an S corporation shows

- Gross receipts of $200,000.
- Passive investment income of $80,000.
- Expenses directly connected with passive investment income of $10,000.
- Taxable income of $20,000.

The excess net passive income is computed as follows:

Calculation of excess passive investment income over 25 percent of gross receipts:	
1. Gross receipts	$200,000
2. Passive investment income	$80,000
3. Gross receipts factor ($200,000 x 25%)	50,000
4. Excess	$30,000
Calculation of net passive income:	
Passive investment income	$80,000
5. Directly connected expenses	10,000
6. Net passive income	$70,000
Determine excess net passive income	
7. $\frac{\$30{,}000\ (from\ line\ 4)}{\$80{,}000\ (line\ 2)}$	37.5%
8. Excess net passive income (line 6 x line 7)	$26,250
Calculation of limitation on excess net passive income:	
9. Taxable income	$20,000
Computation of tax:	
10. Excess net passive income (lesser of line 8 [$26,250] or line 9 [$20,000])	$20,000
Multiply by maximum corporate tax rate	35%
11. Tax	$7,000

Credits

The Sec. 34 credit for uses of gasoline, special fuels, and lubricating oil is the only credit that may be applied against the tax imposed on excess net passive income.[50]

Gains Subject to Tax on Passive Income and Built-in Gains Tax

Income payable to a cash basis corporation at the date the S election is effective can be subject to the built-in gains tax when collected by the S corporation. However, any gain subject to the Sec. 1374 tax on built-in gain will not also be subject to the tax on excess net passive income. In other words, any recognized built-in gain or loss is *not* considered when determining the amount of passive investment income.[51]

Waiver of Tax on Passive Income

The IRS has the authority to a waive the tax on excess net passive income if

- The corporation had determined in good faith that it did not have C corporation earnings and profits, and

[50] Sec. 1375(c).
[51] Sec. 1375(b)(4).

- After determining that the corporation did have C corporation earnings and profits, such earnings and profits were distributed during a reasonable time.[52]

A user fee must accompany the ruling request. User fees are set out in the first revenue procedure issued each year. The current user fee can be found in chapter 3, under the heading *Obtaining a Letter Ruling*.

Passthrough Reduced by Tax on Excess Net Passive Investment Income

If a tax is incurred because of excess net passive income, the passthrough to shareholders is reduced.[53] Each item of passive investment income is reduced by its *pro rata* share of the tax, computed as follows:

$$\frac{\text{Passive Investment Item}}{\text{Total Passive Investment Income}} \times \text{Tax}$$

The reduction occurs in the year the tax is incurred, regardless of when it is actually paid.

Business Credit Recapture

Premature disposition of business credit property (for example, the low-income housing credit of Sec. 42, credit for rehabilitation expenditures under Sec. 47, and energy credits of Sec. 48) can cause recapture of these credits. When a C corporation elects to become an S corporation, there is no business credit recapture at that point. Making the election is considered to be merely a change in the form of doing business.[54]

Business credit recapture can be payable at the S corporation level, however, if property placed in service when the company was a C corporation is prematurely disposed of by the S corporation.

Example 5-28

C Inc. bought property subject to $1,000 of business credit in November 2010. On January 1, 2011, C Inc. becomes an S corporation. There is no recapture at that point. In October, the company disposes of the assets. The corporation is subject to recapture of the unearned business credit for the year ended December 31, 2011.

Effect on Passthrough

Business credit recapture paid at the corporate level is a nondeductible corporate expense and, as such, reduces the shareholder's basis. The recapture also reduces accumulated earnings and profits (AE&P) but does not reduce the Accumulated Adjustments Account (AAA). (The AAA is not reduced by payment of a federal tax relating to a C corporation year.) The corporation files the appropriate tax form (for example, Form 4255, *Recapture of Investment Credit*) with its Form 1120S. Business credit recapture paid at the corporate level is evidently reported to the

[52] Sec. 1375(d); Reg. Sec. 1.1375-1(d).
[53] Sec. 1366(f)(3); Reg. Sec. 1.1366-4(c).
[54] Sec. 1371(d); 47(b).

shareholders on Form 1120S, Schedule K, line 16c, *Items affecting shareholder basis—Nondeductible expenses*. The stockholder's *pro rata* share is evidently reported to the shareholders on Schedule K-1, line 16, code C. Statements relating to both Schedules K and K-1 should be attached to the Form 1120S identifying the item as business credit recapture paid at the corporate level.

If the business credit was taken while the S election is in effect, the recapture is not paid at the corporate level. Rather, details relating to the recapture are passed through to the shareholders. A statement keyed to line 17d, *Other Items and Amounts*, of Schedule K should be attached to the Form 1120S showing details of the recapture. If the recapture is from investment credit property, a Form 4255 is attached to the Form 1120S showing the information necessary to calculate the recapture, but not the recapture itself.

Also, the appropriate code letter (code E, F, G, or H) should be entered on line 17, *Other Information*, of Schedule K-1 and a schedule should be attached to the K-1 providing each shareholder with the information necessary to compute the recapture. Each shareholder then reports his or her share of the recapture on the shareholders' Form 1040 by completing the appropriate tax form (for example, Form 4255) and attaching it to the return.

Estimated Tax Payments

An S corporation is required to pay estimated taxes if the corporation's tax liability for the year is $500 or more.[55] As with other corporations, an S corporation that is required to estimate its taxes makes four estimate payments during the year. An S corporation's estimate payments must generally equal 100 percent of the corporate tax for the taxable year.

The penalty for underestimating the tax on excess net passive income does not apply if the current year's estimate of that tax is at least 100 percent of the prior year's tax on excess net passive income. This exception is available regardless of the size of the S corporation, and can be used even if there was no tax attributable to excess passive income in the prior year.

There is no such exception for the other types of taxes. That is, the estimated tax payments for the other two types of taxes (built-in gains tax or business credit recapture) must be 100 percent of the current year's tax.

An S corporation can use the annualization exception of Section 6655(e).

Example 5-29

S Inc. uses a calendar year. In 2010, it incurs tax on excess net passive income of $800. For 2011, it makes four timely estimate payments of $200 each. Its actual tax on excess net passive income for the year, however, is $3,000. S Inc. is not liable for an underestimation penalty, because it based its estimate payments of the tax on excess net passive income on the prior year's tax.

[55] Sec. 6655(g)(4).

Example 5-30

Assume the same facts as in Example 5-29, except that S Inc. has no corporate-level tax in 2010. The corporation makes no estimated tax payments in 2011, and its excess net passive income tax liability for the year is $3,000. S Inc. is still safe from the underestimation penalty, because it can base its current estimate of the tax on excess net passive income on last year's tax on that income, even if there was no such tax in the prior year.

Example 5-31

Assume the same facts as in Example 5-29, except that the tax is the built-in gains tax, rather than the tax on excess net passive income. S Inc. will be subject to an underestimation penalty for 2011, because the rule allowing the estimated payments to be based on the prior year's tax applies only to the tax on excess net passive income.

Summary

An S corporation can be subject to

- Tax on built-in gains,
- Tax on excess net passive income, and
- Certain business credit recapture.

Exhibit 5-1

Built-in Gains Worksheet

Client _____

Year _____

Step 1. Compute Net Unrealized Built-in Gain

- List *all* assets on the date that the S election became effective.

(A) Fair Market Value	(B) Basis	(C) Built-in Gain (Loss)

- Less: Expenses attributable to the period before S corporation conversion, but deducted by the S corporation _____
- Net unrealized built-in gain _____

Step 2. Compute Recognized Built-in Gain

- List assets disposed of during the year, if the fair market value exceeded basis at the date the S election became effective. Include amounts, such as accounts receivable, that were includable in income during the S corporation year but were attributable to the C corporation period of operation.

(A) Fair Market Value[1]	(B) Basis[2]	(C) Built-in Gain	(D) Actual Gain	(E) Recognized Built-in Gain[3]

- Add carryover of net recognized built-in gain from prior year (Step 7 of last year's worksheet) _____
- Recognized built-in gain _____

Step 3. Compute Recognized Built-in Loss

- List assets disposed of during the year, if basis exceeded fair market value at the date the S election became effective.

(A) Fair Market Value[4]	(B) Basis[5]	(C) Built-in Loss	(D) Actual Loss	(E) Recognized Built-in Loss[6]

- Increase recognized built-in loss by amounts that are deductible in the S corporation year but that were incurred in the C corporation period, such as bonuses and accounts payable. _____
- Recognized built-in loss _____

Step 4. Compute the Limitation on Net Recognized Built-in Gain

(A) Net unrealized built-in gain (from Step 1)	
(B) Net recognized built-in gain in prior taxable years [cumulative amount from Step 5, Item (F), of all previous years' worksheets]	
(C) Limitation on recognized built-in gain [Subtract (B) from (A)]	
Step 5. Compute Net Recognized Built-in Gain	
• Combined recognized built-in gains and losses	
(A) Recognized built-in gain (from Step 2)	
(B) Recognized built-in loss (from Step 3)	
(C) Subtract (B) from (A)	
• Limitation on net recognized built-in gain	
(D) Limitation—From Step 4	
• Corporation's taxable income	
(E) Corporation's taxable income for the year, computes as if it were a C corporation	
• Limitation	
(F) Net recognized built-in gain [Lesser of (C), (D), (E). If negative, enter zero]	
Step 6. Compute the Built-in Gains Tax	
(A) Net recognized built-in gain [Step 5, line (F)]	
(B) Highest corporate tax rate (normally 35 percent, but use zero if for tax year 2009, 2010, or 2011, and the corporation qualifies for suspension period treatment)	
(C) Built-in gains tax [(A) × (B)]	
Step 7. Compute the Built-in Carryover	
(A) Combined recognized built-in gains and losses [Lesser of Item (C) or (D) from Step 5]	
(B) Corporation's taxable income [Item (E) from Step 5]	
(C) Built-in gain carryover [Subtract (B) from (A). If negative, enter zero.]	

[1] At date S election became effective.
[2] At date S election became effective.
[3] (C) or (D), whichever is less.
[4] At date S election became effective.
[5] At date S election became effective.
[6] (C) or (D), whichever is the smaller loss.

Form **4255**
(Rev. December 2010)
Department of the Treasury
Internal Revenue Service

Recapture of Investment Credit

► **Attach to your income tax return.**

OMB No. 1545-0166

Attachment Sequence No. **172**

Name(s) as shown on return | **Identifying number**

Properties	Type of property—State whether rehabilitation, energy, reforestation, qualifying advanced coal project, qualifying gasification project, qualifying advanced energy project, or qualifying therapeutic discovery project property. (See the Instructions for Form 3468 for the year the investment credit property was placed in service for definitions.) If rehabilitation property, also show type of building. If energy property, show type.
A	
B	
C	
D	

Original Investment Credit

Computation Steps: (see Specific Instructions)		**Properties** A	B	C	D
1 Original rate of credit	**1**				
2 Cost or other basis	**2**				
3 Original credit (see instructions)	**3**				
4 Date property was placed in service	**4**				
5 Date property ceased to be qualified investment credit property	**5**				
6 Number of full years between the date on line 4 and the date on line 5	**6**				

Recapture Tax

7 Recapture percentage (see instructions)	**7**					
8 Tentative recapture tax. Multiply line 3 by the percentage on line 7	**8**					
9 Add all the amounts on line 8					**9**	
10 Enter the tentative recapture tax from property for which there was an increase in nonqualified nonrecourse financing. Attach a separate schedule (see instructions)					**10**	
11 Add lines 9 and 10					**11**	
12 Unused credits (see instructions)					**12**	
13 Subtract line 12 from line 11. See section 45K(b)(4) if you claim the nonconventional source fuel credit. Electing large partnerships, see instructions					**13**	
14 Recapture of qualifying therapeutic discovery project grant. Attach statement (see instructions)					**14**	
15 Total increase in tax. Add lines 13 and 14. Enter here and on the appropriate line of your tax return					**15**	

What's New

- The types of property subject to recapture now include qualified investments under the qualifying therapeutic discovery project program.
- If you received a qualifying therapeutic discovery project grant under section 9023 of the Affordable Care Act (ACA), and must recapture any part of that grant, use Form 4255 to report the increase in tax.
- The qualifying therapeutic discovery project credit was added as an investment credit.

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Use Form 4255 to figure the increase in tax for the recapture of investment credit claimed and for the recapture of a qualifying therapeutic discovery project grant.

Credit Recapture Requirements and Special Rules

Generally, you must refigure the investment credit and may have to recapture all or part of it if any of the following apply.

- You disposed of investment credit property before the end of 5 full years after the property was placed in service (recapture period).
- You changed the use of the property before the end of the recapture period so that it no longer qualifies as investment credit property.
- The business use of the property decreased before the end of the recapture period so that it no longer qualifies (in whole or in part) as investment credit property.
- Any building to which section 47(d) applies will no longer be a qualified rehabilitated building when placed in service.
- Any property to which section 48(b) applies will no longer qualify as investment credit property when placed in service.
- Before the end of the recapture period, your proportionate interest was reduced by more than one-third in a partnership (other than an electing large partnership), S corporation, estate, or trust that allocated the cost or other basis of property to you for which you claimed a credit.
- You received a grant under section 1603 of the American Recovery and Reinvestment Tax Act of 2009 for investment credit property for which you figured a credit for any prior year.

• A net increase in the amount of nonqualified nonrecourse financing occurred for any property to which section 49(a)(1) applied. For more details, see the instructions for line 10.

• You returned leased property (on which you claimed a credit) to the lessor before the end of the recapture period.

• In the case of a project under the Phase II gasification program, failure at any time during the applicable recovery period (as defined in section 168(c)) to attain and maintain the separation and sequestration requirements in section 48B(d)(1)(B). For more information, see Notice 2009-23, 2009-16 I.R.B. 802.

• In the case of a project under the Phase II qualifying advanced coal project program, failure during the applicable recovery period (as defined in section 168(c)) to attain and maintain the separation and sequestration requirements in section 48A (e)(1)(G). For more information, see Notice 2009-24, 2009-16 I.R.B. 817.

Exceptions to recapture. Recapture of the investment credit does not apply to the following.

• A transfer because of the death of the taxpayer.

• A transfer between spouses or incident to divorce under section 1041. However, a later disposition by the transferee is subject to recapture to the same extent as if the transferor had disposed of the property at the later date.

• A transfer of an interest in an electing large partnership.

• A transaction to which section 381(a) applies (relating to certain acquisitions of the assets of one corporation by another corporation).

• A mere change in the form of conducting a trade or business if:

1. The property is retained as investment credit property in that trade or business, **and**

2. The taxpayer retains a substantial interest in that trade or business.

A mere change in the form of conducting a trade or business includes a corporation that elects to be an S corporation and a corporation whose S election is revoked or terminated.

For more details on the recapture rules, see section 50(a).

Caution. *See section 46(g)(4) (as in effect on November 4, 1990) to figure the recapture tax if you made a withdrawal from a capital construction fund set up under the Merchant Marine Act of 1936 to pay the principal of any debt incurred in connection with a vessel on which you claimed investment credit.*

Recapture of Qualifying Therapeutic Discovery Project Grant

You may have to recapture all or part of a qualifying therapeutic discovery project grant paid under section 9023 of the ACA. If you received a qualifying therapeutic discovery project grant and the amount of the grant is more than the amount of the allowable grant, you must include the difference as an increase in tax as if the investment to which the excess portion of the grant relates had ceased to be a qualified investment immediately after the grant was made. The increase in tax for any recapture of a qualifying therapeutic discovery project grant is imposed on the person to whom the grant was made. In the case of pass-through entities (including partnerships, S corporations, estates, and trusts), the tax is imposed at the entity level.

Basis Adjustment on Recapture

For property subject to investment credit or qualifying therapeutic discovery project grant recapture, increase the property's basis as follows.

• For rehabilitation credit property, qualifying advanced coal project property, qualifying gasification project property, qualifying advanced energy project property, or depreciable qualifying therapeutic discovery project property, increase the basis by 100% of the amount, attributable to each such property, of the recapture tax, adjustments to carrybacks and carryforwards under section 39, or adjustments to disallowed passive activity credits.

• For energy property or qualified timber property, increase the basis by 50% of the amount, attributable to each such property, of the recapture tax, adjustments to carrybacks and carryforwards under section 39, or adjustments to disallowed passive activity credits.

If you are a partner or S corporation shareholder, the adjusted basis of your interest in the partnership or stock in the S corporation is adjusted to take into account the adjustment made to the basis of property held by the partnership or S corporation.

For more information, see section 50(c) and Regulations section 1.469-3(f).

Specific Instructions

Note. Do not figure the recapture tax on lines 1 through 9 if there is an increase in nonqualified nonrecourse financing related to certain at-risk property. Figure the tentative recapture tax for these properties on separate schedules and enter the recapture tax on line 10. Include any unused credit for these properties on line 12.

Partnerships, S corporations, estates, and trusts. For a partnership, S corporation, estate, or trust that allocated any or all of the investment credit to its partners, shareholders, or beneficiaries, provide the information they need to refigure the credit. See Regulations sections 1.47-4(a) and (c), 1.47-5, and 1.47-6. See the instructions for Form 1065-B for information on recapture of the investment credit by electing large partnerships.

For a partnership, S corporation, estate, or trust that must recapture any part of a qualifying therapeutic discovery project grant, figure the increase in tax at the entity level. Do not complete lines 1 through 13 to figure this increase in tax. Figure the increase in tax on a separate statement and enter the result on line 14. See the instructions for line 14.

Partners, shareholders, and beneficiaries. If your Schedule K-1 shows recapture of investment credit claimed in an earlier year, you will need your copy of the original Form 3468 to complete lines 1 through 6 of this Form 4255.

Lines A through D. Describe the property for which you must refigure the credit.

Complete lines 1 through 8 for each property on which you are refiguring the credit. Use a separate column for each item. If you need more columns, use additional Forms 4255 or other schedules that include all the information shown on Form 4255. Enter the total from all the separate sheets on line 9.

Line 1. Enter the rate you used to figure the original credit from the Form 3468 that you filed.

Line 2. Enter the cost or other basis that you used to figure the original credit. If there has been a net increase in nonqualified nonrecourse financing with respect to the property that you have disposed of or that has otherwise ceased to be investment credit property, enter the cost or other basis you used to figure the original credit reduced by the amount of that net increase. If there has been a net decrease in nonqualified nonrecourse financing with respect to the property, enter the cost or other basis you used to figure the original credit plus the amount of that net decrease. For more details, see section 49(b).

Line 3. Enter the amount of the credit determined under section 46. If the credit determined for the property for which you must refigure the credit was limited (for example, by the kilowatt limit in section 48(c)(1)(B)), do not enter on line 3 more than the amount of the applicable limit.

Line 4. Enter the date (month/day/year) on which the property was placed in service, using the first day of the month in which the property is placed in service. For example, if the property was placed in service on February 20, 2008, enter 02/01/2008 on line 4. See Regulations section 1.47-1(c) for more information.

Line 5. Generally, this will be the date you disposed of the property. For more details, see Regulations section 1.47-1(c).

Line 6. Do not enter partial years. If the property was held less than 12 months, enter zero. In case of failure to attain or maintain the separation and sequestration requirements applicable to a Phase II gasification program or a Phase II advanced coal program, enter zero. For more information, see Notice 2009-23, 2009-16 I.R.B. 802, and Notice 2009-24, 2009-16 I.R.B. 817.

Line 7. Enter the recapture percentage from the following table.

IF the number of full years on line 6 of Form 4255 is . . .	**THEN** the recapture percentage is . . .
0	100
1	80
2	60
3	40
4	20
5 or more	0

Line 9. If you have used more than one Form 4255, or separate sheets to list additional items on which you figured an increase in tax, write to the left of the entry space "Tax from attached" and the total tax from the separate sheets. Include the amount in the total for line 9.

Line 10. For certain taxpayers, the basis or cost of property is limited to the amount the taxpayer is at risk for the property at the end of the tax year. The basis or cost must be reduced by the amount of any "nonqualified nonrecourse financing" related to the property at the end of the tax year. If there is an increase in nonqualified nonrecourse financing, recapture may be required. See section 49(b) for details. For each property for which there is a net increase in nonqualified nonrecourse financing, figure the tentative recapture tax by multiplying the net increase by the percentage originally used to figure the credit. Enter the total tentative recapture tax for all such properties on line 10.

Line 12. Generally, enter the amount of unused credits from line 3 plus the amount of any other general business credit carrybacks and carryforwards that would have been allowed instead of the refigured credit. If you did not use all the credit you originally figured, either in the year you figured it or in a carryback or carryforward year, you do not have to recapture the amount of the credit you did not use. In refiguring the credit for the original credit year, be sure to include any carryforwards from previous years, plus any carrybacks arising within the first tax year (5 years for eligible small business credits (ESBCs) as defined in section 38(c)(5)(B)) after the original credit year that are now allowed because the recapture and recomputation of the original credit made available some additional tax liability in that year. See Regulations section 1.47-1(d) and Rev. Rul. 72-221, 1972-1 C.B. 15, for details.

Figure the unused portion on a separate sheet and enter it on this line. Do not enter more than the recapture tax on line 11.

Example 1. In 2007, Maayan earned a rehabilitation credit of $100,000 from property A. Maayan used all of the credit to offset $100,000 of tax in 2007. In 2008, Maayan earned a rehabilitation credit of $75,000 from property B and used none of the credit to offset tax. In 2009, property A ceased to be investment credit property and Maayan must refigure the credit from property A. Her recapture percentage is 60%. She enters $60,000 on lines 9 and 11. Because unused investment credits can be carried back one year (5 years for ESBC's), Maayan could have carried the rehabilitation credit from property B back to the original credit year for property A, 2007, and she may include $60,000 of the $75,000 carryforward from property B on line 12. Maayan's total increase in tax (line 13) for 2009 is $0.

Example 2. In 2007, Ian earned a rehabilitation credit of $100,000 from property A. Ian used $1,000 of the credit to offset tax in 2007 and used $99,000 as a carryforward to offset tax in 2008. In 2009, Ian earned a rehabilitation credit of $75,000 from property B and used none to offset tax. On February 1, 2009, property A ceased to be investment credit property and Ian must refigure the credit from property A. His recapture percentage is 80%. He enters $80,000 on lines 9 and 11. The unused credit for property B ($75,000) cannot be entered on line 12 because that credit was earned in 2009 and cannot be carried back two years to 2007, the original credit year for property A. Unused investment credits can be carried back only one year (5 years for ESBC's) and any remaining unused credit must be carried forward. Ian's total increase in tax (line 13) for 2009 is $80,000.

Caution. *Disallowed passive activity credits (as defined in section 469(d)(2)) can be used on line 12 only to the extent that credits from passive activities are included on line 11. Unused credits other than "specified credits" (as defined in section 38(c)(4)(B)) and ESBCs can be used on line 12 only to the extent that credits other than specified credits and ESBCs are included on line 11.*

Note. Be sure to adjust your current unused credit to reflect any unused portion of the original credit that was entered on line 12 of this form.

Special rule for electing large partnerships. Electing large partnerships must enter zero on line 12. These partnerships are required to determine the amount of investment credit recapture as if the credit subject to recapture had been fully used to reduce tax.

Line 13. Special rule for electing large partnerships. Subtract the current year credit, if any, shown on Form 3468, from the amount on line 11. Enter the result (but not less than zero) on line 13.

Line 14. Recapture of qualifying therapeutic discovery project grant. Enter the amount of any qualifying therapeutic discovery project grant required to be recaptured under section 9023(e) of the ACA. Do not complete lines 1 through 13 to figure this increase in tax. Attach a statement showing how you figured the increase in tax. Do not adjust the increase in tax for any unused investment credit. Partnerships, S corporations, estates, and trusts, figure the increase in tax at the entity level.

Line 15. Enter the line 15 amount on the appropriate line of your tax return (for example, 2010 Form 1120, Schedule J, line 10, or 2010 Form 1120S, line 22c). Partnerships (other than electing large partnerships), enter the amount from line 15 in the margin of the line for Ordinary business income (loss) on Form 1065, U.S. Return of Partnership Income, (for example, 2010 Form 1065, line 22) and identify the entry as "QTDP grant."

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under the OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below.

Recordkeeping . . . . 4 hr., 4 min.

Learning about the law or the form . . . . 4 hr., 6 min.

Preparing, copying, assembling, and sending the form to the IRS . . . 6 hr., 45 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

Chapter 6

Passthrough to Shareholders

Introduction

In this chapter, we will discuss

- Taxable income.
- Passthrough items.
- How corporation and shareholders treat passthrough items.
- Reasonable compensation.

An S corporation, like a partnership, is basically a *reporting* entity. Generally, instead of paying tax on its income, it reports items of income, loss, deduction, and credit to its shareholders who show these items on their individual income tax returns. We will call this *reporting process "passthrough."*[1]

Notice that passthrough, of income for instance, occurs whether or not the shareholder actually receives the income.

Once income has been taxed to the shareholder because of the passthrough process, it can be distributed to the shareholder with no further tax effect.

Schedule K-1

Schedule K-1 of the S corporation's tax return, Form 1120S, is used to notify shareholders of their share of the passthrough items.

Each line on the Schedule K-1 is enclosed in a box, and may have multiple lines within each box. Page 2 of the Schedule K-1 lists various codes to be used to identify the lines within the boxes. The instructions to the Schedule K-1 say that an asterisk should be placed after the code number if a separate schedule is attached. Thus, if an S corporation is passing through, for example, $15,000 of other portfolio income, it would enter *A* 15,000* in the box for line 10, and would attach a separate schedule showing the nature of the other income.

The Schedule K-1 is also used to report other items of importance to the shareholder, such as distributions and other items that affect basis.

[1] Sec. 1366 of the Code calls it *pass-thru*.

A copy of the S corporation tax return, Form 1120S, and Schedule K-1 can be found at the end of chapter 10.

Passthrough Items

An S corporation reports (passes through) each stockholder's *pro rata* share of the following:

- Nonseparately stated income or loss.
- Separately stated items, that is, items of income, loss, deduction or credit, the separate treatment of which could affect the shareholder's tax liability.[2]

Nonseparately Stated Income or Loss

An S corporation's *nonseparately stated income or loss* passes through to shareholders as ordinary income. This nonseparately stated taxable amount is the *bottom line* net income or loss shown on page 1 of the S corporation's Form 1120S. The Code calls it *taxable income*.[3]

Only trade or business income and expenses are used in arriving at nonseparately stated income or loss. Form 1120S labels nonseparately stated income as *Ordinary business income (loss)*, a more appropriate term than *taxable income*.

The taxable income of an S corporation is computed as if the entity were an *individual*, except that

- Items of income (including tax-exempt income), loss, deduction or credit that could affect the tax liability of an individual shareholder must be separately stated.
- Certain deductions allowed to individuals are not deductible to S corporations. These include
    - Taxes paid or accrued to foreign countries,
    - Charitable contributions,
    - Net operating loss deduction,
    - Oil and gas depletion under Sec. 611, and
    - Additional itemized deductions, such as medical expenses, and certain other expenses applicable only to individuals under Sec. 211, et seq.
- The deduction under Sec. 248 for amortization of organizational expenses is allowable as a deduction to the S corporation.[4]

Therefore, the S corporation's nonseparately stated (taxable) income is the same as the combined items of reportable income and allowable deduction that do not have to be separately stated. (For instance, sales of $10,000 and deductible expenses of $6,000 pass through as taxable income of

[2] Sec. 1366(a)(1); Reg. Sec. 1.1363-1(a).
[3] Sec. 1363(b).
[4] Sec. 1363(b); Reg. Sec. 1.1363-1(b).

$4,000. The $4,000 is called *nonseparately stated income* because the individual amounts making up the $4,000 have no significance when the shareholder prepares his or her individual tax return.)

Nonseparately stated income or loss is reported on line 1 of Schedules K and K-1 of Form 1120S.

NONDEDUCTIBLE CORPORATE ITEMS

The fact that certain items are not deductible at the corporate level does not necessarily mean the tax benefit is lost if the corporation pays them. The items that would otherwise be deductible to individuals (such as charitable contributions) pass through to the shareholders for inclusion on their personal returns.

DIVIDENDS-RECEIVED DEDUCTION

Provisions pertaining to computation of taxable income which are applicable only to corporations do not apply. Therefore, an S corporation is not entitled to the dividends received deduction of Sec. 243.[5]

SEPARATELY STATED ITEMS

As stated earlier, separately stated items are items of income, loss, deduction, or credit that could individually affect the shareholder's tax liability. Following are some examples of separately stated items:

- *Rental real estate income or loss*.
- *Rental (other than real estate) income or loss*.
- *Portfolio income*—Interest, dividends, and other portfolio income earned on an S corporation's investments are passed through separately.
- *Capital gains and losses*—Capital gains or losses pass through to the shareholders as such.
- *Section 1231 gains and losses*—Section 1231 gains (relating to certain property used in a trade or business) are separately passed through to be combined with the shareholder's other Section 1231 gains or losses.
- *Charitable contributions*—The corporate 10 percent limitation will not apply. Contributions pass through to the shareholders and are subject, on the shareholder's return, to the individual limits on deductibility.
- *Tax-exempt interest*—Tax-exempt interest passes through to the shareholders as such [but must be distributed after accumulated earnings and profits].
- *The Section 179 deduction*—The 179 deduction (relating to the expensing of certain depreciable assets) passes through as a separately stated item.

[5] Secs. 1363(b), 243.

- *Domestic production activities deduction*—Information relating to the Section 199 domestic production activities deduction passes through so that the shareholders can calculate the deduction on their personal returns.
- *Nondeductible expenses*—Nondeductible expenses (such as the nondeductible portion of meals and entertainment expense) pass through so that shareholders can reduce basis by these amounts.
- *Foreign tax credit*—Foreign taxes paid by the corporation pass through as such to the shareholders, who claim the taxes either as deductions or credits, subject to the applicable limitations.
- *Credits*—Items involved in the determination of credits are passed through to the shareholders.

Nonpassive or Passive Nature of Passthrough

The classification of passthrough items required by the passive activity rules is explained in chapter 10.

How Shareholders Treat Passthrough Items

Allocation of Items

All items of income, gain, loss, deduction, and credit passed through to the shareholders are allocated among the shareholders on a *pro rata* (that is, per share, per day) basis.[6]

If a shareholder terminates the shareholder's entire interest in the corporation, or if there is a *qualified disposition* of stock, elections can be made to allocate items by treating the tax year as if it consisted of two tax years.

> **Practice Tip:** Although S corporation passthrough is treated similarly to partnerships, there are significant differences. For example, S corporations must allocate items of income, loss, deduction or credit on a *pro rata* basis while partnerships may generally determine each partner's distributive share by means of the partnership agreement.

When Reported

The passed through items are reported by the shareholder in the shareholder's taxable year that includes the last day of the S corporation's taxable year.[7]

> **Example 6-1**
>
> S Inc. uses a fiscal year ending September 30. Its only shareholder, Pete, uses a calendar year. Passthrough to Pete occurs on September 30, so S Inc.'s income or loss for the year ended September 30, 2011, is shown on Pete's 2011 Form 1040.

[6] Sec. 1377(a)(1).
[7] Sec. 1366(a)(1).

If the corporation used a calendar year, S Inc.'s income or loss for the year ended December 31, 2011, would be shown on Pete's 2011 Form 1040.

If the S election terminates before the end of the corporate year, the corporation's tax year will consist of a short S year and a short C year. Passthrough occurs at the end of the entire taxable year, rather than at the date the S year ends.[8]

Losses

Losses are allocated in the same manner as other corporate items. However, each shareholder's ability to deduct losses is affected by the shareholder's basis in stock or debt.

Ownership on Stock Transfer Date

If shares are transferred during the year, who receives the passthrough allocation for the day the shares change hands?

On the day of the transfer, the shares are considered owned by the shareholder who disposed of the shares, rather than the shareholder who acquired the shares.[9] Therefore, allocation of passthrough to the transferor shareholder ends on the day the stock is transferred. Allocation of passthrough to the acquiring shareholder begins on the day following the day the shares are transferred.[10]

How Allocation of Passthrough Is Accomplished

The allocation of passthrough items of income, gain, loss, and deduction is normally based on the amounts at the end of the corporation's tax year. These year-end amounts are then allocated to shareholders on a pro rata (that is, per-share, per-day) basis.

Passthrough When Stock Ownership Remains Unchanged

If no shares change hands during the year, the percentage of each shareholder's stock ownership can be applied to each item of passthrough.

Example 6-2

X Inc. is an S corporation with 100 shares of common stock outstanding. For the year ended December 31, the corporation's only passthrough item is its nonseparately stated income of $47,450.

Don and Dean each owned 50 percent of the stock for the entire taxable year.

Don and Dean must each report 50 percent of the year's taxable income, or $23,725, on Schedule E of their respective Form 1040—simple as that.

But what if shares had changed hands during the year?

[8] Reg. Sec. 1.1362-3(c)(b).
[9] Reg. Sec. 1.1377-1(a)(2)(ii).
[10] Reg. Sec. 1.1367-1(g), Example 2.

The technical method of determining each shareholder's *pro rata* share of passthrough items is set out in Sec. 1377(a)(1). This method can be very cumbersome because it requires an extensive calculation for each passthrough item. In practice, you can shortcut the calculation by using the methods described in the following paragraphs.

Passthrough If Stock Ownership Changes

METHOD USING PERCENTAGE OF OWNERSHIP

The instructions to the Form 1120S provide a simplified method of computing the allocation when shares change hands during the year.

This method consists of multiplying the percentage of stock owned by the percentage of the year the stock is held, then adding the percentages for each shareholder. The simplest way to illustrate it is through a couple of examples.

Example 6-3

Enn Inc. is an S corporation with 100 shares of common stock outstanding. For the year ended December 31, the corporation's only passthrough item is its nonseparately stated income of $47,450. Nell, the sole shareholder, sells all her stock to Nick on September 30.

The nonseparately stated income is allocated between Nell and Nick in this way:

		A Percent of Stock	B Percent of Year	C (A x B)	C Percent for Year	D Taxable Income
Nell		100	74.8[1]	74.8		
	Nell's Total				74.8	$35,493
Nick		100	25.2[2]	25.2		
	Nick's Total				25.2	11,957
	Grand Totals				100.0	$47,450

If there were other passthrough items (such as capital gains), the percentages (74.8 and 25.2 in this example) are applied to each passthrough item.

Practice Tip: Because Nell sold all of her shares, the corporation can make the election to treat the tax year as if it consisted of two tax years upon disposition of a shareholder's entire interest, discussed later in this chapter. Both Nell and Nick must consent to the election.

[1] 273 days ÷ 365 days (366 days would be used in a leap year)
[2] 92 days ÷ 365 days

Now calculate the passthrough allocation when a portion of a shareholder's stock is sold.

Example 6-4

Jay, Inc. is an S corporation with 100 shares of common stock outstanding. For the year ended December 31, the corporation's only passthrough item is its nonseparately stated income of $47,450. John owns 50 shares of stock all year. Joan owns 50 shares until September 30, on which day she sells 25 shares to Jean.

The calculation works this way:

		A Percent of Stock	B Percent of Year	C (A x B)	C Percent for Year	D Taxable Income
John		50	100.0	50.0		
	John's Total				50.0	$23,725
Joan		50	74.8[1]	37.4		
		25	25.2[2]	6.3		
	Joan's Total				43.7	20,736
Jean		25	25.2[2]	6.3		
	Jean's Total				6.3	2,989
	Grand Totals				100.0	$47,450

The percentages (50.0, 43.7 and 6.3 in this example) are applied to each passthrough item.

Practice Tip: Because Joan sold 20 percent or more of the issued stock of the corporation during a 30-day period, the corporation can make the election to treat the tax year as if it consisted of two tax years when there is a qualifying disposition of stock. John, Joan, and Jean must consent to the election.

[1] 273 ÷ 365 days
[2] 92 ÷ 365 days

Death of Shareholder

If an S corporation shareholder dies, his or her *pro rata* share of income, loss, deductions and credits, up to the date of death, must be included on the decedent's final return.[11] In other words, the decedent is considered to be the shareholder through the date of death and the estate or other person acquiring the stock is the shareholder after that date.

Example 6-5

Assume the same facts as in Example 6-3, except that Nell dies on October 1 and the stock is transferred to Nick on that same day. The $47,450 nonseparately stated income would be allocated $35,493 to Nell and $11,957 to Nick, as shown in the example.

If the stock had gone to Nell's estate and remained there through the end of the year, the $11,957 would be allocated to the estate, rather than to Nick.

[11] Sec. 1366(a)(1).

> **Practice Tip:** Since death is a termination of the shareholder's entire interest in the corporation, the election to treat the tax year as if it consisted of two tax years can be used in the year a shareholder dies. All affected shareholders must consent to the election, so the decedent's legal representative would consent on behalf of the decedent.

Election to Treat Tax Year as if It Consisted of Two Tax Years upon Termination of Shareholder's Entire Interest

If a shareholder terminates his or her entire interest in the corporation during the year, the corporation may choose to not have the per share, per day rules apply to the entire tax year.[12]

To accomplish this, the corporation elects to treat the taxable year as if it consisted of two taxable years, with the first one ending on the date of the shareholder's termination. This allows the corporation to have greater control over how much income or loss is passed through to each respective shareholder. (A similar election is available in certain other circumstances.)

If the election is made, the corporation uses normal tax accounting rules to assign passthrough items to each short year based on the corporation's permanent records, including workpapers. Items of income, loss, credit, and deduction are attributed to the period in which they were incurred or realized. (The calculations are similar to those required by the election to split the year into two taxable years upon termination of the S election.) The corporation treats the taxable year as two separate years for purposes of (a) allocating items of income and loss; (b) making adjustments to the AAA, earnings and profits, and basis; and (c) determining the tax effects of distributions.

> **Practice Tip:** This election to treat the tax year as if it consisted of two tax years is sometimes referred to by other names, such as the *election to use normal tax accounting rules* or the *election to use actual book and records*. The Code and Regulations call it the *election to terminate year*, but this is misleading because the year does not actually terminate. Rather, the election provides an alternative method of allocating passthrough items; the allocations are made as if the tax year consisted of two short years. No termination of the S corporation election actually takes place, and only one corporate return (1120S) is filed for the year.

The following example illustrates how the election works:

Example 6-6

John owns 100 percent of X Inc., a calendar year S corporation. At exactly mid-year, he sells his shares to Joan. The corporate records show that the corporation had a $49,000 loss at the transfer date, and a profit of $50,000 after the transfer date, making taxable income for the year of $1,000.

Situation 1: The election to treat the tax year as if it consisted of two tax years is not made, the *pro rata* (per share, per day) method of allocation is used, and John and Joan both pick up $500 of taxable income on their personal returns.

Situation 2: The corporation elects to treat the tax year as if it consisted of two tax years, and both John and Joan consent to the election. Consequently, John

[12] Sec. 1377(a)(2); Reg. Sec. 1.1377-1(b).

reports a $49,000 loss on his return, subject to the limitation rules, and Joan reports $50,000 of income on her return.

Practice Tip: Remember that, to deduct losses passed through by an S corporation, the shareholder must have enough stock and debt basis to absorb the loss in the year the stock sale takes place. Current and carryover passthrough losses that are not deducted because of basis limitations in the year that all of the shareholder's stock is disposed of can be lost forever. Also, the operating gain or loss passed through to the shareholder will cause stock basis to increase or decrease, which will affect the gain or loss on the sale of the stock. Thus, the entire transaction (including both the shareholder's portion of operating income or loss and the gain or loss on the stock disposition) must be considered when determining the best overall treatment.

HOW THE ELECTION TO TREAT THE TAX YEAR AS IF IT CONSISTED OF TWO TAX YEARS IS MADE

The election is filed with the return for the year in which the termination took place.[13]

The election should state that the corporation elects under Sec. 1377(a)(2) and Reg. Sec. 1.1377-1(b) to have the rules provided in Sec. 1377(a)(1) applied as if the taxable year consisted of two taxable years. The date of termination and the manner of termination (for example, sale of a shareholder's entire interest) should be stated.

Shareholders affected by the stock disposition must consent to the election to treat the tax year as if it consisted of two tax years. *Affected shareholders* include all shareholders who disposed of shares and all shareholders who acquired shares during the taxable year. If the shares were transferred to the corporation, all shareholders who owned stock during the year are affected shareholders.[14] The consents should state that the shareholders consent to the corporation making the election under Sec. 1377(a)(2). The consents are not required to be attached to the tax return and should instead be retained by the corporation.[15]

Exhibits 6-1 and 6-2 at the end of this chapter provide examples of the election and consents.

Practice Tip: Because the election is filed with the tax return for the year in which the stock disposition took place, the decision on whether to make the election does not have to be made until the due date of the tax return, including extensions. Thus, the shareholders can wait until the year's results are in—and then make the election only if it provides the best tax result. Normally, however, the shareholders will want to make the election to treat the tax year as if it consisted of two years because then the shareholders report the results from operations that actually occurred during each period of stock ownership. The seller of the shares generally would be aware of the income or loss at the date the sale takes place, and the election would ensure that those amounts would be passed through to that departing shareholder.

[13] Reg. Sec. 1.1377-1(b).
[14] Sec. 1377(a)(2).
[15] Reg. Sec. 1.1368-1(g).

PROTECTING THE USE OF ELECTION TO TREAT THE TAX YEAR AS IF IT CONSISTED OF TWO TAX YEARS

The ability to allocate items as if the tax year consisted of two tax years may cause the shareholders to negotiate for S corporation tax attributes.

Example 6-7

Assume the same facts as in Example 6-6, that is, John has a $49,000 ordinary loss when his shares are sold. Normally, he would want to take advantage of the loss on his personal return. But Joan has to consent to the election. She might require that the purchase price of her shares be reduced to compensate her for the additional tax she must pay if normal accounting records are used.

Actually, at the sale date, John does not know what the final answer will be. He should know what the books and records show, but what will happen between the stock sale date and the end of the corporate year is an unknown.

So, how can he be sure that he will still have an ordinary loss to deduct at year end?

He might consider having Joan agree to consent at the time the sale takes place, but even then she could sell some shares to someone else during the year, and that person would also have to consent. So any agreement with Joan, in this example, should also include some restriction on the sale of Joan's shares, at least until year end.

Another possibility would be for John to terminate the S corporation election shortly before the sale takes place. Then he would be selling a C corporation to Joan. Since 50 percent or more of the shares were sold or exchanged during the year that the revocation occurred, allocation between the S and C short years would have to be made by using normal tax accounting rules.

Of course, Joan might not be happy with the result. After the sale, the corporation could apply for S corporation status and ask the IRS to waive the five-year waiting period. There is a good chance that the IRS will grant the waiver because all the shares changed hands, and she did not have any interest in the corporation when the termination occurred. The corporation would have to timely elect S status, apply for waiver of the five-year period, and pay a user fee.

Because of the potential unfavorable result to the buyer, revocation of the election by the seller may not provide a practical solution to the problem.

It is possible that some shareholders will want to wait until the end of the tax year to sell their shares. Then, at least, the amount of passthrough items can be determined.

Election When a Qualifying Disposition Takes Place

Reg. Sec. 1.1368-1(g) provides that an election to treat the tax year as if it consisted of two tax years can be made when there is a *qualifying disposition* of stock.

Under the regulations, the corporation can elect to treat the tax year as if it consisted of two short years when

- The shareholder disposes of 20 percent or more of the issued stock of the corporation during any 30-day period within the S corporation's taxable year,
- 20 percent or more of the corporation's outstanding stock is redeemed from a shareholder in one or more transactions within any 30-day period during the tax year, if the redemption is treated as an exchange under Sec. 302(a) or Sec. 303(a), or
- Stock equal to or greater than 25 percent of the previously outstanding stock is issued to one or more new shareholders within any 30-day period during the corporation's tax year.

The corporation makes the election when there is a qualifying disposition by stating that it is electing for the taxable year under Reg. Sec. 1.1368-1(g)(2)(i) to treat the tax year as if it consisted of separate taxable years.[16] The corporation should state the type of qualifying disposition that took place. It should also state that each shareholder who held stock during the year consents to the election. *Anyone who held shares during the year* must sign a consent. The election statement is filed with the Form 1120S for the year in which the stock disposition took place. The consent statements themselves, however, do not need to be sent to the IRS, but rather should be retained by the corporation. One election statement can be filed for all qualifying dispositions during the taxable year. The election is irrevocable.

> **Practice Tip:** Notice that only affected shareholders are required to consent to the election to treat the tax year as if it consisted of two tax years when a shareholder disposes of an entire interest in the corporation. When the election is made because of a qualifying disposition, however, all shareholders who held stock during the year must consent.

Samples of the election and consents are shown as Exhibits 6-3 and 6-4 at the end of this chapter.

Credits

The general rule is that credits generated by an S corporation are not used to reduce tax at the corporate level. Rather, the credit (or the information necessary to calculate the credit) passes through to the shareholders to be used on their personal returns. The credit for federal tax on fuels is the exception to the rule, and is the only credit generated at the S corporation level that can be refunded or used by the corporation to offset tax liability.

Business tax credits and minimum tax credits generated at the C corporation level and carried into the S corporation can be used to offset the built-in gains tax.

Credits are not limited to the shareholder's basis in stock and debt. In other words, a shareholder who has no basis can still claim allowable credits.

Credits do not directly affect the shareholder's basis in the S corporation. Basis can be affected, however, if the credit (such as the rehabilitation credit) requires reduction in the basis of assets. In that event, the shareholder's basis is reduced by a corresponding amount.

[16] Reg. Sec. 1.1368-1(g)(2)(iii).

Passthrough of Corporate Tax

An S corporation may incur tax for

- Built-in gains.
- Passive investment income.
- Business credit recapture.

The corporation may also be required to make LIFO recapture payments. This section describes briefly how the tax on each of these items is passed through to shareholders.

Built-in Gains

Built-in gains tax incurred at the corporate level is deductible from the S corporation's income and passes through as a loss. The loss passes through with the same tax character as the item (or items) of recognized built-in gain that created the tax.[17] The loss passes through in the year the built-in gains are recognized, even though the tax may be paid in the following year.

Passive Investment Income

Each item of passive investment income passed through will be reduced by its *pro rata* share of the tax imposed on excess net passive income.[18]

LIFO Recapture

LIFO recapture payments made by the S corporation do not reduce either basis or the AAA.[19] The LIFO payments do, however, reduce AE&P.[20]

Business Credit Recapture

Certain business credits (such as the credit for rehabilitation expenditures under Sec. 47) are subject to recapture if the property is disposed of prematurely.

Business credits claimed while the corporation is in S status are passed through to the shareholders, and, it is the shareholders who are liable for any recapture of these credits.[21] The corporation provides the information that the shareholder needs to compute the recapture on Schedule K-1 of the 1120S by entering the appropriate code (E, F, G, or H) on line 17, *Other Information*, and attaching the required form or statement.

Business credit recapture is paid at the S corporation level if the credit was claimed while the corporation was in C status, but the property is disposed of by the S corporation.

[17] Sec. 1366(f)(2).
[18] Sec. 1366(f)(3).
[19] Secs. 1363(d)(5) and 1368 (e)(1)(A).
[20] Sec. 1363(d)(5).
[21] Reg. Sec. 1.47(a).

TERMINATION OF S ELECTION

Termination of the S election is not a disposition of property.[22] If the resulting C corporation disposes of the assets, however, any applicable recapture is reported by the shareholders who received benefit of the credit.[23]

CHANGE IN STOCK OWNERSHIP

If a shareholder of an S corporation, or of a former S corporation, disposes of the shareholder's entire interest in the corporation, the shareholder is deemed to have disposed of an interest in the corporation's business credit property. If the sale of the interest is a premature disposition of business credit property, the shareholder is liable for the recapture.

A sale of more than a third of the shareholder's interest in the S corporation, or a former S corporation, triggers recapture to the extent of the interest sold.[24] If a premature disposition has been recognized on a partial disposition of an interest in the corporation, a later second disposition can trigger further recapture if the second disposition is for more than one-third of the interest on which the business credit passthrough was originally computed.

BUSINESS CREDIT RECAPTURE IS NONDEDUCTIBLE CORPORATE EXPENSE

Tax paid at the corporate level because of business credit recapture does not decrease passthrough items. Rather, the tax passes through as a nondeductible corporate expense.

The business credit recapture paid at the S corporation level reduces basis, but is a Federal tax relating to a C corporation year and does not reduce the Accumulated Adjustments Account (AAA). The recapture does, however, reduce accumulated earnings and profits (AE&P).[25]

Reasonable Compensation

Lawmakers are not unaware of the fact that certain circumstances make it worthwhile for taxpayers to understate their compensation in order to allocate income to other, lower tax bracket members of the family. Therefore, items taken into account by members of the family (whether or not themselves shareholders) may be adjusted by the IRS if it is necessary to reflect reasonable compensation to the shareholders for services rendered or capital furnished to the corporation.

- The adjustment can apply to both the amount and the timing of the compensation.
- The definition of *family* for these purposes includes the shareholder's spouse, ancestors, lineal descendants and trusts for the primary benefit of such persons.[26]

[22] Reg. Sec. 1.47-4(d).
[23] Reg. Sec. 1.47-4(a)(1).
[24] Reg. Sec. 1.47-4(a)(2).
[25] Sec. 1371(d)(3).
[26] Sec. 1366(e).

Payroll Taxes

Another reason S corporation shareholders may not pay reasonable salaries to themselves is to avoid payroll taxes. Unlike partners, S corporation shareholders who perform services for the corporation are employees, and, as such, are subject to Social Security and other payroll taxes on any compensation from the S corporation.

- Rev. Rul. 74-44 (1974-1 CB 287) states that an S corporation can be considered liable for Social Security and related payroll taxes on dividends distributed if the distributions actually represent disguised salaries to its actively employed shareholders. This is true, even if some wages are actually paid.[27]
- A growing number of court cases have also held that distributions can be reclassified as wages to shareholders who provide services to the corporation, but receive no wages.[28]
- Corporate payments for services provided by an officer-shareholder *cannot* be treated as self-employment income by the shareholder. Compensation for such services is wages.[29]
- An S corporation's dividends, distributions, or passthroughs are not subject to self-employment tax.[30]
- The IRS enforces the income tax withholding rules, and it is on guard against S corporation stockholder-employees reducing salaries to bypass the withholding requirements.

Excessive Compensation

The built-in gains tax and the tax on excess net passive income are imposed at the S corporation level and are limited to the amount of the corporation's taxable income. The shareholders may attempt to lower the corporation's income by increasing their salaries. The IRS, however, has the power to reclassify salaries that are unreasonably high. These excessive wages can then be characterized by the IRS as distributions to the shareholder.

Criteria for Reasonable Compensation

The key to all of the above potential problems is the word *reasonable*. If the compensation is reasonable, no one can argue with you. Of course, *reasonable* in any case is dependent upon the

[27] See *David E. Watson*, 105 AFTR 2d 2010-2624 (DC IA 2010).
[28] See, for example, *Spicer Accounting Inc. v. U.S.*, No. 89-35071, CA9, 11/1/90; *Fred R. Esser, P.C. v. U.S.*, No. CIV 89-973, D. Az., 10/24/90; *Yeagle Drywall Co., Inc. v. Comm.*, 90 AFTR 2d 2002-7744, 2003-1 USTC 50,141 (2002, CA3), *aff'g Veterinary Surgical Consultants, PC. V. Comm.*, 117 TC 141 (2001); and *Nu-Look Design, Inc., v. Comm.*, 93 AFTR 2d 2004-608, 56 F.3d 290, 2004-1 USTC 50,138 (2004, CA3) *aff'g* TC Memo 2003-52 (2003).
[29] Sec. 3121(d)(1); Rev. Rul. 73-361, 1973-2 CB 331; see, for example, *Joseph M. Grey, Public Accountant, P.C. v. Comm.*, 93 AFTR 2d 2004-1626, 93 Fed Appx 473 (2004, CA3) *aff'g* 119 TC 121 (2002).
[30] Rev. Rul. 59-221, 1959-1 CB 225; see, for example, *Antonio Durando*, (1995, CA9) 70 F3d 548, 95-2 USTC 50615, 76 AFTR 2d 95-7464.

pertinent facts and circumstances. Some of the following criteria have been used by the courts[31] when determining a shareholder or employee's reasonable compensation:

- The size, complexity, and financial condition of the business operations
- The employee's position, time spent working, and nature of the services performed
- The company's salary policy and the employee's individual salary history, including the corporation's consistency in determining that salary
- Compensation paid by other firms for comparable services
- Whether return on investment, after considering the shareholder's compensation, would be enough to satisfy a hypothetical independent investor
- The employee's responsibilities and qualifications
- How the employee's compensation compares to sales and net income
- Prevailing economic conditions
- How salaries compare to distributions to shareholders and retained earnings
- History of dividends paid
- Whether the corporation and employee dealt at arms' length
- The corporation's intent
- Whether the corporation's debt was guaranteed by the employee

Cancellation of Indebtedness Income

In general, gross income includes income from the discharge of indebtedness. However, subject to certain rules under Sec. 108, income from the discharge of indebtedness is exempt from income if the taxpayer is bankrupt or insolvent. The taxpayer is required to reduce tax attributes (such as net operating losses, certain carryovers, and basis in assets) to the extent of the excluded income.

For S corporations, the eligibility for the income exclusion is applied at the corporate level. Further, corporate tax attributes that must be reduced include losses that the shareholders have been unable to deduct because of insufficient basis.[32]

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[31] See, for example, *Eberl's Claim Service, Inc. v Comm*., 87 AFTR 2d 2001-2075, 249 F3d 994, 2001-1 USTC 50,396 (2001, CA10); *Exactospring Corp v. Comm*., 84 AFTR 2d 99-6977, 196 F3d 833, 99-2 USTC 50964 (1999, CA7); *Alpha Medical Inc*., 83 AFTR 2d 99-1922, 172 F3d 942, 99-1 USTC 50461 (1999, CA6); *Dexsil Corp. v. Comm.*, 81 AFTR 2d 98-2312, 147 F3d 96, 98-1 USTC 50471 (1998, CA2); *Joseph Radtke, S.C. v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989), 89-2 USTC 9466; *Menard, Inc. v. Comm*, 103 AFTR 2d 2009-1280, 560 F3d 620 (2009, CA7).

[32] See Reg. Sec. 1.108-7.

Income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation.[33]

> **Example 6-8**
>
> Jay, the sole shareholder of Esscorp, has no basis in the corporation's stock. The corporation borrows $10,000 from a bank, then goes bankrupt, and the $10,000 debt is discharged. The corporation passes through a $10,000 loss to Jay for the portion of the year before the bankruptcy occurred. Jay has no basis in his stock, so he cannot deduct any of the $10,000 loss on his personal return. The $10,000 cancellation of debt income is excluded from Esscorp's income, and reduces the $10,000 suspended loss to zero. The cancellation of debt income does not increase Jay's stock basis. Thus, at the end of the year, Jay reports no income from the cancellation of debt. He has no basis in his stock and no loss to carry forward to following tax years.

IRS Issues Guidance on Temporary Election That Allows Businesses to Defer Cancellation of Debt Income

The American Recovery and Reinvestment Act of 2009 (better known as the Stimulus Act) included a favorable temporary provision that permits a business taxpayer (including an individual who operates a business) that reacquires its own debt at a discount to make an irrevocable election to defer the resulting cancellation of debt (COD) income. The COD income is deferred for a period of either four or five years and is then spread evenly over five years after the deferral period has ended. This COD income deferral election, under IRC Section 108(i), can be made for all or any part of any COD income that is triggered by any eligible debt reacquisition transaction that takes place in calendar year 2009 or calendar year 2010.

HOW THE ELECTION WORKS

In Rev. Proc. 2009-37, 2009-36 IRB 309, the IRS issued guidance on how to make Section 108(i) elections. Taken together, the statutory language and Rev. Proc. 2009-37 set out the complex rules. We will provide a quick summary of the provisions here.

Impact of Election for 2009 Debt Reacquisition Transactions

When a Section 108(i) election is made for an eligible debt reacquisition transaction that takes place in calendar year 2009, the amount of COD income for which the election is made is deferred until the fifth tax year following the tax year in which the transaction takes place. Starting with that fifth tax year, the COD income is spread evenly over five tax years. For example, with a calendar-year taxpayer, COD income from a 2009 transaction is deferred until 2014. The COD income is then spread evenly over 2014-2018.

[33] Sec. 108(d)(7).

Impact of Election for 2010 Debt Reacquisition Transactions

When a Section 108(i) election is made for an eligible debt reacquisition transaction that takes place in calendar year 2010, the amount of COD income for which the election is made is deferred until the fourth tax year following the tax year in which the transaction takes place. Starting with that fourth tax year, the COD income is spread evenly over five tax years. For example, with a calendar-year taxpayer, COD income from a 2010 transaction is deferred until 2014. The COD income is then spread evenly over 2014-2018.

As you can see, the time for recognizing the deferred COD income is the same for both 2009 and 2010 transactions.

Election Is Allowed for Applicable Debt Instruments Reacquired in Eligible Transactions

The range of circumstances under which the election is available may make it more far-reaching and advantageous that it originally appears. The Section 108(i) election is available for COD income arising from the reacquisition of an *applicable debt instrument*, which is defined as any debt instrument issued by a C corporation or any other party (including an individual) in connection with the conduct of a business by that party. Debt instruments generally include most bonds, debentures, notes, certificates, and other instruments or contractual arrangements that constitute debt within the meaning of Sec. 1275(a)(1).

The election can be made when an applicable debt instrument is reacquired at a discount by the debtor or by a party related to the debtor.[34] Such debt reacquisitions can be made in exchange for (1) cash or other property, (2) newly issued debt, (3) a significant debt modification that constitutes a debt exchange, (4) corporate stock, (5) a partnership interest, (6) a contribution to capital, or (7) complete forgiveness of the debt. Partial forgiveness of a debt indirectly qualifies as an eligible reacquisition transaction, because it is treated as a significant debt modification resulting in a debt exchange.[35]

Election Is Made at S Corporation Level

When a passthrough entity such as a partnership or S corporation reacquires an applicable debt instrument in an eligible transaction, the Section 108(i) election must be made at the entity level rather than at the owner level. This is not necessarily helpful to owners, because their tax situations may vary.

When an S corporation makes the election, Rev. Proc. 2009-37 says the deferred COD income must be allocated *pro rata* to the shareholders that were present immediately before the debt reacquisition transaction.[36]

Results May be More Favorable if the Election is Not Made

When the taxpayer makes a Section 108(i) election for a particular amount of COD income, that income is ineligible for COD income exclusions that might otherwise be allowed under various

[34] As defined by Sec. 108(e)(4).
[35] Reg. 1.1001-3.
[36] See Section 2.10 of Rev. Proc. 2009-37.

provisions of IRC Section 108.[37] Therefore, the idea of making the Section 108(i) election should be carefully considered before pulling the trigger. Also keep in mind that electing to defer COD income until 2014-2018 will expose that income to whatever federal income tax regime exists in those years (a scary thought!).

PARTIAL ELECTIONS ARE ALLOWED

Section 4.04 of Rev. Proc. 2009-37 allows taxpayers to make the Section 108(i) election for any portion of any COD income that results from any eligible reacquisition of an applicable debt instrument. The advantage of making a partial election is that COD income for which the election is *not* made remains eligible for exclusion under other IRC Section 108 provisions (such as the bankruptcy and insolvency exclusions and the exclusion for qualified real property business indebtedness).

ELECTION STATEMENTS ARE REQUIRED

The Section 108(i) election must be made by attaching an election statement to the taxpayer's timely filed (including extensions) original return for the taxable year in which the eligible debt reacquisition transaction occurs. Section 4.05 of Rev. Proc. 2009-37 specifies the information that must be included on the election statement. Partnerships and S corporations must include a list of partners and shareholders that have deferred COD income as a result of the election, identifying information for each such partner or shareholder, and the deferred COD income amount for each such partner or shareholder. Sections 4.07 and 4.08 of Rev. Proc. 2009-37 require electing partnerships and S corporations to provide additional information to affected partners and shareholders.

ANNUAL STATEMENTS ARE REQUIRED

Section 5 of Rev. Proc. 2009-37 requires electing taxpayers to attach annual statements to their federal returns until all the federal income tax implications of their Section 108(i) elections have been accounted for. These annual statements must be attached to federal returns for years following the years in which the elections are made. This requirement creates tax compliance issues that will last through 2018. Annual required statements for partnerships and S corporations are more complicated.

Summary

- Passthrough is a reporting process.
- Net taxable income from operations passes through as nonseparately stated income or loss.
- Items of income, loss, deduction, or credit that could affect an individual's tax liability are separately stated.
- Normally, items of passthrough are allocated based on a per share, per day calculation.

[37] See Sec. 108(i)(5)(C).

- Items of passthrough can be allocated as if the taxable year consisted of two taxable years if a shareholder terminates his or her entire interest in the corporation.
- An S corporation must pay reasonable compensation for services rendered by its shareholders.

Exhibit 6-1

Election to Treat Tax Year as If It Consisted of Two Tax Years Upon Disposition of a Shareholder's Stock

Name:	ABC Inc.
Address:	985 Main Street Portland, OR 97001
Employer Identification Number:	93-1234567
Service Center:	Ogden, UT

The above corporation, ABC Inc., hereby elects under Sec. 1377(a)(2) and Reg. Sec. 1.1377-1(b) to have the rules provided in Sec. 1377(a)(1) applied as if the taxable year consisted of two taxable years. All affected shareholders consent to the election.

Date corporate year ends:	December 31, 2011
Name of shareholder who terminated entire interest in corporation:	Don A. Jones
Cause of termination:	Sale of all the shareholder's stock in ABC Inc.
Date of termination:	July 1, 2011

Dated: February 15, 2012

Exhibit 6-2

Consent to Election to Treat Tax Year as If It Consisted of Two Tax Years Upon Disposition of a Shareholder's Stock

Corporation:	ABC Inc.
Address:	985 Main Street Portland, OR 97001
Employer Identification Number:	93-1234567
Service Center:	Ogden, UT

We, the undersigned, constituting all of the affected shareholders of ABC Inc., during the corporation's taxable year beginning January 1, 2011, and ending December 31, 2011, hereby consent to the aforementioned corporation's election under Sec. 1377(a)(2) and Reg. Sec. 1.1377-1(b) to have the rules provided in Sec. 1377(a)(1) applied as if the taxable year consisted of two taxable years.

Name, Address, and I.D. Number of Shareholder	**Date**	**Signature**
Don A. Jones 6666 Sixth Ave. Portland, OR 97001 540-00-0000	_____	_____
David Johnson 7777 Seventh Ave. Portland, OR 97001 541-11-1111	_____	_____

Exhibit 6-3

Election to Treat Tax Year as If It Consisted of Two Tax Years Upon Qualifying Disposition of Stock

Name:	DEF Inc.
Address:	990 Main Street Portland, OR 97001
Employer Identification Number:	93-7654321
Service Center:	Ogden, UT

The above corporation, DEF Inc., hereby elects under Reg. Sec. 1.1368-1(g)(2)(i) to have the rules provided in Sec. 1377(a)(1) applied as if the taxable year consisted of two taxable years. As explained below, a *qualifying disposition* of stock took place on July 31, 2011.

Date corporate year ends:	December 31, 2011
Details of qualifying disposition:	

Dated: February 15, 2012

Exhibit 6-4

Consent to Election to Treat Tax Year as If It Consisted of Two Tax Years Upon Qualifying Disposition of Stock

Corporation:	DEF Inc.
Address:	990 Main Street Portland, OR 97001
Employer Identification Number:	93-7654321
Service Center:	Ogden, UT

We, the undersigned, constituting all of the shareholders of DEF Inc., during the corporation's taxable year beginning January 1, 2011, and ending December 31, 2011, hereby consent to the aforementioned corporation's election under Sec. 1377(a)(2) to have the rules provided in Sec. 1377(a)(1) applied as if the taxable year consisted of two taxable years. A *qualifying disposition* of stock took place on July 31, 2011.

Name, Address, and I.D. Number of Shareholder	**Date**	**Signature**
Don Smith 8888 Sixth Ave. Portland, OR 97001 540-00-2222	_____	_____
Melvin Johnson 999 Seventh Ave. Portland, OR 97001 541-11-3333	_____	_____

Chapter 7

Basis and Losses

Introduction

In this chapter, we will discuss

- Basis Adjustments.
- Order of Application to Basis.
- Indebtedness to Shareholders.
- Carryover of Losses.
- Carryover after Termination of Election.

Basis of Stock

Basis is generally computed at the end of the corporation's taxable year.[1]

In short, a shareholder's stock basis is

- First, increased by passthrough income items,
- Second, decreased by nontaxable distributions, and
- Third, reduced by loss and deduction passthrough items for the year.[2]

More precisely, the basis of a shareholder's S corporation stock is computed as follows:

1. Original cost or basis beginning of year.
2. Increase basis by shareholder additions to basis, such as contributions to capital, stock purchases, or gifts, and inheritance of stock.
3. Increase basis by the stockholder's share of passthrough items:
    a. Nonseparately stated income.[3] (This is the corporation's bottom line income from trade or business activities shown on page 1 of Form 1120S.)

[1] Reg. Sec. 1.1367-1(d).
[2] Sec. 1368(d)(1); Reg. Sec. 1.1367-1(e).
[3] Sec. 1367(a)(1)(B).

b. Separately stated items of income.[4] (This category includes the income items that, if treated separately, could affect the tax liability of any shareholder and include such items as tax exempt interest, net capital gains, and net Sec. 1231 gains [sales of certain business assets].)

c. Excess of the shareholder's deductions for depletion (other than oil and gas) over the shareholder's proportionate share of basis in the property subject to depletion.

d. Changes in asset basis due to certain business tax credit recapture.

4. Decrease basis by distributions which are not includable in the shareholder's income.[5] (These are distributions that are considered to be a nontaxable return of capital, including those applied against the Accumulated Adjustments Account (AAA) and previously taxed income (PTI) [to the extent of basis].)

5. Decrease basis by the stockholder's share of passthrough items:

   a. Nonseparately stated loss.[6] (This is the bottom line loss from trade or business activities shown on page 1 of Form 1120S.)

   b. Separately stated items of deduction or loss.[7] (This category includes the items that, if stated separately, could affect the tax liability of any shareholder. Some examples are net capital losses, charitable contributions, and expenses relating to tax-exempt income.)

   c. Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account.[8] (These are items that are neither deductible, nor capitalizable. They include nondeductible expenditures such as tax penalties and the 50 percent disallowed portion of meal and entertainment expenses.)

   d. The amount of the shareholder's deduction for depletion of oil and gas property to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to the shareholder under Sec. 613A(c)(11)(B).[9]

   e. Changes in asset basis due to certain business tax credit.

   f. Certain income in respect of a decedent.

Stock basis is also reduced when the shareholder sells, makes gifts, or otherwise disposes of S corporation stock.

LIFO recapture payments made by the S corporation do not reduce either basis or the Accumulated Adjustments Account (AAA).[10] The LIFO payments do, however, reduce accumulated earnings and profits (AE&P).[11]

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[4] Sec. 1367(a)(1)(A).
[5] Sec. 1367(a)(2)(A).
[6] Sec. 1367(a)(2)(C).
[7] Sec. 1367(a)(2)(B).
[8] Sec. 1367(a)(2)(D).
[9] Sec. 1367(a)(2)(E).

Example 7-1

On January 1, Pete buys stock in a calendar year S corporation for $10,000. Pete's distributive share of the corporation's nonseparately stated income is $28,000 and his share of long-term capital gain is $7,000. The corporation also passes through a Section 1231 loss on the sale of business assets of $12,000. The corporation distributes $2,500 to Pete during the year. The corporation has been in S status since its incorporation date. Losses and deductions on Pete's personal income return are not limited by the passive loss, at-risk, or other rules.

Pete's stock basis is calculated as follows:

	Basis in Stock
Original basis	$10,000
Add income items:	
Nonseparately stated income	28,000
Long-term capital gain	7,000
Basis, before distributions and loss items	45,000
Distribution	(2,500)
Basis, before loss items	42,500
Subtract loss items:	
Section 1231 loss	(12,000)
Basis, end of year	$30,500

The distribution reduces basis and is a nontaxable return of capital. Pete has sufficient basis to cover the Section 1231 loss, so the $12,000 is deductible on Pete's personal tax return.

Example 7-2

Assume the same facts as in Example 7-1, except the Section 1231 loss is $46,000 instead of $12,000. Now, Pete's stock basis is calculated as follows:

	Basis in Stock
Original basis	$10,000
Add income items:	
Nonseparately stated income	28,000
Long-term capital gain	7,000
Basis, before distributions and loss items	45,000
Distribution	(2,500)
Basis, before loss items	42,500
Subtract loss items:	
Section 1231 loss (to extent of remaining basis)	(42,500)
Basis, end of year	$None

[10] Secs. 1363(d)(5) and 1368(e)(1)(A).
[11] Sec. 1363(d)(5).

Pete can deduct the Section 1231 loss to the extent he has basis, $42,500. The remaining $3,500 ($46,000 - $42,500) carries over to future years and can be used when Pete has either stock or debt basis. As discussed throughout this chapter, stock basis can be increased by passthrough income, by purchasing stock, or by making contributions to the corporation. Debt basis can be increased by making loans directly from the shareholder to the S corporation. Furthermore, previously-reduced debt basis can be restored by passthrough income when the S corporation has a *net increase*. (As discussed later, a net increase is the excess of passthrough income and gains over losses, deductions, and nondividend distributions for the year.)

Basis Cannot Be below Zero

The basis of S corporation stock can never be below zero.[12]

Changes to Asset Basis Due to Business Credit and Recapture Can Affect Stock Basis

If the basis of a corporate asset is reduced because the corporation is taking the business credit, each shareholder's basis in the S corporation is reduced by the stockholder's share of the reduction. Also, when recapture of the business credit that was taken by the S corporation causes an increase in an asset's basis, each shareholder's basis in the corporation is likewise increased.[13] The AAA is increased or decreased in the same amount as basis when these adjustments are made.

Income in Respect of a Decedent and Basis of Inherited Stock

Income in respect of a decedent (IRD) is made up of income amounts a decedent was entitled to that were not includable in taxable income under the method of accounting used by the decedent for the year of death.[14] The IRD is included in assets on the decedent's estate tax return and is also included in the income of the beneficiary when it is received. In the S corporation context, IRD includes the decedent's share of interest, dividends, and accounts receivable due to a cash basis S corporation.

The income that represents IRD is passed through by the S corporation to the beneficiary that acquires the shares. The beneficiary is allowed to deduct the federal estate tax attributable to the IRD.[15] The deduction is taken on the beneficiary's Schedule A as a miscellaneous itemized deduction, not subject to the 2 percent of AGI limitation.[16]

The IRD passed through by the S corporation to the shareholder increases the shareholder's basis and AAA. Stock inherited by the shareholder is generally "stepped up" to the stock's fair market value at the date of death, or the alternate valuation date, if elected.[17] (For 2010, a modified

[12] Sec. 1367(a)(2).
[13] Sec. 50(c)(5).
[14] Reg. Sec. 1.691(a)-1(b).
[15] Sec. 691(c).
[16] Sec. 67(b)(7).
[17] Sec. 1014.

carryover basis rule, rather than a basis step-up rule, may apply.) To avoid stock basis being increased twice (once by the passthrough of IRD and once by the estate asset step-up), the shareholder must reduce the step-up in the stock's basis to the extent the stock's value is attributable to IRD.[18]

Basis of Stock Received by Gift

The basis of stock acquired by gift is generally the same as the stock's basis in the hands of the donor. However, if the stock's basis is more than its fair market value when the gift is made, the recipient shareholder's basis is the donor's basis for purposes of determining gains, but is the stock's fair market value for purposes of determining losses.[19] Also, the stock's fair market value at the date of the gift is used to determine basis for purposes of deducting current and carryover losses.[20]

This evidently means that you must make two calculations when making annual adjustments to basis—one calculation for purposes of gains that starts with the stock's basis at the date of the gift and another for purposes of losses starting with the stock's fair market value at the date of the gift. The same adjustments will normally be made to each calculation, but current and carryover losses will be limited if basis is reduced to zero under the calculation that began with the stock's fair market value. This loss limitation applies under the regulation, even if the calculation beginning with the donor's basis has a positive balance.

Items Must Be Reported

No increase in basis is allowed for passthrough income items unless the taxable items are reported on the shareholder's tax return.[21] This prevents a shareholder from reporting less than the stockholder's share of income and, when the statute of limitations for that year has expired, increasing stock basis for the amount that was properly reportable.

Basis Is Reduced by Nondeductible Losses

Basis is decreased by losses and deductions, even if the loss or deduction is disallowed or deferred under another Code provision, such as the passive activity rules or the at-risk rules.[22]

When Basis Is Adjusted

S CORPORATION'S YEAR END

Because basis must be adjusted for corporate income or loss, basis adjustments generally occur at the end of the S corporation's year.[23]

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[18] Sec. 1367(b)(4).
[19] Sec. 1015.
[20] Reg. Sec. 1.1366-2(a)(6).
[21] Sec. 1367(b)(1).
[22] *Fred E. Hudspeth v. Comm.*, (1990, CA9) 66 AFTR 2d 90-5582, 914 F2d 1207, 90-2 USTC 50501, *rev'g. & rem'g*. (1985) TC Memo 1985-628 PH TCM 85628, 51 CCH TCM 175.
[23] Reg. Sec. 1.1367-1(d)(1).

It is important to note that additions to basis are made at the end of the corporation's, rather than the shareholder's, tax year.

Example 7-3

Esscorp's fiscal year ends on September 30. John, the sole shareholder, has $20,000 basis on September 30, 2011, before considering the corporation's income or loss. The corporation reports a $25,000 loss for the year. John makes a $5,000 capital contribution on October 1, 2011. John can deduct only $20,000 of loss from Esscorp on his personal 2011 calendar-year return. The $5,000 capital contribution increases his basis for the corporate year ending September 30, 2012.

Assume now that John made the $5,000 capital contribution on September 30, 2011. His stock basis would increase on that date and he could deduct the full $25,000 loss on his 2011 calendar-year return.

WHEN ELECTION TO USE NORMAL TAX ACCOUNTING RULES IS MADE

An S corporation can elect to use normal tax accounting rules for passthrough purposes when

- A shareholder's entire interest in the S corporation is disposed of,[24] and
- Certain stock is disposed of, issued, or redeemed.[25]

If either of these elections is made, basis is adjusted as if the tax year consisted of separate tax years, with the first year ending on the date of the disposition.[26]

WHEN STOCK IS DISPOSED OF DURING THE YEAR

Basis adjustments to shares that are disposed of during the year are effective immediately prior to the stock disposition.[27]

Example 7-4

Martin has been the sole shareholder in MM, Inc., an S corporation, for five years. Martin's stock basis at January 1, the beginning of the current year, is $10,000. On July 15, he sells his shares for $15,000. Martin receives no distributions and the corporation passes through to Martin $4,000 of nonseparately stated trade or business income for the year.

Martin reports ordinary income from the S corporation of $4,000 and increases his stock basis to $14,000 ($10,000 + $4,000). He reports $1,000 ($15,000 - $14,000) of long-term capital gain on his current year's Form 1040, Schedule D.

[24] Sec. 1377(a)(2).
[25] Reg. Sec. 1.1368-1(g)(2).
[26] Reg. Sec. 1.1367-1(d)(1).
[27] Reg. Sec. 1.1367-1(d)(1).

Carryover of Losses

Any loss or deduction not allowable due to lack of basis is treated as incurred in the succeeding taxable year and carried over indefinitely by the shareholder as long as the S corporation election is in effect and the shareholder holds stock in the corporation.[28]

Losses are carried over, however, only "with respect to that shareholder."[29] Therefore, losses that could not be deducted because of basis limitations can carry over only as long as the shareholder owns stock in the S corporation.[30]

The carryover loss cannot be used by any other shareholder (except for a spouse or former spouse incident to a divorce), so the loss will disappear when *all* of the stockholder's shares are transferred to another party. This can occur, for example, when the shareholder's stock is sold, exchanged, or transferred because the shareholder dies.

The loss continues to carry over so long as the shareholder holds *some* of the corporation's stock. In other words, a partial disposition of the shareholder's stock will not cause a reduction in the amount of the loss carryover.

LOSSES CAN BE TRANSFERRED TO SPOUSE OR FORMER SPOUSE INCIDENT TO A DIVORCE

If stock is transferred to a spouse or former spouse incident to a divorce, carryover losses related to that stock transfer to the spouse or former spouse.[31]

Under the regulations, a loss generated in the year the stock transfer takes place (for example, 2011) is allocated based on the relative stock ownership for that year. Losses for years before the year of transfer (for example, 2010 and preceding years) are allocated based on stock ownership at the beginning of the year *following* the year the stock is transferred (for example, 2012).

Furthermore, the transferor shareholder who acquires basis during the year the stock is transferred can apply that basis to deduct all or a portion of *prior* year's losses before those losses are allocated to the transferee.

Example 7-5

Janet owns 100 shares of JKL, Inc., a calendar-year S corporation. Janet has $50,000 of losses that she has not been able to deduct because she has no stock basis. During July 2011, Janet transfers all of her S corporation shares to her ex-husband, John, as part of the divorce settlement. At the end of the year, the corporation passes through $5,000 of ordinary income to Janet and $5,000 of ordinary income to John. For the year the stock was transferred, 2011, the carryover losses are considered to belong to the transferor shareholder, Janet. Thus, Janet's basis increases $5,000 because of the passthrough income, and she can deduct $5,000 of the loss on her Form 1040. On January 1, 2012, the

[28] Sec. 1366(d)(2); Reg. Sec. 1.1366-2(a).
[29] Sec. 1366(d)(2).
[30] Reg. Sec. 1.1366-2(a)(5).
[31] Sec. 1366(d)(2)(B), Reg. Sec. 1.1366-2(a)(5).

remaining $45,000 loss carryover ($50,000 – $5,000) is treated as if it were the loss of the spouse who received the stock, John. Therefore, John can deduct the losses in 2012 and later years when he acquires basis by making capital contributions to the corporation, lending funds to the corporation, or reporting passthrough income from the corporation.

Note that the carryover loss from prior years is considered to be Janet's in the year the stock transfer takes place. If her basis increased sufficiently during that year, she could deduct all of the carryover loss. However, if she does not deduct the carryover loss in the year the stock is transferred, the loss transfers to John at the beginning of the following year.

If Janet transferred *all* of her shares to anyone other than a spouse or former spouse incident to a divorce, the carryover loss would expire and neither Janet nor the recipient of the stock would be able to deduct it in the current or future years.

If Janet transferred a *portion* of her shares to anyone other than a spouse or former spouse incident to a divorce, the carryover loss is not diminished by the stock transfer. That is, she would continue to carryover the entire loss until she could apply it against basis in her S corporation stock.

Reg. Sec. 1.1366-2(a)(5) provides examples illustrating how carryover losses are allocated when only a portion of the stockholder's shares are transferred to a spouse or former spouse incident to a divorce.

TREATMENT OF CARRYOVER LOSSES ON FORM 1040

S shareholders claiming passthrough losses in excess of passthrough income should attach a schedule to the Form 1040 calculating the shareholder's adjusted basis in stock and debt. (See the instructions to Form 1040, Schedule E.)

A carryover loss from an S corporation that becomes deductible because the shareholder has acquired basis is shown on a separate line of Schedule E. According to the Schedule E instructions, prior year amount (PYA) is entered on the separate line in column (a), *Name*, of Schedule E.

Basis in Debt

If the passthrough items affecting basis reduce the stock basis to zero, any remaining loss is applied to reduce (but again, not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.[32]

Example 7-6

ABC, Inc., incorporates on January 2 and simultaneously elects S status. Jack purchases all the stock for $10,000 and loans the corporation $21,000 on that day. At the end of the corporation's first tax year, the corporation's only passthrough item is a nonseparately stated loss of $35,000. Losses on Jack's personal income tax return are not limited by the passive loss or at-risk rules.

[32] Sec. 1367(b)(2)(A); Reg. Sec. 1.1367-2(b)(1).

Jack's basis in stock and debt is calculated as follows:

	Basis in Stock	Basis in Debt
Original basis	$10,000	$21,000
Passthrough income	0	–
Basis, before distributions and loss items	10,000	21,000
Distributions	0	–
Basis, before loss items	10,000	21,000
Loss items to extent of stock basis	(10,000)	
Loss items to extent of debt basis	–	(21,000)
Basis, end of year	$None	$None

Jack can deduct $31,000 ($10,000 + $21,000) of the $35,000 passthrough loss on his personal income tax return, Form 1040. The remaining $4,000 of loss carries forward to the following year to be used when Jack acquires stock or debt basis.

Distributions do not reduce debt basis.

> **Practice Tip:** Losses that reduce stock and debt basis are deductible by the shareholder, subject to limitations under the passive activity loss and at-risk rules. Losses that cannot be deducted because the shareholder lacks stock or debt basis carry forward until the shareholder's basis increases sufficiently to cover the loss. Basis is increased when the corporation passes through income or gain items to the shareholder, the shareholder makes capital contributions, or the shareholder loans funds directly to the corporation.

Basis Reduction Applies to Debt Outstanding at Year-end

Debt basis is generally reduced only to the extent of debt owed to the shareholder at the end of the corporation's taxable year. The reduction does not apply to debt that was satisfied, disposed of, or forgiven during the corporation's taxable year.[33]

Restoration of Basis in Debt

When the basis of indebtedness has been reduced below a shareholder's original basis in that debt, the shareholder's basis in stock generally will not be increased by passthrough income until the basis in *indebtedness* has been restored to the extent of reductions made to debt basis in tax years beginning after 1982.[34] Reductions made in tax years beginning before 1983 are not restored.

Debt basis that has been reduced by post-1982 losses is restored by a *net increase* in a subsequent taxable year. A *net increase* for this purpose is

- The excess of the sum of the shareholder's passthrough items of income for the year, over the sum of
    - The items of passthrough loss and deduction, and

[33] Reg. Sec. 1.1367-2(b).
[34] Sec. 1367(b)(2)(B); Reg. Sec. 1.1367-2(c).

- Distributions to the shareholder (if the distribution is not a dividend distribution of earnings and profits).

Example 7-7

On January 1, John buys stock in a calendar year S corporation for $10,000, and loans the corporation $20,000. John's distributive share of income items is $18,000 and his share of loss and deduction items is $26,000. The corporation distributes $31,000 to John during the year. The corporation has been in S status since its incorporation date. Losses and deductions on John's personal income tax return are not limited by the passive loss or at-risk rules.

John's basis in stock and debt is calculated as follows:

	Basis in Stock	Basis in Debt
Original basis	$10,000	$20,000
Passthrough income	18,000	–
Basis, before distributions and loss items	28,000	20,000
Distribution to extent of stock basis	(28,000)	–
Basis, before loss items	0	20,000
Loss items to extent of stock basis	0	
Loss items to extent of debt basis	–	(20,000)
Basis, end of year	$None	$None

Distributions do not reduce debt basis. The distribution is a nontaxable return of capital to the extent it reduced stock basis ($28,000) and is capital gain from the deemed sale of stock to the extent it exceeded stock basis ($3,000). John reports the $18,000 of passthrough income on his personal return, but his deduction of the loss items is limited to $20,000, the amount that the loss items reduced debt basis. The remaining $6,000 ($26,000 – $20,000) of loss carries forward as if it were incurred in the following year.

The next year, John's distributive share of income items is $49,000, and his share of loss and deduction items (including his $6,000 unused carryover loss) is $14,000. The corporation distributed $5,000 to him during the year. (John has experienced a net increase for the year of $30,000, that is, the difference between $49,000 [passthrough items of income] and $19,000 [passthrough items of loss and deduction, $14,000, and nontaxable distributions, $5,000].) John's basis in stock and debt is calculated as follows:

	Basis in Stock	Basis in Debt
Basis, beginning of year	$None	$None
Net increase of $30,000 is applied:		
(1) To basis in debt, up to amount of prior reduction		20,000
(2) To stock basis	10,000	–
Basis, end of year	$10,000	$20,000

John reports the $49,000 of passthrough income on his personal return, and the $14,000 loss is fully deductible against John's other income because the loss was,

in effect, netted against the income for the year. Likewise, because the distribution was offset against the income for the year, the $5,000 is a nontaxable return of capital.

Example 7-8

Assume the same facts as in Example 7-7, except that the corporation distributes $41,000 (instead of $5,000) to John during the second year. John now does not have a net increase for the year because the passthrough items of loss and deduction ($14,000) and distributions ($41,000) total $55,000 which is more than the passthrough items of income and gain ($49,000). Thus, no restoration of debt basis takes place. John's basis is computed as follows:

	Basis in Stock	**Basis in Debt**
Basis, beginning of year	$None	$None
Passthrough items of income	49,000	–
Basis, before distributions and loss items	49,000	None
Distributions	(41,000)	–
Basis, before loss items	8,000	None
Loss items applied against stock basis	(8,000)	
Loss items applied against debt basis	–	0
Basis, end of year	$None	$None

The distribution offsets stock basis and is a nontaxable return of capital to John. The $14,000 loss is deductible to the extent of stock basis, $8,000. The $6,000 ($14,000 – $8,000) unused portion of the loss carries over to the following year to be used when John has stock or debt basis.

DEBT BASIS INCREASES ARE APPLIED TO DEBT HELD ON FIRST DAY OF THE YEAR

Debt basis increases caused by passthrough income are applied only to debt basis held by the shareholder on the *first* day of the taxable year in which the net increase arises. Also, the debt basis is restored only to the extent of the outstanding balance on that day.[35] This means that debt basis is increased (up to the amount of the debt outstanding at the beginning of the year) even if the debt is paid off during the year.

Example 7-9

Donna owns all the stock of DD, Inc., a calendar year S corporation. Five years ago, she loaned the corporation $80,000 which is evidenced by a written note. On January 1 of the current year, her stock basis is zero and her debt basis has been reduced to $35,000 because of prior passthrough losses. On December 1 of the current year, DD pays her the full amount of the note, $80,000. No distributions were made to her during the year. At the end of the year, the corporation passes through nonseparately stated trade or business income of $30,000.

[35] Reg. Sec. 1.1367-2(c)(1).

There is a net increase (that is, passthrough income [$30,000] exceeds losses [none] deductions [none], and distributions [none]), so debt basis is increased. The nonseparately stated income increases Donna's debt basis (up to the amount it was reduced by passthrough losses, limited to the note balance at the beginning of the year). Her basis in stock and debt at year-end is calculated as follows:

	Basis in Stock	Basis in Debt
Basis, beginning of year	$None	$35,000
Nonseparately stated income		30,000
Balances, before loan repayments		65,000
Loan repayments (to extent of debt basis)		(65,000)
Balances, end of year	$None	$None

Donna reports the $30,000 of income on her Form 1040. The passthrough income increases Donna's debt basis to $65,000. She recognizes long-term capital gain of $15,000 ($80,000 - $65,000) on the debt repayment.

Practice Tip: As discussed earlier, debt basis is increased by passthrough items when the debt basis has previously been reduced by passthrough losses. Further, debt basis is reduced by passthrough losses and deductions when stock basis has been reduced to zero. It is important to note that such debt basis *increases* are based on debt basis held by the shareholder at the beginning of the taxable year, while such debt basis *decreases* are based on debt basis held at the end of the taxable year.

Separate Corporate Debts

If there are various separate corporate debts payable to the shareholder, the reduction in debt basis caused by passthrough losses reduces the basis of all such corporate debt. The passthrough loss is allocated to the debts in the ratio that each debt's adjusted basis bears to the adjusted basis of all the debts.[36]

Practice Tip: This requirement for proportionate debt basis reduction only arises if there is more than one debt to the shareholder, and there is debt basis remaining after the losses have been applied.

What Constitutes Basis in Debt

As we saw, basis is reduced by losses and deductions. Since basis cannot be reduced below zero, the deduction of losses is limited to the shareholder's remaining basis in stock and debt.

Without question, then, when the losses or deductions exceed the shareholder's basis in stock, determining the proper basis in debt becomes exceedingly important.

DEBT MUST BE TO SHAREHOLDER

An S corporation's shareholder has basis only in any indebtedness that the S corporation owes *directly to the shareholder*.[37]

[36] Reg. Sec. 1.1367-2(b).
[37] Sec. 1367(b)(2)(A).

This is differentiated from a partner, who is considered to have basis in any partnership indebtedness for which the partner may be held personally liable.

GUARANTEED LOANS

There are innumerable court decisions in which S corporation shareholders lost part or all of the allocated net operating loss because of a lack of basis. These decisions show that the borrowings of an S corporation generally provide no basis for the S corporation's shareholder even if the shareholder has guaranteed the loans. For example, in *Estate of Daniel Leavitt*,[38] the Tax Court held that a loan to the corporation was a loan and not a capital contribution, even though the bank would not have made the loan without the shareholder's guarantee. The court left no room for argument by stating that a shareholder's guarantee of a loan to an S corporation is not treated as a capital contribution to the corporation unless the shareholder suffers some economic outlay. The loan must come directly from the shareholder. The shareholder does not have basis in loans made by a third party to the S corporation, even if the loans are secured by the shareholder's own property.[39]

One taxpayer who did prevail, however, was *Selfe*.[40] In that case, a shareholder was found to have basis in a loan guaranteed by her. The Court said that an S corporation shareholder would be considered to have basis in a guaranteed loan if the facts showed that, in substance, the shareholder had borrowed the funds and advanced them to the corporation. The facts in *Selfe* fit a very narrow set of circumstances, and that case should not be used as a planning device, but may provide a defense in some circumstances.

The moral here is that shareholders, rather than the S corporation, must borrow from outside sources, if borrowing is necessary. The shareholders then either contribute the borrowed funds to the corporation or lend them to the corporation. It is essential that the transaction be properly documented. If the funds are loaned to the corporation, the note should show a maturity date, and a reasonable rate of interest should be paid.

PAYMENT ON GUARANTEED NOTE PROVIDES DEBT BASIS

The shareholder does acquire debt basis, however, if and when the shareholder personally makes a payment on the corporation's note under the guarantee.[41]

SUBSTITUTING SHAREHOLDER'S NOTE

If the bank or other unrelated creditor accepts the shareholder's note in discharge of the corporation's obligation to the creditor, the stockholder, in effect, steps into the S corporation's shoes (the doctrine of subrogation). In other words, the bank substitutes a note from the shareholder for the corporation's note. The bank releases the corporation from its obligation to repay its note. The shareholder then is responsible for the note to the unrelated creditor, and the S corporation becomes indebted to the shareholder. The debt thus acquired under the doctrine of

[38] 90 TC 206 (1988), *aff'd* 89-1 USTC 9332 (1989, CA4).
[39] *Estate of Alton Bean*, TC Memo 2000-355 (2000), *aff'd* 2001-2 USTC 50,669 (2001, CA8); *William H. Maloof.* TC Memo 2005-75 (2006), *aff'd* 2006-2 USTC 50,443 (2006, CA6).
[40] 778 F2d 769 (1985, CA11).
[41] Rev. Rul. 71-288, 1971-2 CB 319.

subrogation provides a basis against which the shareholder can apply the stockholder's share of the S corporation's losses.[42]

The note must be payable by the corporation to the shareholder only. The shareholder does not gain debt basis if the corporation's note payable to an unrelated creditor is replaced with a note showing the shareholder and S corporation as co-makers.[43]

DEBT BASIS ARISES ONLY IF SHAREHOLDER EXPERIENCES ECONOMIC OUTLAY

The shareholder acquires debt basis only if the shareholder experiences an actual economic outlay.[44] As we discussed above, substituting the shareholder's note for an unrelated creditor's note will generally provide the shareholder with debt basis because the shareholder has experienced economic outlay (that is, is responsible for payment of the debt to the bank or other unrelated creditor).

However, in the case of *William T. Ellis and Wilma O. Ellis*,[45] the Tax Court ruled that the shareholders did not have basis when the shareholders substituted their note for the corporation's note. Basis was denied because the shareholders experienced no economic outlay. (The court noted, however, that the note substitution occurred when the corporation was insolvent.) This decision makes note substitution a more worrisome course of action. It may be better for the shareholder to obtain a new loan, as discussed in the following paragraph.

PLEDGING STOCK AS COLLATERAL

Instead of transferring the note to the shareholder, the shareholder can borrow the money from the bank, loan the funds to the corporation, and have the corporation pay off its note to the bank. In Ltr. Rul. 8747013, the IRS states that this arrangement provides the shareholder with debt basis, even if the bank loan is secured by collateral owned by the corporation or by the shareholder's stock in the corporation. The following conditions must be met:

- The shareholder must be personally liable for the bank debt.
- The corporation must not be a guarantor or co-maker on the note.
- The interest on the loan to the shareholder must be at the bank's current rate.

Similar results were achieved in *Dennis Bolding*[46] and *Thomas Gleason*.[47]

> **Caution:** The corporation should make all payments on shareholder loans directly to the shareholder. If the shareholder has borrowed the funds, he or she can then make payments to the bank. Under no circumstances should the corporation make payments on *shareholder* loans to the bank or lender, other than the shareholder. If the corporation

[42] See Rev. Rul. 75-144, 1975-1 CB 277 and *Timothy J. Miller*, TC Memo 2006-125 (2006).
[43] *Richard J. Salem*, TC Memo 1998-63 (1998), *aff'd* 99-2 USTC 50,898 (1999, CA11).
[44] Rev. Rul. 81-187; 1981-2 CB 167; *Rafe Silverstein v. U.S.*, AFTR 2d 73-902, 349 F. Supp. 527, 73-1 USTC 9217 (DC La. 1972).
[45] 57 TCM 677, P-H Memo 89,280 (1989), *aff'd*. 937 F.2d 602 (1991, CA4).
[46] 80 AFTR 2d 97-5481 5th Cir. (1997).
[47] TC Memo 2006-191 (2006).

does make payments directly to the bank, the IRS might argue that the shareholder has not experienced a true economic outlay.

LOAN FROM RELATED ENTITY GENERALLY DOES NOT RESULT IN DEBT BASIS

Rather than making direct loans to their S corporations, many shareholders have relied on loans to provide debt basis when the loans were from another entity that is owned or controlled by the shareholder. Such related entities might include a brother-sister corporation, an estate, a trust, or a partnership. In the litigated cases, the shareholder seldom wins on this issue, because of the rule that debt basis arises only if the debt is owed by the corporation directly to the shareholder.[48] In the case of *Bergman*, the Eighth Circuit even ruled that shareholders who remitted a check directly to their wholly owned S corporation did not have debt basis in the loan. The shareholders exchanged a series of checks between themselves and three S corporations they controlled. The court ruled that the exchanges resulted in the shareholders lending the S corporation funds they had borrowed from the other S corporations. The entire transaction, according to the court, prevented the shareholders from suffering any economic outlay that left the shareholders poorer in a material sense. Thus, the shareholders did not have basis in the debt.[49]

The Third Circuit, however, allowed debt basis to a shareholder when loans were made from one controlled corporation to his S corporation. The court treated the loans as if they were personal loans to the shareholder from the controlled corporation, followed by personal loans to the S corporation. The corporation's records reflected the fact that the advances by the controlled corporation to the S corporation were made on the shareholder's behalf, with the intention that the shareholder would be the creditor.[50]

> **Practice Tip:** Under the Code, an S shareholder has debt basis only if the debt is owed by the corporation directly to the shareholder. The decisions in *Culnen* and *Yates* seems to stretch this rule by deeming that certain loans run directly to the shareholder, even if the check is written by a related corporation. The author strongly recommends that shareholders *always* write loan checks directly to the S corporation. The shareholder will unarguably have debt basis if the check is written to the corporation by the shareholder, and the shareholder has an economic outlay by being the entity that will suffer the loss if the corporation does not repay the loan.

Collections on Shareholder Loans

What happens if a shareholder has reduced basis in a receivable from the corporation, and then collects on that receivable?

Collections in excess of basis are, of course, gains. But is the gain capital or ordinary?

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[48] Sec. 1366(d)(1)(B).

[49] See *Larry and Patricia Bergman v. U.S.*, 83 AFTR 2d 99-1882, 174 F.3d 1324, 99-2 USTC 50,475 (1999, CA8). See also *F. Howard Hitchins*, 103 TC 711 (1994); *Bill L. Spencer v. Comm.*, 84 AFTR 2d 99-6040, 194 F.3d 1324, 99-2 USTC 50,830 (1999, CA11); *Jerry L. Thomas*, 92 AFTR 2d 2003-5292 (2003, CA11); *Donald G. Oren v. Comm.*, 93 AFTR 2d 2004-858, 357 F.3d 854, 2004-1 USTC 50,165 (2004, CA8); *Donald L. Russell*, 106 AFTR 2d 2010-5243 (2010, CA8).

[50] *Daniel J. Culnen*, TC Memo 2000-139 (2000), *rev'd* and *rem'd* 89 AFTR 2d 2002-383, 2001 USTC 50,200 (3rd Cir. 2002). The Tax Court reached a similar result in *Charles E. Yates*, TC Memo 2001-280 (2001).

Well, it depends. If the debt is an open account, the gain is ordinary because a collection on that type of indebtedness is not considered to be a sale or exchange.

Collection of a corporate note, however, is deemed to be a sale or exchange, so, if the note is a capital asset to the shareholder, the gain is a capital gain.[51] The capital gain is long-term if the shareholder held the note for more than one year.

Notes should be drawn up when a shareholder lends money to an S corporation. A loan is safe harbor debt if it is evidenced by a note, and, as such, it can prevent loss of the S election because of the second class of stock rule.

If loan basis has been reduced, but not to zero, a partial payment to the shareholder on the loan cannot be applied solely to the basis portion. Rather, the payment must be allocated proportionately to represent (a) return of basis, and (b) taxable income to the shareholder.[52]

Example 7-10

Kathy owns all the stock of KK, Inc., a calendar year S corporation. Five years ago, she loaned the corporation $80,000 which is evidenced by a written note. On January 1 of the current year, her stock basis is zero and her debt basis has been reduced to $35,000 because of prior passthrough losses. The corporation has no accumulated earnings and profits (AE&P). On December 1 of the current year, KK pays her one-half of the note's balance, $40,000. For the year, the corporation passes through nonseparately stated income of $10,000. Distributions of $14,000 were made to Kathy during the year. Because the distributions exceed the passthrough income, there is no *net increase* during the year (that is, losses [none], deductions [none], and distributions [$14,000] exceeded passthrough income ($10,000]), so debt basis is not increased by the passthrough income.

Kathy recognizes long-term capital gain on the partial debt repayment based on the following formula:

$$\frac{\text{Face amount of note before repayment-basis of note}}{\text{Face amount of note before repayment}} \times \text{Repayment Amount} = \text{Capital Gain}$$

Her capital gain, then, is $22,500, calculated like this:

$$\frac{\$80{,}000-\$35{,}000}{\$80{,}000} \times \$40{,}000 = \$22{,}500$$

The $40,000 repayment received by Kathy is made up of:

Capital gain	$22,500
Nontaxable return of basis	17,500
Total repayment	$40,000

Kathy's basis in stock and debt at year-end is calculated as follows:

	Basis in Stock	Basis in Debt
Basis, beginning of year	$None	$35,000

[51] Sec. 1271(a)(1).
[52] Rev. Rul. 64-162, 1964-1 CB 304, Rev. Rul. 68-537, 1968-2 CB 372.

Nonseparately stated income	10,000	
Balances, before distributions and loan repayments	10,000	35,000
Distributions, to extent of basis	(10,000)	
Basis portion of loan repayment		(17,500)
Balances, end of year	$None	$17,500

Kathy reports the $10,000 of income on her Form 1040. The $14,000 distribution received by Kathy is nontaxable to the extent of her stock basis ($10,000) and the remainder ($4,000) is long-term capital gain.

Shareholder Advances and Open Account Debt

As discussed earlier, the basis of each separate indebtedness (including open account debt) is reduced by corporate passthrough losses in an amount that is proportionate to the adjusted basis of all corporate debts to shareholders. Furthermore, gain results when the loan's basis has been reduced by passthrough losses and the corporation repays all or part of the loan, as discussed above.

Many S corporations maintain "open accounts" to keep track of advances that the shareholders make to the corporation and repayments by the corporation of those advances. Usually, such open account advances are not evidenced by written notes.

Before October 20, 2008, shareholder advances and open account debt not evidenced by separate written notes were treated as a single indebtedness under Reg. Sec. 1.1367-2(a). This meant that open account loans made by shareholders could be netted with losses allocated to the debt and with repayments made to shareholders during the year. This netting process allowed the shareholder to avoid recognition of gain on repayment of reduced basis debt by advancing more funds near the end of the year.[53] If the advances and open accounts were treated as separate debts (rather than being considered a single indebtedness), gain could result from repayments.

Not surprisingly, the IRS did not like the decision in *Brooks*, and regulations have been issued that effectively reverse that decision.

$25,000 THRESHOLD APPLIES TO OPEN ACCOUNT DEBT

The regulations provide that open account debt owed to a shareholder is treated as a single indebtedness if the outstanding open account balance due to that shareholder is $25,000 or less at the end of the S corporation's tax year.[54]

If a shareholder's open account balance due to the shareholder is $25,000 or less at the end of the corporation's tax year, the account continues to be treated as open account debt. This treatment allows advances and repayments during the year to be netted against each other.

If, however, the balance of a shareholder's open account is more than $25,000 at the end of the corporation's year, the character of the debt changes. Beginning with the next tax year, the principal amount of the open account debt is treated as if it were indebtedness evidenced by a

[53] *Fleming G. Brooks*, TC Memo 2005-204 (2005).
[54] Reg. Sec. 1.1367-2(a).

separate written instrument, and is no longer considered to be open account debt. Treating the debt as if it were evidenced by a separate written instrument means that advances and repayments on that loan cannot be netted. Repayments on the debt reduce both the shareholder's basis in the loan and the loan's face value. A new advance that is not evidenced by a written note is considered to be new open account debt that will continue to be treated as an open account, subject to a new $25,000 limit.

> **Practice Tip:** If a shareholder's open account balance does not exceed $25,000 at the beginning of the corporation's tax year, the regulations allow advances to the account and corporate repayments to be netted. For example, if the open account balance is $24,000 at January 1, 2011, but is, say, $35,000 at the end of the year, the debt is still considered to be open account debt for 2011. But on January 1, 2012, the $35,000 is not considered to be open account debt.

The $25,000 threshold applies to each shareholder separately.

DISPOSITION OF SHAREHOLDER'S STOCK DURING YEAR

If a shareholder with open account debt disposes of his or her S corporation shares before the end of the corporation's tax year, the adjustments to the stockholder's debt basis must be made immediately before the termination of the shareholder's interest in the S corporation.[55]

$25,000 THRESHOLD APPLIES TO EACH SHAREHOLDER

The $25,000 open account debt threshold applies to each shareholder separately, as illustrated in the following example, which was adapted from Reg. Sec. 1.1367-2(e), Example 6.

Example 7-11

A/B Inc. is a calendar-year S corporation. Alicia and Barbara have each owned one-half of A/B's stock for the last several years. On January 1, 2011, Alicia and Barbara both have stock bases of zero, and there are no loans due to the shareholders. During the year, Alicia advances A/B $16,000, which is not evidenced by a written instrument. On August 1, Barbara advances A/B $22,000, which is not evidenced by a written instrument. Both the $16,000 advance and the $22,000 advance are open account debt and remain outstanding at those amounts during the year.

At December 31, neither open account debt exceeds $25,000. Therefore, both Alicia's $16,000 and Barbara's $22,000 of open account debt carry over as open account debt to the following year.

GAIN CAN APPLY WHEN REDUCED BASIS OPEN ACCOUNT DEBT IS REPAID

If passthrough losses reduce the basis of debt owed to the shareholder, and all or a portion of that debt is repaid by the corporation, the shareholder can be subject to gain on the repayment, as discussed earlier. The determination of whether there has been a repayment of open account debt is made by netting (a) the advances made by the shareholder, and (b) the corporation's

[55] Reg. Sec. 1.1367-2(d)(2).

repayments during the tax year. This is illustrated in the following example, which is adapted from Reg. Sec. 1.1367-2(e), Example 7.

Example 7-12

Assume the same facts as in the preceding example, except that A/B passes through an $8,000 loss to each shareholder on December 31, 2011. The loss reduces Alicia's $16,000 basis in the open account debt to $8,000 ($16,000 – $8,000), and reduces Barbara's basis in open account debt to $14,000 ($22,000 – $8,000).

On April 1, 2012, A/B repays Alicia $4,000 of the open account indebtedness. On September 1, Alicia advances A/B an additional $1,000, which is not evidenced by a written instrument.

The balance in Alicia's open account debt is $16,000 at the beginning of the year and $13,000 at the end of the year ($16,000 – $4,000 + $1,000). The $4,000 April repayment and the $1,000 September advance are netted to result in a net repayment of $3,000 for the tax year.

Alicia recognizes $1,500 of gain on the $3,000 partial debt repayment. The gain is ordinary because the open account debt is not evidenced by written notes. The gain is calculated by using the following formula:

$$\frac{\text{Face amount of loan before repayment-basis of loan}}{\text{Face amount of loan before repayment}} \times \text{Repayment amount} = \text{Gain}$$

Her $1,500 gain is calculated as shown below. (Evidently, the open account balance at the beginning of the year is considered to be the face amount of the loan when making the calculation.)

$$\frac{\$16{,}000-\$8{,}000}{\$16{,}000} \times \$3{,}000 = \$1{,}500$$

The net repayment of $3,000 on Alicia's $16,000 open account debt leaves Alicia with an open account debt at the end of the year of $13,000 ($16,000 – $3,000), which will carry forward as open account debt to the following year.

Practice Tip: If Alicia had made additional advances of $3,000 during the year, there would be no net repayment after netting the advances ($1,000 + $3,000) and repayments ($4,000). Then, Alicia would not recognize any gain because there would be no net loan repayment during the year. Also, there would be no gain if the corporation had net income, rather than a loss, for the year. If the corporation could have passed through at least $8,000 of income to Alicia, her debt basis would have increased by that amount, which would bring the debt up to its original basis, $16,000, and eliminate any potential gain.

TREATMENT WHEN OPEN ACCOUNT BALANCE EXCEEDS $25,000 AT END OF YEAR

When the shareholder's open account balance is $25,000 or less at the beginning of the corporation's tax year, but exceeds $25,000 at the end of the tax year, the debt is *not* considered to be open account debt as of the beginning of the next tax year. This is illustrated in the following example, which was adapted from Reg. Sec. 1.1367-2(e), Example 8.

Example 7-13

Alicia has open account debt of $13,000 on January 1, 2013. (This is a continuation of the facts in the preceding example.) Also assume that A/B repays $5,000 of the open account debt on February 1, and on March 1, Alicia advances A/B $20,000, which is not evidenced by a written instrument.

The advances and repayments are netted during the year to result in an open account balance of $28,000 ($13,000 + $20,000 – $5,000) at the end of the year. Beginning with the 2014 tax year, the $28,000 indebtedness will not be considered open account debt. Rather, it will be treated in the same manner as indebtedness evidenced by a separate written instrument for debt basis purposes, beginning with the 2014 tax year.

On January 1, 2014, Alicia is considered to have (a) no open account debt, and (b) debt of $28,000 evidenced by a written instrument. If she makes advances to A/B that are not evidenced by written notes, the advances, and repayments on those advances, will be considered open account debt, subject to the $25,000 limitation at the end of the year.

EFFECTIVE DATE

The open account regulations apply to any shareholder advances to the S corporation made on or after October 20, 2008, and repayments on those advances by the S corporation.[56]

Open account debt outstanding as of the effective date is not subject to the $25,000 threshold because the regulations apply only to shareholder advances after the effective date and to repayments on those advances. The *prior* final regulations apply to any repayments on open account debt outstanding on the effective date. Advances made after October 19, 2008, however, are considered to be new open account debt.

Charitable Contributions of Appreciated Property

Charitable contributions made by an S corporation pass through to shareholders as a separately stated item on Schedule K-1.

Charitable Contributions of Appreciated Property before 2012

The amount that an S corporation passes through to shareholders for contributions of ordinary income property is normally limited to the corporation's adjusted basis in the contributed property, rather than its fair market value (FMV).[57]

Alternatively, when an S corporation makes a charitable contribution of appreciated long-term capital gain property (that is, the contributed property's FMV exceeds its basis), the deduction passed through to each shareholder is his or her *pro rata* share of the property's FMV on the date of the contribution.[58] Each shareholder, however, reduces his or her basis by the shareholder's

[56] Reg. Sec. 1.1367-3.
[57] Sec. 170(e)(1)(A).
[58] See Reg. Sec. 1.170A-1(c) and Sec. 170(e).

pro rata portion of the contributed property's *adjusted basis*, rather than its FMV.[59] The corporation's AAA is also reduced by the amount of the property's basis.

This rule is effective for contributions made in tax years beginning after December 31, 2005, and prior to January 1, 2012 (unless it is extended by Congress).

> **Practice Tip:** This provision is favorable because shareholder basis and the AAA are being reduced by the contributed property's basis, which is less than its fair market value. This lesser reduction means that a larger basis and AAA balance remain after the adjustment than would have been true had the adjustment been based on the property's fair market value.

Example 7-14

Frank owns 100 percent of the shares of ABC, Inc., a calendar year S corporation. Frank has basis of $16,000 in his stock on January 1, 2010. ABC's AAA balance on that date is $14,000.

ABC has held land for investment for the last five years. ABC contributes the land to charity August 1, 2010, when the land has an adjusted basis of $110,000 and a fair market value of $150,000. For the 2010 tax year, ABC passes through nonseparately stated (ordinary) income of $105,000. Frank received no distributions during the year.

ABC also passes through to Frank a charitable contribution deduction of $150,000. Frank reduces his basis by $110,000, the amount of the contributed property's adjusted basis.

Frank's stock basis at the end of the year is $11,000, as shown below.

Basis, beginning of year	$16,000
Passthrough income	105,000
Basis, before considering charitable contributions	121,000
Charitable contributions (property's adjusted basis)	(110,000)
Basis, end of year	$11,000

Frank has a positive stock basis after considering the contribution, so he can deduct the full FMV of $150,000 on his Form 1040, Schedule A, subject to the AGI limitations that apply to charitable contributions.

The corporation reduces its AAA by $110,000. ABC's AAA balance at the end of the year is $9,000, as calculated below,

AAA balance, beginning of year	$14,000
Passthrough income	105,000
Charitable contributions (property's adjusted basis)	(110,000)
AAA balance, end of year	$9,000

[59] Sec. 1367(a)(2).

Deduction for Charitable Contribution of Appreciated Property May Exceed Shareholder's Basis under Certain Circumstances

Sec. 1366(d)(4) and Rev. Rul. 2008-16 (2008-11 IRB 585) spell out rules relating to an S shareholder's allowable deduction for charitable contributions of appreciated long-term capital gain property made in tax years beginning after 2005 and before 2012. Normally, a shareholder cannot deduct losses or deductions that exceed his or her stock and debt basis. However, under the charitable contribution provisions, the shareholder basis limitation rules *do not apply* to the amount of deductible appreciation in the contributed property.

This means that the shareholder's *pro rata* share of the property's fair market value in excess of its adjusted basis is deductible by the shareholder, even if the shareholder has no stock or debt basis.

The rules accomplish this by setting a limit on the amount that can be deducted for a charitable contribution of appreciated long-term capital gain property equal to the sum of (a) the shareholder's basis in the S corporation, *plus* (b) the difference between the contributed property's FMV and its adjusted basis.

Example 7-15

Assume the same facts as in the preceding example. The shareholder basis limitation rules do not apply to the extent of the $40,000 excess of the property's FMV ($150,000) over its adjusted basis ($110,000).

Technically, Frank's deduction is limited under Sec. 1366(d)(4) to (a) his $121,000 stock basis before considering contributions plus (b) $40,000, the excess of the property's FMV over its adjusted basis. Under this provision, Frank's deduction is limited to $161,000 ($40,000 + $121,000). Thus, he is entitled to deduct the full $150,000 contribution on his Form 1040, Schedule A (subject to the AGI limitations on charitable contributions).

What happens, though, if Frank's basis is *less* than the contributed property's adjusted basis? Assume now that Frank's stock basis before considering contributions was not $121,000, but was instead $90,000. His contribution deduction is limited to (a) his $90,000 stock basis, plus (b) $40,000, the excess of the property's FMV over its adjusted basis. Therefore, Frank deducts $130,000 ($90,000 + $40,000). The $20,000 ($150,000 – $130,000) of the charitable contribution that cannot be deducted in the current year carries over to be deducted when Frank acquires basis in future years.

Frank's basis in stock at the end of 2010 is zero, as calculated below.

Basis, before contributions	$90,000
Contribution (property's adjusted basis, to extent of stock basis)	(90,000)
Basis, end of year	$ 0

We can go a step further and ask this question: What happens if Frank's basis is zero before considering the contribution? In that event, his contribution deduction is limited to (a) his stock basis of zero, plus (b) $40,000, the excess of the

property's FMV over its adjusted basis. Thus, Frank can still deduct $40,000 of the contribution. The $110,000 ($150,000 – $40,000) that is not deductible in the current year carries over to be deducted when Frank acquires basis in future years. This paragraph illustrates that the amount by which the contributed property has appreciated (in this case $40,000) can be deducted regardless of the shareholders' bases.

Caution: If an S shareholder has charitable contributions of appreciated property and other deductions that, in total, exceed the shareholder's stock basis, the shareholder must allocate the deductions and contribution amounts as provided in Rev. Rul. 2008-16.

Charitable Contributions of Appreciated Property after 2011

The current law is scheduled to expire at the end of the 2011 tax year. Beginning in 2012, if the corporation contributes appreciated property to charity, each shareholder's *pro rata* share of the property's *fair market value* (rather than its basis) evidently will reduce the shareholder's stock or debt basis.[60] The AAA will also be reduced by the amount of the property's fair market value.

Note that reducing the S corporation shareholder's basis by the amount of the contributed property's fair market value will differ from the treatment afforded to partnerships. A partner's basis is reduced by the appreciated property's basis, not fair market value.[61] Hopefully, Congress will extend the more favorable rules for S corporations beyond 2011.

Stock Dispositions

Stock basis is adjusted by passthrough income and losses, even if the stock has been sold during the year.

The basis adjustments are made as of the close of the year for stock held at year end.

If the stock was sold before the end of the year, the adjustments are made immediately prior to the stock disposition.[62]

An S corporation can elect to use normal tax accounting rules for passthrough purposes when (1) a shareholder's entire interest in the S corporation is disposed of[63]; and (2) certain stock is disposed of, issued, or redeemed.[64] If either of these elections is made, basis is adjusted as if the tax year consisted of separate tax years, with the first year ending on the date of the disposition.[65]

[60] See Sec. 1367(a)(2) and *Joint Committee on Taxation, Technical Explanation of H.R. 4, The Pension Protection Act of 2006*, page 271.
[61] See Rev. Rul. 96-11, 1996-1 CB 140.
[62] Reg. Sec. 1.1367-1(d)(1).
[63] Sec. 1377(a)(2).
[64] Reg. Sec. 1.1368-1(g)(2).
[65] Reg. Sec. 1.1367-1(d)(1).

Reduction of Basis of Individual Shares

The basis of each share is reduced by the shareholder's portion of losses and deductions attributable to each share. Therefore, the calculation of each share's basis depends upon the number of shares and the number of days each share was held during the year.[66]

If the same number of shares is held all year, the computation is relatively simple.

Example 7-16

Jane has 100 shares of S Inc., which she held all year. Her basis in the shares (before applying the loss) is $500 each, for a total of $50,000. For the calendar year, her share of the passthrough loss is $15,000.

The loss reduces basis of each share by $150, ($15,000 loss ÷ 100 shares) so after applying the loss, Jane has 100 shares with a basis of $350 each, for a total of $35,000.

DIFFERENT LOTS OF SHARES

The calculation of each share's basis gets complicated if the number of shares changes during the year. If any share's *pro rata* passthrough of losses and deductions exceeds the basis of that share, the excess reduces the basis of all other shares held by the same shareholder *in proportion to the basis of the remaining shares*, after reducing the shares' basis for their portion of the loss and deductions.

Example 7-17

Joan owns four shares of S Inc. stock. At the end of the taxable calendar year, S Inc. notifies Joan (on Schedule K-1) that her share of the corporate loss is $2,000. Joan's basis in the shares is shown below. Share #3 was sold during the year, and share #4 was acquired during the year.

Each share's basis is determined as follows:

	Share				Total
	#1	#2	#3	#4	
Days shares were held	365	365	182	92	1,004
Basis of shares—beginning of year	$500	$800	$400	$900	$2,600
Loss allocation:					
Shares 1 & 2 $\left(\frac{365}{1004}\times\$2{,}000\right)$	(727)	(727)			
Share 3 $\left(\frac{182}{1004}\times\$2{,}000\right)$			(363)		
Share 4 $\left(\frac{92}{1004}\times\$2{,}000\right)$				(183)	(2,000)
Basis minus loss	(227)	73	37	717	600
Reallocate sub-zero basis to:					
Share 2 $\left(\frac{73}{73+37+717}\times\$227\right)$		(20)			

[66] Reg. Sec. 1.1367-1(c)(3).

Share 3 $\left(\frac{73}{73+37+717}\times\$227\right)$			(10)		
Share 4 $\left(\frac{73}{73+37+717}\times\$227\right)$				(197)	
	227				0
Basis after loss allocation	$0	$53	$27	$520	$600

Notice that Joan can deduct the loss attributable to share #3, even though it was sold during the year. Her basis for determining gain from the sale of that share is $27.

Identity of Passthrough Losses

Losses That Exceed Basis

It may be that a combination of losses and deductions exceed a shareholder's basis. In that case, a question arises of how the items of loss or deduction pass through.

Example 7-18

Jack, an S corporation shareholder, can deduct only $1,000 of loss due to basis limitations, and the S corporation passes through $3,000 ordinary loss, $2,000 capital loss and $500 charitable contributions. The loss and deduction items add up to $5,500. What is the nature of the shareholder's $1,000 deductible loss?

Under the regulations, the shareholder takes a part of each deduction using an allocation formula.[67] So, Jack would deduct the following:

Ordinary loss $\left(\frac{\$3,000}{\$5,500}\times\$1,000\right)$	$545
Capital loss $\left(\frac{\$2,000}{\$5,500}\times\$1,000\right)$	364
Charitable contribution $\left(\frac{\$500}{\$5,500}\times\$1,000\right)$	91
Total	$1,000

The portions that could not be deducted this year would retain their character and would be carried forward until there was basis to absorb them.

In this example, there are no passthrough items of nondeductible noncapitalizable expenses. If there were, the shareholder might want to make the election covered in the following discussion.

Order of Adjustments to Basis

Under Reg. Sec. 1.1367-1(e) basis adjustments, other than distributions, are made in the following order:

1. Increases for income items and the excess of the deductions for depletion,

[67] Reg. Sec. 1.1366-2(a)(4).

2. Decreases for nondeductible, noncapital expenses and certain oil and gas depletion deductions, and

3. Decreases for items of loss or deduction.

This means that nondeductible, noncapital expenses will reduce basis before other items of loss or deduction are considered. Normally, it makes no difference whether basis is affected first by nondeductible or deductible items. But it does make a difference when there is insufficient basis to absorb both the nondeductible and deductible expenses.

Example 7-19

Marvin is the sole shareholder in MNO, Inc., an S corporation. Marvin's basis at the beginning of the year is $9,000. At the end of its taxable year, the corporation passes through an ordinary loss of $10,000 and nondeductible meals and entertainment expense of $3,000.

The $3,000 of nondeductible expenses reduces basis first. This leaves Marvin with $6,000 ($9,000 – $3,000) of basis. Marvin can deduct $6,000 of the ordinary loss and the remaining $4,000 of ordinary loss is carried forward to the following year.

ELECTION TO FIRST REDUCE BASIS BY ITEMS OF LOSS OR DEDUCTION

The regulations allow the taxpayer to elect to reduce basis by items of loss or deduction before nondeductible, noncapital expenses and certain oil and gas depletion deductions.[68] In the election statement, the taxpayer agrees to carry over to the succeeding tax year the nondeductible, noncapital expenses and certain oil and gas depletion deductions that are not used to reduce basis. The statement is attached to a timely filed original or amended return and, once made, cannot be changed without permission from the Commissioner.

Example 7-20

Assume the same facts as in Example 7-19, except that Marvin makes the election to first reduce basis by items of loss and deduction. Marvin reduces his basis by $9,000 of the ordinary loss first, and that amount is deductible on his personal return. The remaining $1,000 of ordinary loss carries over to the following year. Marvin has no remaining basis, so the $3,000 of nondeductible expenses also carries over. In the following year, Marvin will first reduce basis by items of loss and deduction (including the $1,000 carryover) before reducing basis by nondeductible, noncapitalizable expenses (including the $3,000 carryover) and certain oil and gas depletion deductions.

As stated earlier, if the election to reduce basis by items of loss or deduction before nondeductible expenses is made, the S corporation must agree to carry over to future years nondeductible expenses that do not reduce basis. Because this agreement is required, some tax analysts believe that the nondeductible expenses in excess of basis do *not* carry over unless the election is made. That is, if the election is not made, the nondeductible expenses in excess of

[68] Reg. Sec. 1.1367-1(f).

basis do not carry over and will never reduce basis. Not making the election, however, means that each year's nondeductible expenses must reduce basis before other loss and deduction items can be deducted. This will cause the deductible items to be permanently lost if basis continues to be less than the nondeductible expenses. Therefore, in the author's opinion, it will normally be better to make the election.

> **Practice Tip:** It will normally be beneficial to make the election when two conditions are present: (1) the client has nondeductible, noncapitalizable expenses, and (2) there is insufficient basis to deduct all of the loss and deduction items, including the nondeductible expenses. The election allows the deductible items to reduce basis first in each year so that the taxpayer can deduct these, rather than having to reduce basis by nondeductible expenses for which the taxpayer receives no tax benefit. In effect, the election allows the taxpayer to benefit from current and prior years' deductible items to the extent of basis, before reducing basis by nondeductible expenses.

Election to Reduce Basis by Loss Items First Does Not Apply to the AAA

The accumulated adjustments account (AAA) is reduced by nondeductible, noncapital expenses each year. This is true regardless of whether the corporation makes the election to reduce basis by loss items first.[69]

Carryover after Termination of Election—The Post-Termination Transition Period

If a shareholder has unused S corporation losses or deductions, and the S corporation election is terminated, such losses or deductions will be treated as if they were incurred by the shareholder on the last day of the corporation's post-termination transition period, but the losses and deductions are allowed only to the extent they reduce the basis in stock (not loans) to zero. (Also, the losses may be subject to other limitations, such as the passive loss or at-risk rules.)

Any losses or deductions not so used are lost forever.[70]

Basis Increases during the Post-Termination Transition Period

Stock basis may be increased during the PTTP by making capital contributions or by purchasing additional shares in the S corporation.[71]

> **Practice Tip:** The PTTP provisions give the shareholder a chance to increase stock and at-risk basis after the S election terminates so that unused losses can be deducted. The shareholder must determine, however, whether it makes economic sense to contribute funds to the corporation in exchange for the loss deduction.

Definition of Post-Termination Transition Period

The *post-termination transition* period is the period that

[69] Reg. Sec. 1.1368-2(a)(3)(ii).
[70] Sec. 1366(d)(3); Reg. Sec. 1.1366-2(b).
[71] FSA 200207015.

- Begins on the day after the last day of the corporation's last taxable year as an S corporation, and
- Ends on the later of
  - The day which is one year after such last day, or the due date for filing the return for such last year as an S corporation, including extensions, whichever is later;
  - The end of the 120-day period beginning on the day of the determination that the S corporation's election had terminated for a previous taxable year; or
  - The end of the 120-day period beginning on the date of a determination under an IRS audit occurring after the termination of the S election, if an S corporation item of income, loss, or deduction is adjusted.[72]

Determination in the above context means

- A court decision which became final,
- A closing agreement, or
- An agreement between the corporation and the IRS that the corporation failed to qualify as an S corporation.

Worthless Stock

If S corporation stock becomes worthless, corporate passthrough items and adjustments to the stock's basis will be made before the stock's worthlessness is taken into account.[73]

Example 7-21

John acquired his stock a few years ago, and has a $6,000 basis in the shares at the beginning of the taxable calendar year. The corporation experiences a $5,000 loss, and goes bankrupt during the year.

The calculation of the deductible loss and stock basis is as follows:

Stock basis, before loss	$6,000
Deductible net operating loss	5,000
Stock basis	1,000
Loss due to stock becoming worthless	(1,000)
Stock basis	$ 0

Section 1244 Stock

Section 1244 allows an individual who incurs a loss due to the sale, exchange, or worthlessness of *Section 1244 stock* to deduct the loss as an ordinary (rather than capital) loss. If a gain on such sale or exchange is recognized, it is a capital gain. Since an ordinary loss is normally preferable

[72] Sec. 1377(b); Reg. Sec. 1.1377-2.
[73] Sec. 1367(b)(3).

to a capital loss, Section 1244 is a relief provision that is very favorable to the taxpayer. Section 1244 applies to dispositions and worthlessness of both C and S corporation stock.

The amount of the ordinary loss is limited to $50,000 on a separate return and $100,000 on a joint return.[74] The ordinary deduction is available only to an individual who is the original purchaser of the stock, and is not available to transferees of the shares.[75]

> **Practice Tip:** Section 1244 stock does not have to be issued when the entity originally becomes a corporation. The shareholder can acquire Section 1244 stock from the corporation at any time, but the stock must be acquired from the corporation, not from another shareholder.

To qualify, the stock must be issued by a *small business corporation*.

The definition of small business corporation is different for Sec. 1244 purposes than it is for S corporation purposes. (A corporation must therefore be a *small business corporation* in order to qualify for S corporation treatment, and must also fit other *small business corporation* criteria to qualify for Sec. 1244 treatment.)

A *small business corporation* for Sec. 1244 purposes is one in which the aggregate amount of money and other property received by the corporation for stock (as capital contribution and as paid-in surplus) does not exceed $1,000,000 ($500,000 for stock issued before November 7, 1978). The determination is made at the date the stock is issued, but includes amounts received for the stock and for all stock previously issued.[76]

Basically, the corporation cannot receive more than 50 percent of its gross receipts from passive sources.[77]

If the above tests are met, the following requirements apply:

- The stock must be common or preferred stock of a domestic corporation, and must not be convertible into other securities.[78] If issued before July 1, 1984, the stock must be common under former Sec. 1244(c)(1).
- The stock must be issued for valuable consideration, other than stock, securities or services.[79]

Only basis acquired through the purchase of Section 1244 stock can be used when computing a Sec. 1244 loss.[80] Therefore, basis acquired due to the passthrough of income does not qualify for Sec. 1244 treatment. Passthrough losses, however, reduce basis for Sec. 1244 purposes.

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[74] Sec. 1244(b).
[75] Reg. Sec. 1244(a)-1(b).
[76] Sec. 1244(c)(3).
[77] Sec. 1244(c)(1)(C).
[78] Reg. Sec. 1.1244(c)-1(b).
[79] Reg. Sec. 1.1244(c)-1(d).
[80] Sec. 1244(d)(1)(B); Reg. Sec. 1.1244(d)-2(a).

Shareholder and Corporate Documentation

The shareholders and the corporation are required to maintain records to document that a loss qualifies under Section 1244.[81]

A shareholder deducting a Sec. 1244 loss does not have to attach a statement to the return for the year that the loss is taken. However, the shareholder must maintain records sufficient to establish that the Sec. 1244 requirements have been met and the shareholder is entitled to deduct the loss.[82]

Additionally, the corporation should maintain records in accordance with Reg. Sec. 1.1244(e)-1(a) to substantiate the stockholder's Sec. 1244 loss.

When a client's business goes under, it is, of course, a painful time. By exercising some caution when shares are issued, Sec. 1244 can be there to ease the shareholder's burden a little in the event the corporation fails.

[81] Reg. Sec. 1.1244(e)-1.
[82] Reg. Sec. 1.1244(e)-1(b).

Chapter 8

Distributions

Introduction

In this chapter, we will discuss

- Relationship among Passthrough, Basis, and Distributions.
- Distributions—If No AE&P.
- Distributions—If There Is AE&P.
- Accumulated Adjustments Account (AAA).
- Distributing AE&P.
- Distributions during the Post-Termination Transition Period.

Definition of Distribution

A *distribution* is a payment in cash or property to a shareholder based on stock ownership. Payments of compensation for the shareholder's services are not distributions, but instead are wages subject to social security and other payroll taxes.

> **Practice Tip:** Distributions are made to each shareholder based on that shareholder's proportionate share of outstanding stock. If, for example, an S corporation has two equal shareholders and one shareholder receives a $1,000 distribution, the other shareholder should also receive a $1,000 distribution. Otherwise, the corporation may be deemed to have more than one class of stock and lose its S election.

Self-Employment Tax

Distributions and passthrough from an S corporation are not subject to self-employment tax.[1]

The rules relating to the taxation of distributions are very complex and compliance with these rules requires careful and ongoing recordkeeping.

[1] Rev. Rul. 59-221, 1959-1 CB 225; see also *Antonio Durando*, (1995, CA9) 70 F3d 548, 19 EBC 2191, 95-2 USTC ¶50615, 76 AFTR 2d 95-7464.

Reporting Distributions to Shareholders

Nondividend Distributions

Distributions made during the S corporation's tax year (other than distributions of accumulated earnings and profits [AE&P], discussed later) are reported on Form 1120S, Schedule K, line 16d, *Property distributions*. Each shareholder's portion of the distributions made during the year is reported to the shareholder on Schedule K-1, line 16, *Items affecting shareholder basis*, Code D, *Property distributions*.

> **Practice Tip:** The instructions to the Schedule K-1 explain that the term *property distributions* includes distributions of cash.

Schedule K-1 is explained in more detail in chapter 6. A copy of the Form 1120S and Schedule K-1 can be found at the end of chapter 10.

Dividend Distributions

Distributions of AE&P are dividends, as discussed later in this chapter. Dividend distributions are not reported on Schedule K-1. Rather, the corporation reports these distributions on Form 1099-DIV.

Property Distributions

Distributions of property other than cash are included with cash distributions on Schedule K-1, line 16, Code D.

Relationship of Passthrough, Basis, and Distribution

One of the advantages of operating as an S corporation is that the income is taxed only once. Generally, income escapes tax at the corporate level, and the shareholder pays tax on it by reporting it on the shareholder's personal income tax return. When the income is distributed, then, it is received by the shareholder with no further tax effect. This is accomplished by the interaction of passthrough, basis and distributions. Basically, it works through the following process:

1. Passthrough items are taxed to the shareholder.
2. Income taxed at the shareholder level increases stock basis.
3. Distributions are treated as a nontaxable return of capital that reduces stock basis.

Here is a very simplified example.

Example 8-1

On January 1, 2011, John has a zero basis in his stock of S Corp. On December 31, 2011, the end of its taxable year, John's share of the S corporation's income is $50,000. Nothing is distributed to John during that year.

John's basis in his stock becomes $50,000, and he reports that amount on his 2011 individual income tax return.

Assume that the company breaks even in 2012, and that John receives a distribution of $50,000.

The character of the distribution is as follows:

Nontaxable return of capital—to extent of stock basis	$50,000

John's stock basis is again zero:

Basis, beginning of year	$ 0
Increase by passthrough income	50,000
Basis, end of year	50,000
Decrease by distribution in following year	(50,000)
Basis, after distribution	$ 0

John paid tax on the $50,000 in 2011, and received $50,000 in 2012, with no further tax effect. His basis went up when the income was taxed, and went down when the distribution was made.

Application of Distributions

The taxability or nontaxability of distributions is determined after taking into account the adjustments to the basis of the stockholder's shares.[2] At the end of the corporation's taxable year, the shareholder's basis is first adjusted by corporate passthrough items of income. It is only after these adjustments have been made that the taxable or nontaxable nature of distributions is determined.

The order in which distributions are applied differs depending upon whether the corporation has or does not have accumulated earnings and profits (AE&P).

Distributions If No AE&P

The treatment of distributions is relatively simple if the S corporation has no AE&P at the end of its taxable year. In that event, distributions are applied using a two-tier system in the following order:

1. As a nontaxable return of capital to the extent of the shareholder's stock basis
2. As gain from the deemed sale or exchange of stock (capital gain)[3]

   Practice Tip: The capital gain is long-term or short-term depending on how long the shareholder held the S corporation's stock.

[2] Reg. Sec. 1368-1(e)(1).
[3] Sec. 1368(b); Reg. Sec. 1.1368-1(c).

Example 8-2

John has owned his stock in S Corp. for 10 years. He has a $45,000 basis in S Corp. stock at the beginning of the current year. During the year, he receives a distribution of $60,000, and the corporation passes through $5,000 of income to him at the end of the year. What is his stock basis at the end of the year and what is the taxable or nontaxable character of the distribution?

His stock basis at the end of the year is zero, as shown in the following calculation:

Basis, beginning of year	$45,000
Increase by passthrough income	5,000
Basis, before distributions	50,000
Distribution	(50,000)
Basis, end of year	$ 0

The distribution is nontaxable to the extent of John's stock basis ($50,000). The $10,000 distribution in excess of his basis is reported on Schedule D of his individual income tax return as gain from the deemed disposition of stock, which is long-term capital gain because he held his stock for more than one year.

AE&P

An S corporation can have accumulated earnings and profits (AE&P) from two sources:

1. Previous C corporation AE&P
2. AE&P from an acquired corporation under Sec. 381, regarding carryovers in certain corporate acquisitions

A C corporation generates AE&P under Sec. 312. When the C corporation elects S status, the AE&P balance carries into the S corporation. AE&P is designed to track the C corporation's income in a way that reflects the corporation's economic (rather than taxable) income. For example, new assets can be depreciated for tax purposes by using the modified accelerated cost recovery system (MACRS), but for AE&P purposes must be depreciated by using the alternative depreciation system (ADS).

When considering AE&P, keep the following points in mind:

- An S corporation does not generate AE&P.[4]
- A distribution of AE&P is a taxable dividend to the recipient.
- An S corporation without AE&P or with a negative AE&P balance cannot distribute a taxable dividend.
- If a corporation is formed and immediately elects S corporation status, it cannot have AE&P so long as it remains an S corporation and does not acquire a corporation carrying

[4] Sec. 1371(c).

over AE&P under Sec. 381. To say it another way, an S corporation cannot have AE&P if it has never (1) operated as a C corporation or (2) acquired a corporation with AE&P.

- Dividends are taxed at long-term capital gains rates for tax years beginning before 2013. Thus, the maximum tax rate on qualified dividend income is 15 percent.

REDUCTION OF AE&P

When a C corporation with AE&P becomes an S corporation, the amount of AE&P is basically frozen. Once S corporation status is effective, the AE&P amount is reduced only by

- Distributions of that AE&P (taxable dividend distributions),[5]
- Certain redemptions, reorganizations, liquidations, or corporate divisions in which the C corporation rules are applied,[6]
- Tax paid at the corporate level because of business credit recapture,[7]
- Transactions that involve the application of C corporation rules to the S corporation (which presumably could include payment of taxes attributable to C corporation tax years that are paid by the S corporation),[8] and
- LIFO recapture payments.[9]

Example 8-3

C Inc., elects S status on January 1, when it has $10,000 of AE&P. The company passes through a $6,000 loss for the year ended December 31 and distributes $3,000 to its sole shareholder during the year. The $6,000 passthrough loss does not affect AE&P. Since the corporation has no undistributed earnings at the end of the year, the $3,000 distribution reduces AE&P, and is dividend income to the shareholder. The balance in the corporation's AE&P at December 31 is $7,000 ($10,000 - $3,000).

Distributions If There Is AE&P

Remember, if an S corporation does not have AE&P, there is a simple two-tier distribution order. Distributions are first a nontaxable return of capital to the extent of basis, and then are capital gain.

But if an S corporation has AE&P, the distribution order is more complicated. More layers are introduced into the distribution order, because you have to know when distributions have penetrated the AE&P layer.

[5] Sec. 1371(c)(3).
[6] Sec. 1371(c)(2).
[7] Sec. 1371(d)(3).
[8] Sec. 1371(c)(2).
[9] Sec. 1363(d)(5).

The income that has already been taxed, though, gets to come out first. You keep track of this income by using the AAA (Accumulated Adjustments Account). The purpose of the AAA is to track income that has been previously taxed to the shareholder so it can be distributed free of further tax.

> **Example 8-4**
>
> S Corp., which has AE&P, passes through taxable income of $40,000 for the year ended December 31. It makes no distributions to Gene, its sole shareholder, during that year. The $40,000 is taxed to Gene, and increases both his basis and the corporation's AAA. The $40,000 can then be distributed in the following year with no further tax effect, so long as the shareholder has adequate basis.

AE&P DISTRIBUTIONS ARE DIVIDENDS

Distributions of AE&P by an S corporation are dividends that the S corporation reports to the shareholder on Form 1099-DIV. For passive activity purposes, distributions of AE&P received by a shareholder are portfolio income. The passive versus active nature of distributions is considered in chapter 10.

S CORPORATION WITHOUT POSITIVE AE&P CANNOT DISTRIBUTE DIVIDENDS

Since dividends are distributions of AE&P, an S corporation can distribute a dividend only if it has a positive AE&P balance. Thus, an S corporation that does not have AE&P (for example, because it never was a C corporation) or an S corporation with negative AE&P cannot distribute a dividend to shareholders.

Dividends (that is, distributions of AE&P) received by an S corporation shareholder are generally subject to a maximum tax rate of 15 percent.

AE&P BALANCE IS REPORTED ON FORM 1120S

The AE&P balance at the end of the corporation's tax year is reported on Form 1120S, Schedule B, line 7.

Summary of Distribution Layers

Distributions are discussed in more detail later in this chapter. But first we want to explain more about the AAA. However, to quickly summarize the distribution layers, we should point out that distributions are generally applied in the following order:

1. AAA (nontaxable to the extent of stock basis)
2. AE&P (dividends)
3. Nontaxable to extent of remaining basis in stock
4. Capital gain from deemed disposition of stock

> **Practice Tip:** Distributions (other than distributions of AE&P) reduce stock basis, but they do not reduce debt basis.

Accumulated Adjustments Account (AAA)

The AAA starts at zero on the first day of an S corporation's first taxable year beginning after 1982. Thereafter, it is increased and decreased each year by, with certain exceptions, the same items that adjust basis, but *not in the same order* as basis is adjusted.

Unlike basis, the AAA can have a negative balance. Distributions to shareholders, however, can not reduce the AAA balance below zero.

Under Sec. 1368(e)(1)(A), the AAA is adjusted by using the following steps:

- Step 1—The balance of AAA at the beginning of the taxable year is increased by
    - Nonseparately stated income (this is the *bottom line* net income from trade or business activities shown on page 1 of Form 1120S);
    - Separately stated items of income and gain (*exception*—the AAA is not increased by tax-exempt income);
    - Excess of the shareholder's deductions for depletion (other than oil and gas) over the shareholder's proportionate share of basis of the property subject to depletion; and
    - Changes in asset basis due to certain business tax credit recapture.
- Step 2—AAA is decreased by
    - Nonseparately stated loss (this is the net loss from trade or business activities shown at the bottom of page 1, Form 1120S);
    - Separately stated items of loss or deduction (*exception*—the AAA is not decreased by any expense related to tax-exempt income);
    - Any expense of the corporation that is neither deductible in computing its taxable income nor capitalizable (*exception*—the AAA is not reduced by Federal taxes attributable to a C corporation year);
    - The amount of the shareholder's deduction for depletion of oil and gas property held by the S corporation to the extent the deduction does not exceed the property's adjusted basis allocated to the shareholder under Sec. 613A(c)(11)(B); and
    - Changes in asset basis due to certain business tax credit, discussed later in this chapter.

  Important: The aggregate reduction in Step 2 is limited to the aggregate increase in Step 1. If the amount of loss and deduction items total more than the income and gain items, there is a net negative adjustment (see Step 4).

- Step 3—AAA is decreased (but not below zero) by

    - Nondividend distributions (that is, distributions other than those made from AE&P).

- Step 4—If the aggregate loss and deduction passthrough items (Step 2) are more than the aggregate income and gain items (Step 1), there is a *net negative adjustment*. AAA is now reduced in Step 4 by the excess of the loss and deduction items over the income and gain items.[10] Example 8-8 shows the calculation of AAA when there is a net negative adjustment.

Annual Adjustments to AAA

Generally, the AAA will be adjusted annually by using Steps 1, 2, and 3 in the preceding list. Step 4 is necessary only when there is a net negative adjustment.

Examples 8-5 through 8-9 illustrate how the taxability of distributions is determined under various circumstances.

CHANGES IN ASSET BASIS DUE TO CERTAIN BUSINESS CREDIT AND RECAPTURE

The AAA can be affected by business credit recapture. When the business credit is taken, it may cause an asset's basis to decrease, and when business credit recapture occurs, an asset's basis may be increased. Stock basis is decreased and increased by those changes in an asset's basis.[11] Corresponding adjustments must be made to the AAA.[12]

AAA IS REDUCED BY THE FULL AMOUNT OF LOSS OR DEDUCTION

The AAA, like basis, is reduced by the entire amount of a loss or deduction, even though the shareholder cannot use the deduction because of another provision such as the passive activity loss rules or the at-risk rules.[13]

AAA CAN HAVE NEGATIVE BALANCE

Unlike basis, the AAA can be negative. A negative AAA balance can be caused by S corporation losses and deductions, but not by distributions.[14]

EFFECT OF LIFE INSURANCE PROCEEDS AND PREMIUMS ON AAA AND BASIS

Life insurance proceeds received by an S corporation are generally tax-exempt if the corporation owns the policy and is the beneficiary. Likewise, life insurance premiums paid by the corporation are not deductible if the S corporation is the beneficiary.[15] The IRS has ruled that an S corporation's AAA is not reduced by premiums paid on such a policy. Furthermore, the AAA is not increased by the tax-exempt life insurance benefits paid by the policy. Instead, these

[10] Sec. 1368(e)(1)(A); Reg. Sec. 1.1368-2(a).
[11] Sec. 50(c)(5).
[12] Sec. 1368(e)(1).
[13] Reg. Sec. 1.1368-2(a)(3)(ii).
[14] Sec. 1368(e)(1)(A); Reg. Sec. 1.1368-2(a)(3).
[15] Sec. 101(a)(1); Reg. Sec. 1.1366-1(a)(2).

adjustments are made to the other adjustments account (OAA) discussed later.[16] Stock basis, however, is decreased by the premiums and increased by the tax-free benefits.

> **Practice Tip:** This is a favorable ruling. Previously, it was not clear whether life insurance premiums reduced the AAA or the OAA. (It was always clear, though, that tax-free life insurance benefits would not increase the AAA.) By not having to reduce the AAA balance by the premiums, the AAA balance remains higher, allowing more tax-free distributions to be made to shareholders, if the S corporation has AE&P.
>
> **Note:** The treatment of a whole life insurance policy's cash surrender value is not addressed in Rev. Rul. 2008-42. Evidently, however, the portion of the premiums that increase cash surrender value should be capitalized. Such capitalized amounts would not affect stock basis or the OAA.

ELECTION TO REDUCE BASIS BY LOSS ITEMS FIRST DOES NOT APPLY TO THE AAA

The accumulated adjustments account (AAA) is reduced by nondeductible, noncapital expenses passed through to shareholders each year. This is true regardless of whether the shareholder makes the election to reduce basis by loss items first.[17] In other words, the election to reduce basis by loss items before nondeductible, noncapital expenses does not affect the calculation of AAA.

DIFFERENCES BETWEEN BASIS AND AAA ADJUSTMENTS

The AAA increases and decreases by the same items as basis does each year, except

- Tax-exempt income increases basis, but does not increase the AAA.
- Expenses relating to tax-exempt income reduce basis, but do not decrease the AAA.
- Federal taxes relating to a C corporation year reduce basis, but do not decrease the AAA.
- The order that increases and decreases are applied to basis and AAA differ.
- The shareholder can elect to reduce basis by loss items before nondeductible, noncapital expenses. This election does not apply to AAA adjustments.
- Losses and deductions (but not distributions) can reduce the AAA below zero. Basis can never have a negative balance.

> **Practice Tip:** Even though basis and AAA are adjusted by many of the same items, AAA is always adjusted in a different *order* from basis. Because AAA is used to determine the amount of distributions that are from AE&P, and distributions from AE&P do not reduce basis, the AAA balance should be determined before stock basis is calculated.

[16] See Rev. Rul. 2008-42, 2008-30 IRB 175.
[17] Reg. Sec. 1.1368-2(a)(3)(ii).

BUSINESS CREDIT RECAPTURE

Business credit recapture paid at the S corporation level reduces basis, but is a Federal tax relating to a C corporation year and does not reduce the Accumulated Adjustments Account (AAA).[18] The recapture does, however, reduce accumulated earnings and profits (AE&P).[19]

> **Practice Tip:** Not reducing AAA is generally favorable because the higher the AAA balance, the more that can be distributed free of further tax, so long as stock basis equals or exceeds the AAA balance.

LIFO RECAPTURE

LIFO recapture payments made by the S corporation do not reduce either basis or the AAA.[20] The LIFO payments do, however, reduce AE&P.[21]

That is a lot to absorb, and we will get to some examples illustrating the calculation of AAA in just a minute, but first you will need to know how AE&P fits into the equation. As stated earlier in this chapter, distributions of AE&P are dividends.

Order of Applying Distributions—If AE&P

Distributions from an S corporation with AE&P are applied in the following order:

1. As a distribution of AAA. (Distributions of the AAA are treated as distributions from an S corporation without AE&P, that is, they are a nontaxable return of capital up to basis in stock, and are capital gain from the deemed disposition of stock to the extent they exceed basis.)[22]
2. As a dividend to the extent of the corporation's AE&P.[23]
3. As a nontaxable reduction of basis to the extent of the remaining basis, if any, in stock.
4. As a taxable gain from the deemed sale or exchange of stock subject to capital gain treatment on the shareholder's personal tax return.[24]

Calculation of AAA, AE&P, and Basis Illustrated

The calculation of AAA, AE&P, and basis and the resulting tax effect on distributions is illustrated in the following examples.

[18] Sec. 1368(e)(1)(A).
[19] Sec. 1371(d)(3).
[20] Secs. 1363(d)(5) and 1368(e)(1)(A).
[21] Sec. 1363(d)(5).
[22] Sec. 1368(c)(1).
[23] Sec. 1368(c)(2).
[24] Sec. 1368(c)(3).

Example 8-5

Nontaxable Distribution

S Inc. is a corporation that became an S corporation on January 1, of the current year, when it had $12,500 of AE&P. Jean, the sole shareholder, had basis in her stock of $4,000 on that date. For the taxable year ended December 31, S Inc. showed the following items:

Nonseparately stated income	$30,000
Tax exempt interest	1,000
Long-term capital gain	2,000
Charitable contributions	800
Disallowed 50 percent portion of meals and entertainment (M&E)	500
Expenses relating to tax-exempt income	150
Federal corporate tax paid for preceding year	2,500
Distribution to Jean	10,000

To determine the taxability of the distribution, you must first compute the AAA and AE&P balances at December 31.

	AAA	AE&P
Balances, beginning of year	$ 0	$12,500
Nonseparately stated income	30,000	–
Tax-exempt interest	–	–
Long-term capital gain	2,000	–
Balances, before reductions	32,000	12,500
Charitable contributions	(800)	–
Disallowed 50 percent of M&E	(500)	–
Expenses relating to tax-exempt income	–	–
C corporation income tax	–	–
Balances, before distributions	30,700	12,500
Distributions nontaxable	(10,000)	–
Balances, end of year	$20,700	$12,500

Next, stock basis is calculated as follows:

Basis, beginning of year	$4,000
Nonseparately stated income	30,000
Tax-exempt interest	1,000
Long-term capital gain	2,000
Basis, before distributions and other reductions	37,000
Distributions	(10,000)
Basis, before other reductions	27,000
Charitable contributions	(800)
Disallowed 50 percent of M&E	(500)
Expenses relating to tax-exempt income	(150)
C corporation income tax	(2,500)
Basis, end of year	$23,050

The $10,000 distribution reduces both the AAA and Jean's stock basis, and is consequently a nontaxable return of capital.

Note that tax-exempt interest, expenses relating to tax-exempt income, and C corporation Federal income tax affect basis, but do not cause adjustments to the AAA. Also note that AE&P is not adjusted by passthrough items.

Example 8-6

Distributions of AE&P

Joan has been the sole stockholder of S Inc. for five years. At the beginning of the current calendar taxable year, Joan's basis in her stock is $43,000, and the corporation shows an AAA balance of $31,000, and an AE&P balance of $25,000. During the year, she receives a $50,000 distribution. At the end of the current year, the corporation passes through nonseparately stated income of $10,000 and a capital loss of $2,000.

The AAA and AE&P balances at December 31 are calculated as follows:

	AAA	AE&P
Balances, beginning of year	$31,000	$25,000
Nonseparately stated income	10,000	–
Balances, before reductions	41,000	25,000
Long-term capital loss	(2,000)	–
Balances, before distributions	39,000	25,000
Distributions to extent of AAA	(39,000)	
Distributions to extent of AE&P		(11,000)
Balances, end of year	$ 0	$14,000

Note that distributions cannot reduce AAA below zero.

Next, stock basis is calculated as follows:

Basis, beginning of year	$43,000
Nonseparately stated income	10,000
Basis, before distributions and other reductions	53,000
Distributions to extent of AAA	(39,000)
Basis, before other reductions	14,000
Long-term capital loss	(2,000)
Basis, end of year	$12,000

The tax consequences of the distribution are that Joan received the following:

Nontaxable return of capital distributions	$39,000
Dividend	11,000
Total	$50,000

In practice, Joan would receive the following notification from the corporation:

- Form 1120S K-1 showing a nondividend distribution of $39,000 on line 16, Code D, *Property distributions*
- Form 1099-DIV reflecting a dividend of $11,000

Example 8-7

Distributions Exceeding AAA and AE&P

Jane has been the sole stockholder of S Inc. for five years. At the beginning of the current calendar taxable year, Jane's basis in her stock is $43,000, and the corporation shows an AAA balance of $31,000, and an AE&P balance of $25,000. During the year, she receives a $90,000 distribution. At the end of the current year, the corporation passes through nonseparately stated income of $10,000 and a capital loss of $2,000.

The AAA and AE&P balances at December 31 are calculated as follows:

	AAA	AE&P
Balances, beginning of year	$31,000	$25,000
Nonseparately stated income	10,000	–
Balances, before reductions	41,000	25,000
Long-term capital loss	(2,000)	–
Balances, before distributions	39,000	25,000
Distributions to extent of AAA	(39,000)	
Distributions to extent of AE&P	–	(25,000)
Balances, end of year	$ 0	$ 0

Next, stock basis is calculated, as follows:

Basis, beginning of year	$43,000
Nonseparately stated income	10,000
Basis, before distributions and other reductions	53,000
Distributions to extent of AAA	(39,000)
Distributions in excess of AAA, to extent of remaining basis	(14,000)
Basis, before other reductions	0
Long-term capital loss to extent of basis	(0)
Basis, end of year	$ 0

The tax treatment of the $90,000 distribution is determined in the following order:

1. Distribution to extent of AAA (also reduces basis)	$39,000
2. Distribution of AE&P	25,000
3. Distribution to extent of remaining basis	14,000
4. Distribution in excess of basis	12,000
Total	$90,000

The tax consequences of the distribution are that Jane received the following:

Nontaxable return of capital distributions ($39,000 + $14,000)	$53,000
Dividend	25,000
Capital gain	12,000
Total	$90,000

The $12,000 gain from deemed disposition of stock represents the remainder of the $90,000 distribution after applying $53,000 to basis and $25,000 to AE&P. The gain will normally be capital gain and will be long-term because the shareholder held her stock for more than one year.

Jane receives the following notification from the corporation:

- Form 1120S K-1 showing a nondividend distribution of $65,000 ($53,000 + $12,000) on line 16, Code D.
- Form 1099-DIV reflecting a dividend of $25,000.

Because Jane's basis has been reduced to zero before considering the long-term capital loss, the $2,000 loss is not deductible in the current year. The loss will carry over to the following year and will be deductible when Jane has sufficient basis to cover it.

Now we will look at an example illustrating how AAA is adjusted when there is a net negative adjustment, that is, the aggregate loss and deduction passthrough items exceed the aggregate income and gain passthrough items.

Example 8-8

Distributions When There Is a Net Negative Adjustment

Joe has been the sole stockholder of S Inc. for five years. At the beginning of the current calendar taxable year, Joe's basis in his stock is $43,000, and the corporation shows an AAA balance of $31,000, and an AE&P balance of $25,000. During the year, he receives a $40,000 distribution. At the end of the current year, the corporation passes through nonseparately stated income of $2,000 and a capital loss of $10,000.

In this case, there is a net negative adjustment because the corporation's passthrough items of loss and deduction ($10,000) exceed its income and gain items ($2,000). The net negative adjustment rules limit the amount of loss and deduction items that reduce AAA before considering distributions; this reduction is limited to the amount of the increase for income and gain items ($2,000 in this example). After distributions are considered, the AAA is decreased by the excess of the aggregate loss and deduction items over the aggregate income and gain items ($8,000 [$10,000 – $2,000] in this example).[25]

The AAA and AE&P balances at December 31 are calculated as follows:

	AAA	AE&P
Balances, beginning of year	$31,000	$25,000
Nonseparately stated income	2,000	–
Balances, before reductions	33,000	25,000
Long-term capital loss (limited to the amount of income items)	(2,000)	–
Balances, before distributions and other reduction items	31,000	25,000
Distributions to extent of AAA	(31,000)	
Distributions of AE&P	–	(9,000)
Balances, before other reduction items	0	16,000
Net negative adjustment ($2,000 – $10,000)	(8,000)	–

[25] Sec. 1368(e)(1)(C); Reg. Sec. 1.368-2(a)(5).

Balances, end of year	$(8,000)	$16,000

Next, stock basis is calculated as follows:

Basis, beginning of year	$43,000
Nonseparately stated income	2,000
Basis, before distributions and other reductions	45,000
Distributions to extent of AAA	(31,000)
Basis, before other reductions	14,000
Long-term capital loss	(10,000)
Basis, end of year	$4,000

The tax consequences of the distribution are that Joe received the following:

Nontaxable return of capital distributions	$31,000
Dividend	9,000
Total	$40,000

Stock Basis or AAA Balance at Beginning of Year Can Be Distributed Free of Tax

Example 8-8 illustrates that the net negative adjustment rule does not allow the beginning balance of AAA to be reduced by losses before distributions are considered. Also, distributions reduce stock basis before it is reduced by passthrough loss and deduction items. Therefore, the shareholders will be able to receive *tax-free* distributions during the year of at least the lesser of (1) the AAA balance at the beginning of the year, or (2) the shareholder's stock basis at the beginning of the year.

Distributions When AAA Is Less than Zero

Losses can reduce the AAA (but not basis) below zero.[26] If that happens, distributions will be made out of the second layer first. This could have the effect of having *all* distributions being treated as dividends to the extent of AE&P.

Example 8-9

S Corp. has $1,000 negative AAA balance and $25,000 of AE&P at the beginning of its calendar year. During the year, the corporation makes a distribution of $15,000 to Pat, its sole shareholder. Pat's stock basis is $17,500. At the end of the year, S Corp. passes through nonseparately stated income of $750.

The ending AAA, AE&P, and basis balances are calculated like this:

	AAA	AE&P	Basis
Balances, beginning of year	$(1,000)	$25,000	$17,500
Passthrough income	750		750
Distributions	–	(15,000)	–
Balances, end of year	$(250)	$10,000	$18,250

Since there is no AAA, the distribution comes entirely out of AE&P, and is taxable to the shareholder as dividend income. This company cannot make a

[26] Sec. 1368(e)(1)(A); Reg. Sec. 1.1368-2(a)(3).

nontaxable return of capital distribution until it has passed through income items of more than $250 to bring the AAA back above zero.

THE AAA IS A CORPORATE ACCOUNT

The AAA is a *corporate* account and is not apportioned among the shareholders.[27] (AE&P is also maintained at the corporate level.) This is contrasted with basis, which is calculated at the *shareholder* level.

AAA—New Shareholder

A distribution to a new shareholder qualifies for nontaxable return of capital treatment to the extent the distribution is out of the corporation's AAA. By contrast, previously taxed income (PTI) is not transferable, and nontaxable distributions of PTI cannot be made to a new shareholder. PTI is covered in the following discussion.

Distributions of Previously Taxed Income (PTI)

Before 1983, the S corporation income amount upon which the shareholder had paid tax, but which had not been distributed, was called Previously Taxed Income, or PTI. For tax years beginning after 1982, S corporations do not generate PTI, but the AAA represents a variation on the same theme; income that has been previously taxed to the shareholder can be distributed free of further tax. But what if the S corporation carried PTI into a post-1982 year? It could, and in many cases did, happen. Unfortunately, the Code is something less than enlightening when it addresses the problem of how to distribute these items, because it seems to ignore the fact that there can be a distribution tier composed of PTI.

If the corporation has no AE&P, there is no problem. PTI has already increased the basis of the stock. Distributions from an S corporation with no AE&P apply first as a nontaxable return of capital, to the extent of stock basis, so PTI will automatically be a tax-free reduction in basis when distributed.

When the S corporation has PTI and AE&P, regulations provide that distributions are applied in the following order:

1. AAA
2. PTI
3. Dividends, to extent of AE&P
4. Nontaxable return of capital, to extent of remaining stock basis
5. Capital gain from deemed disposition of stock[28]

Notice that distributions of both AAA and PTI are nontaxable to the extent of the shareholder's stock basis. The significant difference between the AAA and the PTI is that a new shareholder can receive a nontaxable distribution of AAA, while PTI is not transferable. Also AAA (but not

[27] Sec. 1368(e)(1)(A); Reg. Sec. 1.1368-2(a)(1).
[28] Sec. 1379(c); Reg. Sec. 1.1368-1(d)(2).

PTI) can be distributed during the post-termination transition period, discussed later in this chapter. Further, a distribution of PTI must be an actual distribution of money.[29] Distributions of AAA and AE&P can be made in either money or property.

Distributions of PTI (like distributions of AAA) reduce the shareholder's stock basis.

If the corporation has a PTI balance and elects to distribute AE&P before AAA, the corporation should make two elections. The second election should state that the corporation elects to have AE&P distributed before PTI.

Property Distributions

The amount of any distribution to a shareholder is the cash, plus the fair market value of any property distributed. Generally there is no differentiation in the order that distributions of cash or property are applied. Distributions of PTI, however, must be actual distributions of money.[30]

Gain or Loss on Property Distributions

Treatment of a property distribution depends on whether the property has appreciated (over basis) or not.

APPRECIATED PROPERTY

If an S corporation holds property which has fair market value in excess of basis, and distributes such property to a shareholder, gain is recognized to the corporation as if it had sold the property to the shareholder at its fair market value.[31]

Here is what happens when a shareholder receives a distribution of appreciated property:

1. The gain passes through *pro rata* to each shareholder as ordinary income or capital gain, as appropriate.
2. The recipient shareholder increases stock basis by the shareholder's *pro rata* share of the gain, through the normal passthrough process.
3. The recipient shareholder is considered to have received a distribution in the amount of the fair market value of the property received.
4. The shareholder's basis in the property is its fair market value.

The following are some potential consequences of distributing appreciated property to shareholders:

1. A built-in gains tax may be payable at the corporate level. The gain passes through pro rata to each shareholder. The built-in gains tax passes through as a loss, with the same tax characteristics as the gain that generated the tax.

[29] Reg. Sec. 1.1368-1(d)(2).
[30] Reg. Sec. 1.1368-1(d)(2).
[31] Secs. 1371(a), 311(b).

2. The corporation's gain on property distributed to a shareholder may be ordinary income if the property is depreciable by the shareholder who receives it. As stated earlier, the corporation treats the distribution as if it had sold the property to the shareholder. Under Sec. 1239, gain on a sale of property is ordinary if the property is sold to a related party (as defined in Sec. 267), and is depreciable in the hands of the transferee. A shareholder is a related party for these purposes if the shareholder directly or indirectly owns more than 50 percent of the stock.[32]

3. There may be recapture of depreciation to pass through to the shareholders. Further, there may be business credit recapture which normally passes through, but which may create tax at the corporate level if the credit was taken when the company was a C corporation.

NON-APPRECIATED PROPERTY

If the property's fair market value equals (or is less than) its basis, no loss is recognized at the corporate level on account of nonliquidating distributions.[33] The shareholder is considered to have received a distribution in the amount of the fair market value of the property. The distribution is applied against the AAA, AE&P, and stock basis, in the order discussed previously, as if it were cash.

A loss is recognized at the corporation level if non-appreciated property is distributed in liquidation of the corporation (Sec. 336).

Dividend Tax Rates

Dividends received by an individual (noncorporate) shareholder from domestic and qualified foreign corporations generally are taxed at the same rates that apply to long-term capital gains.[34] These rates of 0 percent for lower tax bracket taxpayers and 15 percent are effective for tax years beginning before 2013. The favorable rates apply to dividends for both regular and alternative minimum tax purposes.

Several points are worth noting about the favorable dividend rates:

- A special holding period requirement applies in order to receive the favorable rates. A shareholder must hold the shares of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date. In other words, a dividend will qualify for the favorable rates if the stock has been held for at least 61 days. The ex-dividend date is day the stock begins trading without rights to a previously declared dividend; that is, the purchaser is not entitled to the dividend. (The holding period requirements are increased for preferred stock—to 90 out of the 181 days beginning 90 days before the ex-dividend date.)

- An S corporation shareholder qualifies for the favorable rates on dividend distributions received from the S corporation, provided the shareholder has held the S shares long enough to satisfy the holding period requirement described above. A dividend

[32] Sec. 267(b).
[33] Sec. 311(a).
[34] Sec. 1(h)(11).

distribution from an S corporation is made up of distributions from the corporation's accumulated earnings and profits (AE&P).

- Dividends received by an S corporation should be eligible for the favorable rates to the extent the dividends are ultimately taxed to individual (noncorporate) owners. Dividends on both common and preferred stock should qualify for the favorable rates.
- Dividends do not qualify for the favorable rates when a taxpayer is obligated (because of a short sale or otherwise) to make related payments on certain positions.
- In a significant restriction for certain taxpayers, any dividends a taxpayer elects to count as investment income (for the purposes of the investment interest deduction limitation) will not qualify for the favorable rates. Taxpayers can exclude either part or all of their dividend income from the computation of investment income and receive the favorable tax rates on such income, or they can give up the favorable tax rates in return for a higher investment interest deduction limit.[35] A similar rule applies to capital gains.

Distributing AE&P to Eliminate Dividend Distributions and Avoid Passive Investment Income Problems

As we have seen throughout this book, an S corporation with AE&P has more problems to cope with than one without AE&P. Accumulated earnings and profits can cause difficulties with passive income; an S corporation with AE&P can be subject to the tax on excess net passive income and the S election will terminate if the corporation has excess net passive income for three consecutive years. Also, distributions are more complicated and can include dividend income if there is AE&P.

So what can your client do if the corporation has AE&P?

If the corporation is still a C corporation and the S corporation election is being considered, it would be a good idea to look at the amount of AE&P. If it would not have too much tax effect, it might be worthwhile to distribute it to the shareholders as a dividend before making the S corporation election.

Unfortunately, that solution is not practical in many instances.

However, now that the maximum tax rate on qualified dividend income is 15 percent, some existing S corporations may want to distribute AE&P to shareholders to take advantage of the favorable rates. Also, under some circumstances, because of losses or other considerations, receipt of the taxable dividend may not cause a tax burden on the shareholders, making it an opportune time to distribute AE&P to them.

> **Practice Tip:** If the S corporation does not have AE&P (because the C corporation had no AE&P at the date the S election became effective or because the S corporation has distributed all of the AE&P), things become simpler. The S corporation will not be subject to the tax on excess net passive income and will not risk termination of the S election if the corporation receives excess net passive income for three years. Furthermore, an S corporation without AE&P can never issue a dividend.

[35] See Sec. 163(d)(4)(B).

AE&P Can Be Distributed before AAA

The order of distributions normally would require that the AAA be distributed first, before the AE&P layer is reached. But the corporation can elect to distribute AE&P before distributing the AAA.[36]

All shareholders receiving a distribution from the corporation during the corporation's taxable year must consent to this election. The election is attached to the corporation's Form 1120S.

The corporation cannot elect to divide the distributions between AAA and AE&P. When the election to distribute AE&P first is made, all distributions during the year must be treated as distributions of AE&P, to the extent of the AE&P balance.

The election is made on a year-by-year basis and must be made in any year that AE&P is distributed before AAA.

The regulations set out the information that must be included in the election statement and consents.[37] A sample election to distribute AE&P before AAA and related shareholder consents are shown at the end of this chapter as Exhibits 8-1 and 8-2.

If the election is made by a corporation with previously taxed income (PTI), the election bypasses the AAA only. In other words, if the election is made, the distributions would be from PTI, AE&P, and AAA in that order.[38] If the corporation has both AAA and PTI, and it wants to distribute AE&P first, it must make two elections; one to distribute AE&P first and one to forego PTI.[39] A sample election to forego previously taxed income and related shareholder consents are included at the end of this chapter as Exhibits 8-3 and 8-4.

Election to Make a Deemed Dividend

If the S corporation makes the election to distribute AE&P before AAA (and PTI, if necessary), the corporation can also elect to distribute all or part of its C corporation AE&P through a deemed dividend. Under the deemed-dividend provisions, no actual distribution is made. Therefore, the corporation can distribute AE&P through a deemed dividend, even though it does not have the cash to make the actual distributions. The deemed dividend cannot be more than the balance in AE&P at the end of the year after considering actual distributions made during the year. The deemed dividend is considered made as if it were distributed in money to the shareholders in proportion to their stock ownership. The shareholders treat the dividend as if it were received by them (it is included in dividend income on Form 1040), then immediately contributed by the shareholder to the corporation.

These transactions are deemed to occur on the last day of the corporation's taxable year.[40] All persons owning shares at the end of the taxable year must consent to the election. A sample election to make a deemed dividend and related consents are included as Exhibits 8-5 and 8-6 at the end of this chapter.

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[36] Sec. 1368(e)(3); Reg. Sec. 1.1368-1(f)(2).
[37] Reg. Sec. 1.1368-1(f)(5).
[38] Reg. Sec. 1.1368-1(f)(2).
[39] Reg. Sec. 1.1368-1(f)(4).
[40] Reg. Sec. 1.1368-1(f)(3).

Example 8-10

S Inc. has $10,000 in AAA and $15,000 in AE&P at the end of the year, after adjustments for current income and losses. No distributions were made during the year. S Inc. faces the corporate-level tax on excess net passive income and elects to distribute AE&P before AAA. Under the regulations, S Inc. can elect to make deemed distributions in amounts up to $15,000, the AE&P balance, instead of distributing cash.

The corporation elects to make deemed distributions of the full $15,000. Jake, the sole shareholder, must report $15,000 of dividends as if they were received on the last day of the corporation's taxable year. The corporation evidently makes the following entry in its books to reflect that the dividends were paid, then recontributed back to the corporation:

	Debit	Credit
Retained earnings	$15,000	
Paid-in capital		$15,000

Jake increases his stock basis by $15,000 to reflect the amount deemed contributed to capital.

Tax-Exempt Income

Tax-exempt income passes through and is not taxed to the shareholder when it is received by the S corporation. However, tax-exempt income increases basis, but does not increase the AAA.[41]

Therefore, if the corporation has AE&P, the tax-exempt income cannot be drawn out until the shareholder has received taxable dividends in the amount of the AE&P.

Here is an example that has been very simplified to illustrate this point.

Example 8-11

S Corp. had income of $3,500 for the current year, made up of ordinary income of $1,000 and tax-exempt income of $2,500. At the beginning of the year S Corp. had AE&P of $4,000, and the balance in the AAA was zero. Bob's basis in his stock also was zero. During the year, distributions of $3,500 were made to Bob.

What is the taxability of the distribution?

The calculation of AAA, AE&P, and basis is as follows:

	AAA	AE&P	Basis
Balances, beginning of year	$0	$4,000	$0
Ordinary income	1,000	–	1,000
Tax-exempt income	–	–	2,500
Balances, end of year before distributions	1,000	4,000	3,500
Distributions to extent of AAA	(1,000)		(1,000)

[41] Sec. 1368(e)(1)(A).

Distributions of AE&P		(2,500)	
Balances, end of year	$ 0	$1,500	$2,500

The taxability of the distribution is as follows:

1. AAA (nontaxable)	$1,000
2. AE&P (dividend)	2,500
Total distribution	$3,500

In essence, the tax exempt income remains nontaxable to the shareholder, but the corporation must distribute through the AE&P layer (if there is one) for the shareholder to get to it. After the AE&P balance has been reduced to zero, tax-exempt income can be distributed tax-free because the income has increased the shareholder's basis, and distributions, to the extent of stock basis, are nontaxable.

Other Adjustments Account

The S corporation tax return, Form 1120S, states that tax-exempt income should increase the Other Adjustments Account (OAA), and expenses directly related to tax-exempt income should reduce OAA. The OAA is not in the Code and is used to record passthrough items that do not adjust AAA. The OAA does not directly affect the taxability of distributions. Rather, distributions from an S corporation without AE&P are nontaxable to the extent of stock basis and capital gain thereafter. Distributions from an S corporation with AE&P are taxable in tiers, as discussed earlier in this chapter.

Tracking AAA, OAA, and PTI on Form 1120S

The AAA, OAA, and PTI balances are tracked on Schedule M-2 of Form 1120S. (PTI is calculated in the column titled Shareholders' Undistributed Taxable Income Previously Taxed.)

A Form 1120S and Schedule K-1 can be found at the end of chapter 10.

> **Practice Tip:** If the corporation has no AE&P, the AAA has no effect on the taxability of distributions. Distributions from an S corporation without AE&P are nontaxable to the extent of the shareholder's stock basis and capital gain thereafter. The AAA balance should be tracked on Schedule M-2, however, even if the S corporation does not have AE&P. It will be necessary to know the correct AAA balance during the post-termination transition period if the S election terminates, or if the corporation merges with another corporation that has AE&P.

AAA—Stock Redemption

The AAA account is reduced by the percentage of any stock redeemed under Sec. 302(a) or 303(a) (that is, a redemption that is treated as a sale or exchange). The calculation is made as of the date of redemption, and is made by multiplying the AAA balance by the number of shares redeemed and dividing by the total number of shares outstanding.[42]

[42] Sec. 1368(e)(1)(B); Reg. Sec. 1.1368-2(d)(1).

Example 8-12

S Corp. has an AAA account of $30,000 as of the date that forty shares (representing 40 percent) of the company's stock are redeemed. What is the AAA after the redemption?

The AAA is $18,000, determined as follows:

AAA immediately before redemption	$30,000
Reduction: $\frac{\text{40 shares redeemed}}{\text{100 shares, before redemption}}=40\%\times\$30,000$	(12,000)
AAA after redemption	$18,000

Rules relating to AAA adjustments because of redemptions, reorganizations, and divisions are set out in Reg. Sec. 1.1368-2(d).

Reasonable Compensation

Distributions can be reclassified as wages to shareholders who provide services, but are not paid salary. Reasonable compensation is discussed in more detail in chapter 6.

Post-Termination Transition Period

A break for the taxpayer is provided by Sec. 1371(e). It states that cash distributions during the post-termination transition period (PTTP) are to be applied against stock basis to the extent of the Accumulated Adjustment Account.

In effect, these provisions provide an escape hatch. They give the corporation some time to distribute its AAA (which has already been taxed) as a tax-free return of capital in the event the election is revoked or involuntarily terminated.

Rather than having distributions during the post-termination transition period treated as coming out of AAA, the corporation can elect to apply such distributions against AE&P. In that case, the distributions would be dividend income to the shareholder recipients.[43]

Also, unused losses and deductions can be taken by the shareholder at the end of the post-termination period, provided the shareholder has sufficient stock basis (and subject to other limitations, such as the passive loss and at-risk rules).

Further, an S corporation's unused at-risk losses carry over into the PTTP. The shareholder can deduct the at-risk losses at the end of the PTTP to the extent stock basis and at-risk basis are increased by capital contributions during the PTTP.

The definition of post-termination transition period is provided by Sec. 1371(e). Basically, it means the later of one year after the day of termination, or 120 days after determination upon audit that the election had involuntarily terminated.

[43] Secs. 1371(e)(2), 1377(b)(2); Reg. Sec. 18.1371-1.

Summary

- Income that has been taxed to the shareholder can be distributed with no further tax effect.
- Basis and AAA are adjusted for passthrough items, before considering distributions. If there is no AE&P, distributions are
    - Nontaxable return of capital to extent of basis, and
    - Capital gain.
- If there is AE&P and PTI, the distribution order is as follows:
    1. AAA
    2. PTI
    3. AE&P
    4. Nontaxable return of capital to extent of remaining basis
    5. Capital gain

Exhibit 8-1

Election to Distribute Earnings and Profits First

Corporation:	ABC Inc.
Address:	985 Main Street Portland, OR 97001
Employer Identification Number:	93-1234567

The above corporation, ABC Inc., hereby elects under Reg. Sec. 1.1368-1(f)(2) to treat distributions to shareholders during the taxable year ended December 31, 2011, as first made from the corporation's accumulated earnings and profits. All affected shareholders consent to the election.

_____	_____
Date	David Johnson, President

Exhibit 8-2

Consent to Election to Distribute Earnings and Profits First

Corporation:	ABC Inc.
Address:	985 Main Street Portland, OR 97001
Employer Identification Number:	93-1234567

We, the undersigned, constituting all of the shareholders of ABC Inc. who received corporate distributions during the taxable year ended December 31, 2011, hereby consent to the aforementioned corporation's election under Reg. Sec. 1.1368-1(f)(2) to treat distributions as first made from the corporation's accumulated earnings and profits.

Name, Address and I.D. Number of Shareholder	**Date**	**Signature**
Don A. Jones 111 Main St. Portland, OR 97001 111-11-1111	_____	_____
David Johnson 222 Main St. Portland, OR 97001 222-22-2222	_____	_____

Exhibit 8-3

Election to Forego Previously Taxed Income

Corporation:	ABC Inc.
Address:	985 Main Street Portland, OR 97001
Employer Identification Number:	93-1234567

The above corporation, ABC Inc., hereby elects under Reg. Sec. 1.1368-1(f)(4) to treat distributions to shareholders during the taxable year ended December 31, 2011, as not made from the shareholder's share of previously taxed income. All affected shareholders consent to the election.

_____ _____

Date David Johnson, President

Exhibit 8-4

Consent to Election to Forego Previously Taxed Income

Corporation:	ABC Inc.
Address:	985 Main Street Portland, OR 97001
Employer Identification Number:	93-1234567

We, the undersigned, constituting all of the shareholders of ABC Inc. who received corporate distributions during the taxable year ended December 31, 2011, hereby consent to the aforementioned corporation's election to treat distributions as not made from the shareholder's share of previously taxed income.

Name, Address and I.D. Number of Shareholder	**Date**	**Signature**
Don A. Jones 111 Main St. Portland, OR 97001 111-11-1111	_____	_____
David Johnson 222 Main St. Portland, OR 97001 222-22-2222	_____	_____

Exhibit 8-5

Election to Make a Deemed Dividend

Corporation:	GHI Inc.
Address:	589 Main Street Portland, OR 97001
Employer Identification Number:	93-3456123

The above corporation, GHI Inc., hereby elects under Reg. Sec. 1.1368-1(f)(3) to distribute all or part of its accumulated earnings and profits as a deemed dividend to all persons owning corporate shares on the last day of the taxable year ended December 31, 2011. All shareholders at the end of the taxable year consent to the election.

_____	_____
Date	Donald Johnson, President

Exhibit 8-6

Consent to Election to Make a Deemed Dividend

Corporation:	GHI Inc.
Address:	589 Main Street Portland, OR 97001
Employer Identification Number:	93-3456123

We, the undersigned, constituting all of the shareholders of GHI Inc. on the last day of the taxable year ended December 31, 2011, hereby consent to the aforementioned corporation's election to distribute all or part of its accumulated earnings and profits as a deemed dividend. We agree to treat the deemed dividend in accordance with the rules of Section 1368 and the regulations thereunder.

Name, Address and I.D. Number of Shareholder	**Date**	**Signature**	**Amount of Deemed Dividend**
Don A. Smith 222 Main St. Portland, OR 97001 333-33-3333	_____	_____	_____
Donald Johnson 444 Main St. Portland, OR 97001 444-44-4444	_____	_____	_____

Chapter 9

Taxable Year of Corporation

Introduction

In this chapter, we will discuss

- Permitted Years.
- Business Purpose Fiscal Years.
- Applying for a Fiscal Year.
- The Sec. 444 Election.
- Required Payments.

To reduce the income deferral that may occur when an entity chooses a fiscal year, there are tough rules that deny fiscal year treatment to most S corporations. However, S corporations are allowed to use certain fiscal years under some circumstances.

Taxable Year Choices

An S corporation has a number of choices relating to taxable years:

- It can use a calendar year.
- It can make the Sec. 444 election, and use an acceptable fiscal year-end (generally September 30, October 31, or November 30), if required payments are made.
- It can apply for an automatically approved fiscal year, that is, a calendar year, a year that meets the 25 percent of income test, or a year that is the same as that used by shareholders owning more than half the shares.
- It can apply for a business purpose fiscal year.

The rules relating to taxable years can differ depending on whether the corporation is a new or existing S corporation, as discussed later in this chapter.

Permitted Year

Generally, an S corporation must use a permitted year as its taxable period.[1]

[1] Sec. 1378(a).

A *permitted year* is a taxable year that

- Ends on December 31, or
- Is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS.[2]

However, there is an exception to the permitted year rule. Section 444 allows S corporations to elect certain fiscal year-ends (generally September 30, October 31, or November 30) if required payments are made under Sec. 7519. We will refer to this election as the Sec. 444 election.

A permitted year, then, is allowable without regard to Sec. 444. That is, if an S corporation retains or adopts a permitted year, it can do so without making the Sec. 444 election and without making required payments.

Business Purpose Fiscal Years

Business Year

An S corporation can use a fiscal year without making the Sec. 444 election (and without making required payments) if the year has a business purpose that is acceptable to the IRS. The IRS will *automatically* approve certain fiscal years, but will have to be convinced of the validity of other business years.

We will discuss *automatically* approved years first, then we will explore requests for other business fiscal years.

Automatically Approved Years

Years that fit certain criteria will be automatically approved. These years are considered to have a business purpose, so the Sec. 444 election is not required.[3]

No user fee is assessed when an automatically approved fiscal year is used. The IRS charges a user fee when other business purpose fiscal years are requested.

The IRS will automatically approve a fiscal year if the S corporation is adopting, changing to, or retaining

- A calendar year,
- A fiscal year that meets the 25 percent of income test,
- A year that is the same as that used by shareholders owning more than half of the shares. A new S corporation applies for this fiscal year simply by checking the second box under Item P in Part II of Form 2553.

[2] Sec. 1378(b).
[3] Rev. Proc. 2006-46, 2006-45 IRB 859.

Natural Business Year—The 25 Percent Test

An S corporation will be considered to have a natural business year, and the fiscal year will be automatically approved, if the corporation passes an objective test.[4] The test is composed of three steps, as follows:

1. Determine gross income from sales or services for the two consecutive months ending with the day that corresponds with the last day of the requested fiscal year.
2. Starting with the end of that two-month period, compute gross income from sales or services for the preceding twelve month period.
3. If the amount in Step 1 is at least 25 percent of the amount in Step 2, the corporation can use the date that corresponds with the end of the two-month period as the end of its fiscal year, if it can also pass the 25 percent test as a business entity for the preceding two years.

A corporation may meet the test requirements for more than one period. If so, the end of the two-month period that has the highest average of gross receipts will coincide with the close of the natural business year.

We can illustrate the test by use of the following example:

Example 9-1

S Inc. began business twelve years ago as a partnership. It incorporated on February 1, 2010, and the shareholders want to use January 31, 2011, as the end of the corporate fiscal year.

Gross income from sales were as follows:

Twelve-Month Period Ending January 31	Gross Sales for Period	Gross Sales December and January	Percent
2010	$200,000	$50,000	25%
2009	$150,000	$45,000	30%
2008	$125,000	$32,000	26%

S Inc. has exceeded the 25 percent gross income requirement for three years, and will receive automatic approval of a fiscal year ending on January 31.

Corporations starting new businesses, and those which have been businesses for less than 47 months, do not qualify for automatic approval of a natural business year.

- Note that the business is not required to have been an S corporation for 47 months, but it must have been in business that long to verify the income pattern.
- A record of the company's gross receipts for a 47 month period must accompany the request for a fiscal year.

[4] Rev. Proc. 2006-46, 2006-45 IRB 859.

> **Practice Tip:** No user fee is assessed when the corporation meets the 25 percent test and applies for an automatically approved natural business year.

S corporations that receive automatic approval of a natural business year can use that year only as long as the requirements for the natural business year continue to be met.

Business Purpose

A corporation that does not qualify for automatic approval of a fiscal year can still apply for one if there is a business purpose for it.

We can get a feel for what a business purpose is by examining Rev. Proc. 2002-39.[5]

Rev. Proc. 2002-39 states that a natural business year is a substantial business reason for a fiscal year. A natural business year occurs when the business has a non-peak period and a peak period of business. The natural business year is generally deemed to end at, or soon after, the close of the peak period of business. If the income is steady from month to month for the entire year, there is no natural business year.

The revenue procedure further provides that the following reasons will not be sufficient to prove that a business reason exists:

- The use of a particular year for regulatory or financial accounting purposes
- The hiring patterns of a particular business, such as the fact that a firm typically hires staff during certain times of the year
- The use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders
- The fact that a particular business involves the use of price, lists, model year, or other items that change on an annual basis
- The use of a particular year by related entities
- The use of a particular year by competitors

Even though these reasons are not sufficient by themselves to justify a business year, they can be used as legitimate supplementary reasons. In fact, in the author's opinion, any and all information that points to the validity of the business year should be submitted.

Documentation should be provided to the IRS to back up the business purpose of the requested year.

The instructions to Form 2553 state that gross receipts from sales or services, and approximate monthly inventory costs (if applicable), should be shown for each month of the three years preceding the effective date of the S election. If the corporation was in existence for less than three years, the figures for the period of existence should be submitted.

[5] 2002-1 CB 1046.

The request for a fiscal year should point out that it is not made for tax advantage and that income will not be substantially distorted because of the requested year. The application should also give all of the valid business reasons why the fiscal year should be allowed.

A corporation electing S status must indicate that it will use a calendar year or will make a backup Sec. 444 election if the business year is not allowable. Unless the intention to undertake these backup procedures is indicated on the Form 2553, the S election is invalid if the business purpose fiscal year is denied.

> **Practice Tip:** The tone of the fiscal year provisions is pretty tough. Rev. Proc. 2002-39 states that a taxpayer will be granted permission to use a business purpose fiscal year (other than one that is automatically approved) only in rare and unusual circumstances. You cannot expect the IRS to grant these fiscal years unless the business reasons are significant and justified—even then there is no assurance that the requested year will be approved.

User Fee

If an S corporation applies for a business purpose fiscal year that must be approved by the IRS, a user fee applies. The current user fee for requesting a business purpose fiscal year is $3,200 for corporations with gross receipts of $1 million or more; $2,000 for a corporation with gross receipts of $250,000 or more but less than $1 million; and $625 for a corporation with gross receipts of less than $250,000.[6] The fee does not apply if the requested year is applied for under Sec. 444, or is one that will be automatically approved.

The fee should not accompany the S election (Form 2553); rather, the IRS will bill the corporation if the fee is applicable.[7]

An existing S corporation requesting a fiscal year on Form 1128, Application for Change in Accounting Period, should send the user fee along with the form. No fee is payable if the fiscal year is one that will be automatically approved.

Applying for a Fiscal Year

How a New S Corporation Applies for a Fiscal Year

When a new S corporation files its S election, the desired fiscal year is indicated on the face of the election form, Form 2553. (Form 2553 is reproduced at the end of chapter 3.)

CALENDAR YEAR

If a calendar year is chosen, no further action is necessary.

SECTION 444 ELECTION

A corporation electing S status can make the Section 444 election and adopt a fiscal year that does not create a deferral period (that is, the period between the beginning of the fiscal year and December 31) of longer than three months. Thus, the S corporation is generally limited to a

[6] Rev. Proc. 2011-1, 2011-1 IRB 1.
[7] Rev. Proc. 2011-1, 2011-1 IRB 1.

Section 444 year ending September 30, October 31, or November 30. An S corporation using a fiscal year under the Section 444 election is responsible for making required payments to offset the potential deferral of income.

An S corporation makes the Sec. 444 election on Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year.*

The Form 8716 can be attached to the Form 2553, or it can be submitted separately, since the allowable filing times differ for the two forms.

However, the first box in Item R on page 3 of the Form 2553 must be checked to indicate that the Sec. 444 election will be made.

Item R also contains a check-off box to indicate that the S corporation will use a calendar year if the Sec. 444 election is not allowed. (The Sec. 444 election may be denied, for example, because the Form 8716 is filed late, or because an improper year is chosen.) It is very important to check the backup calendar year box because if the Sec. 444 election is applied for and disallowed, the S election is invalid.

AUTOMATICALLY APPROVED FISCAL YEAR

If an automatically approved year is applied for, the appropriate box in Item P on page 3 of Form 2553 is checked. Supplementary information to substantiate that the year qualifies for automatic approval must be attached to the form.

BUSINESS PURPOSE FISCAL YEAR

A business purpose year (other than one that will be automatically approved) is applied for by checking the first box in Item Q on page 3 of the Form 2553.

Supplementary information to substantiate the business purpose must be attached to the form.

BACKUP ELECTION

The S corporation election is *invalid* if a requested fiscal year is denied, unless proper backup procedures are used.[8] The second box under item Q on page 3 of Form 2553 is used to indicate that a backup Sec. 444 election will be made if the business purpose year is denied.

The backup election is made on Form 8716, which must be filed by the later of

- The normal due date of the Form 8716 (the 15th day of the fifth month following the month that includes the first day of the taxable year in which the Sec. 444 election is effective), or
- Sixty days from the date that the IRS denies the business purpose fiscal year request.

The words *Backup Election* should be written on the top of the Form 8716. (Form 8716 is also used to make the Section 444 election.)

[8] Reg. Sec. 18.1378-1(d).

The S corporation can also make a backup calendar-year request, either alone or in conjunction with a backup Sec. 444 election. The backup calendar-year request is made by checking the third box under Item Q on page 3 of Form 2553.

Example 9-2

AB Inc. becomes an S corporation on July 1. It applies for a business purpose year ending on June 30. If the June 30 year is not approved, the shareholders intend to have AB Inc. make a Sec. 444 election and use a September 30 year-end. Consequently, the first box under Item Q on page 3 of the Form 2553 is checked to indicate that a business purpose year is being applied for. The second box is checked to indicate that a backup Sec. 444 election will be made if the June 30 year-end is not approved. The third box is checked to show that the corporation will use a calendar year if both the June 30 and September 30 year ends are not acceptable. (The Sec. 444 election may be denied, for example, if an improper year is requested or if the Form 8716 was not timely filed.)

Example 9-3

Assume the same facts as in Example 9-2, except that AB Inc.'s shareholders do not want the corporation to make the Sec. 444 election. The first and third boxes under Item Q are checked to show that a business purpose year has been applied for, and if it is not approved, a calendar year will be used.

Existing S Corporations

CHANGING TO A CALENDAR YEAR WITHOUT PERMISSION

An existing S corporation can change to a calendar year at any time without permission.[9]

CHANGING TO A CALENDAR YEAR THAT TERMINATES THE SECTION 444 ELECTION

If the corporation has been using a fiscal year under Sec. 444, changing to a calendar year terminates the Section 444 election. In that event, the corporation changes to a calendar year by simply filing a short period return that ends on December 31. It is not necessary to make a special election or file Form 1128, *Application for Change in Accounting Period*.[10]

> **Practice Tip:** A short S corporation tax year results when the Section 444 election is terminated. (An S corporation that terminates the Section 444 election at the end of its fiscal year on, for example, October 31 has a short tax year beginning November 1 and ending December 31.) You should type or print "SECTION 444 ELECTION TERMINATED" on the top of page 1 of the short period return.[11]

[9] Rev. Proc. 2006-46, 2006-45 IRB 859.
[10] Sec. 444(d)(2)(A); Temp. Reg. Sec. 1.444-1T(a)(5).
[11] Temp. Reg. Sec. 1.444-1T(a)(5)(ii).

CHANGING TO A CALENDAR YEAR THAT DOES NOT TERMINATE SECTION 444 ELECTION

If the S corporation is using a fiscal year other than a Section 444 year, it can automatically elect to use a calendar year, but makes the change by filing Form 1128. (In some cases, Form 1128 will be filed because the S corporation is *required* to change to a calendar year. This can occur, for example, when a fiscal year is being used under the 25 percent natural business year test, and the S corporation no longer qualifies under that test.) The Form 1128 is filed with the Internal Revenue Service Center, Attention: ENTITY CONTROL, where the S corporation files its Form 1120S. Also, a copy of the Form 1128 is attached to the S corporation's Form 1120S for the year in which the change to December 31 becomes effective. The Form 1128 must be filed after the end of the year ending December 31, but no later than the due date (including extensions) for filing the Form 1120S for that year. The Form 1128 should be signed by an authorized corporate officer and the words "FILED UNDER REV. PROC. 2006-46" should be written or typed across the top of page 1 of the form. No user fee is assessed.[12]

> **Practice Tip:** If an S corporation is using a fiscal year and changes to a calendar year, the shareholders will include more than 12 months of the corporation's passthrough items of income, loss, deduction or credit on their personal returns for that year. For example, if an S corporation using an October 31 year-end changes to a calendar year, the shareholders will report passthrough items for the year ending October 31 and the two-month period (short year) ending December 31.

SECTION 444 ELECTION

An S corporation makes the Sec. 444 election on Form 8716.

> **Practice Tip:** While it is possible for an existing S corporation to make the Sec. 444 election, it will seldom, if ever, be practical to do so. Making the Sec. 444 election restricts the fiscal year end to September 30, October 31, or November 30. Further, the Sec. 444 election cannot be made if it increases the deferral period, that is, the period between the beginning of the fiscal year and December 31. Thus, an existing calendar year S corporation is ineligible to make the Sec. 444 election because any new fiscal year would increase the deferral period.

AUTOMATICALLY APPROVED FISCAL YEAR

An existing S corporation applies for an automatically approved fiscal year on Form 1128, *Application for Change in Accounting Period*. No user fee is required.

BUSINESS PURPOSE FISCAL YEAR

An existing S corporation applies for a business purpose fiscal year (other than one that will be automatically approved) on Form 1128. Documentation supporting the business purpose of the requested year must be attached to the form. A user fee is required.

[12] Rev. Proc. 2006-46, Sec. 7.02.

The Sec. 444 Election

If an S corporation makes the Sec. 444 election, it may adopt or retain a fiscal year under certain conditions, and is responsible for making *required payments* of 36 percent of the *net base year income*, as described later in this chapter.[13] The corporation is limited to a fiscal year ending September 30, October 31, or November 30.

Length of Election

Once the Sec. 444 election is made, it remains in effect until it is terminated. It is terminated when the S corporation

- Changes to a calendar year (which can be done without IRS approval),
- Terminates the S election,
- Liquidates,
- Willfully fails to comply with the required payment rules of Sec. 7519, or
- Becomes a member of a tiered structure, unless it meets the same taxable year exception of Temp. Reg. Sec. 1.444-2T(e).[14]

If the corporation terminates its S election and immediately becomes a personal service corporation, the Sec. 444 election does not terminate unless the year is changed.[15]

Once the Sec. 444 election is terminated, it cannot be made again.

How Section 444 Election Is Made

The Sec. 444 election is made on Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year*. The form is filed with the Internal Revenue Service Center where the entity files its tax return.[16]

S corporations making the election must file Form 8752, *Required Payment or Refund under Section 7519*, regardless of whether payments are required.

The election must generally be filed the earlier of

- The 15th day of the fifth month following the month that includes the first day of the taxable year in which the Sec. 444 election is effective, or
- The due date of the return (without considering extensions) for the first Sec. 444 election taxable year.[17]

[13] Secs 444, and 7519.
[14] Sec. 444(d); Temp. Reg. Secs. 1.444-1T(a)(2)(ii), 1.444-1T(a)(5).
[15] Temp. Reg. Sec. 1.444-1T(a)(5).
[16] Temp. Reg. Sec. 1.444-3T(b)(2).
[17] Temp. Reg. Sec. 1.444-3T(b)(1).

Example 9-4

Beecorp incorporates and elects S status. Its first tax year begins on September 10, 2011. It qualifies for a September 30 fiscal year under Sec. 444. The election is due by December 15, 2011. That is, the earlier of

- February 15, 2012, that is, the 15th day of the fifth month following September, or
- December 15, 2011, that is, the due date of the return for the year ended September 30, 2011.

Reg. Sec. 301-9100-2 provides an automatic 12-month extension for filing Form 8752. Thus, the form can be timely filed within 12 months of its original due date. A Form 8752 filed during the automatic extension period should be completed in accordance with the instructions to the form.

Another exception to the election filing deadline is made if the corporation requests a business purpose year, and also makes a Sec. 444 backup request. In that event, the Sec. 444 election can be made within 60 days after the business purpose request is denied.[18]

A new S corporation can attach the Form 8716 to the S election Form 2553.

Grandfather Rules

An S corporation that was using a fiscal year for the year beginning in 1986 can continue to use that year, if the Sec. 444 election was made.[19]

An S corporation that was using a *permitted* year in 1986 can continue to use that year, without making the Sec. 444 election and without making required payments. This rule applies if the corporation applied for, and got permission to use, a fiscal year for which there was a business purpose. (However, it cannot be a September, October, or November year-end that was automatically approved because of the three-month or less deferral rule.)

Restrictions on Section 444 Fiscal Years

As explained below, only certain fiscal years can be elected, even if required payments are made.

A new S corporation can make the Sec. 444 election and adopt a fiscal year that does not create a deferral period of longer than three months; that is, a September 30, October 31, or November 30, year end.

If a C corporation elects to become an S corporation, it can elect to retain its fiscal year under Sec. 444, so long as income is not deferred for more than three months.[20]

If a C corporation that becomes an S corporation is using a fiscal year that produces less than three months of income deferral, it cannot elect to change to a year that causes a longer deferral period, even if it is still within the three-month period.

[18]Temp. Reg. Sec. 1.444-3T(b)(4).
[19] Sec. 444(b)(3).
[20] Sec. 444(b)(1); Temp. Reg. Sec. 1.444-1T(b).

Example 9-5

A C corporation with an October 31 year end may elect S corporation status and retain its October year end under Sec. 444, but it may not choose a September 30 year end. By contrast, a C corporation with a July 31 year end that becomes an S corporation may elect only a September 30, October 31, or November 30 year end under Sec. 444 (or it can use a calendar year).

Under this rule, a C corporation that is using a calendar year may not elect S status and make the Sec. 444 election to use a fiscal year, because any fiscal year would extend the deferral period.

Evidently, a proprietorship or partnership that incorporates is not subject to the longer deferral period rule. That is, a calendar year partnership that incorporates and simultaneously becomes an S corporation can choose a September 30, October 31, or November 30 fiscal year, if the Sec. 444 election is made.

Furthermore, a personal service corporation with a Section 444 election in effect can make the S election and retain its fiscal year. The Section 444 election remains in effect, and the corporation continues to make required payments.[21] A personal service corporation for this purpose is defined in Reg. Sec. 1.441-3.

Tiered Structures

An entity that is part of a *tiered structure* may not elect to retain or adopt a fiscal year unless the tiered structure is made up of only S corporations or partnerships that all have the same taxable year.

A tiered structure is an entity that has personal service corporations, partnerships, or certain trusts as partners or shareholders.[22]

Required Payments

Fiscal Year S Corporation Can Be Liable for Required Payments

For S corporations that are eligible to make the Section 444 election, the choice of a fiscal year *has a price*—basically 36 percent of the *net base year income*.

Under Sec. 7519, an S corporation whose liability exceeds $500 must make a required payment for any year that the Sec. 444 election is in effect. The payment is made by the S corporation itself, rather than by the individual shareholders.

Required Payments Are Deposits

Required payments are designed to represent the approximate tax that would have been due if a calendar year had been used. That is, they offset the deferral of income that results from use of a fiscal year.

[21] Temp. Reg. Sec. 1.444-1T(a)(5).
[22] Sec. 444(d)(3); Temp. Reg. Secs. 1.444-2T, 1.444-4T.

From a practical standpoint, required payments are *deposits*, and some important points relating to them follow. Careful study of each S corporation will be required to determine if retention of the fiscal year is worth the cost.

- The applicable rate for the deposit may (and in most cases will) exceed the actual deferred tax, depending on the individual shareholders' tax brackets.
- If the S corporation's income increases, the deposit will continually increase.
- If the income remains the same over a period of years, the required payment becomes, in effect, a permanent tax deposit.
- If income decreases or the Sec. 444 election is terminated, all or part of the required payments will be refunded.

Interest and Penalties

The S corporation receives no interest on the required payments, even if it receives a refund of a previous payment.[23]

Interest is *charged* to the entity, however, if underpayments of the required payment, which is considered a tax, occur.

Underpayments are also subject to the 10 percent underpayment penalty, as well as the negligence and fraud penalties of Sections 6662 and 6663.

Willful failure to comply with the rules causes the Section 444 election to be cancelled.[24]

Definitions

Before getting into the calculation of required payments, we need some definitions:

- *Required payment*—To calculate the amount of the required payment,
  - Multiply the net base year income by the adjusted highest Sec. 1 rate.
  - Adjust this figure as necessary for *applicable payments*.
  - Subtract the preceding year's required payment.

  Form 8752 has specific instructions. In the rest of this section, we will look more closely at a few important considerations involved in this calculation and at details of submitting the required payment.
- *Adjusted highest Sec. 1 rate*—The rate is the tax rate imposed by Sec. 1, as of the end of the base year, plus one percentage point.[25] The rate is presently 36 percent.

[23] Sec. 7519(f)(3).
[24] Sec. 7519(f)(4).
[25] Sec. 7519(b); Temp. Reg. Sec. 1.7519-1T(b)(2)(ii).

- *Deferral period*—The number of months from the beginning of the fiscal year to the end of the calendar year.[26]

> **Example 9-6**
>
> S Corp's fiscal year begins on October 1, 2011, and ends on September 30, 2012. The deferral period is October, November, and December, 2011.

- *Deferral ratio*—The deferral ratio is composed of the number of months in the deferral period, compared to 12, the total number of months in the year.[27]

- *Base year*—The taxable year that *precedes* the applicable election year.[28]

  Any taxable year occurring during the time that an election is in effect is an applicable election year.

> **Example 9-7**
>
> S Corp's year ends September 30, 2011. The election and required payments are made in 2012. The base year is the year ending in 2011.

- *Base year net income*—The deferral ratio is applied to the base year's net income. The base year's net income is the total of the corporation's taxable (nonseparately stated) items of income, loss and expense and all of the separately stated items of income and expense. (These are the items, except for credits and tax-exempt income, described in Sec. 1366[a].) Limitations imposed at the shareholder level are disregarded when making the calculation of net income.[29]

  - The base year income must be annualized if a short year precedes the election year.[30]

  - If an S corporation was a C corporation for the base year, the C corporation's taxable income is used to determine base year income.[31] The C corporation's applicable payments must also be considered.

  - If an S corporation makes the Sec. 444 election for the first year of its corporate existence, the base year income is considered to be zero.[32]

- *Applicable payments*—Payments paid or incurred by an S corporation that are included in the gross income of a shareholder, not including any gain from the sale or exchange of property between the shareholder and the corporation, and dividends of S corporations. Certain payments (such as to a spouse) are also deemed to be applicable payments.[33]

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[26] Sec. 7519(e).
[27] Sec. 7519(d).
[28] Sec. 7519(e)(2)(A).
[29] Sec. 7519(d)(2).
[30] Temp. Reg. Sec. 1.7519-1T(b)(5)(v).
[31] Sec. 7519(d)(2)(B); Temp. Reg. Sec. 1.7519-1T(b)(5)(iii)(A).
[32] Temp. Reg. Sec. 1.7519-1T(b)(4).
[33] Sec. 7519(d)(3); Temp. Reg. Sec. 1.7519-1T(b)(5)(iv).

Calculation of Required Payment

We will start with an explanation of the calculation, then follow it up with an example.

The payment is based on the amount of income in the preceding taxable year prorated for the number of months in the deferral period—the period between the beginning of the fiscal year and the end of the calendar year.

- For instance, an S corporation with a September 30 fiscal year end has a deferral period of three months (from the beginning of the fiscal year, October 1, to the end of the calendar year). Thus, the required payment is based on three-twelfths of the net base year income. If the base year's income was $24,000, the applicable rate is applied to $6,000 dollars (3/12 × $24,000).
- It does not matter what the actual results of operations for the deferral period are.

APPLICABLE PAYMENTS ADJUSTMENT

If applicable payments are reduced in the deferral period compared to what they were in the earlier portion of the year, this can *add* to the base year's income, and therefore can increase the required payment.

Applicable payments are payments made by an S corporation that are included in the gross income of a shareholder. (Examples would be salary, rent, and so on) They do not include dividends, or any gain from the sale or exchange of property between the shareholder and the corporation.

The first step in the calculation of the applicable payments adjustment is to determine the amount of applicable payments that were made during the base year.

Then the deferral ratio is applied to that amount. The result is the deferral period's *pro rata* share of applicable payments.

This amount is compared to the actual applicable payments made during the base year's deferral period.

If the actual payments are less than the *pro rata* amount, the difference increases the base period net income for purposes of the required payment calculation. Example 9-15 illustrates this point.

REASON FOR THE APPLICABLE PAYMENTS RULE

It is obviously possible to defer a shareholder's income in a fiscal year situation by holding back on payments to that shareholder until after the first of the calendar year.

Example 9-8

Assume an S corporation has a fiscal year ending on September 30. Rick, the sole stockholder, normally receives salary of $5,000 a month. But for the months of October, November, and December, he receives no salary, and in January receives $20,000 in salary to catch up. If the payments had actually been made in October, November, and December, Rick would have been taxed on those payments in the

current year. By putting off the payments until January, he defers tax on the salary until the next calendar year.

There is no addition to the calculation of required payments unless the payments to shareholders during the deferral period are less than the average of the payments during the entire preceding year. This discourages entities from reducing deductible payments to owners during the deferral period.

REQUIRED PAYMENTS ARE CUMULATIVE

Now we will move from *applicable* payments to cover more points relating to *required* payments. Required payments are computed cumulatively. That is, the calculation is performed for the current year, then the cumulative payments (net of refunds) for preceding years are subtracted.[34]

The amount of net cumulative payments and refunds is called the *net required payment* balance.[35]

Example 9-9

ABC is an S corporation. The required payment for ABC's first S year is $600. The second year, the calculation of applying the rate to the deferred income results in a total of $900. The first year's required payment, $600, is subtracted, and the difference, $300, must be paid for the second year.

If the required payment for a year is less than the cumulative payments in the previous years, the difference will be refunded.

Example 9-10

Assume the same facts as in Example 9-9. In the third year, the calculation of applying the rate to the deferred income results in a total of $550. In the fourth year, the result is $1,000. The required payments (or refunds) are computed as follows:

	Year 1	Year 2	Year 3	Year 4
Result of applying rate to deferred income	$600	$900	$550	$1,000
Net required payment balance	–	(600)	(900)	(550)
Required payment (refund)	$600	$300	$(350)	$450

PAYMENTS ARE MADE WITH FORM 8752

Required payments are submitted to the IRS with Form 8752, *Required Payment or Refund Under Section 7519*. The calculation of the payment or refund is made on the form.

PAYMENTS OF $500 OR LESS ARE NOT REQUIRED

[34] Sec. 7519(b).
[35] Sec. 7519(e)(4).

No payment is due unless required payments for the current year and *all previous years* exceed $500.[36] No credit is allowed for a previous year's required payment unless it was actually made.

> **Example 9-11**
>
> BCD is an S corporation. Its required payment for Year One is $450. No payment has to be made that year. Assume in Year Two that the calculation of the required payment comes to $100; that is, a total amount for the current year of $550 less last year's required payment of $450. Since no required payment had actually been made in the prior year, a payment of $550 must be made this year.

Form 8752, however, must be filed for any year that the Section 444 election is in effect, regardless of whether required payments are due.

DUE DATE

The required payment must be made by May 15 of the calendar year following the calendar year in which the applicable year begins.[37]

> **Example 9-12**
>
> Beecorp, an S corporation, has a year beginning September 1, 2011, and makes the Sec. 444 election. The first required payment is due May 15, 2012. The Form 8752 must be filed by that date even if a payment is not due, for example, because the amount is less than $500.

Refund of Required Payments

All or part of an S corporation's required payments will be refunded if one of the following situations occur:

- The required payment for the current year is less than the previous cumulative required payments.
- The Sec. 444 election is terminated.[38]
- The corporation is liquidated.[39]

The time in which refunds will be made is as follows:

- For years when the required payment is less than the net required payment balance, the refund is payable on April 15 of the calendar year following the calendar year in which the election year giving rise to the refund begins.

[36] Sec. 7519(a).
[37] Temp. Reg. Sec. 1.7519-2T(a)(4)(ii).
[38] Temp. Reg. Sec. 1.7519-1T(c).
[39] Sec. 7519(c).

Example 9-13

Dyecorp uses a fiscal year ending September 30 under Sec. 444. For the year beginning October 1, 2010, the required payment calculation comes to $1,000, while a total of $2,500 in required payments was made in prior years. (The required payment would be calculated by using information from the base year, that is, the year ending September 30, 2010.) The $1,500 refund will be payable by the IRS on April 15, 2011.

- For years in which the S election terminates or the corporation liquidates, the refund is payable on April 15 of the calendar year that follows the calendar year in which the year of termination or liquidation ends.

Example 9-14

Eyecorp uses a fiscal year ending September 30, under Sec. 444. The S election is terminated on September 30, 2010. A total of $2,500 had been made in required payments. A refund of the $2,500 is due on April 15, 2011.

- If the April 15th dates in the points above have gone by, the refund is payable 90 days after a claim for refund is filed with the Secretary of the Treasury.[40]

APPLYING FOR REFUND OF REQUIRED PAYMENTS

Refunds (as well as required payments) are calculated on Form 8752.

Illustration of Required Payments

The following example illustrates the required payments calculation.

Example 9-15

AB Corp is a C corporation that has been using a fiscal year ending on September 30. AB Corp. becomes an S corporation on October 1, 2011, and elects to retain its fiscal year under Sec. 444.

The corporation experiences the following over a two-year period:

[40] Sec. 7519(c).

	Year Ended 9-30-2011	Year Ended 9-30-2012
Ordinary income (after deduction for applicable payments)	$55,000	$115,000
Charitable contributions	(5,000)	(5,000)
Base period net income	$50,000	$110,000
Applicable payments:		
Wages to sole shareholder:		
10-1 through 12-31	$ 3,000	$24,000
1-1 through 9-30	57,000	48,000
Totals	$60,000	$72,000

AB Inc. must make a required payment by May 15, 2012, computed using amounts from the base year—the year ended September 30, 2011. (It is important to note that this pre-S year is the base year because AB Inc. was a C corporation during that period. If it had been a proprietorship, partnership, or not yet in business, there would be no base year, and no required payment would be due during the first S year.)

The deferral period in this case is three months, October, November, and December.

Required payments for the two years are computed (using the general format of Form 8752) as follows:

	Year Ended 9-30-2011	9-30-2012
1. Net income for base year	$50,000	$110,000
2. Applicable payments during base year	60,000	72,000
3. Base year deferral ratio (3/12)	25%	25%
4. Line 1 times line 3	12,500	27,500
5. Line 2 times line 3	15,000	18,000
6. Applicable payments during deferral period	3,000	24,000
7. Line 5 less line 6	12,000[1]	0
8. Net base year income – Add line 4 and 7	24,500	27,500
9. Multiply line 8 by adjusted highest Sec. 1 rate (36 percent)	8,820	9,900
10. Net required payment balance (cumulative previous payments less previous refunds)	0	8,820
11. Required payment due (line 9 – line 10) (Not less than zero)	8,820	1,080
12. Refund (line 10 – line 9) (Not less than zero)	$ 0	$ 0
Payment due by	May 15, 2012	May 15, 2013

[1] This illustrates that applicable payments can increase the required payment. In practice, applicable payments should be timed so that the increase does not occur, as is the case in the second year in this example

Summary

- All S corporations must use a permitted year or make the Sec. 444 election.
- If the Sec. 444 election is made, the S corporation is responsible for submitting required payments based on the operations of the preceding year.

Form **8716**
(Rev. December 2008)
Department of the Treasury
Internal Revenue Service

Election To Have a Tax Year Other Than a Required Tax Year

OMB No. 1545-1036

Type or Print	Name	Employer identification number
	Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
	City or town, state, and ZIP code	

1 Check applicable box to indicate type of entity:
- ☐ Partnership
- ☐ S corporation (or C corporation electing to be an S corporation)
- ☐ Personal service corporation (PSC)

2 Name and telephone number (including area code) of person who may be called for information:

	Month	Day	Year
3 Enter ending date of the tax year for the entity's last filed return. A new entity should enter the ending date of the tax year it is adopting			
	Month	Day	
4 Enter ending date of required tax year determined under section 441(i), 706(b), or 1378 . .			
5 **Section 444(a) Election.** Check the applicable box and enter the ending date of the first tax year for which the election will be effective that the entity is (see instructions):	Month	Day	Year
☐ Adopting ☐ Retaining ☐ Changing to			

Under penalties of perjury, I declare that the entity named above has authorized me to make this election under section 444(a), and that the statements made are, to the best of my knowledge and belief, true, correct, and complete.

▶ Signature and title (see instructions)

▶ Date

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Form 8716 is filed by partnerships, S corporations, and personal service corporations (as defined in section 441(i)(2)) to elect under section 444 to have a tax year other than a required tax year.

When To File

Form 8716 must be signed and filed by the earlier of:

1. The 15th day of the 5th month following the month that includes the 1st day of the tax year the election will be effective or

2. The due date (not including extensions) of the income tax return for the tax year resulting from the section 444 election.

Items **1** and **2** relate to the tax year, or the return for the tax year, for which the ending date is entered on line 5 above.

Under Regulations section 301.9100-2, the entity is automatically granted a 12-month extension to make an election on Form 8716. To obtain an extension, type or legibly print "Filed Pursuant To Section 301.9100-2" at the top of Form 8716, and file the form within 12 months of the original due date.

Where To File

File Form 8716 at the applicable IRS address shown below.

If the entity's principal place of business or principal office or agency is located in ▼	Use the following address ▼
Connecticut, Delaware, District of Columbia, Georgia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Virginia, West Virginia, Wisconsin	Department of the Treasury Internal Revenue Service Center Cincinnati, OH 45999
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wyoming	Department of the Treasury Internal Revenue Service Center Ogden, UT 84201

An entity without a principal office or agency or principal place of business in the United States must file Form 8716 with the Internal Revenue Service Center, P.O. Box 409101, Ogden, UT 84409.

Also file a copy of Form 8716 with your income tax return for the first tax year for which the election is made. To enable electronic filing, you may file an unsigned Form 8716 containing the same information as on the signed Form 8716 you filed separately.

Effect of Section 444 Election

Partnerships and S corporations. An electing partnership or S corporation must file Form 8752, Required Payment or Refund Under Section 7519, for each year the election is in effect. Form 8752 is used to figure and make the payment required under section 7519 or to obtain a refund of net prior year payments. File Form 8752 by May 15 following the calendar year in which each applicable election year begins.

The section 444 election will end if the partnership or S corporation is penalized for willfully failing to make the required payments.

Personal service corporations (PSC). An electing PSC should not file Form 8752. Instead, it must comply with the minimum distribution requirements (see next paragraph) of section 280H for each year the election is in effect. If the PSC does not meet these requirements, the applicable amounts it may deduct for payments made to its employee-owners may be limited.

Use Schedule H (Form 1120), Section 280H Limitations for a Personal Service Corporation (PSC), to figure the required minimum distribution and the maximum deductible amount. Attach Schedule H to the income tax return of the PSC for each tax year the PSC does not meet the minimum distribution requirements.

The section 444 election will end if the PSC is penalized for willfully failing to comply with the requirements of section 280H.

Members of Certain Tiered Structures May Not Make Election

No election may be made under section 444(a) by an entity that is part of a tiered structure other than a tiered structure that consists entirely of partnerships and/or S corporations all of which have the same tax year. An election previously made will be terminated if an entity later becomes part of a tiered structure that is not allowed to make the election. See Temporary Regulations section 1.444-2T for other details.

Acceptance of Election

After your election is received and accepted by the service center, the center will stamp it "Accepted" and return a copy to you. Be sure to keep a copy of the form marked "Accepted" for your records.

End of Election

The election is made only once. It remains in effect until the entity changes its accounting period to its required tax year or some other permitted year or it is penalized for willfully failing to comply with the requirements of section 280H or 7519. If the election is terminated, the entity may not make another section 444 election.

Signature

Form 8716 is not a valid election unless it is signed. For partnerships, a general partner or a member-manager of a limited liability company must sign and date the election.

For corporations, the election must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer (such as tax officer) authorized to sign its tax return.

If a receiver, trustee in bankruptcy, or assignee controls the entity's property or business, that person must sign the election.

Specific Instructions

Line 1

Check the applicable box to indicate whether the entity is classified for federal income tax purposes as a partnership, an S corporation (or a C corporation electing to be an S corporation), or a PSC.

A corporation electing to be an S corporation that wants to make a section 444 election is not required to attach a copy of Form 8716 to its Form 2553, Election by a Small Business Corporation. However, the corporation is required to state on Form 2553 its intention to make a section 444 election (or a backup section 444 election). If a corporation is making a backup section 444 election (provided for in Part II, item Q, of Form 2553), it must type or print the words "Backup Election" at the top of the Form 8716 it files. See Temporary Regulations section 1.444-3T for more details.

Line 2

Enter the name and telephone number (including the area code) of a person that the IRS may call for information needed to complete the processing of the election.

Line 4

Required tax year. The required tax year for an S corporation or PSC is a calendar year. Generally, the required tax year for a partnership is the tax year of a majority of its partners (see Regulations section 1.706-1(b) for details).

Line 5

The following limitations and special rules apply in determining the tax year an entity may elect.

New entity adopting a tax year. An entity adopting a tax year may elect a tax year under section 444 only if the deferral period of the tax year is not more than 3 months. See *Deferral period* below.

Existing entity retaining a tax year. In certain cases, an entity may elect to retain its tax year if the deferral period is not more than 3 months. If the entity does not want to elect to retain its tax year, it may elect to change its tax year as explained below.

Existing entity changing a tax year. An existing entity may elect to change its tax year if the deferral period of the elected tax year is not more than the shorter of 3 months or the deferral period of the tax year being changed. If the tax year being changed is the entity's required tax year, the deferral period for that year is zero and the entity is not permitted to make a section 444 election.

Example. ABC, a C corporation that historically used a tax year ending October 31, elects S status and wants to make a section 444 election for its tax year beginning November 1. ABC's required tax year under section 1378 is a calendar tax year. In this case, the deferral period of the tax year being changed is 2 months. Thus, ABC may elect to retain its tax year beginning November 1 and ending October 31 or elect a tax year beginning on December 1 (with a deferral period of one month). However, it may not elect a tax year beginning October 1 because the 3-month deferral period would be longer than the 2-month deferral period of the tax year being changed. If ABC elects a tax year beginning on December 1, it must file a short tax year return beginning November 1 and ending November 30.

Deferral period. The term "deferral period" means the number of months between the last day of the elected tax year and the last day of the required tax year. For example, if you elected a tax year that ends on September 30 and your required tax year is the calendar year, the deferral period would be 3 months (the number of months between September 30 and December 31).

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping . . . . 2 hr., 37 min.
Learning about the law or the form . . . . 1 hr., 12 min.
Preparing and sending the form to the IRS . . . 1 hr., 16 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send the form to this address. Instead, see *Where To File* on page 1.

Chapter 10

Passive Activity Rules, LIFO Recapture, Fringe Benefits, and Other Considerations

Introduction

In this chapter, we will discuss

- Passive Activity Rules.
- Investment Interest Limitation and Interest to Finance S Corporation Stock.
- LIFO Recapture.
- Fringe Benefits.
- Shareholder Expenses.
- Section 199 Domestic Production Activities Deduction.
- Section 179 Deduction.
- Other Considerations, Including Tax Administration Rules.

Passive Activity Loss Rules

Summary of Passive Activity Loss Rules

In this chapter, we will primarily deal with the passive activity loss provisions of Sec. 469 that specifically affect S corporations.

We will also look at a variety of other subjects not covered in previous chapters, including investment interest limitation, LIFO recapture, fringe benefits, shareholder expenses, and more.

CATEGORIES OF INCOME OR LOSS

The passive activity loss rules place income into three categories:

1. Nonpassive income or loss from salaries or from a trade or business in which the taxpayer materially participates. (We will sometimes call this *active* income or loss.)
2. Passive activity income or loss (income from a trade or business in which the taxpayer does not materially participate). With certain exceptions, it also includes rental income whether or not the taxpayer materially participates.

3. Portfolio income (generally, interest, dividends, royalties, and gain or loss from the disposition of activities that generate portfolio income).

The basic rule is that losses from passive activities cannot offset income or gains from nonpassive (that is, active and portfolio) activities.

SUSPENDED LOSSES CAN BE DEDUCTED UPON DISPOSITION OF ACTIVITY

Passive activity losses that cannot be deducted because there is no passive income become *suspended*, and carry over to subsequent years to apply against passive income in those years. When a taxpayer disposes of an entire activity in a fully taxable (rather than tax-deferred) transaction to an unrelated party, suspended passive losses and loss on the disposition of the activity can be deducted against nonpassive income.

PASSIVE ACTIVITY RULES APPLY AT SHAREHOLDER LEVEL

The passive activity loss rules do not apply loss limitations at the S corporation level. Rather, the S corporation items are passed through to the shareholder as active, passive, or portfolio income. Applicable limitations are then applied at the shareholder's return.

INTEREST AND DIVIDENDS ARE NOT PASSIVE ACTIVITY INCOME

One of the confusing aspects of this law is the term *passive*. We are used to thinking of interest and dividend income as passive income—and it is. But it is not passive *activity* income. For purposes of the passive activity rules, interest and dividend income is portfolio (nonpassive activity) income.

Definition of Activity

The Code does not define *activity*. Instead, Congress authorized the IRS to provide one, and that is done in Reg. Sec. 1.469-4. These regulations provide guidance on how to identify activities under the passive loss rules.

An S corporation can conduct more than one activity. The operating results of each activity pass through separately to the shareholders.

But how do you determine whether there is more than one activity?

Regulations generally provide that one or more activities are treated as a single activity if they constitute an *appropriate economic unit for the measurement of gain or loss* under the facts and circumstances.[1]

Combining or Separating Activities

The facts and circumstances can be applied using any reasonable method when determining the makeup of a specific activity. The regulations list four factors that are the most important when determining whether activities should be separated or combined:

[1] Reg. Sec. 1.469-4(c).

1. Similarities and differences in types of business
2. Extent of common control and common ownership
3. Geographical location
4. Interdependence between the activities[2]

Activity Groupings Generally Cannot be Regrouped

When a taxpayer has grouped the activities, they cannot be regrouped later, unless the original grouping was inappropriate or there has been a material change in the facts. However, the IRS has the power to regroup activities if the taxpayer is circumventing the passive activity regulations.[3]

Example 10-1

BT, Inc., an S corporation, owns a bakery and a movie theater in a shopping center in Baltimore and a bakery and movie theater in Philadelphia. Depending on the relevant facts and circumstances, BT may (or may not) be able to group the activities into:

- One activity made up of the businesses in both locations;
- Two activities made up of (1) the movie theaters, and (2) the bakeries;
- Two activities made up of (1) the businesses in Baltimore, and (2) the businesses in Philadelphia; or
- Four separate activities.

Once BT groups these activities into appropriate economic units, it must continue using that grouping unless a material change in the facts and circumstances makes it clearly inappropriate.

Pros and Cons of Combining or Separating Activities

Combining trade or business activities can make it easier for the taxpayer to meet the material participation test, described later, so that the taxpayer materially participates in the combined activities. You will need to carefully consider the effects of each potential combination, both in light of the ongoing passive activity rules and the effect on the client upon disposition of the activities.

A client can deduct prior suspended passive activity losses against nonpassive income when the activity is disposed of in a fully taxable (rather than tax-deferred) transaction with an unrelated party. It may be more difficult to dispose of the entire activity if multiple businesses are combined into one activity. For instance, in Example 10-1, if BT elects to combine all four businesses into one activity, all four businesses must be disposed of in order to deduct suspended losses against nonpassive income. On the other hand, if BT treats each of the four businesses as a

[2] Reg. Sec. 1.469-4(c)(2).
[3] Reg. Sec. 1.469-4(f).

separate activity, the disposition of any one business will free up suspended losses generated by that activity.

How S Corporations and Shareholders Group or Separate Activities

An S corporation groups or separates its activities under the specific facts and circumstances. Once the S corporation groups its activities, a shareholder can group those activities with each other, with activities conducted directly by the shareholder, and with activities conducted through other entities, using the facts and circumstances tests. However, a shareholder cannot separate activities that the S corporation has grouped together.[4]

Combining Rental Activity with Trade or Business Activity

A rental activity and trade or business activity cannot be combined unless one of the following applies:

- One activity is insubstantial in relation to the other activity.
- Property is rented to a trade or business and the rental and trade or business activities are owned by the same taxpayers in the same proportion.

ONE ACTIVITY IS INSUBSTANTIAL IN RELATION TO THE OTHER ACTIVITY

A rental activity is not combined with a trade or business activity unless one activity is *insubstantial* in relation to the other activity.[5] (*Insubstantial*, however, is undefined.)

The District Court tackled the issue of whether an activity was insubstantial in relation to another activity in *Eugene B. Glick*, 86 AFTR 2d 2000-5083, 96 F.Supp.2d 850 (DC IN 2000). The Court used a two-pronged test. One test evaluated the relationship of the rental and business activities to determine whether they were operating as an integrated unit representing a single economic enterprise. The other test compared each activity's gross income and the fair market value of each activity's assets. The Court implied that it would consider percentages under 20 percent of the total income and assets to be insubstantial.[6]

The IRS has ruled that the taxpayer could not combine rental and business activities because one activity was not insubstantial when compared to the other activity, even though the gross rental income was less than 20 percent of the combined income from both activities.[7] The letter ruling states that additional factors must be considered, including the value of each activity and each activity's capital investment.

[4] Reg. Sec. 1.469-4(d)(5).
[5] Reg.Sec.1.1469-4(d)(1).
[6] See also *Leroy Candelaria*, 100 AFTR 2d 2007-6381 (DC TX 2007) and *Eugene J. Schumacher*, TC Summary Opinion 2003-96(2003).
[7] Ltr. Rul. 200014045.

RENTAL AND TRADE OR BUSINESS ACTIVITIES ARE OWNED PROPORTIONATELY BY THE SAME TAXPAYER OR TAXPAYERS

Rental and trade or business activities can be combined (regardless of whether one activity is insubstantial in relation to the other) if (a) property is rented to a trade or business activity, (b) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, and (c) the activities represent an appropriate economic unit under the passive activity rules.[8]

Making the Election to Combine Activities

For tax years beginning before January 25, 2010 (that is, the effective date of Rev. Proc. 2010-13, discussed below), it is evidently not necessary to make a formal election to combine activities. The Seventh Circuit, however, has ruled that the taxpayer must clearly notify the IRS how activities are grouped.[9] In light of the *Krukowski* decision, the author recommends that affected taxpayers follow the provisions of Rev. Proc. 2010-13, even if the tax return covers a period before the effective date of the procedure.

GUIDANCE FOR DISCLOSING ACTIVITY GROUPINGS BY S SHAREHOLDERS

For tax years beginning on or after January 25, 2010, Rev. Proc. 2010-13 (2010-4 IRB 329) provides guidance on how grouping or separating activities should be disclosed.

> **Note:** The following rules under Rev. Proc. 2010-13 do not apply to S corporations at the entity level. The revenue procedure provisions can, however, apply to S corporation shareholders who combine activities.

Under Rev. Proc. 2010-13, the taxpayer must file a written statement with its original return for the *first* taxable year in which one or more of the following took place:

- *Trade or business activities or rental activities are grouped as a single activity*. The statement must identify the names, addresses, and employer identification numbers of the activities that are being grouped. Also, a statement reporting a new grouping of two or more activities into a single activity must include a declaration that the grouped activities constitute an appropriate economic unit for measuring gain or loss under the passive activity loss rules of Sec. 469.

- *A new activity is added to an existing grouping*. The statement must include the name, address, and employer identification number of the new activity. The statement must also identify the names, addresses, and employer identification numbers of the activities within the existing grouping. Furthermore, a declaration that the activities constitute an appropriate economic unit for purposes of Sec. 469 must be included in the statement.

- *Activities are regrouped because the original grouping was clearly inappropriate or there was a change in facts and circumstances*. The statement must identify the names, addresses, and employer identification numbers of the activities that are being regrouped.

[8] Reg. Sec. 1.469-1(d)(1).
[9] *Thomas P. Krukowski*, 89 AFTR 2d 2002-827, 279 F.3d 547, 2002-1 USTC 50,219 (2002, CA7) *aff'g* 114 TC 366 (2000).

> If two or more activities are regrouped into a single activity, the statement must contain a declaration that the regrouped activities constitute an appropriate economic unit for purposes of Sec. 469. Furthermore, the statement must explain why the taxpayer's original grouping was clearly inappropriate or what material change in the facts and circumstances occurred that made the original grouping clearly inappropriate.

No Written Statement Required for Previous Groupings

Under Rev. Proc. 2010-13, no statement will be required to report activities that were grouped *before* the requirements become effective. Statements will not be required until the taxpayer makes one or more changes to the grouping, as described above.

Activities are Treated Separately unless Statement Is Properly Filed

The requirements under Rev. Proc. 2010-13 provide that the taxpayer's activities will be treated as separate activities unless the taxpayer properly files the required statements.

> **Practice Tip:** Because activities are considered to be separate unless the required statements are filed, it is evidently not necessary for taxpayers to file a grouping statement if the taxpayer treats each activity as a separate activity. A grouping statement is required under Rev. Proc. 2010-13 only in the first taxable year that the taxpayer is grouping activities or adding an activity to an existing group.

SPECIAL RULES FOR S CORPORATIONS

The preceding grouping rules do *not* apply to S corporations (or partnerships). S corporations must instead comply with the disclosure instructions set out in the instructions to the S corporation tax return, Form 1120S. Generally, the S corporation's groupings must be disclosed to the shareholder on a statement (attached to the shareholder's Schedule K-1) that separately states the amounts of income and loss for each activity grouping conducted by the S corporation.

According to the instructions to Form 1120S, the statement should identify the type of each activity by specifying whether it is a trade or business, rental real estate activity, rental activity other than real estate, or investment activity. The attachment for each activity should provide a statement detailing the net income (loss), credits, and separately stated items from each activity, using the same line and box numbers as shown on Schedule K-1.

The shareholder is not required to make a separate disclosure of the groupings shown on the K-1 statement, unless the shareholder

- Groups together any of the activities that the S corporation does not group together,
- Groups the S corporation's activities with activities conducted directly by the shareholder, or
- Groups the S corporation's activities with activities conducted through other Section 469 entities (defined in Rev. Proc. 2010-13 as C corporations subject to the Section 469 passive activity loss rules, S corporations, or partnerships).

If the S corporation groups activities at the entity level, a shareholder cannot treat these grouped activities as separate activities.[10]

Real Estate Professionals Are under Separate Aggregation Rules

Rev. Proc. 2010-13 does not apply to real estate professionals, who are under special rules.

Material Participation

The treatment of S corporation income or loss depends, in most instances, upon whether or not the shareholder materially participates in the operations of the business. Therefore, we will discuss material participation first, and then we will cover the effect of material participation on passthrough items.

To materially participate, the shareholder (or the shareholder's spouse) must be involved in the S corporation's operations on a regular, continuous, and substantial basis.[11]

The temporary regulations expand on this definition, and set out seven situations in which a shareholder (or other taxpayer) is deemed to materially participate in an activity.[12] Those situations are as follows:

1. The taxpayer participates in the activity for more than 500 hours during the year.
2. The taxpayer's participation is substantially all of the participation in the activity, that is, the business is a *one-person* operation.
3. The taxpayer participates for more than 100 hours during the year, and no other individual participates more than the taxpayer.
4. The activity is one in which the taxpayer participates for more than 100 hours during the year (a *significant participation activity*) and the taxpayer's participation in all significant participation activities is more than 500 hours.
5. The taxpayer materially participated in the activity any five of the ten immediately preceding taxable years.
6. The activity is a personal service activity and the taxpayer materially participated in the activity for any previous three taxable years. (A personal service activity in this context is an activity in the fields of health [including veterinarians], law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.)
7. The taxpayer materially participates based on all of the facts and circumstances.

Items 5 and 6 above are designed to prevent a taxpayer from converting participation from material to nonmaterial so that income will become passive and be available to offset passive losses.

[10] Reg. Sec. 1.469-4(d)(5)(i).
[11] Sec. 469(h).
[12] Temp. Reg. Sec. 1.469-5T.

PARTICIPATION BY SPOUSE

Participation by a spouse is considered to be participation by the taxpayer, even if the spouse does not own stock in the S corporation.[13]

SHORT TAX YEARS

A taxpayer cannot annualize hours worked in a short tax year to reach the 500-hour material participation requirement.[14] In *Gregg*, the taxpayer worked 112 hours in a calendar-year business that began on November 4th. The taxpayer argued that the 112 hours of participation during the short year would have been 728 hours if the business had operated for a full year. The Court, however, ruled that the 500-hour test must be met by actually working 500 hours during the tax year, even if the tax year is less than twelve months.

This could be a problem for any client who starts a business late in the year. We should point out, however, that, even though he could not annualize his hours, the taxpayer in *Gregg* was able to meet the 500-hour test by grouping the activity with another similar activity he had participated in during the tax year.

ONLY QUALIFYING WORK COUNTS IN PARTICIPATION TESTS

Hours cannot be counted in the 500-hour or other participation tests if both of the following two factors are present:

- The type of work is not customarily done by an owner of that type of activity, and
- One of the principal purposes for performing the work is to prevent any loss or credit from being disallowed under the passive activity loss rules.[15]

Furthermore, work done as an investor in the activity cannot be counted unless the individual is directly involved in the day-to-day management or operations of the activity.[16]

Nonpassive or Passive Nature of Passthrough Items

Each passthrough item of income, loss, deduction, or credit is passed through as nonpassive or passive.

- The nonpassive or passive nature of items relating to trade or business activities is determined by the participation of the shareholder.
- Other items are nonpassive or passive depending upon the nature of the item itself, as discussed in the following paragraphs.

[13] Sec. 469(h)(5); Temp. Reg. Sec. 1.469-5T(f)(3).
[14] *Stephen A. Gregg*, 87 AFTR 2d 2001-337, 186 F.Supp. 2d 1123 (DC Or. 2000).
[15] Temp. Reg. Sec. 1.469-5T(f)(2)(i).
[16] Temp. Reg. Sec. 1.469-5T(f)(2)(ii).

NONSEPARATELY STATED INCOME

Nonseparately stated income or loss passed through to a shareholder is nonpassive if the shareholder materially participates in the operation of the S corporation; it is passive activity income if the shareholder does not materially participate. Nonseparately stated income or loss is the net income or loss from business activities shown on the bottom of page 1 of Form 1120S. All other items are separately stated on Schedule K-1.

TRADE OR BUSINESS INCOME ITEMS

Separately stated items of trade or business income, loss, deduction, or credit are categorized (like nonseparately stated income or loss) depending on whether the shareholder materially participated or not. For example, income or loss from the sale of business assets is nonpassive if the shareholder materially participates in the business and is passive if the shareholder does not.

PORTFOLIO INCOME

Portfolio income of an S corporation is determined at the corporate level and is passed through separately to the shareholders as portfolio income.

- Interest, dividends or royalties (unless the income is derived in the normal course of a trade or business, such as interest on accounts receivable) is portfolio income. Income from the investment of working capital can be portfolio income. For instance, if an S corporation invests funds at interest for later use in the business, the interest income is portfolio income.[17]
- Portfolio income is reduced by expenses allocable to the portfolio income.
- Gain or loss from the disposition of property generating portfolio income is also portfolio income.

Rental Activities

Rental activities are generally passive, regardless of whether the rental property is real estate or personal property, and regardless of whether or not the taxpayer materially participates in the activity.[18]

$25,000 DEDUCTION FOR RENTAL REAL ESTATE PASSIVE ACTIVITY LOSSES

However, in the case of rental *real estate*, a taxpayer may be able to deduct up to $25,000 of losses, if the shareholder *actively* participates in the real estate activity and owns at least 10 percent of the value of all interests in the activity at all times during the tax year.[19]

Active participation is a less stringent test than the one for material participation. It does not require regular, continuous, and substantial involvement, but it does require significant

[17] Sec. 469(e)(1); Temp. Reg. Sec. 1.469-2T(c)(3).
[18] Sec. 469 (c)(2).
[19] Sec. 469(i).

involvement in such activities as making management decisions or arranging for others to provide service.

The S corporation passes through the rental losses regardless of amount. The $25,000 rental real estate loss limitation is applied at the shareholder level.

The $25,000 deduction for rental real estate passive activity losses phases out at the rate of 50 percent of the amount by which taxpayer's modified adjusted gross income (AGI) exceeds $100,000.[20] Except for married taxpayers filing separately (who are subject to special rules under Sec. 469(i)(5)), the $25,000 totally phases out when the taxpayer's modified AGI reaches $150,000. (Modified AGI is computed without regard to, among other items, taxable social security benefits, IRA deductions, or the deduction for one-half of the self employment tax.[21])

Also, rental income received by certain real estate professionals may be nonpassive, and, therefore, not subject to the $25,000 limitation.

Not all rent related activities are considered to be rental activities for these purposes. The activity is generally considered to be a trade or business, rather than a passive rental activity, if

- The property is rented by each customer for an average period of seven days or less, or
- Significant personal services are provided and each customer rents the property for an average period of more than seven, but no more than 30 days, or extraordinary services are rendered, as in a hospital.[22]

Consequently, income from car rentals, hotels, motels, hospitals, and so on, would usually not be passive rental activity income.

RENTAL TAX FORM

An S corporation reports rental real estate operations on Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation*. According to the instructions to Form 8825, each rental property should be shown separately, even if the activities are combined for passive activity purposes. The instructions to Form 1040, schedule E, also state that the properties should be shown separately.

Sale of Corporate Assets

Gains or losses (including capital gains) from the sale of corporate trade or business assets are nonpassive or passive, depending on whether the shareholder materially participates in the corporation's business activity.

The nature of the activity in which corporate assets (other than assets used in the corporation trade or business) are used dictates the nature of the gain or loss on sale, for example, the sale of

[20] Sec. 469(i)(3)(A).
[21] See Sec. 469(i)(3)(F) and IRS Publication 925.
[22] See Temp. Reg. Sec. 1.469-1T(e)(3).

portfolio assets cause portfolio (nonpassive) gain or loss, and the sale of rental property generates passive activity gain or loss.[23]

Nonpassive or Passive Nature of Income from Distributions

Taxable, nondividend distributions (those considered to be capital gains from the deemed sale of stock) are treated as gain from the sale of the shareholder's interest in the S corporation (Rev. Rul. 95-5, 1995-1 CB 100). This means that, if the S corporation uses all of its assets in the operations of its trade or business, the capital gain distributions are nonpassive if the shareholder materially participates in the operations of the corporation, and are passive if the shareholder does not materially participate.

If the corporation conducts more than one activity, the gain must be allocated among the activities.[24]

Distributions of AE&P (dividend distributions) are portfolio income.

Nonpassive or Passive Nature of Income from Sale of Stock

When an S corporation shareholder disposes of his or her stock, it is treated as if the shareholder had disposed of an interest in each of the S corporations activities.[25]

If the S corporation uses all of its assets in the operations of its trade or business, the gain or loss from the sale of stock is nonpassive if the shareholder materially participates and is passive if the shareholder does not materially participate.

Self-Rented Property

The IRS, under authority of Sec. 469(l)(3), can recharacterize passive income items as nonpassive. That is, losses from the activity will be passive, while income will be nonpassive, and will not offset passive losses from other activities. (A *heads, the IRS wins; tails, the taxpayer loses* situation.)

The *self-rented property* rule may be the one that S corporations have to deal with most often.

- The self-rented property rule states, generally, that income (but not loss) will be recharacterized as nonpassive when a taxpayer rents property to a business in which he or she materially participates.[26]
- Income is not subject to the self-rented property rule if it is attributable to the rental of property under a written, binding contract entered into before February 19, 1988.
- Suspended losses from the *same* rental activity can be offset by the income from the property.

[23] Temp. Reg. Sec. 1.469-2T(c)(2)(A).
[24] Temp. Reg. Sec. 1.469-2T(e)(3)(ii).
[25] Temp. Reg. Sec. 1.469-2T(e)(3)(ii).
[26] Reg. Sec. 1.469-2(f)(6). See also *Thomas P. Krukowski*, 89 AFTR 2d 2002-827, 279 F.3d 547, 2002-1 USTC 50,219 (2002, CA7) *aff'g* 114 TC 366 (2000) and *Tony R. Carlos*, 123 TC No. 16 (2004).

Example 10-2

Al owns all the shares of Esscorp. He materially participates in the operation of the business, and leases equipment to the corporation at the beginning of 2010. He shows a loss of $5,000 from the rental that year, and the loss is not deductible because he has no passive income. In 2011, he shows net income of $9,000 from the rental. The income first offsets the passive loss from the rental activity, and the remaining $4,000 is nonpassive income. If Al's only other passive activity each year was, say, a limited partnership loss of $10,000, none of the partnership loss would be deductible either year. It would carry forward to be offset against future passive income.

There are five other situations that cause passive income to be recharacterized as nonpassive:

- *Significant participation activities*—As discussed under *Material Participation* above, significant participation occurs when the taxpayer works more than 100 hours in an activity. If a taxpayer works more than 500 hours in all significant participation activities combined, the taxpayer is considered to materially participate in those activities, so income or losses are nonpassive. If the taxpayer works less than 500 hours in the activities, overall losses from the significant participation activities are passive, but if there is a net gain, the gain is generally nonpassive.
- *Rental of nondepreciable property*—Net income or gain from a rental activity is recharacterized as nonpassive when less than 30 percent of the unadjusted basis of the property is subject to depreciation.
- *Net passive income from a passive equity-financed lending activity*.
- *Net income from property rented incidental to development activity*.
- *Income from licensing of intangible property by a passthrough entity*.[27]

Self-Charged Interest

Interest income is generally portfolio income. But if a shareholder has made a loan to an S corporation, and the S corporation pays (or imputes) interest on that loan, the interest income is subject to special rules that can be favorable to taxpayers.

The shareholder may be able to offset all or part of the interest income that the shareholder receives from the corporation from the interest expense on the loan passed through to the shareholder. The rule came about because, in effect, such shareholders have paid interest to themselves.[28]

The self-charged interest rule applies only when the income or loss from the S corporation is passive activity income or loss. Generally, interest income is nonpassive portfolio income, and cannot be offset by passive losses. If the S corporation passes through a passive loss, the loss cannot be deducted against the interest (portfolio) income. The self-charged interest rule,

[27] Temp. Reg. Sec. 1.469-2T(f).
[28] Reg. Sec. 1.469-7.

however, reclassifies self-charged interest expense as a nonpassive item on the shareholder's return. Here is an extreme example to illustrate the point.

Example 10-3

Adam owns all of Esscorp's stock. The corporation pays interest to him of $12,000 on a loan he made to the company. He does not materially participate in the operations of Esscorp, and Esscorp passes through a $15,000 loss to him. His only other income or loss is wage income of $80,000.

Without the self-charged interest rule, Adam would be taxed on the full $12,000 of interest income because the passive loss from Esscorp would not offset either his wages or the nonpassive interest income. The loss of $15,000 would be suspended and carried over to the next year. His AGI would be $92,000, computed as follows:

Wages	$80,000
Interest Income	12,000
Passive loss (limited to passive income)	–
Adjusted gross income	$92,000

Using the self-charged interest rule, Adam's AGI is $80,000, because the $12,000 of interest expense passed through to him offsets the interest income. The suspended loss from Esscorp, then, is $3,000, [$(15,000) + $12,000] because the interest expense will have been reclassified as nonpassive.

Adam's AGI is computed as follows:

Wages		$80,000
Interest income:		
From Esscorp	$12,000	
Less interest expense paid to Adam by Esscorp	(12,000)	–
Passive loss (limited to passive income)		–
Adjusted gross income		$80,000

If Adam owned 40 percent of Esscorp, only the amount of self-charged interest passed through to him can offset interest income. In that case, his AGI would be computed as follows:

Wages		$80,000
Interest income:		
From Esscorp	$12,000	
Less interest expense paid to Adam by Esscorp (40%)	(4,800)	7,200
Adjusted gross income		$87,200

Disposition of an Activity

When a taxpayer disposes of an entire activity, suspended passive losses and loss on the disposition of the activity can generally be deducted. The losses are deducted first against current

net passive income, then against active and portfolio income.[29] Reg. Sec. 1.469-4 provides that disposition of *substantially all* of an activity is treated as an entire disposition, so suspended losses will be allowable. Unfortunately, the regulation does not define what *substantially all* is. However, the regulation does state that, if substantially all of an activity is disposed of, that substantial part can be treated as the disposition of a separate activity if the taxpayer can establish with reasonable certainty the amount of

- Suspended loss deductions and credits allocable to that part of the activity; and
- Gross income, deductions, and credits allocable to that part of the activity for the current taxable year.

DISPOSITION OF SHAREHOLDER'S STOCK

The disposition of all of an S corporation shareholder's stock is treated as if the shareholder disposed of each of the corporation's activities.[30]

CAPITAL LOSS LIMITATION

The disposition of a passive activity could result in a capital loss, and suspended passive losses carrying into the disposition year could include a portion that represents a capital loss. In that event, the $3,000 capital loss limitation applies before any of the passive activity capital losses can be deducted from nonpassive ordinary income.[31] (The capital losses can be applied against capital gains, however.) In the year the activity is disposed of, passive activity capital losses in excess of the $3,000 limitation carry over as capital losses to following years, but are *no longer subject to the passive activity rules*.[32] This makes sense because the activity has been disposed of, so current and suspended losses would have been deducted in full against other income, except for the fact that they were hit with the $3,000 capital loss limitation.

PASSIVE ACTIVITY CREDITS

If an S shareholder cannot use passive activity credits in the year they are generated, the credits are suspended and carried forward to the following year. When the passive activity is disposed of in a fully taxable transaction with an unrelated party, however, suspended passive activity credits arising from that activity *cannot* be used to reduce the tax on nonpassive income. In the year of disposition, the credits apply against the tax arising from passive income or gain for the year. Unused credits then carry forward to the following years until they can be used against the tax arising from passive income.

The shareholder can make an election for the year of the passive activity's disposition to increase the basis of the property disposed of by the amount of any unused credit that reduced the basis of the property in the year in which the credit arose.[33] If the election is made, the increase in basis will reduce the gain or increase the loss on the disposition of the passive activity. If the shareholder disposes of his or her S corporation stock, the passive activity credits that can be

[29] Sec. 469(g)(1).
[30] Temp. Reg. Sec. 1.469-2T(e)(3)(ii).
[31] Reg. Sec. 1.469-1(d)(2).
[32] Reg. Sec. 1.469-2(d)(2)(ix).
[33] Sec. 469(j)(9).

used to increase the basis of the stockholder's shares include the employer social security credit under Sec. 45B and other credits that are required to reduce the S corporation's deductible expenses in the year the credit is claimed, regardless of whether the credit can actually be used by the shareholder. The nondeductible expenses caused by the credit reduce stock basis and, therefore, allow the shareholder to elect to add any unused credit to stock basis upon the stock's disposition. Stock basis can also be increased by credits that reduced the basis of assets, such as the research credit, low-income housing credit, and rehabilitation investment tax credit, among others.

To make the election, the shareholder completes VI of Form 8582-CR, Passive Activity Credit Limitations, for the year in which the activity was disposed of, and submits the form with the shareholder's tax return.

> **Practice Tip:** The election can be beneficial when the shareholder disposes of a passive activity and will have no passive income in the future against which to claim the suspended passive activity credits.

Carryover of C Corporation Passive Activity Losses into an S Year

Generally, Sec. 1371(b) does not allow any carrybacks or carryovers from a C corporation year to an S corporation year. However, the 10th Circuit has ruled that suspended passive activity losses from a C corporation year do carry into an S year.[34]

In reaching its decision, the 10th Circuit cited Sec. 469 (b) and Sec. 469(f)(2) which states, "If a taxpayer ceases for any taxable year to be a closely held C corporation or personal service corporation, this section shall continue to apply to losses and credits to which this section applied for any preceding taxable year in the same manner as if such taxpayer continued to be a closely held C corporation or personal service corporation, whichever is applicable." Therefore, the court ruled that the suspended passive activity losses would be carried into the S year.

Under the 10th Circuit decision, the S corporation would pass through the passive activity loss to the shareholders who could offset it against passive income, if any, shown on their personal returns. If the passive activity losses arose from rental real estate, the $25,000 deduction for rental real estate passive activity losses can apply. Passive activity losses that cannot be deducted in the current year will carry over to the following year at the shareholder level. Further, the suspended passive activity losses become fully deductible when the entire activity is disposed of by the S corporation.

> **Practice Tip:** Certain C corporation carryovers can be used by an S corporation to offset income subject to the built-in gains tax.

Modification of the Passive Activity Loss Rules for Real Estate Professionals

The passive activity loss rules for real estate professionals provide that rental real estate activity is not subject to the passive loss rules if certain requirements are met.[35]

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[34] *St. Charles Investment Co.*, (1998) 110 TC 46, rev'd. (2000, CA10) 86 AFTR 2d 2000-6882.
[35] Sec. 469(c).

To qualify for this provision, the taxpayer must materially participate in one or more real property trades or businesses. For these purposes, a real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

The provision applies to a taxpayer if

- The taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which he or she materially participates, and
- More than one-half of the personal services performed in trades or businesses by the taxpayer are performed in real property trades or businesses in which the taxpayer materially participates.

To see if a client qualifies, you first must determine the real property trades or businesses in which the taxpayer materially participates. Then you add the hours spent in those real property trades or businesses. If the resulting number of hours is 750 or less, the client does not qualify, and rental real estate losses are subject to the passive activity loss rules. If the resulting number of hours is more than 750, you go on to the next step, which is to determine how many hours the client spends in all trades or businesses, regardless of whether participation is material.

If the hours spent in real property trades or businesses in which material participation occurred is more than one-half of the total hours, the client *passes* the test, and losses from rental real estate activities in which the taxpayer materially participates are not subject to the passive loss rules, meaning that the losses are deductible without reference to passive income and without reference to the $25,000 limit on rental real estate losses.

Example 10-4

Your client, Margo, works in three activities during the year. She spends 675 hours running Apartment Building A (which generates a $28,000 loss during the year), she spends 900 hours as a real estate broker, and she spends 500 hours in a retail store she owns that is managed by her son. She also has significant investment income, and her AGI is $200,000, before considering the rental losses. How much of the rental losses can Margo deduct for the year?

First, you must determine the real property trade or business activities in which she materially participated. That would be Apartment Building A and the real estate brokerage business, because she worked more than 500 hours in those real property activities during the year. She worked more than 750 hours in real property trades or businesses in which she materially participates, so you move on to the next step. She spent 2,075 hours (675 + 900 + 500) in all trades or businesses. She passes the test because the 1,575 hours (675 + 900) spent in real estate businesses is more than one-half of the 2,075 hours she spent in all trades or businesses.

Therefore, Margo can deduct the $28,000 loss from Apartment Building A (that is, the rental real estate activity in which she materially participates).

SUBSTANTIATION OF PARTICIPATION HOURS

Under the regulations, an individual's participation in an activity can be established by any reasonable means, such as logs, appointment books, calendars, or narrative (that is, written) summaries.[36] The Tax Court has made it clear, however, that estimates made before or after the activities were undertaken are not adequate. In Fowler, a planning calendar was not sufficient evidence of hours of participation when the entries were made before the participation took place, and were not updated afterwards to reflect the actual hours spent participating in the activity. Plus, some of the spouse's time spent in the activity was not allowable for purposes of satisfying the 750-hour hour test when the spouse was conducting several administrative activities, such as reviewing mail, depositing rental income, and comparing actual and budgeted expenses.[37]

EMPLOYEES

The real property tax break does not extend to real estate professionals who are employees in the real estate business. Personal services performed as an employee are not treated as performed in a real property trade or business unless the person performing the services has more than a five percent ownership interest in the employer.[38]

AGGREGATION OF ALL RENTAL REAL ESTATE ACTIVITIES

The taxpayer can elect to aggregate all of the taxpayer's rental real estate activities as if they were a single activity. This can make it easier to materially participate in the activities. For example, a client who owns two rental real estate activities and worked 450 hours in one of the activities and 75 hours in the other activity would not meet the 500-hour material participation test in either activity. But by electing to aggregate them, the client works 525 hours in the combined rental activities, and is therefore considered to materially participate in both rental real estate activities.

Under Reg. Sec. 1.469-9(g)(3), the taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. The statement must say that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to Sec. 469(c)(7)(A). The taxpayer can make this election for any year in which the taxpayer qualifies under the real estate professional rules. The failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year.[39]

Once made, the election can be revoked only in the tax year in which a material change in the taxpayer's facts and circumstances occurs. The taxpayer revokes the election by filing a statement with the taxpayer's original tax return for that year. The statement must explain the nature of the material change and say that the taxpayer is revoking the election under Sec. 469(c)(7)(A).

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[36] Temp. Reg. Sec. 1.469-5T(f)(4).
[37] See *William C. Fowler*, TC Memo 2002-223 (2002). See also *Lynnda Speer*, TC Memo 1996-323 (1996) and *William N. Carlstedt*, TC Memo 1997-331 (1997); *Tony R. Goolsby*, TC Memo 2010-64.
[38] Sec. 469(h)(5); Reg. Sec. 1.469-9(c)(5).
[39] Reg. Sec. 1.469-9(g)(1).

Practice Tip: Certain clients will have to make the election to aggregate all rental real estate activities in order to take advantage of the special passive activity rules for real estate professionals. (This can happen when the client has multiple rental real estate activities but does not meet the material participation test for any of the activities.) However, the election can have a significant drawback. The drawback is that the election may make it more difficult to free up any suspended passive activity losses when the taxpayer disposes of a rental real estate activity. If the election is made, substantially all of the *combined* interests must be disposed of before suspended passive losses can be offset against nonpassive income.

RULES IN REV. PROC. 2010-13 RELATING TO AGGREGATION DO NOT APPLY TO REAL ESTATE PROFESSIONALS

The IRS has issued Rev. Proc. 2010-13 providing guidance on how grouping or separating activities should be disclosed. The rules in Rev. Proc. 2010-13 do not apply to real estate professionals who are under the special rules provided in Reg. Sec. 1.469-9.

JOINT RETURN TREATMENT

If the taxpayer files a joint return with his or her spouse, the eligibility requirements are met if either spouse satisfies the requirements. So, one spouse *alone* must meet the 750-hour test and the personal service test. A different rule applies when determining material participation, however. The passive activity rules provide that participation of the taxpayer's spouse is considered to be participation by the taxpayer for purposes of the material participation test.[40] In other words, participation of both spouses is considered when determining the real property trades or businesses in which the taxpayer materially participates, but the participation of only one spouse is considered in the 750-hour and other tests to determine whether the real property business exception to the passive loss rules applies.

Example 10-5

Ben and Brenda are married and file a joint return. Both are attorneys and they jointly own three apartment buildings. Ben works 930 hours in his law practice while Brenda works 1,500 hours in hers. They both work 300 hours in Apartment Building C. Ben works 860 hours in Apartment Building D, but Brenda does not devote any time to that building. All of the apartment buildings experience losses during the year. Are the apartment building losses subject to the passive activity loss rules?

The first step is to determine in which real estate property trades or businesses the taxpayers materially participate. Since the regulations provide that participation by the taxpayer's spouse is considered to be participation of the taxpayer, both Ben and Brenda are considered to materially participate in Apartment Building C because their combined participation is more than 500 hours. Ben materially participates in Apartment Building D because his participation relating to it is more than 500 hours.

[40] Temp. Reg. Sec. 1.469-5T(f)(3).

Next, you must determine the total hours worked in real property trades or businesses in which they materially participate. For these tests, Ben and Brenda show only the hours that they individually worked in each activity, so they will each show 300 hours worked in Apartment Building C. Ben also worked 860 hours in Apartment Building D, so he worked 1,160 hours in real property trades or businesses in which he materially participated. Brenda is considered to materially participate in Apartment Building C, but she worked only 300 hours in that building. Since she did not work more than 750 hours in real property trades or businesses in which she materially participated, Brenda does not qualify. However, since one of the spouses, Ben, qualifies based on the hours he alone worked, all of the rental losses can be deducted without reference to the passive activity loss rules.

Investment Interest Limitation

Investment Interest Expense

The deduction for investment interest expense is limited to the amount of investment income.[41] The limitation occurs at the individual (rather than the corporate) level.

Investment interest expense includes only interest expense incurred to carry investments that produce *portfolio income*.

> **Practice Tip:** Investment interest expense does not include interest incurred in the course of the S corporation's business or in the operation of rental property that the S corporation owns. These items are covered under the passive activity rules and are therefore excluded from the investment interest rules.[42]

Interest to Finance S Corporation Stock

Interest on debt incurred by an individual to purchase an interest in an S corporation is normally nonpassive or passive activity expense depending on whether or not the shareholder materially participates in the operations of the S corporation.

If the shareholder materially participates in the operations, and the assets of the corporation are used solely in the conduct of a trade or business, the interest expense is considered incurred in the conduct of that trade or business and, therefore, is deducted as a business expense on the shareholder's Schedule E, Part II. The name of the S corporation, the words *business interest*, and the amount of the interest expense should be shown on a separate line on Schedule E.[43]

If the shareholder does not materially participate in the operations, the interest expense is taken into account in computing the shareholder's income or loss from the passive activity.

If the corporation has more than one activity (for example, conducts a trade or business and also has portfolio income), the interest tracing rules generally require that the debt and related interest expense be allocated among the corporation's assets using any reasonable method. Reasonable

[41] Sec. 163(d).
[42] Sec. 163(d)(3).
[43] IRS Notice 88-37, 1988-1 CB 522.

methods include *pro rata* allocations based on the fair market value, book value, or adjusted basis of the corporation's assets, less any corporate debt that is allocated to the assets.[44]

> **Example 10-6**
>
> John owns all of the stock of Esscorp and materially participates in the business. He borrowed the money to buy the stock and paid $3,000 of interest on the debt during the current year. If the corporation only owns assets that are used in the business, the $3,000 interest expense is active and can be deducted as a business expense on Schedule E of John's Form 1040.
>
> Assume now that Esscorp's assets are 85 percent trade or business assets and 15 percent assets that generate portfolio income. In that case, $2,550 (85% × $3,000) is deductible on Schedule E and $450 would be investment interest expense which is deductible on John's Schedule A to the extent of investment (portfolio) income.

LIFO Recapture

Liquidation of a C corporation generally causes gain from the liquidation to be subject to tax at both the corporate and shareholder level.

The built-in gains rules require an S corporation to pay a corporate level tax on the pre-S-election appreciation upon the disposition of certain assets within a ten-year period after the S election is effective. A disposition under these rules includes sales of inventory on hand at the time the election becomes effective. But, under the LIFO method, no built-in gain occurs until a pre-election LIFO layer is invaded.

Consequently, Sec. 1363(d) discourages C corporations from converting to the LIFO method before electing S corporation status and accelerates recognition of the gain from LIFO inventories.

Under these rules, a LIFO-method C corporation that becomes an S corporation must add a *LIFO recapture amoun*t to its income. The addition is made to the income for the corporation's last C year.

The LIFO recapture amount is the excess of the inventory's value using FIFO over the inventory's LIFO value at the close of the corporation's last year as a C corporation. Both the LIFO and FIFO values are determined by using the lower of cost or market, or, if the corporation valued the LIFO inventory by the retail method, that method will also be used to determine the value of the FIFO inventory.

> **Practice Tip:** The corporation is not required to change inventory methods; it can continue to use LIFO after conversion to S status.

Basis Increased

Basis of the inventory is increased by the inventory recapture amount, so that gain will not occur again when the inventory is sold.

[44] Temp. Reg. Sec. 1.163-8T; IRS Notice 89-35, 1989-1 CB 675.

Tax on LIFO Recapture Is Payable in Installments

The increase in the C corporation's tax caused by LIFO recapture is payable in four installments. One-fourth of the tax must be paid by the due date of the return for the corporation's last taxable year as a C corporation. Extensions cannot be considered for these purposes.

An additional one-fourth must be paid on or before the due dates (not including extensions) of the corporation's tax returns for the next three years.

How Tax Is Paid

The LIFO recapture amount is shown as *other income* on the corporation's last Form 1120. A schedule is attached showing the calculation of the recapture amount and the computation of the tax related to the recapture.[45]

One-fourth of the tax is paid with the 1120.

Because the tax is due by the due date of the return, excluding extensions, it must be included in the tax remitted with the extension request if the Form 1120 is not filed by the original due date.

The remaining recapture tax is paid in three installments with Form 1120S and is included on line 22c on page 1. The installment amount and the words *LIFO tax* should be written to the left of the total on line 22c. Again, payment is due by the original due date of the return.

> **Practice Tip:** There is no incentive to prepay the tax, because no interest is imposed so long as the payments are made by the appropriate dates.

Effect on Basis, AAA, and AE&P

LIFO recapture payments made by the S corporation do not reduce either basis or the Accumulated Adjustments Account (AAA).[46] The LIFO payments do, however, reduce accumulated earnings and profits (AE&P).[47]

Reporting LIFO Recapture to Shareholders

LIFO recapture paid at the corporate level is evidently reported on Form 1120S, Schedule K, line 16c, *Items affecting shareholder basis—Nondeductible expenses*. The stockholder's *pro rata* share is evidently reported on Schedule K-1, line 16, code C. Statements relating to both schedules should be attached to the Form 1120S identifying the item as LIFO recapture paid at the S corporation level.

LIFO Recapture Applies Only When Inventory Is Acquired from a C Corporation

LIFO recapture occurs only when a C corporation using the LIFO method elects S status or when LIFO inventory is acquired by an S corporation from a C corporation in a transferred-basis transaction.[48]

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[45] IRS Ann. 88-60, 1988-15 IRB 47, Instructions to Form 1120.
[46] Secs. 1363(d)(5) and 1368(e)(1)(A).
[47] Sec. 1363(d)(5).

Partnership Interests Held by a C Corporation Can Cause LIFO Recapture

LIFO recapture applies when a C corporation holding an interest in a partnership that owns LIFO inventory elects S status or transfers its partnership interest to an S corporation in a transferred-basis transaction. In that event, the C corporation must include the LIFO recapture inherent in the partnership's inventory in the corporation's gross income.[49] The LIFO recapture amount is generally determined on the day before the S election becomes effective or the date of the transfer. Both the corporation's basis in the partnership interest and the basis of the partnership's inventory are increased by the recapture amount.

The regulation effectively reverses the decision in *Coggin Automotive Corp. v. Comm*.[50] In that case the Eleventh Circuit ruled the LIFO recapture did not apply to a C corporation that owned interests in six partnerships that used the LIFO inventory method.

Fringe Benefits

Special rules apply to fringe benefits paid by an S corporation. However, exactly which benefits are under the rules and the tax treatment of the benefits is not clear. Fringe benefits under the special rules are evidently taxable to the recipient shareholder as wages, as covered in the following discussion; but more IRS guidance is needed to clarify the rules. The fringe benefits subject to these rules evidently include (but are not limited to) the following:

- Group-term life insurance on an employee's life, for coverage up to $50,000[51]
- Accident and health plans, disability plans, and qualified long-term care insurance[52]
- Meals and lodging furnished for the convenience of the employer[53]
- Cafeteria plans[54]

We will call the fringe benefits subject to these special rules "taxable fringe benefits."

Pension and profit-sharing plans are not subject to the special rules. Thus, corporate contributions to qualified pension and profit-sharing plans are deductible by the corporation and are not taxable to the shareholders. Certain other fringe benefits are allowable to partnerships, and should therefore also be deductible at the S corporation level and not taxable to the shareholders (including 2 percent shareholders). These non-taxable fringe benefits evidently include (but are not limited to) compensation for injury or sickness under Sec. 104(a)(3); educational assistance programs under Sec. 127; dependent care assistance under Sec. 129(e)(3); no additional cost services, qualified employee discounts, working condition fringes, *de minimis* fringes, and qualified retirement planning services under Sec. 132.

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[48] Sec. 1363(d); Reg. Sec. 1.1363-2; Ltr. Rul. 9039005.
[49] Reg. Sec. 1.1363-2(b) through (g).
[50] 89 AFTR 2d 2002-2826, 292 F.3d 1326, 2002-1 USTC 50,448 (2002, CA11), rev'g 115 TC 349 (2000).
[51] Sec. 79.
[52] Secs. 105, 106.
[53] Sec. 119. See, for example, *Dilts v. U.S.*, 73 AFTR 2d 94-1633, 845 F. Supp. 1505 (D. Wyo. 1994).
[54] Sec. 125(c)(1)(A).

Shareholder-Employees Treated as Partners

In an S corporation, there is a distinction between fringe benefits paid on behalf of a *2 percent shareholder* and those paid on behalf of other employees.

TWO PERCENT SHAREHOLDERS

In reference to fringe benefits paid on behalf of a 2 percent shareholder, the Code provides that the S corporation will be treated like a partnership, and the two percent shareholder will be treated like a partner.[55] A *2 percent shareholder* includes any person who, on any day during the S corporation's taxable year, owns more than 2 percent of the outstanding stock or owns stock possessing more than two percent of the total combined voting power of the corporation's stock. The attribution rules of Sec. 318 apply.[56]

S corporations offering taxable fringe benefits under the special rules can deduct the cost of the benefits, and the value is not income of the employee if the employee is not a 2 percent shareholder. If the employee is a 2 percent shareholder, the cost of the fringe benefit is included in the shareholder's wage income and deducted by the S corporation.

Taxable fringe benefit costs that would otherwise be deductible by a 2 percent shareholder are deductible on the shareholder's personal return to the extent allowed by law. For example, if the corporation paid for medical care under a medical reimbursement plan, the 2 percent shareholder can deduct it as an itemized deduction, subject to the medical expense limitation.

Taxable Fringe Benefits are Wages

The IRS has not fully clarified how taxable fringe benefits paid on behalf of a 2 percent shareholder should be handled. Treating them in accordance with the Code (that is, treating the corporation as a partnership) is impractical because income and expenses of an S corporation must be passed through to shareholders on a per share, per day basis. There is no provision for special allocations.

Example 10-7

S Corp. has a medical reimbursement plan and pays $4,000 in medical expenses on behalf of Shareholder A, who owns 50 percent of the stock. The remainder of the Stock is owned by Shareholder B. The company showed the following results for the tax year:

Net income, before medical expense	$4,000
Less medical expense	4,000
Net income	$ 0

If the fringe benefit is not deductible at the corporate level, the corporation's taxable income is $4,000. The income must be passed through per share, per day, so Shareholder A reports $2,000 of income, and so does Shareholder B, even though he did not receive any of the benefit of the medical expense

[55] Sec. 1372(a).
[56] Sec. 1372(b).

reimbursement. The nondeductible fringe benefit is also passed through on a per share, per day basis, so Shareholder A is entitled to a $2,000 medical deduction. Shareholder B would not be entitled to a medical deduction since the expenditure was not for his medical expenses.

Health and Accident Insurance Premiums

The IRS has ruled that accident and health insurance premiums paid on behalf of a 2 percent shareholder are deductible by the corporation as wages (under Sec. 162). The premium costs are included in the shareholder-employee's W-2 as wages.[57] (Although this ruling addresses only accident and health insurance plans, it seems that other fringe benefits subject to the 2 percent shareholder rules should be handled in the same way.) Also, Secs. 3121(a) and 3306(b) state that the value of fringe benefits (except those specifically excluded from income, such as no additional cost fringes) are wages.

- Using this method, the cost of taxable fringe benefits paid on behalf of a 2 percent shareholder are deductible at the corporate level, but are deducted as wages, rather than as fringe benefits.

  Therefore, in our example above, the $4,000 would be considered a payment of wages to Shareholder A, and the corporation's ordinary income would be zero. Shareholder A can deduct the $4,000 medical expense, to the extent allowable, on his personal income tax return.

In Announcement 92-16, 1992-5 IRB 53, the IRS clarified that accident and health insurance premiums paid on behalf of a 2 percent shareholder are wages, but *may* not be subject to FICA and FUTA taxes. The cost of premiums is not subject to FICA and FUTA tax if the premiums meet the requirements for exclusion under Sec. 3121(a)(2)(B). The exclusion from FICA and FUTA under that provision applies to payments made under a *plan* or *system* for accident and health, life insurance, or retirement benefits on behalf of an employee or employee's dependents.

It appears to be easy to meet the requirements of setting up and maintaining a plan or system. A plan or system generally exists if any of the following applies:

- The plan is in writing or is otherwise made known to employees.
- The employment contract refers to the plan.
- Employees contribute to the plan.
- There is a separate fund for payments made by the plan.
- The employer is required to make the payments.[58]

The plan must be for employees and their families generally or for a *class* (or classes) of employees and their dependents. There seems to be no rule that the *classes* of employees not be discriminatory.

[57] Rev. Rul. 91-26, 1991-1 CB 184.
[58] Rev. Rul. 80-303, 1980-2 CB 295.

Above-the-Line-Deduction for Medical Insurance

A self-employed person can generally deduct, as an item in arriving at AGI (that is, above the line), 100 percent of medical insurance premiums paid on his or her behalf.[59]

The above-the-line deduction is not available if the shareholder or spouse is eligible to participate in another employer's medical plan.

An S corporation shareholder who owns more than 2 percent of the corporation's stock is entitled to the deduction if the S corporation pays the medical insurance premiums. (The medical insurance premiums paid on behalf of such a shareholder are considered to be wages.)

The deduction is limited to the earned income from the business, and earned income for these purposes is measured by the wages that the S corporation pays the shareholder. Note that, because the health insurance premiums are included in the shareholder's wages, this limitation should not affect S corporation shareholders.

2010 SELF-EMPLOYMENT TAX DEDUCTION FOR MEDICAL INSURANCE DOES NOT APPLY TO S SHAREHOLDERS

The above-the-line medical insurance deduction is also deductible for self-employment tax purposes for the taxable year beginning in 2010.[60] An S shareholder's earned income for purposes of this medical insurance deduction is measured by the shareholder's wages, which are not self-employment income. Therefore, the deduction from self-employment income is not available to an S shareholder.

HEALTH INSURANCE PLAN MUST BE ESTABLISHED BY THE S CORPORATION

In order for a 2 percent shareholder to be eligible for the above-the-line deduction for medical insurance under Sec. 162(l), the medical plan must be established by the corporation.[61]

Under Notice 2008-1, a plan providing medical care coverage for a 2 percent shareholder is established by the S corporation if *one* of the following conditions applies:

- The S corporation makes the premium payments for the accident and health insurance policy covering the 2 percent shareholder (and the shareholder's spouse or dependents, if applicable) in the current taxable year.
- The 2 percent shareholder makes the premium payments and furnishes proof of premium payment to the S corporation. The S corporation reimburses the shareholder-employee for the premium payments in the current taxable year.

The accident and health insurance premiums must be paid or reimbursed by the S corporation in order for the 2 percent shareholder to take the Section 162(l) above-the-line deduction. Furthermore, the S corporation must report the accident and health insurance premiums as wages on the shareholder's Form W-2 in that same year.

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[59] Sec. 162(l).
[60] Sec. 162(l)(4).
[61] Notice 2008-1, 2008-2 IRB 251.

Medical Savings Accounts (MSAs) and Health Savings Accounts (HSAs)

Contributions made by an employer to an employee's MSA or HSA are generally treated as employer-provided coverage for medical expenses under an accident or health plan.[62] This means that such contributions are fringe benefits subject to the 2 percent shareholder rules. The contributions are deductible by the S corporation as wage expenses and are included in the shareholder or employee's wages. The wages are not subject to FICA and FUTA, if they meet the requirements of Sec. 3121(a)(2)(B).[63]

If the S corporation makes contributions to a 2 percent shareholder's MSA, the shareholder can deduct the contributions in arriving at adjusted gross income on Form 1040, limited to the shareholder's W-2 income from the S corporation.[64]

Contributions made by the S corporation to a 2 percent shareholder's HSA are deductible in arriving at adjusted gross income on the shareholder's Form 1040, if the shareholder is eligible to deduct the contributions under the HSA rules of Sec. 223.[65]

Shareholder Expenses

Expenses Paid by Accrual Basis Corporation

Interest or expenses payable by an accrual basis corporation to a cash basis shareholder may not be deductible when accrued at the corporate level. Rather, these expenses are deductible by the corporation when *paid*.

This rule applies to interest or expenses owed to any corporation shareholder.[66] In a C corporation, the rule applies only to shareholders who own more than 50 percent of the stock.[67] In an S corporation, it applies to all shareholders regardless of their ownership interest.[68]

A person is considered a shareholder if he or she owns S corporation stock directly or indirectly, under the attribution rules of Sec. 267(b).

Example 10-8

An accrual basis taxpayer, S Corp., owes Joan, who owns 1 percent of the stock, $5,000 rent properly accrued on the last day of its taxable year, September 30, 2011. The rent is paid to Joan, a cash basis taxpayer, on October 15, 2011.

S Corp. takes the deduction for rent for the year ending September 30, 2012. Joan reports the income in 2011.

[62] Secs. 106(b)(1) and 223; Notice 2005-8, 2005-4 IRB 368.
[63] See IRS Notices 92-16 (1992-5 IRB 53) and 2005-8, Q&A 3 (2005-4 IRB 368).
[64] Secs. 62(a)(16), 220(a), and 220(b)(4).
[65] Notice 2005-8, 2005-4 IRB 368.
[66] Sec. 267.
[67] Sec. 267(b).
[68] Sec. 267(e).

Unreimbursed Shareholder Expenses

An S corporation's expenses are deductible at the corporate level only, and cannot be deducted by shareholders. In the case of *Richard R. Russell*,[69] the S corporation's shareholders personally paid for expenses they incurred in conducting the corporation's business.

The shareholders did not seek reimbursement from the corporation, and deducted the expenses as business expenses on Schedule C of their personal tax returns. The IRS disallowed all of the deductions on the grounds that the taxpayers did not individually operate a trade or business.

The shareholders argued that the S corporation's income or loss would pass through to them anyway, so it did not matter whether the expenses were deducted on their returns or were passed through by the corporation.

The Tax Court disagreed with the shareholders. None of the expenses were allowable, even though they were legitimate and were incurred on behalf of the corporation. The corporation and its shareholders are separate and distinct entities, and one entity cannot take the deductions of another. Thus, neither the corporation nor the shareholders could deduct the expenditures. (The shareholders should, however, be entitled to increase stock basis for the expenditures made on behalf of the business.)

> **Practice Tip:** If the corporation had simply reimbursed the shareholders for the expenses, the corporation would be entitled to the deductions, and the expenses would pass through to the shareholders. If the reimbursements caused the corporation to be short of cash, the shareholders could lend the funds to the corporation. As an alternative, the corporation could pay the expenses directly, using funds borrowed from the shareholders. Such loans should be carefully documented and bear a fair market interest rate to avoid an IRS argument that they do not represent valid indebtedness.
>
> **Practice Tip:** The rules for partnerships allow partners to claim unreimbursed partnership expenses in some cases.

Domestic Production Activities Deduction

The Section 199 Domestic Production Activities Deduction

The Section 199 domestic production activities deduction is designed to stimulate production in the United States. The deduction is 9 percent for tax years beginning in 2010 and later (6 percent for certain oil-related qualified production).

The 9 percent applicable percentage is applied to the lesser of

- The qualified production activities income (QPAI) for the year; or
- Taxable income (determined without regard to the deduction for U.S. production activities) for the year.[70]

[69] TC Memo 1989-207.
[70] Sec. 199(a)(1).

The deduction is based on domestic production gross receipts (DPGR), which is income from the following qualified activities:

- Lease, rental, license, sale, or other disposition of tangible personal property, computer software, or sound recordings that are manufactured produced, grown, or extracted by the taxpayer within the U.S.
- Qualified film produced in the U.S.
- Production of electricity, natural gas, or potable water produced in the U.S. (Transmission or distribution of these items is not subject to the deduction.)
- Construction, engineering, or architectural services for construction projects in the U.S.

The deduction is limited to 50 percent of the *employer's* W-2 wages for the tax year.[71] W-2 wages for these purposes are the wages properly allocable to domestic production gross receipts (DPGR). The wages must actually be reported on Form W-2, and include wages subject to income tax withholding, employee elective deferrals, and employee designated Roth contributions.[72]

> **Practice Tip:** Income does not qualify for the deduction if the income arises from an activity that is exclusively sales of property, or rendering of services (other than services in the fields of construction, engineering, or architecture).

Deduction Applied at Shareholder Level

The deduction is applied at the shareholder (rather than the S corporation) level. This means that the S corporation reports to the shareholder the information that the shareholder needs to calculate the deduction.

Calculation of the Section 199 Deduction

In a nutshell, you calculate an S shareholder's domestic production activities deduction as follows:

1. Determine domestic production gross receipts (DPGR).
2. Determine cost of goods sold and other deductions and costs allocable to the DPGR.
3. Qualified production activities income (QPAI) (Subtract line 2 from line 1).
4. Apply the applicable percentage of 9 percent to the lesser of (1) QPAI, or (2) adjusted gross income for the year determined without the domestic production activities deduction.
5. Determine 50 percent of W-2 wages properly allocable to DPGR.
6. The domestic production activities deduction is the lesser of line 4 or line 5.

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[71] Sec. 199(b).
[72] Sec. 199(b)(2)(A) ; Reg. Sec. 1.199-2(e)(1) ; Rev Proc 2006-47, 2006-45 IRB 869.

Detailed calculation of the deduction is beyond the scope of this course, but we will cover some important points relevant to S corporations. Because of its complexity, computation of the deduction has undergone several changes since its inception.

Current guidance relating to the Section 199 deduction can be found in Sec. 199 and the regulations thereunder; Rev. Procs. 2006-22, 2006-23 IRB 1033; 2006-47, 2005-7 IRB 498, 2007-34, 2007-23 IRB 1345, and 2007-35, 2007-23 IRB 349.

Allocation of Costs May be Required

If the corporation has deductions that are related to income other than DPGR, the costs must be allocated between DPGR and non-DPGR activities. Under Reg. Sec. 1.199-4(c), this is done by using one of the following three methods:

- *The Section 861 method*.[73] The Section 861 method is the most complex. This method requires that costs that cannot be directly allocated to DPGR or non-DPGR must be apportioned and assigned to DPGR or non-DPGR.

- *The simplified deduction method*.[74] This method can be used by a taxpayer with average annual gross receipts of $100 million or less, or total assets at the end of the year of $10 million or less. Under this method, relative gross receipts are generally used to apportion deductions, except for cost of goods sold, between DPGR and non-DPGR.[75]

- *The small business simplified overall method*.[76] This method can be used by a qualifying taxpayer with average annual gross receipts of $5 million or less, or a taxpayer with under $10 million of gross receipts that is eligible to use the cash method under Rev. Proc. 2002-28, 2002-1 CB 815. Under this method, relative gross receipts are generally used to apportion deductions, including cost of goods sold, between DPGR and non-DPGR.[77]

A taxpayer can change from one allowable method to another allowable method from one year to the next.[78]

W-2 Wages Paid to S Corporation Employees

The domestic production activities deduction is limited to the lesser of 9 percent of DPGR, or 50 percent of the W-2 wages that are properly allocable to DPGR.

Wages paid to a shareholder for purposes of the limitation on the Section 199 deduction include wages subject to income tax withholding, employee elective deferrals, and employee designated

[73] Reg. Sec. 199-4(d).
[74] Reg. Sec. 199-4(e).
[75] See Rev. Proc. 2007-34, 2007-23 IRB 1345.
[76] Reg. Sec. 199-4(f).
[77] See Rev. Proc. 2007-34, 2007-23 IRB 1345.
[78] Reg. Sec. 1.199-4(c)(1).

Roth contributions.[79] The wages must be reported on Form W-2 and filed with the Social Security Administration no later than 60 days after the extended due date for filing the forms.

S corporations use one of the following methods[80] for computing the W-2 wages:

- *Unmodified Box Method*. The W-2 wages are the lesser of Box 1 (Wages, tips, other compensation) or Box 5 (Medicare wages).
- *Modified Box 1 Method*. The W-2 wages are determined by modifying the Box 1 wages. The Box 1 wages are (a) reduced by amounts included in Box 1 that are not wages for income tax withholding purposes and amounts included in Box 1 that are treated as wages under Sec. 3402(o), such as supplemental unemployment compensation benefits, and (b) increased by amounts reported in Box 12 of Form W-2 that are coded D, E, F, G, or S.
- *Tracking Wages Method*. Under this method, the taxpayer actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications, including adjustments for supplemental unemployment compensation and amounts reported in Box 12 of Form W-2 that are coded D, E, F, G, or S.

Reporting Information to Shareholders

The S corporation reports to the shareholders the information necessary to calculate the Section 199 deduction at the shareholder level.

The shareholders individually calculate their Section 199 deduction by combining the S corporation items with items from their proprietorships and other passthrough entities.

CERTAIN S CORPORATIONS PASS THROUGH QPAI AND WAGES ONLY

S corporations that use the simplified deduction method or the small business simplified overall method can calculate the QPAI at the S corporation level and pass through each shareholder's portion of the QPAI as one amount.[81] If this method of passing the items through is used, the instructions to Form 1120S provide that the following information is reported on the shareholder's Schedule K-1:

- The shareholder's *pro rata* share of qualified production activities income (QPAI). The QPAI is entered on Schedule K-1, line 12, code Q.
- The shareholder's *pro rata* share of the corporation's W-2 wages, which is entered on Schedule K-1, line 12, code R.

S CORPORATIONS CAN PASS THROUGH DEDUCTION DETAILS

Any S corporation can pass through all the information that each shareholder needs to calculate the shareholder's domestic production activities deduction relating to that S corporation. If this

[79] Reg. Sec. 1.199-2(e)(1).
[80] See Rev. Procs. 2006-22 (2006-23 IRB 1033) and 2006-47 (2006-45 IRB 869; Prop. Reg. Sec. 1.199-2(f)(2).
[81] See Rev. Proc. 2007-34, 2007-23 IRB 1345.

method of passing the items through is used, the instructions to Form 1120S say that the S corporation must attach a schedule to the shareholder's Schedule K-1 providing the following information:

- Domestic production gross receipts (DPGR).
- Gross receipts from all sources.
- Cost of goods sold allocable to DPGR.[82]
- Cost of goods sold from all sources.
- Total deductions, expenses, and losses directly allocable to DPGR.[83]
- Total deductions, expenses, and losses directly allocable to income other than DPGR.
- Other deductions, expenses, and losses not directly allocable to DPGR or another class of income.
- W-2 wages.
- Any other information a shareholder using the Section 861 method will need to allocate and apportion cost of goods sold and deductions between DPGR and other receipts.

Although the instructions do not specifically say it, the schedule attached to Schedule K-1 should show the shareholders *pro rata share* of the above items. A schedule showing the *total* amount of each above item should evidently be attached to Form 1120S and referenced to Schedule E, line 12d, *Other deductions*.

Deduction Does Not Affect Stock Basis

The Section 199 deduction itself does not affect the shareholder's stock basis.[84] The income and expenses used to calculate the deduction, however, increase or decrease stock basis through the normal passthrough process.

Basis and Other Limitations can Restrict the Deduction

A shareholder's Section 199 deduction can be partially or fully disallowed if the shareholder's losses and deductions are limited because of insufficient stock or debt basis, insufficient at-risk basis, or the passive activity loss rules. In that event, the shareholder's share of expenses and Form W-2 wages used to calculate the Section 199 deduction is proportionately reduced and suspended. The suspended expenses and wages can be used for Section 199 purposes when the loss and deduction limitation no longer applies.[85]

[82] See Reg. Sec. 1.199-4(b).
[83] See Reg. Sec. 1.199-4(c).
[84] Reg. Secs. 1.199-9(b)(1) and (c)(1).
[85] Reg. Secs. 1.199-9(b)(2) and (c)(2).

AMT and Self-employment Tax

The deduction is allowed for both regular tax and alternative minimum tax, with some limitations.[86]

The deduction is not allowable when computing self-employment tax.[87]

Shareholder uses Form 8903 to Calculate Deduction

The shareholder calculates the Section 199 deduction on Form 1040, using Form 8903, *Domestic Production Activities Deduction*. The S corporation reports to the shareholders information necessary to calculate the deduction, and does not file Form 8903 with the corporate tax return, Form 1120S.

Section 179 Deduction

Double Limitation

The Section 179 deduction is subject to limitations at both the corporate and shareholder level.

Dollar Limit and Property Limit

Under Sec. 179, up to $500,000 (for tax years beginning in 2010 and 2011) of qualified depreciable properly may be expensed in the year it is placed in service.

The allowable Section 179 deduction begins to phase out at a certain amount that we will call the "property limitation." The limitation on the Section 179 deduction ($500,000 in 2010 and 2011) is reduced dollar for dollar by the cost of Section 179 property placed in service in excess of $2 million (in 2010 and 2011).[88] See also summary section at end of chapter.

The $2 million property limitation applies at the S corporation level. However, at the shareholder level, Section 179 property acquired by the S corporation does *not* count when determining the *shareholder's* property limitation and resulting allowable Section 179 deduction.[89] Thus, an S shareholder who, for example, operates a sole proprietorship that places in service $2 million of Section 179 property in 2010 or 2011 can take the full $500,000 Section 179 deduction, even though the S corporation also acquired Section 179 property during the year.

> **Example 10-9**
>
> Jane is the sole shareholder in S Inc., and she also operates a sole proprietorship. For the year ended December 31, 2010, S Inc. elects to expense $500,000 of the cost of equipment under Sec. 179. The proprietorship purchases $20,000 of property that qualifies for the Sec. 179 deduction.

[86] Sec. 199(d)(6); Reg. Sec. 1.199-8(d).
[87] Sec. 1402(a)(16).
[88] See Sec. 179(b) and Reg. Sec. 1.179-2(b).
[89] Reg. Sec. 1.179-2(b)(3)(i) and (4).

Question: What is the maximum Sec. 179 deduction that Jane can claim on her tax return?

Answer: S Inc. passes through a Sec. 179 deduction of $500,000. Jane is limited to claiming that amount on her personal return. Therefore, she will not be entitled to take a current Sec. 179 deduction on the equipment purchased by the sole proprietorship.

Note that the S corporation is able to pass through a maximum Section 179 deduction of $500,000 regardless of the number of shareholders. If S Inc. had two equal shareholders, each would be allocated one-half of the Section 179 deduction in 2010.

Taxable Income Limit

The Section 179 deduction passed through by an S corporation is limited at the S corporation level to the S corporation's *taxable income*. Taxable income for these purposes includes the corporation's items of income, loss, and deduction (but not the Section 179 deduction) from active trades or businesses. Also, under Reg. Sec. 1.179-2(c)(1) and (c)(3)], the following items are *not* included in the calculation of the corporation's taxable income:

- Deduction for compensation paid to shareholders
- Net operating loss carryovers or carrybacks
- Deductions suspended under any Code section
- Tax-exempt income

  Practice Tip: Not including the first three items on the preceding list in the corporation's income increases income for purposes of the Section 179 deduction, and is therefore favorable to clients.

The shareholder's Section 179 deduction is also limited to the taxable income from all actively conducted trades or businesses. For these purposes, all of the income or losses from the shareholder's trades or businesses actively conducted by the shareholder are aggregated.[90]

The taxable income from an individual's trade or business for purposes of Section 179 is calculated without regard to (1) the Section 179 deduction, (2) net operating loss carryovers or carrybacks, (3) any deduction for one-half of self-employment tax, and (4) deductions suspended under any Code section.[91]

Also—*and this is very important*—when determining the shareholder's taxable income eligible for the Section 179 deduction, you add the shareholder's wages from all employers, including the S corporation, to the trade or business income.[92]

[90] Reg. Sec. 1.179-2(c)(1).
[91] Reg. Sec. 1.179-2(c)(1).
[92] Reg. Sec. 1.179-2(c)(6)(iv).

> **Practice Tip:** The Section 179 deduction is available to taxpayers who conduct an active trade or business. Therefore, a passive investor in an S corporation *cannot* include income from the corporation when calculating the shareholder's taxable income limit.[93]

If the Section 179 deduction is claimed but cannot be used because of the taxable income limitation, the unused portion is carried to the following tax year and added to the Section 179 expense in that year.[94] The Section 179 deduction disallowed by the taxable income limitation is carried forward indefinitely to be passed through by the S corporation or claimed by the shareholder when the taxpayer has enough income. The Section 179 deduction in any year, however, cannot be more than the annual dollar limit on the deduction.[95]

Qualifying Property

Property qualifying for the Section 179 deduction is tangible property that is

- Tangible personal property;
- Other tangible property (except buildings and their structural; components) used for specialized purposes such as certain manufacturing, research, storage, single purpose agricultural or horticultural structures, and off-the-shelf computer software;
- Acquired by purchase from an unrelated party; and
- Used more than 50 percent in the active conduct of a trade or business.

Property is not subject to the Section 179 deduction if it is

- Used predominantly to furnish lodging or in connection with the furnishing of lodging, other than hotels or motels;
- Used outside of the U.S.; or
- An air conditioning or heating unit.[96]

CERTAIN REAL PROPERTY QUALIFIES FOR SECTION 179 DEDUCTION IN 2010 AND 2011

For tax years beginning in 2010 and 2011, up to $250,000 is allowed as a Section 179 deduction for costs relating to the following types of real property:

- Qualified leasehold improvement property; which includes the cost of certain nonresidential building interior improvements that are placed in service more than three years after the building's placed-in-service date.

[93] See Reg. Sec. 1.179-2(c)(3) and (6)(ii).
[94] Sec. 179(b)(3); Reg. Sec. 1.179-3.
[95] Sec. 179(b)(1).
[96] Code Sec. 179(d).

- Qualified restaurant property, which includes the cost of building and improvement costs if more than 50 percent of the building's square footage is devoted to the preparation of meals and seating for consumption of those meals on the premises.
- Qualified retail improvement property, which includes certain nonresidential building interior costs for a building that is used in a retail business of selling tangible personal property to the general public. The improvements must be placed in service more than three years after the building's placed-in-service date.

The $500,000 overall Section 179 deduction limitation continues to apply.[97] This means that the taxpayer is limited to a $500,000 Section 179 deduction for the year, including the deduction for both personal property and qualified real property. The portion relating to qualified real property, however, cannot exceed $250,000.

The taxpayer can elect to expense any combination of personal property and qualified real property costs, as long as

- The deduction for qualified real property does not exceed $250,000, and
- The total section 179 deduction does not exceed $500,000.

CARRYOVER OF QUALIFIED REAL PROPERTY DEDUCTION IS LIMITED

Section 179 deductions from qualified real property that cannot be used in the current tax year because of the taxable income limitation can be carried over to the tax year beginning in 2011. Section 179 deductions relating to qualified real property that are unused at the end of the tax year beginning in 2011 cannot be deducted under Section 179. Instead, any such Section 179 deduction unused in 2011 is deducted under the depreciation rules as if the qualified real property had been placed in service on January 1, 2011.[98]

> **Note:** Congress could extend the rule and allow the carryover of unused Section 179 deductions on qualified real property beyond 2011, but there is no way to know at this point whether that will happen.

Allocation of Excess Deduction Amounts

A special rule applies when an S corporation claims the Section 179 deduction for both personal property and qualified real property, and the deduction is limited because of the taxable income limit.[99] In that case, the amount that is nondeductible in the current year is treated as if it consisted of a proportionate amount of each type of property, taking into account only the property for which a Section 179 election was made, without regard to the amount of the deduction disallowed because of the taxable income limitation.

[97] Code Sec. 179(f)(3).
[98] Code Sec. 179(f)(4).
[99] Code Sec. 179(f)(4)(D).

Higher or Lower Limits May Apply

Higher Section 179 deduction limits apply to certain property, including New York Liberty Zone property and qualified Section 179 disaster assistance property. Certain automobiles and sports utility vehicles are subject to lower limits.

Making or Revoking the Section 179 Deduction

A taxpayers can *make, revoke or amend* the Section 179 deduction expense election for property acquired before 2011 by filing an amended return within the applicable statute of limitations.[100]

Schedule K-1 Reporting

The Section 179 deduction is not included in the expenses on page 1 of Form 1120S, and is instead a separately stated item reported on line 11 of Schedules K and K-1.

Effect on Basis

Stock basis and AAA are reduced by the full amount of the Section 179 deduction passed through to the shareholder, even if a portion of the deduction is disallowed by the taxable income limitation and carried over to the following year.[101]

An S corporation shareholder who disposes of S corporation stock can increase stock basis by the amount of any unused Section 179 deduction attributable to the stock. The basis increase is made immediately before the stock disposition takes place.[102] The Section 179 carryover cannot then be used by either the seller or buyer of the stock.

Other Considerations

Collectible Gain

Collectible gain is taxable at a maximum tax rate of 28 percent. Such gain is long-term capital gain from the disposition of *collectibles*, which (1) have been held as capital assets, and (2) are pieces of art, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, or other personal property designated by the IRS.

This rule applies to (1) gain from the sale or exchange of the collectible, (2) gain from distributions of collectibles to shareholders, and (3) gain from the sale of S corporation stock. When S corporation stock is sold or exchanged, gain attributable to unrealized appreciation on collectibles is considered to be gain on the sale or exchange of a collectible. A portion of the gain from the sale of stock will be attributable to appreciation on the collectibles under rules similar to the partnership provisions of Sec. 751 dealing with appreciated inventory and unrealized receivables.[103]

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[100] Sec. 179(c)(2); Reg. 1.179-5(c); Rev. Proc. 2008-54.
[101] Reg. Sec. 1.1368-2(a)(3)(ii).
[102] Reg. Sec. 1.179-3(h)(1) and (2).
[103] Sec. 1(h)(5)(B).

At-Risk Rules

The at-risk rules of Sec. 465 apply to shareholders of S corporations, if the corporation shows an overall loss.

The at-risk rules must be considered if *nonrecourse* loans are used to finance the S corporation's business activities to acquire property used in the activity, or to acquire S corporation stock.

For these purposes, a nonrecourse loan includes amounts that are protected against loss by guarantee, stop-loss agreement, or similar arrangement. It also includes amounts borrowed from certain related persons or from a person who has an interest in the activity other than as a creditor.[104] (There is an exception for *qualified nonrecourse financing* under Sec. 465(b)(6). This exception provides that nonrecourse loans are at-risk if secured by real property used in the activity of holding real property.)

An S corporation's unused at-risk losses carry over into the post-termination transition period (PTTP). The shareholder can deduct the at-risk losses at the end of the PTTP to the extent stock basis and at-risk basis are increased by capital contributions during the PTTP.[105]

Carryovers between S and C Years

There are no carrybacks or carryovers from a C corporation year to an S corporation year, and there are none from an S corporation year to a C corporation year. The intervening S corporation years do count as elapsed years for purposes of determining when carryovers expire.[106] (An exception to the carryover rule allows certain C corporation carryovers to offset built-in gains. Also, suspended passive activity losses that occurred when the corporation was in C status carry into the S year.)

Sec. 291 Rules Relating to Corporate Preference Items

Sec. 291 increases ordinary recapture on the sale of certain real estate (Sec. 1250 property), and reduces certain depletion and other preference items. Since the taxable income of an S corporation is computed as if the entity were an *individual*, Sec. 291 normally does not apply to S corporations.

However, Sec. 291 applies if the S corporation (or any predecessor) was a C corporation for any of the three immediately preceding taxable years.[107]

Pension and Profit-Sharing Plans

The rules relating to qualified pension and profit-sharing plans are very complex. Entire courses could be (and have been) written just about them.

We will not go into detail about qualified plans here, but we do want to point out that an S corporation can generally have the same types of qualified plans as other entities. The 2 percent

[104] Secs. 456(b)(3) and (c)(3)(D); Reg. Secs. 1.465-8 and 1.465-20.
[105] Sec. 1366(d)(3)(D).
[106] Sec. 1371(b).
[107] Sec. 1363(b)(4).

shareholder rules relating to some S corporation fringe benefits do not apply to qualified retirement plans.

Further, income passed through to an S corporation shareholder is not considered qualifying compensation for purposes of determining allowable contributions to a qualified plan. Only the shareholder's wages from the S corporation qualify as compensation for this purpose.

The deduction for contributions to a qualified retirement plan is reported on Form 1120S, page 1.

Loans from Qualified Retirement Plans

An S corporation's qualified plans can make loans to shareholders if the requirements under Sec. 4975(d)(1) are met. Under these rules, a loan from a qualified plan to an S shareholder is generally not a prohibited transaction if such a loan is

- Available to all plan participants on a reasonably equivalent basis,
- Not made available to highly compensated employees in an amount greater than the amount available to other employees,
- Made in accordance with specific loan provisions set forth in the plan, and
- Adequately secured and bears a reasonable rate of interest.

Oil and Gas

DEPLETION ALLOWANCE

The depletion allowance for oil and gas is computed in a manner similar to partnerships. The percentage or cost depletion allowance is available directly to the shareholders of the S corporation and is computed separately by each individual shareholder.[108]

Each shareholder is treated as having produced his or her *pro rata* share of the production of the S corporation and each shareholder will be allocated his or her respective share of the adjusted basis of the S corporation in each oil or gas property held by the corporation.

BASIS

Each shareholder must separately keep records of his or her share of the adjusted basis in each oil and gas property in order to compute cost depletion and to determine gain or loss on disposition of the property by the S corporation.

In the event that oil or gas property is distributed to shareholders, the S corporation's basis in the property is equal to the sum of the shareholders' adjusted bases in the property.[109]

[108] Sec. 613A(c)(13)(A).
[109] Sec. 613A(c)(13)(B).

Consistency of Shareholder's Return

A shareholder is required to treat items passed through by the S corporation in a way that is consistent with that item's treatment on the corporation's return, unless the shareholder notifies the IRS of the inconsistency (Sec. 6242). Notification is made on Form 8082, *Notice of Inconsistent Treatment or Amended Return*, which is to be attached to the individual's Form 1040.

Statute of Limitations

The statute of limitations for S corporation items on the shareholder's return is determined at the shareholder level, rather than the corporate level.[110]

Example 10-10

Adam is one of ten shareholders in an S corporation, which uses a fiscal year ending September 30. The corporation files its Form 1120S on December 15, 2011 (for the year ended September 30, 2011). Adam files his 2011 Form 1040 on April 15, 2012. On March 1, 2015, the IRS adjusts the S corporation items on Adam's return, even though the statute of limitations on the S corporation's return expired on December 15, 2014. The statute of limitations on Adam's return is open until April 15, 2015.

Penalty for Failure to File S Corporation Return

A penalty is imposed at the S corporation level for (1) failing to file an S corporation return on time, or (2) filing a return that does not contain required information.[111]

The penalty for late filing does not apply if (1) the return is under a valid extension of time to file, or (2) the failure was due to reasonable cause.

For S corporation returns required to be filed for tax years beginning after December 31, 2009, the penalty is $195 per month (or fraction of a month) that the return is late (or does not contain required information) multiplied by the number of shareholders who held stock during any part of the taxable year.

The penalty is in addition to the criminal penalties set out in Sec. 7203 for willful failure to file a return, supply information, or pay tax.

Example 10-11

S Inc. is owned by Jack and Jane, who are married. During 2011, Jack sells half of his shares to Bob and Jane sells all of her shares to Brenda. Bob then transfers a portion of his shares to his son, Bill. The corporation had five shareholders during the year (Jack, Jane, Bob, Brenda, and Bill). The corporation does not file to extend the due date of the return. The 1120S that was due on March 15, 2012, is filed on August 2nd. The penalty is $195 per month multiplied by five

[110] Sec. 6501(a).
[111] Sec. 6699(b)(2).

shareholders, equaling $975 per month for six months (March through August), bringing the total penalty to $5,850.

The corporation has five shareholders for purposes of the penalty even though it only has three shareholders for purposes of the 100-shareholder limit. Under the shareholder limitation, Jack and Jane (as spouses) are counted as one shareholder, as are Bob and Bill (as family members). The penalty could evidently be waived if S Inc. could convince the IRS that failure to file timely was due to reasonable cause.

Practice Tip: A small partnership can use Rev. Proc. 84-35 (1984-1 CB 509) to avoid the penalty for late filing. Under that procedure, the IRS will abate the penalty if the partnership is a domestic partnership with 10 or fewer partners (other than nonresident aliens), and all of the partners have properly reported the partnership's passthrough items on their individual income tax returns. The IRS has not applied similar relief to the S corporation late filing penalty, but an S corporation fitting those conditions might state on its request for abatement of the penalty that it has 10 or less shareholders and they all have properly reported passthrough items on their returns. It is questionable whether that will help, but it probably will not hurt. As things stand presently, however, you should also include in the request a reasonable cause for the late filing.

Small S Corporations Can Skip Portions of Form 1120S

S corporations with less than $250,000 of gross receipts and less than $250,000 in assets are not required to complete Schedules L (Balance Sheets per Books) and M-1 [Reconciliation of Income (Loss) per Books With Income (Loss) per Return] of Form 1120S [News Release IR-2002-48 (April 10, 2002)].

Schedule M-3

S corporations with total assets of $10 million or more must file Form 1120S, Schedule M-3, *Net Income (Loss) Reconciliation for S Corporations with Total Assets of $10 Million or More*.

S Corporations with Foreign Bank Accounts or Foreign Operations

An S corporation may be required to file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*, if the corporation has an interest in or signature power over a foreign bank account. The form is not attached to the Form 1120S, but is instead filed with the Department of the Treasury, as shown on the form. The report is based on a calendar year, and Form TD F 90-22.1 is due by the following *June 30*.

Also, if an S corporation has assets in or operates a business in a foreign country or a U.S. possession at any time during the tax year, it may have to file Schedule N (Form 1120), *Foreign Operations of U.S. Corporations*. A number of additional forms (such as Forms 3520, 5471, 8858, 8865, and 8873) may need to be attached to the Schedule N (Form 1120), which is in turn attached to the S corporation's Form 1120S.

Practice Tip: Severe penalties can be assessed if these forms are required but are not filed in a timely manner.

Form 1120S and Schedule K-1

A copy of Form 1120S and Schedule K-1 follow this chapter. See chapter 6 for discussion relating to the Schedule K-1.

Summary

- Each item of passthrough must be examined, and passed through as nonpassive or passive activity income, loss, credit, or deduction.
- Passthrough items relating to the operations of the business are nonpassive if the shareholder (or spouse) materially participates in the operations of the business, and are passive if he or she does not materially participate.
- Portfolio income is nonpassive activity income, and rental income is generally passive activity income or loss.
- C corporations that are using LIFO and elect S corporation status must include LIFO recapture amount in income.
- Certain fringe benefits paid to or on behalf of a 2 percent shareholder are nondeductible at the corporate level unless they are treated as wage income to the shareholder.
- Expenses payable by an accrual basis S corporation to a cash basis taxpayer cannot be deducted until they are paid.
- Recent changes to the Section 179 depreciation rules include:
    - Sec. 179 depreciation has been increased from $250,000 (with an $800,000 phaseout threshold) to $500,000 (with a $2 million threshold) for 2011 and 2012.
    - A new opportunity to immediately charge off qualified real property (up to $250,000 of the $500,000 cap in 2011 and 2012 can be used to this purpose) which includes qualified leasehold improvements, qualified restaurant property, and qualified retail improvements.
    - The reinstatement of 50 percent bonus depreciation for 2010 (enacted as part of the Small Business Jobs Act) but then replaced by 100 percent bonus depreciation (for certain qualifying assets placed into service after 9/8/2010 and before 1/1/2012).

Form **1120S**

Department of the Treasury
Internal Revenue Service

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.**

► **See separate instructions.**

OMB No. 1545-0130

2010

For calendar year 2010 or tax year beginning , 2010, ending , 20

A S election effective date	**TYPE OR PRINT** Name	**D** Employer identification number
B Business activity code number *(see instructions)*	Number, street, and room or suite no. If a P.O. box, see instructions.	**E** Date incorporated
C Check if Sch. M-3 attached ☐	City or town, state, and ZIP code	**F** Total assets *(see instructions)* $

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☐ No If "Yes," attach Form 2553 if not already filed

H Check if: **(1)** ☐ Final return **(2)** ☐ Name change **(3)** ☐ Address change **(4)** ☐ Amended return **(5)** ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year . . . . . ►

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

Income	**1a**	Gross receipts or sales	**b** Less returns and allowances	**c** Bal ►	**1c**	
	2	Cost of goods sold (Schedule A, line 8)			**2**	
	3	Gross profit. Subtract line 2 from line 1c			**3**	
	4	Net gain (loss) from Form 4797, Part II, line 17 *(attach Form 4797)*			**4**	
	5	Other income (loss) *(see instructions—attach statement)*			**5**	
	6	**Total income (loss).** Add lines 3 through 5		►	**6**	
Deductions (see instructions for limitations)	**7**	Compensation of officers			**7**	
	8	Salaries and wages (less employment credits)			**8**	
	9	Repairs and maintenance			**9**	
	10	Bad debts			**10**	
	11	Rents			**11**	
	12	Taxes and licenses			**12**	
	13	Interest			**13**	
	14	Depreciation not claimed on Schedule A or elsewhere on return (*attach Form 4562*)			**14**	
	15	Depletion **(Do not deduct oil and gas depletion.)**			**15**	
	16	Advertising			**16**	
	17	Pension, profit-sharing, etc., plans			**17**	
	18	Employee benefit programs			**18**	
	19	Other deductions (*attach statement*)			**19**	
	20	**Total deductions.** Add lines 7 through 19		►	**20**	
	21	**Ordinary business income (loss).** Subtract line 20 from line 6			**21**	
Tax and Payments	**22a**	Excess net passive income or LIFO recapture tax (*see instructions*)	**22a**			
	b	Tax from Schedule D (Form 1120S)	**22b**			
	c	Add lines 22a and 22b (*see instructions for additional taxes*)			**22c**	
	23a	2010 estimated tax payments and 2009 overpayment credited to 2010	**23a**			
	b	Tax deposited with Form 7004	**23b**			
	c	Credit for federal tax paid on fuels (*attach Form 4136*)	**23c**			
	d	Add lines 23a through 23c			**23d**	
	24	Estimated tax penalty (*see instructions*). Check if Form 2220 is attached		► ☐	**24**	
	25	**Amount owed.** If line 23d is smaller than the total of lines 22c and 24, enter amount owed			**25**	
	26	**Overpayment.** If line 23d is larger than the total of lines 22c and 24, enter amount overpaid			**26**	
	27	Enter amount from line 26 **Credited to 2011 estimated tax** ►	**Refunded** ►		**27**	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer | Date | Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ►			Firm's EIN ►	
Firm's address ►			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11510H Form **1120S** (2010)

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1		
2	Purchases	2		
3	Cost of labor	3		
4	Additional section 263A costs (*attach statement*)	4		
5	Other costs (*attach statement*)	5		
6	**Total.** Add lines 1 through 5	6		
7	Inventory at end of year	7		
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8		

9a Check all methods used for valuing closing inventory: *(i)* ☐ Cost as described in Regulations section 1.471-3
(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4
(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 9d

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule B Other Information (see instructions)

		Yes	No
1	Check accounting method: **a** ☐ Cash **b** ☐ Accrual **c** ☐ Other (specify) ▶		
2	See the instructions and enter the: **a** Business activity ▶ **b** Product or service ▶		
3	At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a statement showing: **(a)** name and employer identification number (EIN), **(b)** percentage owned, and **(c)** if 100% owned, was a qualified subchapter S subsidiary election made?		
4	Has this corporation filed, or is it required to file, **Form 8918,** Material Advisor Disclosure Statement, to provide information on any reportable transaction?		
5	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
6	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)* ▶ $		
7	Enter the accumulated earnings and profits of the corporation at the end of the tax year. $		
8	Are the corporation's total receipts (*see instructions*) for the tax year **and** its total assets at the end of the tax year less than $250,000? If "Yes," the corporation is not required to complete Schedules L and M-1		
9	During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions		

Schedule K Shareholders' Pro Rata Share Items

					Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 21)		1	
	2	Net rental real estate income (loss) (*attach Form 8825*)		2	
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities (*attach statement*)	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
	4	Interest income		4	
	5	Dividends: **a** Ordinary dividends		5a	
		b Qualified dividends	5b		
	6	Royalties		6	
	7	Net short-term capital gain (loss) (*attach Schedule D (Form 1120S)*)		7	
	8a	Net long-term capital gain (loss) (*attach Schedule D (Form 1120S)*)		8a	
	b	Collectibles (28%) gain (loss)	8b		
	c	Unrecaptured section 1250 gain (*attach statement*)	8c		
	9	Net section 1231 gain (loss) (*attach Form 4797*)		9	
	10	Other income (loss) (*see instructions*) Type ▶		10	

	Shareholders' Pro Rata Share Items (continued)		Total amount
Deductions	11	Section 179 deduction (*attach Form 4562*)	11
	12a	Contributions	12a
	b	Investment interest expense	12b
	c	Section 59(e)(2) expenditures **(1)** Type ▶ **(2)** Amount ▶	12c(2)
	d	Other deductions *(see instructions)* Type ▶	12d
Credits	13a	Low-income housing credit (section 42(j)(5))	13a
	b	Low-income housing credit (other)	13b
	c	Qualified rehabilitation expenditures (rental real estate) (*attach Form 3468*)	13c
	d	Other rental real estate credits (*see instructions*) Type ▶	13d
	e	Other rental credits (*see instructions*) Type ▶	13e
	f	Alcohol and cellulosic biofuel fuels credit (*attach Form 6478*)	13f
	g	Other credits (*see instructions*) Type ▶	13g
Foreign Transactions	14a	Name of country or U.S. possession ▶	
	b	Gross income from all sources	14b
	c	Gross income sourced at shareholder level	14c
		Foreign gross income sourced at corporate level	
	d	Passive category	14d
	e	General category	14e
	f	Other (*attach statement*)	14f
		Deductions allocated and apportioned at shareholder level	
	g	Interest expense	14g
	h	Other	14h
		Deductions allocated and apportioned at corporate level to foreign source income	
	i	Passive category	14i
	j	General category	14j
	k	Other (*attach statement*)	14k
		Other information	
	l	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	14l
	m	Reduction in taxes available for credit (*attach statement*)	14m
	n	Other foreign tax information (*attach statement*)	
Alternative Minimum Tax (AMT) Items	15a	Post-1986 depreciation adjustment	15a
	b	Adjusted gain or loss	15b
	c	Depletion (other than oil and gas)	15c
	d	Oil, gas, and geothermal properties—gross income	15d
	e	Oil, gas, and geothermal properties—deductions	15e
	f	Other AMT items (*attach statement*)	15f
Items Affecting Shareholder Basis	16a	Tax-exempt interest income	16a
	b	Other tax-exempt income	16b
	c	Nondeductible expenses	16c
	d	Distributions *(attach statement if required) (see instructions)*	16d
	e	Repayment of loans from shareholders	16e
Other Information	17a	Investment income	17a
	b	Investment expenses	17b
	c	Dividend distributions paid from accumulated earnings and profits	17c
	d	Other items and amounts (*attach statement*)	
Reconciliation	18	**Income/loss reconciliation.** Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18

Schedule L **Balance Sheets per Books**

	Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	( )		( )	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (*see instructions*)				
6	Other current assets (*attach statement*)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (*attach statement*)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	( )		( )	
11a	Depletable assets				
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )		( )	
14	Other assets (*attach statement*)				
15	Total assets				
	Liabilities and Shareholders' Equity				
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (*attach statement*)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (*attach statement*)				
22	Capital stock				
23	Additional paid-in capital				
24	Retained earnings				
25	Adjustments to shareholders' equity (*attach statement*)				
26	Less cost of treasury stock		( )		( )
27	Total liabilities and shareholders' equity				

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income (Loss) per Return**

Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books		5 Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize):		a Tax-exempt interest $	
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize):		6 Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize):	
a	Depreciation $		a Depreciation $	
b	Travel and entertainment $			
			7 Add lines 5 and 6	
4	Add lines 1 through 3		8 Income (loss) (Schedule K, line 18). Line 4 less line 7	

Schedule M-2 **Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (see instructions)

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year			
2	Ordinary income from page 1, line 21			
3	Other additions			
4	Loss from page 1, line 21	( )		
5	Other reductions	( )	( )	
6	Combine lines 1 through 5			
7	Distributions other than dividend distributions			
8	Balance at end of tax year. Subtract line 7 from line 6			

SCHEDULE D (Form 1120S)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses and Built-in Gains

► Attach to Form 1120S.
► See separate instructions.

OMB No. 1545-0130

2010

Name

Employer identification number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

	(a) Description of property (Example: 100 shares of Z Co.)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Sales price	(e) Cost or other basis (see instructions)	(f) Gain or (loss) (Subtract (e) from (d))
1						

2	Short-term capital gain from installment sales from Form 6252, line 26 or 37	2	
3	Short-term capital gain or (loss) from like-kind exchanges from Form 8824	3	
4	Combine lines 1 through 3 in column (f)	4	
5	Tax on short-term capital gain included on line 21 below	5	( )
6	**Net short-term capital gain or (loss).** Combine lines 4 and 5. Enter here and on Form 1120S, Schedule K, line 7 or 10	6	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 shares of Z Co.)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Sales price	(e) Cost or other basis (see instructions)	(f) Gain or (loss) (Subtract (e) from (d))
7						

8	Long-term capital gain from installment sales from Form 6252, line 26 or 37	8	
9	Long-term capital gain or (loss) from like-kind exchanges from Form 8824	9	
10	Capital gain distributions	10	
11	Combine lines 7 through 10 in column (f)	11	
12	Tax on long-term capital gain included on line 21 below	12	( )
13	**Net long-term capital gain or (loss).** Combine lines 11 and 12. Enter here and on Form 1120S, Schedule K, line 8a or 10	13	

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

14	Excess of recognized built-in gains over recognized built-in losses (attach computation schedule)	14	
15	Taxable income (attach computation schedule)	15	
16	Net recognized built-in gain. Enter the smallest of line 14, line 15, or line 6 of Schedule B	16	
17	Section 1374(b)(2) deduction	17	
18	Subtract line 17 from line 16. If zero or less, enter -0- here and on line 21	18	
19	Enter 35% of line 18	19	
20	Section 1374(b)(3) business credit and minimum tax credit carryforwards from C corporation years	20	
21	**Tax.** Subtract line 20 from line 19 (if zero or less, enter -0-). Enter here and on Form 1120S, page 1, line 22b	21	

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S. Cat. No. 11516V **Schedule D (Form 1120S) 2010**

671110

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S)
Department of the Treasury
Internal Revenue Service

2010

For calendar year 2010, or tax year beginning _____, 2010
ending _____, 20 _____

Shareholder's Share of Income, Deductions, Credits, etc.

► **See back of form and separate instructions.**

Part I Information About the Corporation

A Corporation's employer identification number

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return

Part II Information About the Shareholder

D Shareholder's identifying number

E Shareholder's name, address, city, state, and ZIP code

F Shareholder's percentage of stock ownership for tax year . . . . . _____ %

For IRS Use Only

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

1	Ordinary business income (loss)	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items
11	Section 179 deduction	16	Items affecting shareholder basis
12	Other deductions		
		17	Other information

* See attached statement for additional information.

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

		Report on
1.	**Ordinary business income (loss).** Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:	
	Passive loss	See the Shareholder's Instructions
	Passive income	Schedule E, line 28, column (g)
	Nonpassive loss	Schedule E, line 28, column (h)
	Nonpassive income	Schedule E, line 28, column (j)
2.	**Net rental real estate income (loss)**	See the Shareholder's Instructions
3.	**Other net rental income (loss)**	
	Net income	Schedule E, line 28, column (g)
	Net loss	See the Shareholder's Instructions
4.	**Interest income**	Form 1040, line 8a
5a.	**Ordinary dividends**	Form 1040, line 9a
5b.	**Qualified dividends**	Form 1040, line 9b
6.	**Royalties**	Schedule E, line 4
7.	**Net short-term capital gain (loss)**	Schedule D, line 5, column (f)
8a.	**Net long-term capital gain (loss)**	Schedule D, line 12, column (f)
8b.	**Collectibles (28%) gain (loss)**	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
8c.	**Unrecaptured section 1250 gain**	See the Shareholder's Instructions
9.	**Net section 1231 gain (loss)**	See the Shareholder's Instructions
10.	**Other income (loss)**	
	Code	
A	Other portfolio income (loss)	See the Shareholder's Instructions
B	Involuntary conversions	See the Shareholder's Instructions
C	Sec. 1256 contracts & straddles	Form 6781, line 1
D	Mining exploration costs recapture	See Pub. 535
E	Other income (loss)	See the Shareholder's Instructions
11.	**Section 179 deduction**	See the Shareholder's Instructions
12.	**Other deductions**	
A	Cash contributions (50%)	See the Shareholder's Instructions
B	Cash contributions (30%)	
C	Noncash contributions (50%)	
D	Noncash contributions (30%)	
E	Capital gain property to a 50% organization (30%)	
F	Capital gain property (20%)	
G	Contributions (100%)	
H	Investment interest expense	Form 4952, line 1
I	Deductions—royalty income	Schedule E, line 18
J	Section 59(e)(2) expenditures	See the Shareholder's Instructions
K	Deductions—portfolio (2% floor)	Schedule A, line 23
L	Deductions—portfolio (other)	Schedule A, line 28
M	Preproductive period expenses	See the Shareholder's Instructions
N	Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions
O	Reforestation expense deduction	See the Shareholder's Instructions
P	Domestic production activities information	See Form 8903 instructions
Q	Qualified production activities income	Form 8903, line 7b
R	Employer's Form W-2 wages	Form 8903, line 17
S	Other deductions	See the Shareholder's Instructions
13.	**Credits**	
A	Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Shareholder's Instructions
B	Low-income housing credit (other) from pre-2008 buildings	See the Shareholder's Instructions
C	Low-income housing credit (section 42(j)(5)) from post-2007 buildings	Form 8586, line 11
D	Low-income housing credit (other) from post-2007 buildings	Form 8586, line 11
E	Qualified rehabilitation expenditures (rental real estate)	See the Shareholder's Instructions
F	Other rental real estate credits	
G	Other rental credits	
H	Undistributed capital gains credit	Form 1040, line 71, box a
I	Alcohol and cellulosic biofuel fuels credit	Form 6478, line 8
J	Work opportunity credit	Form 5884, line 3
K	Disabled access credit	See the Shareholder's Instructions
L	Empowerment zone and renewal communtiy employment credit	Form 8844, line 3
M	Credit for increasing research activities	See the Shareholder's Instructions
N	Credit for employer social security and Medicare taxes	Form 8846, line 5
O	Backup withholding	Form 1040, line 61
P	Other credits	See the Shareholder's Instructions
14.	**Foreign transactions**	
A	Name of country or U.S. possession	Form 1116, Part I
B	Gross income from all sources	
C	Gross income sourced at shareholder level	
	Foreign gross income sourced at corporate level	
D	Passive category	Form 1116, Part I
E	General category	
F	Other	
	Deductions allocated and apportioned at shareholder level	
G	Interest expense	Form 1116, Part I
H	Other	Form 1116, Part I
	Deductions allocated and apportioned at corporate level to foreign source income	
I	Passive category	Form 1116, Part I
J	General category	
K	Other	
	Other information	
L	Total foreign taxes paid	Form 1116, Part II
M	Total foreign taxes accrued	Form 1116, Part II
N	Reduction in taxes available for credit	Form 1116, line 12
O	Foreign trading gross receipts	Form 8873
P	Extraterritorial income exclusion	Form 8873
Q	Other foreign transactions	See the Shareholder's Instructions
15.	**Alternative minimum tax (AMT) items**	
A	Post-1986 depreciation adjustment	See the Shareholder's Instructions and the Instructions for Form 6251
B	Adjusted gain or loss	
C	Depletion (other than oil & gas)	
D	Oil, gas, & geothermal—gross income	
E	Oil, gas, & geothermal—deductions	
F	Other AMT items	
16.	**Items affecting shareholder basis**	
A	Tax-exempt interest income	Form 1040, line 8b
B	Other tax-exempt income	See the Shareholder's Instructions
C	Nondeductible expenses	
D	Distributions	
E	Repayment of loans from shareholders	
17.	**Other information**	
A	Investment income	Form 4952, line 4a
B	Investment expenses	Form 4952, line 5
C	Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions
D	Basis of energy property	See the Shareholder's Instructions
E	Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
F	Recapture of low-income housing credit (other)	Form 8611, line 8
G	Recapture of investment credit	See Form 4255
H	Recapture of other credits	See the Shareholder's Instructions
I	Look-back interest—completed long-term contracts	See Form 8697
J	Look-back interest—income forecast method	See Form 8866
K	Dispositions of property with section 179 deductions	See the Shareholder's Instructions
L	Recapture of section 179 deduction	
M	Section 453(l)(3) information	
N	Section 453A(c) information	
O	Section 1260(b) information	
P	Interest allocable to production expenditures	
Q	CCF nonqualified withdrawals	
R	Depletion information—oil and gas	
S	Amortization of reforestation costs	
T	Section 108(i) information	
U	Other information	

Appendix A

S Corporation Income Tax Return Checklist—Form 1120S

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

Client Name and Number: _____

Prepared by: _____ Date: _____ Reviewed by: _____ Date: _____

	DONE	N/A	COMMENTS OR EXPLANATION
100) GENERAL INFORMATION			
101) Determine if requirements for avoiding penalties for improper disclosure or use of taxpayer information by tax return preparers imposed under §§6713 and 7216 have been met. (See Final Regs. T.D. 9437 and 9478; Prop. Reg. REG-121698-08 (7/2/08); and Rev. Proc. 2008-35).	___	___	_____
102) Consider obtaining signed:			
.1) Engagement letter	___	___	_____
.2) Engagement letter for tax advice under the CPA-client privilege provisions of 7525	___	___	_____
.3) Power of attorney in addition to "check-box" option.	___	___	_____
103) Review and update the S corporation and shareholders' names, addresses, fiscal year, incorporation date, business code, identification numbers, and IRS and other tax filing addresses.	___	___	_____
104) Review permanent file, prior year returns, memos, workpapers, carryovers and correspondence files.	___	___	_____
105) Review pro forma/organizer for accuracy.	___	___	_____
106) If the S corporation has been examined by the Internal Revenue Service, state or local taxing authority:			
.1) Obtain copies of the revenue agent's reports.	___	___	_____
.2) Determine that the agent's adjustments have been entered on the S corporation's records, and appropriate carryover workpapers.	___	___	_____
.3) If the agent's adjustments affect income tax returns of years other than those audited, or the corresponding federal or state returns for the same year, consider filing amended returns.	___	___	_____
.4) Inquire whether the S corporation has informed the shareholders of examination by the IRS or state agency.	___	___	_____
107) Obtain copies of correspondence with the IRS or state taxing authorities. Consider impact.	___	___	_____
108) Inquire whether the S corporation has made or received any below-market-rate loans. Determine imputed interest consequences and existence of properly executed note.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
109) Review for adequate stated interest on debt instruments:			
.1) Determine whether original issue discount or unstated interest rules require restatement of note interest and principal.	___	___	_____
.2) Consider election for purchased discount under § 1278.	___	___	_____
110) Review for proper reporting of interest recognition in accordance with Regs. §§ 1.483-4 and 1.1274-5 for debt instruments providing contingent payments.	___	___	_____
111) Election/revocation/termination of S status:			
.1) If S or QSUB status was elected during the current year:			
(a) Confirm that IRS (and state if applicable) approval of the election has been received and is in effect for the current year.	___	___	_____
(b) Consider scheduling potential "built-in" gains at date of election.	___	___	_____
(c) Consider requesting relief of an invalid election under § 1362(f).	___	___	_____
(d) Consider requesting relief for a late election under § 1362(b)(5). (Rev. Proc. 97-48, 2004-35, and 2007-62)	___	___	_____
.2) If the S status was revoked during the current year:			
(a) Confirm that a revocation was properly filed.	___	___	_____
(b) Determine whether the revocation is effective for the entire year (if filed within the first 2½ months of the year) or prospectively.	___	___	_____
(c) Obtain a copy of IRS approval letter.	___	___	_____
.3) Events terminating S status:			
(a) Determine that no disqualifying event has occurred related to excess number of shareholders, prohibited type of shareholder or issuance of a second class of stock. Consider changes regarding number of shareholders, types of shareholders and safe harbor debt.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
(b) Determine that termination is not triggered by excess passive income for three consecutive years if corporation has C corporation accumulated earnings and profits. Note passive income exclusion of dividends from 80% or greater subsidiary attributable to E&P derived from an active trade or business. Note for tax years beginning after May 25, 2007, excess passive investment income does not include capital gain from the sale of stock or securities and E&P excludes pre-1983 accumulated E&P for certain corporations.	___	___	_____
.4) If S status was terminated or revoked during the year:			
(a) Verify allocation method - per day basis or actual. More than 50% cumulative change in stock ownership during the year requires actual cutoff. If less than 50% cumulative change and electing actual, match the election and the shareholders' consent.	___	___	_____
(b) Consider C corporation estimated tax payments for the succeeding year based on the S corporation's net income.	___	___	_____
(c) Consider requesting relief under the "inadvertent termination rule" under § 1362(f).	___	___	_____
(d) Consider whether suspended losses were triggered due to a basis increase during post-termination transition period.	___	___	_____
112) If the corporation owns a qualified Subchapter S subsidiary (QSub) (TD 8869):			
.1) Include all assets, liabilities, and items of income, deduction and credits of the QSub on the return.	___	___	_____
.2) Note new relief available to inadvertent invalid Subchapter S elections and terminations under § 1362(f).	___	___	_____
113) If the corporation has selected an allowable fiscal tax year, determine that Form 8716 has been timely filed, and that "required payments" (Form 8752) have been made, if required. Note that a copy of Form 8716 must be attached to Form 1120S for the first taxable year for which the election is made, if required.	___	___	_____
114) If the corporation is considering adopting or changing its taxable year (or, in the case of a former C corporation that has recently elected S corporation status retaining a taxable year which is other than a calendar year), see the temporary and proposed regulations under §§ 441, 442, 706 and 1378.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
115) If the corporation is on the cash basis, determine if the accrual basis is required.	___	___	_____
116) If the corporation is on the accrual method, consider change to cash method. This area has been subject to IRS modifications.	___	___	_____
117) Determine that accounting methods are comparable to the preceding year unless changes are approved or required. (See instructions to Form 3115 and current year's revenue procedures for a list of approved automatic changes.) See Rev. Proc. 2009-39, amplifying, clarifying and modifying Rev. Proc. 2008-52.	___	___	_____
118) Consider economic performance requirements, including recurring item exceptions and 3½ month rule.	___	___	_____
119) Review and update schedules for federal and state carryover items (regular and AMT) such as:			
.1) Prior year deferred deductions.	___	___	_____
.2) Installment sales. Consider applicable tax rates for components of gain.	___	___	_____
.3) Changes in accounting methods requiring § 481 adjustments.	___	___	_____
.4) Suspended losses/credits due to at-risk limitations.	___	___	_____
.5) Suspended losses due to basis limitations. Update basis schedules accordingly.	___	___	_____
.6) Net unrealized built-in gain.	___	___	_____
.7) Effect of prior tax audits.	___	___	_____
120) Review financial statements and footnotes for relevant information.	___	___	_____
121) Consider the effect of financial statement disclosures under FASB Interpretation "Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109." (FIN 48)	___	___	_____
122) Review Board minutes.	___	___	_____
123) Review prior year's return Schedule M-1 and/or M-3 for items which may have an effect upon or require similar treatment in the current year.	___	___	_____
124) Consider filing power of attorney in addition to "check-box" option.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
125) Determine if Form TDF 90-22.1 is needed to report foreign financial accounts. (Note new penalties, June 30 filing deadline and increased IRS activity in this area.)	___	___	_____
126) Determine if the corporation:			
.1) Created a foreign trust.	___	___	_____
.2) Transferred property to a foreign trust.	___	___	_____
.3) Received distributions, directly or indirectly, from a foreign trust. (§ 6048)	___	___	_____
.4) Received loans, unless with arms-length terms, from a foreign trust.	___	___	_____
.5) Is a beneficiary of a foreign trust and transferred property to a foreign grantor of the trust.	___	___	_____
127) Consider if disaster relief provisions apply.	___	___	_____
128) Determine state and local tax filing requirements (see Nexus Practice Guide). Furnish necessary information to shareholders. Consider:			
.1) Recognition of S status.	___	___	_____
.2) State modification requirements.	___	___	_____
.3) State withholding requirements on income allocated to non-resident shareholders.	___	___	_____
.4) Information to allow shareholder to file the necessary state tax returns.	___	___	_____
.5) Composite filing on behalf of nonresident shareholders.	___	___	_____
.6) Apportionment data for multistate taxpayer.	___	___	_____
129) Consider listed and reportable transactions that need to be disclosed on Form 8886. Note penalties for failure to report.	___	___	_____
130) Consider rule under § 1361(c)(1)(A) which treats stock owned by family members as stock owned by one shareholder.	___	___	_____
200) INCOME			
201) Compare sources and amounts of interest and dividend income with prior year items.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
202) Review Forms 1099 and year-end statements for dividends, interest and gross proceeds from sales. Segregate qualified dividends.	___	___	_____
203) Determine that only trade or business (e.g., not portfolio or rental) income is shown on page 1 of Form 1120S.	___	___	_____
204) If installment method rules apply, see Installment Sales Checklist.	___	___	_____
205) If long-term contract rules apply, see Long-Term Contracts Checklist.	___	___	_____
206) If property was sold, exchanged or involuntarily converted during the year:			
.1) Reconcile to depreciation schedule.	___	___	_____
.2) Determine holding period and federal, state, and AMT bases.	___	___	_____
.3) Determine that gains and losses are properly characterized.	___	___	_____
.4) For § 1231 gains, determine the amount subject to ordinary income treatment as a result of five-year recapture rule for prior net § 1231 losses.	___	___	_____
.5) Determine that sales of securities settled after year-end, with a trade date within current year, are reported this year. Note special rules for short sales in § 1233.	___	___	_____
.6) Review application of the wash sale rules.	___	___	_____
.7) Report gains on constructive sales of appreciated financial positions. Note exception under § 1259(c)(3).	___	___	_____
.8) Review application of straddle rules and available elections under § 1092 and see final regulation § 1.1092(c)-1.	___	___	_____
.9) Consider allowable methods of calculating basis on the sale of mutual funds.	___	___	_____
.10) Consider if limitations apply for a mutual fund sold within six months of acquisition.	___	___	_____
.11) Consider the effect on basis of nontaxable stock dividends, reinvested dividends and OID.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.12) Consider provisions related to:			
(a) Rules for like-kind and related party exchanges. (Form 8824) Note restrictions on exchange of U.S. property for foreign property. See final regulations under §§ 468B(g), 1031 and 7872 regarding the taxation of qualified escrow accounts, qualified trusts or funds used during deferred like-kind exchanges. (T.D. 9413, 7/9/08) Note restrictions for U.S. exchange of foreign property. See also PLR 200912004 for rules on cars, light-duty trucks and crossover vehicles and CCA 200911006 for certain intangible property. Note extension of time rules for failed like-kind exchanges with bankrupt qualified intermediary.	___	___	_____
(b) Recapture of depreciation (including § 291 recapture, if applicable) and/or tax credit, or reduction of credit carry-forwards. Note §§ 1245 and 1250 applications.	___	___	_____
(c) Presumption of capital gain relating to subdivision of land. (§ 1237)	___	___	_____
(d) Gain from distributions of appreciated property.	___	___	_____
(e) Forced sale of livestock on account of weather related conditions. (§ 1033 (e) and (f) and Notices 2006-82, 2007-80, 2008-86, 2009-81 and 2010-64)	___	___	_____
(f) Sale of "qualified community assets" located in "renewal communities" (CRTRA 2000 effective January 1, 2002 through December 31, 2014).	___	___	_____
(g) Ordinary income treatment of commodities derivatives sold by commodities derivatives dealers; hedging transactions, and supplies of a type regularly consumed in the ordinary course of business.	___	___	_____
(h) Involuntary conversion rules and elections. Note extension of replacement period from two to five years if:			
(1) Property is in the Hurricane Katrina disaster area and the property is compulsorily or involuntarily converted on or after August 25, 2005, by reason of Hurricane Katrina.	___	___	_____
(2) Property is in the Kansas disaster area and the property is compulsorily or involuntarily converted on or after May 4, 2007.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
207) Deferred income and expenses:			
.1) Include in gross income, as appropriate, income deferred for books in the current year.	___	___	_____
.2) Exclude from gross income, as appropriate, income for books in the current year that was taken into income for tax in a prior year.	___	___	_____
.3) Consider whether there are any advance payments for goods that can be determined under Reg. § 1.451-5 and §§ 455 and 456. Note the information schedule requirements.	___	___	_____
.4) Determine proper treatment of certain advance payments.	___	___	_____
.5) If a lessor, consider economic accrual of rent under § 467.	___	___	_____
.6) Determine deductibility of prepaid expenses. [See Reg. § 1.263(a)-4(f)]	___	___	_____
208) Exclude tax-exempt (federal and/or state) income.	___	___	_____
209) Accrual basis taxpayers should consider deferral of state or local income or franchise tax refunds.	___	___	_____
210) Determine that sales of securities settled after year end, with a trade date within current year, are reported this year. Note special rules for short sales in § 1233.	___	___	_____
211) Determine if there were passive activities. (See Passive Activity Checklist.)	___	___	_____
.1) Note requirements to separate or group activities.	___	___	_____
.2) Consider disclosure statement for new/changed groupings.	___	___	_____
212) Inquire if securities held by the S corporation became worthless during the year. Note that substantial worthlessness of short sale property is a gain recognition event.	___	___	_____
213) Report rental real estate activities on Form 8825.	___	___	_____
214) For leased vehicles, calculate the appropriate income inclusion amount to be reported by referring to the IRS tables. (See Vehicle Related Guides.)	___	___	_____
215) Determine if there is income from discharge of indebtedness. (REG-102822-08, 8/6/08) (§§61, 108, 108(i) , 1017 and T.D. 9498)	___	___	_____
.1) Consider exclusion and elections under § 108. (See Reg. § 1.1017-1)	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.2) Consider election to defer income from the discharge of indebtedness in connection with a reacquisition on an applicable debt instrument after December 31, 2008 and before January 1, 2011. {§108 (i)} (T.D. 9498)	___	___	_____
.3) Consider Form 982.	___	___	_____
.4) Do not increase basis for excluded amounts.	___	___	_____
216) Consider ordinary income on market discount bonds and deferral of related interest expense.	___	___	_____
217) Inquire if the taxpayer engaged in bartering transactions.	___	___	_____
218) Consider disallowance of losses for transactions with related parties.	___	___	_____
219) Consider the mark to market rules for dealers in securities under § 475 and the related § 481 adjustment.	___	___	_____
220) If Form 1099-OID is received, compute for includible amount.	___	___	_____
221) Consider exclusion from income of cash or rent reduction received from lessor under a short-term lease of retail space utilized to construct leasehold improvements which will revert to the lessor at termination of lease.	___	___	_____
222) Consider at-risk rules. Also see final Regs. §§ 1.465-8 and 1.465-20 for amounts borrowed from interested or related parties.	___	___	_____
223) Consider the need to file Form 5713, International Boycott Report.	___	___	_____
300) DEDUCTIONS			
301) Ascertain officer(s)/shareholder(s) compensation and review for reasonableness.	___	___	_____
302) Review the taxpayer's vacation pay policy to determine if a deduction is allowable on the accrual basis (vested at year end and paid within two and one-half months after year end).	___	___	_____
303) For inventories consider:			
.1) If the uniform capitalization rules apply. Note increased IRS scrutiny in this area. (See Uniform Capitalization Checklist.)	___	___	_____
.2) Lower of cost or market adjustments.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.3) Write down of subnormal inventories. Note allowable estimated inventory shrinkage.	___	___	_____
.4) Whether method of valuing inventory is valid including new rules for use of the rolling-average method under Rev. Proc. 2008-43.	___	___	_____
304) If Long-Term Contract rules apply, see Long-Term Contract Checklist.	___	___	_____
305) For charitable contributions consider:			
.1) If contributions are to qualified charitable organizations.	___	___	_____
.2) That certain contributions to organizations conducting lobbying activities related to the taxpayer's trade or business are not deductible.	___	___	_____
.3) Reduction of contribution deduction due to value of athletic tickets or token benefits.	___	___	_____
.4) The limitation related to contributions of patents or other intellectual property.	___	___	_____
.5) The limitations on donations of vehicles exceeding $500.	___	___	_____
.6) If adequate contemporaneous documentation was obtained for charitable contributions of $250 or more and quid pro quo donations in excess of $75.	___	___	_____
.7) If recordkeeping and substantiation requirements have been met for all cash and property donations.	___	___	_____
.8) If adequate contemporaneous documentation was obtained for charitable contributions of vehicles. Note limits on deduction allowed.	___	___	_____
.9) Limits on donations of property disposed of within 3 years.	___	___	_____
.10) New basis adjustment rules for donations of appreciated property (TRUIRJCA2010).	___	___	_____
.11) The limitation related to contributions of appreciated ordinary income property and multi-years' donations calculations to be tracked.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

		DONE	N/A	COMMENTS OR EXPLANATION
.12)	That costs of contributed property held for sale in the course of a trade or business that are incurred in the year of contribution are treated as part of cost of goods sold for such year, not a charitable contribution subject to the related rules and limitations.	___	___	_____
.13)	The deduction for more than cost of appreciated capital gains property.	___	___	_____
.14)	Rev. Rul. 2000-43 disallowing year-end accrued charitable contributions	___	___	_____
.15)	If Form 8283 is required for other than cash gifts.	___	___	_____
.16)	Appraisal for gifts exceeding $5,000. Note for gifts exceeding $500,000, appraisal must be attached to return.	___	___	_____
.17)	Denial of charitable contribution deduction for transfers associated with split-dollar insurance arrangements.	___	___	_____
.18)	Enhanced deduction for computer technology and equipment (TRUIRJCA 2010).	___	___	_____
.19)	Enhanced deduction for contribution of food inventory (TRUIRJCA 2010).	___	___	_____
.20)	Limitations on donations of partial tangible personal property (e.g., art work).	___	___	_____
.21)	Special rules on donations of conservation and easements {(§170(b)(1)(E)} (TRUIRJCA 2010).	___	___	_____
306)	Inquire if fringe benefits (including Health Savings Accounts contributions) for more than 2% shareholders claimed as deductions by the S corporation have been reported on the recipient shareholders' Forms W-2 as wages subject to income tax.	___	___	_____
307)	Inquire whether the S corporation can substantiate by adequate records, as required under § 274, expenses claimed for entertainment, entertainment facilities, gifts, travel and conventions. Consider optional per diem method and note limitation on deductibility of certain nonemployee travel expenses. (See Rev. Proc. 2009-47 and Rev. Rul. 2008-23) (See also Rev. Proc. 2004-29 regarding the ability to use statistical sampling for meals and entertainment expenses that are not subject to the 50% limitation.)	___	___	_____
308)	Limit deduction for meals and entertainment to allowable percentage. Consider exceptions, including employer-provided meals.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
309) Consider limitations on personal use of business aircraft for officers, directors and >10% owners.	___	___	_____
310) Determine deductibility of club dues.	___	___	_____
311) Determine that expenses allocable to portfolio income have not been deducted on page 1, Form 1120S.	___	___	_____
312) Determine if professional fees and/or employee salaries require capitalization.	___	___	_____
313) If taxpayer maintains a profit sharing plan and has not contributed the maximum contribution for each taxable year beginning prior to 1987, calculate the unfunded contribution carryover amount.	___	___	_____
314) Determine that specific write-off and/or nonaccrual experience method is used for bad debts for entities other than financial institutions.	___	___	_____
315) Review partially worthless debt for write-off under Reg. § 1.166-3.	___	___	_____
316) Consider rules for expensing/amortizing start-up (SBJA 2010) and organizational costs.	___	___	_____
317) Officers and shareholders:			
.1) Determine the ownership of life insurance policies and the proper treatment of related expenses.	___	___	_____
.2) Determine split-dollar insurance treatment. (See Reg. § 1.61-22 and Notice 2007-34.)	___	___	_____
.3) Determine deductibility of disability insurance premiums.	___	___	_____
.4) If there were any accruals of interest, compensation or other expenses payable to a shareholder or other related party, determine that for tax purposes the deduction is deferred until the year in which it is includible in income of the shareholder or other related party.	___	___	_____
.5) Consider if compensation to shareholders who perform substantial services for the corporation was sufficient.	___	___	_____
.6) Review documentation of shareholder loans and adequate interest rate.	___	___	_____
318) Determine if compensation deductions are allowable with respect to qualified and nonqualified stock options.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
319) Determine applicability of 2½ month deferred compensation rule for nonshareholder employees and independent contractors.	___	___	_____
320) Determine if § 409A deferred compensation applies to compensation arrangements. See Reg. §§ 1.409A-1 through 1.409A-6, T.D. 9321, (4/10/07) corrected 7/13/07, effective 1/1/09 and prop. reg. REG-148326-05, 12/8/08.	___	___	_____
321) Interest considerations:			
.1) Treat amortizable bond premium (for bonds acquired after 1987) as an offset to interest income.	___	___	_____
.2) Eliminate interest expense on debts with respect to life insurance policies (purchased after June 20, 1986) on current or former beneficial owners and key employees to the extent that the total of such loans exceeds $50,000. No interest deduction is allowed for new or materially changed contracts issued after June 8, 1997.	___	___	_____
.3) Determine that the proper classifications have been made by type (trade or business, investment, passive activity, tax-exempt expenditures, etc.).	___	___	_____
.4) Determine that proper allocation of interest expense has been made if the proceeds of a loan were used for more than one purpose.	___	___	_____
.5) Determine if interest deduction limitations apply to interest incurred to purchase or carry market discount bonds or short-term debt obligations.	___	___	_____
.6) Determine if there is an allowable interest deduction related to deferred compensation agreements.	___	___	_____
.7) Capitalize interest and carrying charges on straddles. (§ 263(g))	___	___	_____
.8) Determine if there is nondeductible disqualified debt interest under § 163(1).	___	___	_____
.9) Determine deductibility of accrued interest on related party loans. (§267)	___	___	_____
322) Consider limitations on deducting expenses related to federally tax exempt income. Note that these expenses may be deductible at the state level if the related income is state taxable.	___	___	_____
323) Determine that certain lobbying expenses are not deducted. Note exceptions.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

		DONE	N/A	COMMENTS OR EXPLANATION
324)	Inquire if dues include nondeductible lobbying expenses.	___	___	_____
325)	Consider economic performance requirements, including recurring item exceptions and 3 ½ month rule (Reg. §1.461-(d)(6)(ii).	___	___	_____
326)	Determine if compensation deductions are allowable and whether amounts must be included in recipient's W-2 with respect to:			
	.1) Current or past transfers of property that are no longer subject to a substantial risk of forfeiture. (§ 83)	___	___	_____
	.2) Current transfers of property for which a § 83(b) election is made.	___	___	_____
	.3) Disqualifying dispositions of stock under incentive stock options. (§ 422)	___	___	_____
	.4) Employee stock purchase plans. (§ 423)	___	___	_____
	.5) Exercise of nonqualified stock options for stock without a readily ascertainable fair market value.	___	___	_____
327)	Determine that retirement plan contributions have been calculated using the eligible compensation limit and were timely made. Obtain a listing of dates and amounts of payments. (See PACMBPRA 2010.)	___	___	_____
328)	Determine if deductions should be reduced by credits claimed.	___	___	_____
329)	Determine proper treatment of environmental clean-up expenses. Note expense election under § 198 and Rev. Rul. 2004-18.	___	___	_____
330)	Consider expensing environmental remediation costs (including clean up of certain petroleum products) for qualified contaminated sites in then GOZone area, Midwestern disaster area and other qualified disaster areas. (TRUIRJCA 2010)	___	___	_____
331)	If a lessee, determine proper treatment for long-term leases where leases provide for deferred payments or increasing payments under § 467. Also Reg. § 1.467-9.	___	___	_____
332)	Consider § 266 election to capitalize carrying charges (interest, taxes, etc.) on non-productive property. (CCA 200721015, 1/6/07)	___	___	_____
333)	Determine the proper treatment for costs incurred to acquire, create, or enhance intangible assets. (Reg. § 1.263(a)-4, 1.263(a)-5 and 1.167(a)-3(b), T.D. 9107.)	___	___	_____
334)	Consider deduction for cleaning up polluted "brownfields".	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
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	DONE	N/A	COMMENTS OR EXPLANATION
335) Consider deduction for domestic production activities. (TRUIRJCA 2010) (Form 8903) Note increased IRS scrutiny in this area.	___	___	_____
336) Determine casualty loss limit.	___	___	_____
337) Determine the proper treatment for costs incurred to acquire, create, or enhance tangible assets. (Prop. Regs. REG-168745-03, 3/10/08, corrected 4/9/08)	___	___	_____
338) For accrual basis taxpayers, determine whether state taxes are properly deducted.	___	___	_____
339) Consider expensing for certain demolition and clean-up costs in qualified disaster areas (§§198A and 1400N(f).	___	___	_____
340) Determine deductibility of state and local income taxes. Note accrual deduction is limited to actual liability and cash basis payment is limited to reasonable prepayments.	___	___	_____
341) Consider deduction for energy-efficient commercial building property for property placed in service after 12/31/05 and before 1/1/14.	___	___	_____
400) DEPRECIATION/AMORTIZATION			
401) For assets placed in service during the current year:			
.1) Consider § 179 election to expense qualifying assets. Note that expanded allowable amounts and higher limits apply for tax years beginning in 2010 and 2011 (SBJA 2010)	___	___	_____
.2) Consider "off-the-shelf software" as eligible for § 179 election for tax years beginning before 2013. (TRUIRJCA 2010) (Final Regs. T.D. 9209)	___	___	_____
.3) Consider new §179 election up to $250,000 for qualified real property (qualified leasehold improvements, qualified restaurant property and qualified retail improvement property) for tax years beginning in 2010 and 2011 (§179(f((1) and SBJA 2010).	___	___	_____
.4) Consider § 179A election to expense qualifying clean-fuel vehicles and related refueling property.	___	___	_____
.5) Consider § 179D election to expense energy-efficient commercial building property placed in service before 1/1/14.	___	___	_____

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	DONE	N/A	COMMENTS OR EXPLANATION
.6) Consider additional first-year depreciation for qualified property (capped at $8,000 for passenger automobiles) placed in service before January 1, 2013 (January 1, 2014 for certain property). Note for property placed in service after September 8, 2010 and before January 1, 2012, the additional first-year depreciation is increased from 50/% to 100% (TRUIRJCA 2010).	___	___	_____
.7) Consider 50% expensing for safety equipment for underground mines in the U.S. (TRUIRJCA 2010)..	___	___	_____
.8) Consider enhanced depreciation rules for qualifying nonresidential and residential rental property placed in service in the GOZone and Kansas disaster areas through 12/31/2011 (TRUIRJCA 2010) and qualified disaster property placed in service in qualified disaster areas.	___	___	_____
.9) Determine depreciation of property received in a like-kind exchange or involuntary conversion. (T.D. 9314, 2/26/07)	___	___	_____
.10)Determine the depreciable basis of each asset.	___	___	_____
.11)Determine the property class, recovery period (ARRA 2009) and depreciation method for each asset. Note limitations on property qualifying for income forecast method and designated lives of rent-to-own property.	___	___	_____
.12) Determine the applicable convention (half-year, mid-quarter or mid-month).	___	___	_____
.13) Consider special 15-year straight-line depreciation for qualified leasehold improvements, qualified restaurant property and qualified retail improvements (TRUIRJCA 2010).	___	___	_____
.14) Consider 7-year depreciable life for motorsports entertainment complexes (TRUIRJCA 2010).	___	___	_____
.15) Determine that the cost of leasehold improvements is being recovered over the applicable recovery period regardless of the lease period.	___	___	_____
.16) 36-month amortization rules for software.	___	___	_____
.17) Consider reduced depreciable lives for real estate improvements and special use structures.	___	___	_____
.18) Consider cost segregation analysis for building components.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
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	DONE	N/A	COMMENTS OR EXPLANATION
.19) Consider electing the Alternative Depreciation System (straight line over an ADS recovery period) for qualifying General Depreciation System property.	___	___	_____
.20) Consider electing the 150% DB method over the recovery periods applicable to the regular tax for tangible personal property otherwise qualifying for the 200% DB method.	___	___	_____
.21) For farming, determine that MACRS is applied using 150% DB. Note ADS required if elected out of § 263A.	___	___	_____
.22) If property is leased to a tax-exempt entity, consider the possible need to use the ADS.	___	___	_____
.23) Consider depreciation limitations for Industrial Development Bond (IDB) financed property, and certified historic structures for which a tax credit was taken.	___	___	_____
.24) If a short year, determine that Rev. Proc. 89-15 is followed.	___	___	_____
.25) If there has been a purchase price adjustment, see Prop. Reg. § 1.168-2 (d)(3).	___	___	_____
.26) Determine if interest is payable or receivable under look-back method where income forecast method is used. Note interest calculation change.	___	___	_____
.27) Consider modifications to the income forecast method of depreciation for property placed in service after October 22, 2004 as it relates to "participations and residuals."	___	___	_____
.28) Consider election under §181(a)(2) to deduct cost of production in the year incurred for qualified film and television productions (TRUIRJCA 2010).	___	___	_____
.29) Consider accelerated depreciation for qualifying property located on Indian reservations (TRUIRJCA 2010).	___	___	_____
.30) Consider new accelerated depreciation for racehorses placed in service after 12/31/08 and before 1/1/14.	___	___	_____
.31) Determine if New York Liberty Zone or NYC benefits and incentives are applicable.	___	___	_____
.32) Consider change in accounting method for like-kind exchange property under Reg. § 1.168(k)-1(g)(4)(ii).	___	___	_____
402) Consider amending returns to make and/or revoke a § 179 election. (SBJA 2010)	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
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	DONE	N/A	COMMENTS OR EXPLANATION
403) Determine that amortizable items, including goodwill, are written off over the correct periods. Note:	___	___	_____
.1) Limits for organizational and start-up expenditures.	___	___	_____
.2) Recapture rules for § 197 intangibles.	___	___	_____
.3) Twenty-four month amortization for qualified geological and geophysical expenditures.	___	___	_____
.4) 5-year amortization of musical compositions and copyrights placed in service before 1/1/2011.	___	___	_____
404) Consider the provisions of Rev. Proc. 2002-54 to rectify prior year claims of less than allowable depreciation or amortization.	___	___	_____
405) Consider change in accounting method under Rev. Proc. 2009-39 amplifying, clarifying and modifying Rev. Proc. 2008-52 to correct MACRS lives, methods, etc. and Rev. Proc. 2006-43 for automatic consent for accounting method change for additional first-year depreciation.	___	___	_____
406) Consider final and temporary Regs for changes in computing depreciation and amortization. (T.D. 9307, 12/22/06) See Rev. Proc. 2007-16.	___	___	_____
407) Determine if leased property should be capitalized.	___	___	_____
408) Consider anti-churning rules.	___	___	_____
409) For listed property {Note new exclusion of cellular phones (SBJA 2010).} (e.g.,, autos, computers, airplanes, boats):			
.1) For business vehicles, consider the maximum allowable under the luxury auto rules. (ARRA 2009) Note exceptions for clean burning, electric vehicles with GVW of more than 6,000 lbs. and qualified non-personal use trucks and vans. [Reg. § 1.280F-6(c)(3)(iii)] Note first-year dollar limitations. (Rev. Proc. 2010-18)	___	___	_____
.2) For business vehicles, consider the expensing limitations for trucks and vans rated at 14,000 lbs. GVW or less.	___	___	_____
.3) For business vehicles, determine limitation if the business usage is 50% or less.	___	___	_____
.4) Determine limitations for all other mixed-use property, if the business usage is 50% or less.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
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	DONE	N/A	COMMENTS OR EXPLANATION
.5) Inquire if the individual has kept the required records indicating the business and personal use of property. Note certain travel between home and temporary work locations is considered business.	___	___	_____
.6) Determine recapture if the business usage has declined to 50% or less.	___	___	_____
410) Form 4562 if required:			
.1) Reconcile depreciation expense to supporting schedules.	___	___	_____
.2) Complete all questions regarding personal use of listed property.	___	___	_____
.3) If costs were incurred during the current year, determine that all amortizable items are separately stated and the proper Code section cited.	___	___	_____
411) Consider state depreciation, if different.	___	___	_____
412) Consider federal and state AMT depreciation. Note depreciable lives of tangible personal property placed in service after 1998 are the same for regular and AMT purposes.	___	___	_____
413) For depreciable assets which are demolished, obsolete, abandoned and/or out of service:			
.1) Make adjustments for depreciation.	___	___	_____
.2) Consider credit recapture.	___	___	_____
414) Report depreciation recapture and related investment credit recapture if taxpayer converted depreciable business assets to non-business personal assets.	___	___	_____
415) Determine depreciation allowable for property "after use-change" (§ Reg. 1.168(i)-4).	___	___	_____
416) Consider Rev. Proc. 2007-16 for claiming depreciation after disposal of an asset.	___	___	_____
500) TAX COMPUTATION AND CREDITS			
501) Tax on excess net passive income:			
.1) Determine if passive investment income is greater than 25% of gross receipts and the S corporation has earnings and profits from any C years. Note passive income exclusion of dividends from an 80% or greater subsidiary attributable to E&P from an active trade or business. Note for tax years beginning after May 25, 2007, capital gains from sale or exchange of stock or securities will no longer be considered passive investment income.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
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		DONE	N/A	COMMENTS OR EXPLANATION
.2)	Consider election to designate distributions as deemed out of earnings and profits. (§ 1368(e)(3)) Note for tax years beginning after May 25, 2007, accumulated earnings and profits (E&P) of certain S Corporations may be reduced by pre-1983 accumulated E&P to eliminate tax on excessive net passive income.	___	___	_____
.3)	Consider election to forgo previously taxed income. (§ 1.1368-1(f)(4))	___	___	_____
502)	Tax on "built-in" gains–applies to prior C corporations that filed S status election subsequent to 1986. See Final Regs. T.D. 9180, 70 Fed. Reg. 8727, 2/3/05 and Final Regs. T.D. 9236 under § 1374. Note ARRA 2009 temporarily reduces the holding period from ten years to seven years for tax years beginning in 2009 and 2010 and SBJA 2010 temporarily reduces the holding period from ten years to five years for tax years beginning in 2011. Consider the following:			
.1)	Disclose remaining "built-in" gains on Schedule B.	___	___	_____
.2)	Compute tax at maximum corporate rate for the net recognized gains for the taxable years (not to exceed Subchapter C taxable income as adjusted) on the disposition of assets. (§ 1374)	___	___	_____
.3)	If S election was made after March 30, 1988, determine built-in gain carryover.	___	___	_____
.4)	Gasoline and special fuel credits as well as the following carryforwards from C years may be used to reduce built-in gains tax:			
	(a) Net operating loss.	___	___	_____
	(b) Capital losses.	___	___	_____
	(c) Business credits.	___	___	_____
	(d) Minimum tax credits.	___	___	_____
503)	Consider C Corporation available carryovers.	___	___	_____
504)	Consider tax on LIFO recapture for C corporations electing S status.	___	___	_____
505)	Consider tax payable by the corporation from recomputing a prior year investment tax credit as a result of the early disposition of assets acquired in C corporation years.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
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	DONE	N/A	COMMENTS OR EXPLANATION
506) Confirm the amounts and dates of any federal, state and local estimated tax deposits for the year, prior year overpayments applied, backup withholding and extension payments.	___	___	_____
507) Consider federal (SBJA 2010 and HIREA 2010) and state estimated tax requirements and related electronic filing requirements	___	___	_____
508) Consider credit recapture.	___	___	_____
509) Consider expanded carryback and carryover provisions for general business credits for certain taxpayers (SBJA 2010).			
510) Determine if the S corporation is eligible for tax credits (TRUIRJCA 2010, SBJA 2010, HCERA 2010 and ARRA 2009), such as:			
.1) Foreign tax credit. (§§ 27 and 901)	___	___	_____
.2) Rehabilitation credit. (See Notice 2006-38 for rehab credit relief in disaster areas and increase in the credit in the GO Zone area, (TRUIRJCA 2010) and Midwest Disaster Area (expenses incurred before 1/1/12). (Form 3468) (§§ 38, 46 and 47)	___	___	_____
.3) Energy credit. (ARRA 2009) (Form 3468) (§§ 38, 46, and 48)	___	___	_____
.4) Qualifying advanced coal project credit. (Form 3468) (§§ 38, 46 and 48A)	___	___	_____
.5) Qualifying gasification project credit (Form 3468) (§§ 38, 46 and 48B)	___	___	_____
.6) Qualifying advanced energy project credit. (ARRA 2009) (Form 3468) (§§ 38, 46 and 48C)	___	___	_____
.7) Advanced lean-burn technology motor vehicle credit for qualified vehicles placed in service through 2010. (Form 8910) (See Notice 2009-37 for phase out of the credit for advanced lean-burn technology motor vehicles manufactured by Ford that are purchased for use or lease in the U.S. beginning on April 1, 2009.) (§ 30B)	___	___	_____
.8) Qualified alternative fuel motor vehicle credit. (Form 8910) (§ 30B)	___	___	_____
.9) Qualified fuel cell motor vehicle credit. (Form 8910) (§ 30B)	___	___	_____
.10) Plug-in conversion credit for qualified vehicles that are converted and placed in service after February 17, 2009. (ARRA 2009) (Form 8910) (§ 30B)	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
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		DONE	N/A	COMMENTS OR EXPLANATION
.11)	Alternative fuel vehicle refueling property credit (property relating to hydrogen). (Form 8911) (ARRA 2009) (§ 30C)	___	___	_____
.12)	Credit for qualified plug-in electric drive motor vehicles. (Form 8834, as revised August 2009) (ARRA 2009) (§ 30D)	___	___	_____
.13)	Credit for certain plug-in vehicles acquired after February 17, 2009 and before December 31, 2011. (ARRA 2009) (Form 8834, as revised August 2009) (§ 30)	____	____	_____
.14)	Credit for federal tax paid on fuels. (Form 4136) (§§ 34, 6420, 6421, 6426 and 6427) Note increased IRS scrutiny in this area.	___	___	_____
.15)	Alcohol and cellulosic biofuels credit. (Form 6478) (TRUIRJCA 2010, SBJA 2010 and FCEA 2008) (§ 40)	___	___	_____
.16)	Biodiesel and renewable diesel fuels credit (TRUIRJCA 2010). (Form 8864) (§ 40A)	___	___	_____
.17)	Credit for small agri-biodiesel fuels credit (TRUIRJCA 2010).	___	___	_____
.18)	Credit for increasing research activities (TRUIRJCA 2010). (Form 6765) (ARRA 2009) (§ 41) Note increased IRS scrutiny in this area.	___	___	_____
.19)	Low-income housing credit. (Form 8586)(§ 42)	___	___	_____
.20)	Enhanced oil recovery credit. Note: This credit is unlikely to apply for 2010 due to phase-out rule. (Form 8830) (§ 43).	___	___	_____
.21)	Disabled access credit. (Form 8826) (§ 44)	___	___	_____
.22)	Renewable electricity, refined coal (TRUIRJCA 2010), and Indian coal production (TRUIRJCA 2010) credit. (Form 8835) (ARRA 2009) (§ 45)	___	___	_____
.23)	Indian employment credit for wages paid before January 1, 2012. (TRUIRJCA 2010). (Form 8845) (§ 45A)	___	___	_____
.24)	Credit for employer social security and Medicare taxes paid on certain employee tips. (Form 8846) (§ 45B)	___	___	_____
.25)	Credit for qualified clinical testing expenses. (Orphan Drug Credit) and associated carrybacks and carryovers. (Form 8820) (§ 45C)	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
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		DONE	N/A	COMMENTS OR EXPLANATION
.26)	New markets tax credit for qualifying investments in a "Community Development Entity." (Form 8874) (§ 45D) (TRUIRJCA 2010 and ARRA 2009 and REG-149404-07, 8/11/08)	___	___	_____
.27)	Credit for pension plan start-up costs. (Form 8881) (§ 45E)	___	___	_____
.28)	Credit for employer-provided child care expenses. (Form 8882) (§ 45F)	___	___	_____
.29)	Credit for maintenance of railroad tracks (TRUIRJCA 2010). (Form 8900) (EESA 2008) (§ 45G)	___	___	_____
.30)	Mine rescue team training credit (TRUIRJCA 2010).	___	___	_____
.31)	Credit for production from advanced nuclear power facilities. (§ 45J)	___	___	_____
.32)	Energy-efficient home credits for homes substantially completed after 12/31/05 and purchased after 2005 (TRUIRJCA 2010). (Form 8908) (§ 45L)	___	___	_____
.33)	Energy-efficient appliance credit. (TRUIRJCA 2010) (Form 8909) ((§ 45M)	___	___	_____
.34)	Agricultural chemicals security credit. (Form 8931) (§ 45O)	___	___	_____
.35)	Differential wage payment credit for amounts paid to employees on active military duty after 6/17/08 (TRUIRJCA 2010) (Form 8932) (§ 45P)	___	___	_____
.36)	Carbon dioxide sequestration credit. (Form 8933) (ARRA 2009) (§ 45Q)	___	___	_____
.37)	Work Opportunity Tax Credit for certified eligible employees who began work after December 31, 2006 and before January 1, 2012 (TRUIRJCA 2010 and ARRA 2009). (Form 5884) (§ 51)	___	___	_____
.38)	Credit for holders of clean renewable energy bonds. (Form 8912) (§ 54)	___	___	_____
.39)	Credit for qualified forestry conservation bonds. (Form 8912) (§ 54B)	___	___	_____
.40)	Credit for holders of new clean renewable energy bonds. (Form 8912) (ARRA 2009) (§ 54C)	___	___	_____
.41)	Credit for qualified energy conservation bonds. (Form 8912) (ARRA 2009) (§ 54D)	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
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	DONE	N/A	COMMENTS OR EXPLANATION
.42) Credit for qualified zone academy bonds. (Form 8912) (ARRA 2009) (§ 1397E for bonds issued on or before October 3, 2008; § 54E for bonds issued after October 3, 2008)	___	___	_____
.43) Credit for qualified school construction bonds issued during 2009 and 2010. (ARRA 2009) (§ 54F)	___	___	_____
.44) Credit for Build America Bonds issued after February 17, 2009 and before January 1, 2011. (ARRA 2009) (§ 54AA)	___	___	_____
.45) Empowerment zone and renewal community employment credit for qualifying wages paid before January 1, 2012 (TRUIRJCA 2010). (Form 8912) (§1400N)	___	___	_____
.46) Credit for Gulf tax credit bonds and Midwestern tax credit bonds. (Form 8912) (ARRA 2009) (§ 1400N)	___	___	_____
.47) Distilled spirits credit. (Form 8906) (§ 5011)	___	___	_____
.48) Credit for small employers offering health coverage (HCERA 2010)	___	___	_____
.49) Credit for investments in new therapies (HCERA 2010)	___	___	_____
511) Consider "Eligible Small Business Credits Provisions" {§38(c)(5)}.	___	___	_____
512) If corporation is subject to a corporate tax and taxpayer is part of a controlled group, consider special allocation rules under §§ 1561 and 1563. Attach apportionment schedules. (Schedule O)	___	___	_____
600) SHAREHOLDER INFORMATION (See Final Regs. §§ 1.1366-1 through 5, 1.1367-1 through 3 and 1.1368-1 through 4.)			
601) Shareholder allocation/limitation:			
.1) Determine that items of income, deductions, credits, etc., are allocated to the shareholders on a per-share, per-day basis.	___	___	_____
.2) If stock transfers occurred during the year which resulted in a termination of a shareholder's interest, consider allocations based on time of actual occurrence. Attach the affected shareholders' and corporation's statement of election.	___	___	_____
.3) Consider transfer of attributes in a divorce property settlement.	___	___	_____

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	DONE	N/A	COMMENTS OR EXPLANATION
602) Shareholder distribution/basis computations:			
.1) Determine that equity increases and decreases (Schedule M-2) are properly segregated among:			
(a) Accumulated adjustment account. See Rev. Rul. 2008-42 for treatment of premiums on key man life insurance.	___	___	_____
(b) Other adjustment account.	___	___	_____
(c) Shareholders undistributed PTI.	___	___	_____
.2) Determine that distributions exceeding the accumulated adjustment account for S corporations with earnings and profits from C years are reported (Form 1099-DIV) to shareholders as dividends to the extent of accumulated earnings and profits. Note that current year net reductions are disregarded in this computation. (Prepare Form 5452 where applicable.)	___	___	_____
.3) Consider electing to treat distributions as being from accumulated earnings and profits (AEP) for tax years beginning after May 25, 2007 (exclude pre-83 AEP). (Form 5452 required)	___	___	_____
.4) Determine that gain is recognized and allocated to each shareholder for distribution of appreciated property.	___	___	_____
.5) If corporation is in bankruptcy or insolvent, determine that basis is not increased for cancellation of debt that is not treated as an income item.	___	___	_____
.6) Determine whether election to take losses and deductions against basis before nondeductible items has been made (Reg. 1.1637-1(g)).	___	___	_____
.7) Determine that shareholder loans will be treated as economic investment. (Oren v. Commr., No. 03-1448, 8th Cir. 2/12/04) See final regs for determining basis and gain from reduced basis debt repayment on open account debt. (T.D. 9428, 10/20/08)	___	___	_____
.8) Consider new calculation of basis adjustment due to charitable contributions of appreciated property (TRUIRJCA 2010).	___	___	_____
.9) Consider triggering of suspended losses by a basis increase during the post-termination transition period.	___	___	_____
.10) Consider distributions from accumulated adjustment account during post-termination period. (Form 5452 required)	___	___	_____

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	DONE	N/A	COMMENTS OR EXPLANATION
.11) Consider equalization of distributions among shareholders when state composite returns' taxes are paid for shareholders by the corporation.	___	___	_____
603) If shareholder is an Electing Small Business Trust, see new temporary and proposed regulations in T.D. 8915.	___	___	_____
604) Consider use of the S Corporation Shareholder Basis Schedule.	___	___	_____
700) K-1 INFORMATION			
701) Verify correctness of shareholders' names, addresses and identification numbers.	___	___	_____
702) Determine that proper and separate reporting have been provided for all appropriate items such as:			
.1) Ordinary trade or business activities.	___	___	_____
.2) Rental activities.	___	___	_____
.3) Portfolio income and related deductions.	___	___	_____
.4) Dividends. Note reporting requirements for different types of ordinary dividends.	___	___	_____
.5) Gains and losses, dates of dispositions, respective holding periods and types of assets sold.	___	___	_____
.6) Passive activity data (note elections), including disclosure statement for grouping of activities. See Passive Activity Checklist.	___	___	_____
.7) Self-charged interest. Note final Reg. § 1.469-7 allowing for possible recharacterization of interest income. See Passive Activity Checklist.	___	___	_____
.8) All items that affect shareholder basis calculations (e.g., nondeductible items and nontaxable income). Consider election to take losses and deductions against basis before nondeductible items. (Reg. § 1.1367-1(g))	___	___	_____
.9) Charitable contributions including copy of Form 8283 and appraisal when required.	___	___	_____
.10) Information to determine domestic production activities deduction.	___	___	_____
.11) Shareholder loan repayments [REG-144859-04, 72 Fed. Reg. 18,417 (4/12/07)].	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
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		DONE	N/A	COMMENTS OR EXPLANATION
.12)	Distributions.	___	___	_____
.13)	At risk information.	___	___	_____
.14)	Credit information.	___	___	_____
.15)	Interest incurred in the production of property that may have to be capitalized at the shareholder level. (Notice 88-99)	___	___	_____
.16)	Other pass-through items (e.g., intangible drilling costs, depletion).	___	___	_____
.17)	Tax shelter registration number and Form 8271 when required.	___	___	_____
.18)	State allocation and characterization of income, deductions and credits.	___	___	_____
.19)	Unrelated business taxable income.	___	___	_____
.20)	Other items required to be reported. (See the list of codes included with the current Schedule K-1 to ensure that all items have been addressed.)	___	___	_____
703)	Segregate tax preference and adjustment items and report on the appropriate lines.	___	___	_____
704)	Prepare schedules that reflect information to allow each shareholder to compute credit recapture.	___	___	_____
705)	Determine that information relating to interest expense on debt-financed distributions to shareholders has been provided. (Notice 89-35)	___	___	_____
706)	Consider interest paid or accrued on debt to acquire stock in an S Corporation in determining the taxable income of an electing small business trust.	___	___	_____
800)	OTHER REQUIREMENTS			
801)	Compare net income or loss to projections.	___	___	_____
802)	Consider elections and statements, such as:			
.1)	Election to distribute accumulated earnings and profits first.	___	___	_____
.2)	Election to take losses and deductions against basis before non-deductible items. (Reg. § 1.1367-1(g))	___	___	_____

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		DONE	N/A	COMMENTS OR EXPLANATION
.3)	Election to expense/amortize organization expense.	___	___	_____
.4)	Election to expense/amortize business start-up costs (SBJA 2010).	___	___	_____
.5)	Separate reporting of intangible drilling costs, mining development, mining exploration and circulation expenses.	___	___	_____
.6)	Cash vs. accrual method of accounting. (Rev. Proc. 2001-10)	___	___	_____
.7)	Section 351, statement of transferred assets.	___	___	_____
.8)	Method for valuation of inventory.	___	___	_____
.9)	Method of calculating § 263A adjustment. Note increased IRS scrutiny in this area.	___	___	_____
.10)	Separate reporting of research and experimental cost.	___	___	_____
.11)	Exception from economic performance requirements for recurring items and 3½ month rule (Reg. §1.461-4(d)(6)(ii). Note that the recurring item exception election does not apply to tax shelters.	___	___	_____
.12)	A § 732(d) election, if there is a distribution of property from a partnership within two years of receiving the partnership interest.	___	___	_____
.13)	If this is the first year the taxpayer has incurred real property taxes, determine if a § 461(c) election to accrue ratably is more beneficial than adopting the recurring item exception. (Rev. Proc. 92-28 amplified by 94-32)	___	___	_____
.14)	The option to treat current year qualifying disaster losses on appropriate preceding year tax return.	___	___	_____
.15)	Change in accounting method or period. (Rev. Proc. 2009-39, amplifying, clarifying and modifying Rev. Proc. 2008-52) (Form 3115 or Form 1128) Note requirement to file copy with National Office as well as with tax return.	___	___	_____
.16)	Disclosure statement under Reg. § 1.368-3 for any reorganization.	___	___	_____
.17)	Tax shelter disclosure statement under Reg. § 1.6011-4 (T.D. 9046, 2/28/03) (Form 8886) if S corporation participates, directly or indirectly, in listed transactions	___	___	_____
.18)	Qualified electing fund for passive foreign investment company. (Form 8621)	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
803) Determine if expenditures were incurred that are eligible for the Disabled Access Credit (Form 8826). If the taxpayer does not qualify for the credit or has expenditures in excess of the credit, consider making a § 190 election to expense the cost.	___	___	_____
804) Cross-reference the following items:			
.1) Schedule L beginning balances to prior year's ending balances.	___	___	_____
.2) Schedules M-1 and M-2 beginning and ending equity accounts to Schedule L.	___	___	_____
.3) Detail listings of Schedule L beginning balances to prior year's detail listings of ending balances.	___	___	_____
805) If the corporation was a party to an applicable asset acquisition (transfer of assets that constitute a trade or business), determine that applicable reporting requirements regarding allocation of purchase price have been met. (Form 8594)	___	___	_____
806) If the corporation purchased stock of another corporation, consider §338(h)(10) election.			
807) Determine that book/tax accounting method differences related to Schedule M are documented in the workpaper files.	___	___	_____
808) Prepare Schedule M-3 and Form 8916A, if applicable.	___	___	_____
809) Consider § 6662 accuracy-related penalty.	___	___	_____
.1) Determine if disclosure is adequate. (Rev. Procs. 2008-14 and 2010-5) (Forms 8275 and 8275R)	___	___	_____
.2) Consider advising the taxpayer, in writing, of the penalty.	___	___	_____
810) Consider new § 6699 penalty for failure to file timely S corporation return or failure to contain information required under § 6037. (§6699(b)(1), HIREA 2010 and WHBAA 2009)	___	___	_____
811) Consider partial payment installment agreement for taxes owed.	___	___	_____
812) Complete and attach Form 5452 to report nondividend distribution (i.e., distributions in excess of earnings and profit and accumulated adjustment account).	___	___	_____
813) Complete and attach Form 5452 to report cash distributions under § 1371(e) during the post-termination transition period.	___	___	_____
814) Inquire if the corporate minute book has been updated.	___	___	_____

S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
815) Inquire if the required Forms 5500 have been filed for retirement plans covered by this period.	___	___	_____
816) Inquire if the required Forms 5500 have been filed for welfare benefit plans (e.g., medical benefits, life insurance, disability or death benefit plans that have more than 100 participants).	___	___	_____
817) Inquire if employee benefit plans have been reviewed to determine if they are in compliance due to changing corporate circumstances and law changes.	___	___	_____
818) Advise the client that any unpaid retirement plan contribution must be made before the due date of the return. Note contributions to defined benefit plans may have earlier due dates.	___	___	_____
819) Information returns {Note increased penalties for failure to timely file (SBJA 2010)}:			
.1) Inquire whether the S corporation has filed all required Forms 1098, 1099 and 1042 and whether the value of the personal use of employer property, expense reimbursements under "nonaccountable plans," 401(k) deferred compensation information, and nonqualified deferred compensation information has been included in employees' Forms W-2 or Forms 1099. Note reporting requirements on certain payments made to attorneys. (See Notice 2007-34 and 2007-86 and Final Regs. T.D. 9321 (4/17/07) corrected 7/13/07, effective 1/1/09.)	___	___	_____
.2) Consider worker classification (i.e., independent contractor vs. employee).	___	___	_____
.3) Inquire if the taxpayer has complied with electronic filing requirements for Forms 1099 and W-2.	___	___	_____
.4) Inquire if nonqualified deferred compensation information has been included in employees' W-2s or Forms 1099. (See Notices 2007-86 and 2007-34 and Final Regs T.D. 9321 (4/10/07) corrected 7/13/07, effective 1/1/09.)	___	___	_____
.5) Inquire if additional items subject to employer FICA such as 401(k) deferrals, vested non-qualified deferred compensation, employer provided excess group term life insurance, all cash tips, etc., have been properly reported. Note FICA and FUTA do not apply to exercise of a statutory stock option after October 22, 2004.	___	___	_____
.6) Determine that reimbursement of employee moving expenses and tuition and related expenses are properly reported.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.7) Inquire whether club dues, spouse travel, employee stock options, restricted property (§ 83(b) election), etc., is treated as compensation and included on employee's Forms W-2.	___	___	_____
.8) Inquire if OASDI taxes were properly determined for wages paid beginning March 19, 2010 through December 31, 2010 for qualified unemployed workers (HIREA 2010).	___	___	_____
.9) Consider notifying taxpayer of recordkeeping requirements for new up-to-$1,000 credit which may be taken on taxpayer's 2011 return for each retained worker (qualified individual as defined for purposes of the 2010 payroll tax holiday (see .8) above) (HIREA 2010)	___	___	_____
.10) Consider filing information returns relating to ownership in foreign entities.	___	___	_____
(a) Controlled foreign corporations. Consider new look-through rules under § 954(c)(6). (TRUIRJCA 2010 and TIPRA 2005) (Form 5471)	___	___	_____
(b) Foreign partnerships. (Form 8865)	___	___	_____
(c) Foreign disregarded entities. (Form 8858)	___	___	_____
(d) Transfer of property to a foreign corporation. (Form 926)	___	___	_____
820) Determine if Form TD F 90-22.1 is needed to report foreign financial accounts. (Note new penalties, June 30 filing deadline and increased IRS activity in this area.)			
821) Inquire as to whether employment taxes were timely deposited. (EFTPS)	___	___	_____
822) Determine that related party transactions are properly reported on all returns.	___	___	_____
823) Consider informing client of requirement to file Form 8300 for certain payments received exceeding $10,000.	___	___	_____
824) If the S corporation is a partner in a partnership, consider § 465 at risk and/or § 704(d) basis rules.	___	___	_____
825) If the corporation sold partnership interests during the year, determine:			
.1) That appropriate information was given to the partnership to enable it to prepare Form 8308.	___	___	_____
.2) That the required statement under Reg. § 1.751-1(a)(3) is attached if the partnership had § 751 assets.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
826) If the corporation acquired partnership interests during the year	___	___	_____
.1) Determine that the appropriate information was given to the partnership.	___	___	_____
.2) Inquire if § 754 election is in effect. If so, include disclosure statement.	___	___	_____
827) Record syndication costs treated as nondeductible expense or distribution in permanent file for write-off upon termination of partnership interest.	___	___	_____
828) Determine whether there are any reportable transactions that need to be disclosed on Form 8886. Note penalties for failure to disclose and new relaxed penalty for failure to include with return (SBJA 2010).. A copy of Form 8886 must be sent to each individual shareholder. Note Final Regs on abusive S Corporation ESOP arrangements [T.D. 9302, 71 Fed. Reg. 76,143 (12/20/06)].	___	___	_____
829) Consider whether transactions meet the "economic substance" doctrine. (Notice 2010-62)	___	___	_____
830) Determine whether there are tax shelter registration disclosures. (See Tax Shelter Guide.)	___	___	_____
831) Consider new modified requirements for avoiding preparer penalties for returns prepared after May 25, 2007:	___	___	_____
.1) Undisclosed positions generally must meet the "substantial authority" standard.	___	___	_____
.2) Disclosed positions must meet the "reasonable basis" standard.	___	___	_____
.3) Tax shelters and reportable transactions to which § 6662A applies must meet the "more likely than not be sustained on the merits" standard.	___	___	_____
832) If corporation purchased life insurance on employees or directors after 8/17/06, consider whether the corporation has satisfied notification and annual information requirements. (Form 8925) (§§ 101(j) and 6039I)	___	___	_____
833) Consider disclosure requirements for written tax advice under Circular 230.	___	___	_____
834) Note tax planning/additional service suggestions. (See Client Review for Additional Services.)	___	___	_____
835) Attach extension request. Note some states may require checked boxes on the return or a copy of the federal extension.	___	___	_____

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S CORPORATION INCOME TAX RETURN CHECKLIST
2010 - FORM 1120S

		DONE	N/A	COMMENTS OR EXPLANATION
900	E-FILING			
901)	Consider federal and state e-filing requirements.	___	___	_____
902)	Review software validation, create and print e-file returns(s)	___	___	_____
903)	Provide taxpayer with complete Federal return, including Form 8879-S/8453-S and state(s) consent form(s).	___	___	_____
904)	Obtain signed Form 8879-S/8453-S and state(s) consent form(s).	___	___	_____
905)	If using Form 8453-S, scan signed Form 8453-S into a PDF document and insert into the electronic return as an attachment named "8453-S Signature Document".	___	___	_____
906)	Transmit the e-file return(s). Note that Form 8453-S must be submitted with the e-filed return	___	___	_____
907)	Review rejection(s) and make corrections, if necessary.	___	___	_____
908)	Resubmit return.	___	___	_____
909)	Confirm IRS and state(s) acceptances.	___	___	_____
910)	If ineligible for e-file, inform the taxpayer within 24 hours and provide paper return(s) to taxpayer for filing.	___	___	_____
911)	Retain signed Form 8479-S/8453-S and state(s) consent form(s) for three years.	___	___	_____

COMMENTS OR EXPLANATIONS

_____

_____

_____

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Appendix B

Short Version—S Corporation Income Tax Return Checklist—Form 1120S

SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

Client Name and Number: _____

Prepared by: _____ Date: _____ Reviewed by: _____ Date: _____

	DONE	N/A	COMMENTS OR EXPLANATION
100) GENERAL INFORMATION			
101) Determine if requirements for avoiding penalties for improper disclosure or use of taxpayer information by tax return preparers imposed under §§6713 and 7216 have been met. (See Final Regs. T.D. 9437 and 9478; Prop. Reg. REG-121698-08 (7/2/08); and Rev. Proc. 2008-35.)	____	____	_____
102) Consider obtaining signed:			
.1) Engagement letter.	____	____	_____
.2) Engagement letter for tax advice under the CPA-client privilege provisions of § 7525.	____	____	_____
.3) Power of attorney in addition to "check-box" option.	____	____	_____
103) Review and update the S corporation and shareholders' names, addresses, fiscal year, incorporation date, business code, identification numbers, and IRS and other tax filing addresses.	____	____	_____
104) Review permanent file, prior year returns, workpapers, etc.	____	____	_____
105) Review pro forma/organizer for accuracy.	____	____	_____
106) Obtain information concerning IRS, state tax audits and/or correspondence.	____	____	_____
107) Inquire whether the S corporation has made or received any below-market-rate loans. If so, determine imputed interest consequences.	____	____	_____
108) Review for adequate interest on new or modified debt instrument.	____	____	_____
109) If the corporation has selected an allowable fiscal tax year, determine that Forms 8716 and 8752 have been timely filed.	____	____	_____
110) Determine that accounting methods used are comparable to the preceding year unless changes are approved or required. (See Form 3115 instructions and current year's revenue procedures.)	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
111) If the corporation is on the cash basis, determine if the accrual basis is required.	____	____	_____
112) Review and update schedules for carryforward items and effect of prior tax audits.	____	____	_____
113) Review financial statements and footnotes for relevant information.	____	____	_____
114) Consider if disaster relief provisions apply.	____	____	_____
115) Review Board minutes.	____	____	_____
116) Determine if Schedule M-3 is required.	____	____	_____
117) If the corporation owns a QSub include all activity on the return.	____	____	_____
118) Consider state and local tax filing requirements. Furnish necessary information to shareholders. (See Nexus Practice Guide.)	____	____	_____
119) Consider if Form(s) 926, 8621 and/or 8886 are required.	____	____	_____
120) Consider rule under § 1361(c)(1)(A) which treats stock owned by family members as stock owned by one shareholder.	____	____	_____
200) INCOME			
201) Compare sources and amounts of portfolio income with prior year.	____	____	_____
202) Determine that only trade or business (e.g., not portfolio or rental) income is reported on page 1 of Form 1120S.	____	____	_____
203) Review Forms 1099 for dividends, interest and gross sales proceeds.			
204) Segregate qualified dividends.	____	____	_____
205) Review dispositions of property for holding period and federal, state, AMT bases. Consider nonrecognition, gains, losses and recaptures.	____	____	_____
206) Consider the following:			
.1) Wash sales.	____	____	_____
.2) Timing differences.	____	___	_____
.3) Sales or exchanges between the corporation and shareholder.	____	____	_____
.4) Worthless securities.	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.5) Long-term contract rules. See Long-term Contract Checklist.	____	____	_____
.6) Installment sales and related interest charged on deferred tax. See Installment Sales Checklist.	____	____	_____
.7) Economic accrual of rent.	____	____	_____
.8) Discharge of indebtedness. Consider exclusion and elections under §108. (REG-102822-08, (8/6/08) (§§61, 108, 108(i), 1017 and T.D. 9498)	____	____	_____
.9) Tax-exempt income and related investment fees and/or interest expense disallowance.	____	____	_____
.10) Like-kind exchanges and related party exchanges (Form 8824). See regulations under §§ 468B(g), 1031 and 7872 regarding the taxation of qualified escrow accounts, qualified trusts or funds used during deferred like-kind exchange. [T.D. 9413 (7/19/08)] (Note restrictions on exchange of U.S. property for foreign property.) Note extension of time rules for failed like-.kind exchanges with bankruptcy qualified intermediary.	____	____	_____
.11) Straddle rules and § 1092 election.	____	____	_____
.12) Gains on constructive sales of appreciated financial position.	____	____	_____
.13) Rules for involuntary conversions in qualified disaster areas including livestock (§ 1033 (e) and (f) and Notice 2010-64).	____	____	_____
207) Determine that deferred income and expenses for book purposes are properly reported for tax purposes.	____	____	_____
208) If accrual basis taxpayer, consider deferral of state or local income or franchise tax refunds.	____	____	_____
209) Determine if there were passive activities (See Passive Activity Checklist.):			
.1) Note requirement to separate or group activities	____	____	_____
.2) Consider disclosure statement for new/changed groupings .	____	____	_____
210) Consider appropriate income inclusion amount for leased property. See Vehicle Related Guides.	____	____	_____
211) Consider ordinary income on market discount bonds and deferral of related interest expense.	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

		DONE	N/A	COMMENTS OR EXPLANATION
212)	Consider mark to market rules for "dealers in securities" under § 475 and the related § 481 adjustment.	____	____	_____
213)	Determine proper treatment of certain advance payments.	____	____	_____
300)	DEDUCTIONS			
301)	Ascertain officer/shareholders' compensation and review for reasonableness.	____	____	_____
302)	Determine deductibility of vacation pay accrual.	____	____	_____
303)	For inventories consider:			
.1)	If the uniform capitalization rules apply. Note IRS scrutiny in this area. (See Uniform Capitalization Checklist.)	____	____	_____
.2)	Lower of cost or market adjustments.	____	____	_____
.3)	Write down of subnormal inventories.	____	____	_____
304)	Consider charitable rules, limitations and contemporaneous receipt requirements for charitable contributions of $250 or more and quid pro quo donations in excess of $75.	____	____	_____
305)	Consider recordkeeping and substantiation requirements for all cash and property donations. Note limitations for deductions to organizations conducting lobbying activities.	____	____	_____
306)	Consider enhanced deduction for contributions of food inventory. (TRUIRJCA 2010)	____	____	_____
307)	If noncash charitable contributions exceed $500, attach Form 8283. Note:			
.1)	Certain noncash donations exceeding $500,000 in value require the corporation to attach a qualified appraisal to its tax return for the year of the donation.	____	____	_____
.2)	Limitations for donations of vehicles exceeding $500.	____	____	_____
.3)	New basis adjustment rules for donations of appreciated property. (TRUIRJCA 2010)	____	____	_____
.4)	Limits on deduction of donations of property disposed of within three years.	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.5) Limitation on partial donations of tangible personal property (e.g., art work).	____	____	_____
.6) Conservation easement donation limitations. (§170 (b)(1)(E). (TRUIRJCA 2010)	____	____	_____
308) Determine that fringe benefits (including Health Savings Accounts contributions) for more than 2% shareholders have been reported on the recipient shareholders' W-2s (usually non FICA wages) and claimed as a deduction by the S corporation.	____	____	_____
309) Inquire whether the S corporation can substantiate by adequate records, as required under § 274, expenses claimed for entertainment, entertainment facilities, gifts, travel and conventions. Consider optional per diem method. (Rev. Proc. 2009-47 and Rev. Rule 2008-23 and Rev. Proc. 2004-29, regarding the ability to use statistical sampling for meals and entertainment expenses that are not subject to the 50% limitation)	____	____	_____
310) Limit deduction for meals and entertainment to allowable percentage. Consider exceptions, including employer-provided meals.	____	____	_____
311) Consider limitations on personal use of business aircraft for officers, directors and >10% owners.	____	____	_____
312) Consider limitations on deductibility of:			
.1) Club dues	____	____	_____
.2) Lobbying expenses./association dues.	____	____	_____
.3) Casualty losses.	____	____	_____
.4) Penalties (not deductible	____	____	_____
313) Determine that expenses allocable to portfolio income have not been deducted on Page 1, Form 1120S.	____	____	_____
314) Determine that retirement plan contributions are made timely and within allowable limits. (See PACMBPRA 2010.)	____	____	_____
315) Determine that specific charge off method (or nonaccrual experience method, when permitted) is used for bad debts.	____	____	_____
316) Consider rules for expensing/amortizing start-up (SBJA 2010) and organizational costs.	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
317) Officers and shareholders:			
.1) Determine the ownership of life insurance policies and the proper treatment of related expenses.	____	____	_____
.2) Determine split-dollar insurance treatment. (See Reg. § 1.61-22 and Notice 2007-34.)	____	____	_____
.3) Identify expenses, including interest if applicable, for officers' life insurance which are nondeductible.	____	____	_____
.4) Determine limitation on any losses or accruals of expenses during the year between related corporations/shareholders under § 267(a)(1) and 267(a)(2).	____	____	_____
.5) Determine if expenses to shareholders (§ 267(e)) or other related parties on the cash basis were paid by corporation's year end.	____	____	_____
.6) Consider reasonableness of compensation to shareholders who perform substantial services.	____	____	_____
.7) Review documentation of shareholder loans and adequate interest rate.	____	____	_____
318) Determine if compensation deductions are allowable with respect to qualified and nonqualified stock options.	____	____	_____
319) Determine if compensation deductions are allowable if a § 83(b) election is made.	____	____	_____
320) Determine applicability of 2½ month deferred compensation rule for nonshareholder employees and independent contractors.	____	____	_____
321) Determine if § 409A deferred compensation applies to compensation arrangements. See Regs. §§ 1.409A-1 through 1.409A-6 and T.D. 9321, (4/10/07), corrected 7/13/07, effective 1/1/09 and prop. reg. REG-148326-05, 12/8/08.	____	____	_____
322) Verify that the proper allocations have been made dividing interest expense among various types of expenditures.	____	____	_____
323) Determine if interest deduction limitations apply to interest incurred to purchase or carry market discount bonds or short-term debt obligations.	____	____	_____
324) Consider capitalization of carrying charges on nonproductive property. (§266)	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
325) Consider deductibility of state and local income taxes. Note accrual deduction is limited to actual liability and cash basis payment is limited to reasonable prepayments.	____	____	_____
326) Consider deduction for energy-efficient commercial building property for property placed in service after 12/31/05 and before 1/1/14.	____	____	_____
327) Consider limitations of deductibility of lobbying expenses/association dues.	____	____	_____
328) Consider economic performance requirements, including recurring item exceptions and 3½ month rule (Reg. §1.461-4(d)(6)(ii) .	____	____	_____
329) Determine casualty loss limit.	____	____	_____
330) Determine the proper treatment of costs incurred to acquire, create, or enhance tangible assets. (Prop. Regs. REG-168745-03, 3/10/08, corrected 4/9/08)	____	____	_____
331) Determine the proper treatment of costs incurred to acquire, create, or enhance intangible assets. [Regs. §§ 1.263(a)-4, 1.263(a)-5 and 1.167(a)-3(b) (T.D. 9107)]	____	____	_____
332) Consider expensing for certain demolition and clean-up costs in qualified disaster areas {(§§198A and 1400N(f)}.	____	____	_____
333) Consider expensing environmental remediation costs (including clean up of certain petroleum products) for qualified contaminated sites in the GOZone area, Midwestern disaster area and other qualified disaster areas. (TRUIRJCA 2010)	____	____	_____
334) Consider deduction for domestic production activities. (Form 8903) Note increased IRS scrutiny in this area.	____	____	_____
400) DEPRECIATION/AMORTIZATION			
401) Consider all depreciation requirements and options including:			
.1) § 179 election, including "off the shelf" software. (TRUIRJCA 2010) Note that expanded allowable amounts and higher limits apply for tax years beginning in 2010 and 2011 (SBJA 2010).	____	____	_____
.2) New § 179 election up to $250,000 for qualified real property (qualified leasehold improvements, qualified restaurant property and qualified retail improvement property) for tax years beginning in 2010 and 2011 (§179(f)(1) and SBJA 2010).	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

		DONE	N/A	COMMENTS OR EXPLANATION
.3)	§ 179A election to expense qualifying clean-fuel vehicles.	____	____	_____
.4)	§ 179D election to expense energy-efficient commercial building property placed in service before 1/1/14.	____	____	_____
.5)	Cost segregation analysis for building components.	____	____	_____
.6)	Additional first-year depreciation for qualified property (capped at $8,000 for passenger automobiles) placed in service before January 1, 2013 (January 1, 2014 for certain property). Note for property placed in service after September 8, 2010 and before January 1, 2012, the additional first-year depreciation is increased from 50% to 100% (TRUIRJCA 2010).	____	____	_____
.7)	Enhanced depreciation rules for qualifying nonresidential real and residential rental property placed in service in the GOZone and Kansas disaster areas and qualified disaster property placed in service in the Midwestern disaster area and other qualified-disaster areas.	____	____	_____
.8)	Methods and lives (ARRA 2009). Note accelerated depreciation for business property on Indian reservations and note accelerated depreciation for racehorses placed in service after 12/31/08 and before 1/1/14.	____	____	_____
.9)	Limitations relating to listed property (SBJA 2010). Note exceptions for vehicles with GVW of more than 6,000 lbs. and qualified non-personal use trucks and vans. (Reg. § 1.280F-6(c)(3)(iii) and Rev. Proc. 2010-18)	____	____	_____
.10)	For business vehicles, consider the limitations for trucks and vans rated at 14,000 lbs. GVW or less.	____	____	_____
.11)	Special 15-year straight-line depreciation for qualified leasehold improvements, qualified restaurant property and qualified retail improvements. (TRUIRJCA 2010)	____	____	_____
.12)	Depreciation of property received in a like-kind exchange or involuntary conversion. (T.D. 9314, 2/26/07)	____	____	_____
.13)	Capitalization of leased property.	____	____	_____
.14)	36-month amortization rules for software.	____	____	_____
.15)	Election of 150% DB method for 200% DB method personal property.	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.16) Reduced depreciable lives for real estate improvements and special structures.	____	____	_____
.17) Change in accounting method for like-kind exchange property under Reg. § 1.168(k)-1(g)(4)(ii).	____	____	_____
.18) Depreciation of realty and tangible property in the GOZone area (Notice 2007-36) and the Kansas disaster area .	____	____	_____
402) Consider amending returns to make and/or revoke a § 179 election. (SBJA 2010)	____	____	_____
403) Consider AMT depreciation.	____	____	_____
404) Determine that amortizable items, including goodwill, are written off over the correct periods. Note recapture rules for § 197 intangibles.	____	____	_____
405) Compute state depreciation, if different.	____	____	_____
406) Consider change in accounting method under Rev. Proc. 2009-39 to correct MACRS lives, methods, etc.	____	____	_____
407) Consider final and temporary Regs for changes in computing depreciation and amortization (T.D. 9307, 12/22/06). See Rev. Proc. 2007-16.	____	____	_____
500) TAX COMPUTATION AND CREDITS			
501) Consider tax on excess net passive income. Note for tax years beginning after May 25, 2007, capital gains from sale or exchange of stock securities will no longer be considered passive investment income.	____	____	_____
502) Consider tax on built-in gain. (See Final Regs. T.D. 9180, 70 Fed. Reg. 8727, 2/3/05 and final Reg. T.D. 9236.) Note ARRA 2009 temporarily reduces the holding period from ten years to seven years for tax years beginning in 2009 and 2010 and SBJA 2010 temporarily reduces the holding period from ten years to five years for tax years beginning in 2011.	____	____	_____
503) Consider C Corporation available carryovers.	____	____	_____
504) Consider credit recapture.	____	____	_____
505) Claim current year estimated tax payments, prior year overpayments applied and extension payments.	____	____	_____
506) Consider requirement for estimated tax payments. (EFTPS) (SBJA 2010 and HIREA 2010)	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

		DONE	N/A	COMMENTS OR EXPLANATION
507)	Consider tax credits. (TRUIRJCA 2010, HCERA 2010 and ARRA 2009) Note increased IRS scrutiny of R&D and rehabilitation credits. Note expanded carryback and carryover provisions for certain taxpayers (SBJA 2010). See section 509 of long form checklist for more details.	____	____	_____
508)	If member of a controlled group, attach apportionment schedules. (Schedule O)	____	____	_____
600)	SHAREHOLDER INFORMATION (See final Regs. §§ 1.1366-1 through 5, Regs. 1.1367-1 through 3 and 1.1368-1 through 4.)			
601)	Shareholder allocation/limitation:			
.1)	Determine that items of income, deductions, credits, etc., are allocated to the shareholders on a per-share, per-day basis.	____	____	_____
.2)	If stock transfers occurred during the year resulting in a termination of a shareholder's interest, consider allocations based on time of actual occurrence. Attach the affected shareholder's and corporation's statement of election.	____	____	_____
.3)	Consider transfer of attributes in a divorce property settlement.	____	____	_____
602)	Shareholder distribution/basis computations:			
.1)	Determine that equity increases and decreases (Schedule M-2) are properly segregated between:			
(a)	Accumulated adjustment account. See Rev. Rul. 2008-42 for treatment of premiums on key man life insurance.	____	____	_____
(b)	Other adjustments account.	____	____	_____
(c)	Shareholders' undistributed PTI.	____	____	_____
.2)	Determine that distributions exceeding accumulated adjustment account for S corporations with earnings and profits from C years are reported (Form 1099-DIV) to shareholders as dividends to the extent of accumulated earnings and profits. Note current year net reductions are disregarded in this computation.	____	____	_____
.3)	Consider electing distributions out of accumulated earnings and profits (AEP). For tax years beginning after May 25, 2007, exclude pre-83 AEP. (Form 5452 required)	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.4) For distributions of appreciated property, determine that gain is recognized and allocated to each shareholder and reduced for any tax (federal and state) on built-in-gain.	____	____	_____
.5) If corporation is bankrupt or insolvent, determine that basis is not increased for cancellation of debt that is not treated as an income item.	____	____	_____
.6) Consider Shareholder Basis Practice Guide.	____	____	_____
.7) Determine whether election to take losses and deductions against basis before nondeductible items has been made. (Reg. 1.1367-1(g))	____	____	_____
.8) Consider suspended losses triggered by a basis increase during post-termination transition period.	____	____	_____
.9) Consider distributions from accumulated adjustment account during post-termination period. (Form 5452 required)	____	____	_____
.10) Determine that shareholder loans will be treated as economic investment. See Final Reg. for determining basis and gain from reduced basis debt repayment on open account debt. (T.D. 9428, 10/20/08)	____	____	_____
.11) Consider new calculation of basis adjustment due to contributions of appreciated property. (TRUIRJCA 2010)	____	____	_____
.12) Consider equalization of distributions among shareholders when state composite returns' taxes are paid for shareholders by the corporation.	____	____	_____
700) K-1 INFORMATION			
701) Verify correctness of shareholders' names, addresses and identification numbers.	____	____	_____
702) Determine that proper reporting has been provided for all items on Schedule K-1 that affect shareholder's tax liability. Note:	____	____	_____
.1) Reporting requirements for different types of ordinary dividends.	____	____	_____
.2) Reporting requirements for domestic production activities.	____	____	_____
.3) Other items required to be reported. See the list of codes included with the current Schedule K-1 to ensure that all items have been addressed.	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

		DONE	N/A	COMMENTS OR EXPLANATION
703)	Provide information about nontaxable income and nondeductible expenses to enable shareholders to make adjustments to basis of their stock.	____	____	_____
704)	Consider separate reporting of passive activities and disclosure statement for grouping of activities.	____	____	_____
705)	Segregate all tax preference and adjustment items and report on the appropriate lines.	____	____	_____
706)	Determine that information relating to interest expense of debt-financed distributions to shareholders has been provided. (Notice 89-35)	____	____	_____
707)	Consider interest paid or accrued on debt to acquire stock in an S Corporation in determining the taxable income of an electing small business trust.	____	____	_____
708)	Consider at risk rules.	____	____	_____
800)	OTHER REQUIREMENTS			
801)	Compare taxable income to projections.	____	____	_____
802)	Consider elections such as:			
.1)	Cash vs. accrual method of accounting.	____	____	_____
.2)	Expensing/amortization of organization expense.	____	____	_____
.3)	Expensing/amortization of business start-up costs. (SBJA 2010)	____	____	_____
.4)	Separate reporting of intangible drilling costs, mine development exploration expenses and circulation expenses.	____	____	_____
.5)	Method for valuation of inventory.	____	____	_____
.6)	Method of calculating § 263A adjustment.	____	____	_____
.7)	Change in accounting method application approval. (Rev. Proc. 2009-39, amplifying, clarifying and modifying Rev. Proc. 2008-52) (See Form 3115 instructions and note requirement to file copy with National Office, as well as with return.)	____	____	_____
.8)	Ratable accrual of real property taxes (first year only).	____	____	_____
.9)	Separate reporting of research and experimental cost.	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.10) Exception from economic performance for recurring items and 3 ½ month rule (REG §1.461-4(d)(6)(ii). Note that the recurring item exception does not apply to tax shelters.	____	____	_____
.11) Taking losses and deductions against basis before nondeductible items. (Reg. 1.1367-1(g))	____	____	_____
803) Complete and attach Form 5452 to report nondividend distributions (i.e., distributions in excess of earnings and profits and accumulated adjustment account). For years beginning after May 25, 2007, exclude pre-1983 accumulated earnings and profits.	____	____	_____
804) If the corporation was a party to an "applicable asset acquisition," determine that the reporting requirements have been met. (Form 8594)	_____	____	_____
805) If the corporation purchased the stock of another corporation, consider §338(h)(10) election.	____	____	_____
806) Advise the client that any unpaid retirement plan contribution must be made before the due date of the return. Note contributions to defined benefit plans may have earlier due dates.	____	____	_____
807) Reconcile income and expenses per books with return.	____	____	_____
808) Prepare Schedule M-3 and form 8916A, if applicable.	____	____	_____
809) Consider § 6662 accuracy-related penalty.	____	____	_____
.1) Determine if disclosure is adequate. (Rev. Procs. 2008-14 and 2010-5) (Forms 8275 and 8275R)	____	____	_____
.2) Consider advising the taxpayer, in writing, of the penalty.	____	____	_____
810) Consider new § 6699 penalty for failure to file timely the S corporation return or failure to contain information required under § 6037. (§ 6699(b)(1) and HIREA 2010)	____	____	_____
811) Consider partial payment installment agreement for taxes owed.	____	____	_____
812) Inquire if employee benefit plans have been reviewed to determine if they are in compliance due to changing corporate circumstances and law changes.	____	____	_____
813) Inquire if nonqualified deferred compensation information has been included in employees' Forms W-2 or Forms 1099.	____	____	_____
814) Inquire whether all required information returns have been filed. Note increased penalties for failure to timely file (SBJA 2010).	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
815) Inquire if foreign financial accounts exist. Note reporting requirements, June 30 deadline and increased IRS activity in this area.	____	____	_____
816) Attach extension request. Note some states may require checked boxes on the return or a copy of the federal extension.	____	____	_____
817) Consider whether worker classification is proper (i.e., employee vs. independent contractor).	____	____	_____
818) Inquire if employment taxes were timely deposited. (EFTPS)	____	____	_____
819) Inquire if OASDI taxes were properly determined for wages paid beginning March 19, 2010 through December 31, 2010 for qualified unemployed workers. (HIREA 2010)	____	____	_____
820) Consider notifying taxpayer of recordkeeping requirements for new up-to-$1,000 credit which may be taken on taxpayer's 2011 tax return for each retained worker (qualified individual as defined for purposes of the 2010 payroll tax holiday (HIREA 2010).	____	____	_____
821) Determine that related transactions are properly reported on all available returns. Note new penalties.	____	____	_____
822) Determine whether there are any reportable transactions (see Reportable Transaction Guide) that need to be disclosed on Form 8886. Note penalties for failure to disclose and new relaxed penalty for failure to include with return (SBJA 2010). .A copy of Form 8886 must be sent to each individual shareholder. Note Final Regs on abusive S Corporation ESOP arrangements. (T.D. 9302)	____	____	_____
823) Consider whether transactions meet the "economic substance" doctrine. (Notice 2010-62)	____	____	_____
824) If Corporation purchased life insurance on employees or directors after 8/17/06, consider whether the corporation has satisfied the notification and annual information reporting requirements. (Form 8925) (§§ 101(j) and 6039I)	____	____	_____
825) Consider new modified requirements for avoiding preparer penalties for returns prepared after May 25, 2007:			
.1) Undisclosed positions must generally meet the "substantial authority" standard.	____	____	_____
.2) Disclosed positions must generally meet the "reasonable basis" standard.	____	____	_____

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SHORT VERSION
S CORPORATION INCOME TAX RETURN CHECKLIST
2010– FORM 1120S

	DONE	N/A	COMMENTS OR EXPLANATION
.3) Tax shelters and reportable transactions to which § 6662A applies must meet the "more likely than not be sustained on the merits" standard.	____	____	_____
826) Consider disclosure requirements for written tax advice under Circular 230.	____	____	_____
827) Note tax planning/additional service suggestions. (See Client Review for Additional Services.)	____	____	_____
900) E-FILING			
901) Consider federal and state e-filing requirements.	____	____	_____
902) See section 900 of the long S corporation checklist for further information.	____	____	_____

COMMENTS OR EXPLANATIONS

_____

_____

_____

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Appendix C

Mini-Checklist—S Corporation Income Tax Return—Form 1120S

MINI-CHECKLIST
S CORPORATION INCOME TAX RETURN
2010 – FORM 1120S

Client Name and Number: _____

Prepared by: _____ Date: _____ Reviewed by: _____ Date: _____

GENERAL INFORMATION

	Done	N/A
1. Determine if requirements for avoiding penalties for improper disclosure or use of taxpayer information by tax return preparers imposed under §§6713 and 7216 have been met, (See Final Regs. T.D. 9437 and 9478; Prop.. Reg. REG-121698-08 (7/2/08); and Rev. Proc. 2008-35.)	___	___
2. Consider obtaining signed engagement letter/ privilege engagement letter/ power of attorney.	___	___
3. Review permanent file, prior year returns, workpapers, correspondence and audit results.	___	___
4. Review and update the corporation's and shareholders' names and addresses, fiscal year, and business code.	___	___
5. Review pro forma/organizer accuracy.	___	___
6. Update carryforward schedules including effect of prior period tax audits.	___	___
7. Review methods of accounting.	___	___
8. Consider below-market-rate loan rules.	___	___
9. Review financial statements and footnotes for relevant information.	___	___
10. Review Board minutes.	___	___
11. Consider filing power of attorney in addition to "check-box" option.	___	___
12. Consider state and local tax filing requirements and report necessary shareholder information.	___	___
13. Consider if disaster relief provisions apply.	___	___
14. Consider if Form(s) 926, 8621 and/or 8886 are required.	___	___
15. If fiscal year retained, determine that Forms 8716 and 8752 are timely filed.	___	___
16. Include QSub activity.	___	___

INCOME

	Done	N/A
1. Compare portfolio income with prior year.	___	___
2. Segregate qualified dividends.	___	___
3. Include only trade or business income on page 1, Form 1120S.	___	___
4. Calculate gains, losses and recaptures on disposition of property.	___	___
5. Consider the following:		
Advance payments	___	___
At-risk rules	___	___
Deferred income/expenses	___	___
Discharge of indebtedness	___	___
Economic accrual of rent	___	___
Installment sales and related interest charges on deferred tax (Installment Sales Checklist)	___	___
Involuntary conversions of livestock {§1033 (e) and(f)} (Notice 2010-64)	___	___
Lease inclusion for luxury autos	___	___
Like-kind exchanges	___	___
Ordinary income on market discount bonds and deferral of related interest expense	___	___
Sales or exchanges between the corporation and shareholder or other related parties	___	___
Wash sales	___	___
Worthless securities	___	___
Passive activities (See Passive Activity Checklist.)	___	___

DEDUCTIONS

	Done	N/A
1. Consider uniform capitalization rules. Note IRS scrutiny in this area. (Uniform Capitalization Checklist)	___	___
2. For charitable contributions consider:		
If Form 8283 is required for noncash contributions. (Note increased reporting requirements for certain noncash donations.)	___	___
New basis adjustment rules for donations of appreciated property, if extended.	___	___
If adequate contemporaneous documentation was obtained for charitable contributions of $250 or more. (Note receipts required for all cash donations.)	___	___
Limits on donations if property disposed of within three years.	___	___
3. Determine officers/shareholders' compensation.	___	___
4. Determine deductibility of vacation pay accrual.	___	___
5. Determine applicability of 2½ month deferred comp rule for nonshareholder employees and independent contractors.	___	___
6. Determine that fringe benefits (including Health Savings Accounts) for more than 2% shareholders are properly reported on Form W-2 and deducted. (Notice 2008-1)	___	___
7. Inquire if travel and entertainment expenses are substantiated by adequate records. (Rev Proc. 2009- 47 and Rev. Rul. 2008-23)	___	___

Page Completed ☐

MINI-CHECKLIST
S CORPORATION INCOME TAX RETURN
2010 – FORM 1120S

	Done	N/A
8. Limit meals and entertainment to allowable percentage.	___	___
9. Consider deduction for domestic production activities. (Form 8903) Note increased IRS scrutiny in this area.	___	___
10. Consider limitations on personal use of business aircraft for officers, directors and >10% owners.	___	___
11. Consider expensing for certain demolition and clean-up costs in qualified disaster areas.	___	___
12. Consider the following for officers and shareholders:		
Nondeductible officers' life insurance. (Other Adjustment Account) (Rev. Rul. 2008-42)	___	___
Limitation on losses, or accruals between related parties.	___	___
Inadequate compensation.	___	___
Split-dollar insurance treatment (Reg. § 1.61-22)	___	___
13. Review amount and timeliness of retirement plan contributions. (See PACMBPRA 2010.)	___	___
14. Properly report expenses allocable to portfolio income on Schedules K and K-1 and not deducted on page 1, 1120S.	___	___
15. Determine if § 409A deferred compensation applies to compensation arrangements. See Final Reg. §§ 1.409A-1 through 1.409A-6. T.D. 9321 (4/10/07), corrected 7/13/07, effective 1/1/09 and prop. reg, REG-148326-05 (12/8/08)	___	___
16. Consider limitations on deductibility of:		
Bad debts	___	___
Casualty loss	___	___
Club dues	___	___
Lobbying expense/Association dues	___	___
Organizational expenses	___	___
Split-dollar insurance	___	___
Start-up expenditures (SBJA 2010)	___	___
State taxes	___	___
Stock option compensation	___	___
17. Consider deduction for energy-efficient commercial building property for property placed in service after 12/31/05 and before 1/1/14.	___	___

DEPRECIATION/AMORTIZATION

	Done	N/A
1. Consider the following:		
§ 179 election (SBJA 2010)	___	___
§ 179D election	___	___
Methods and lives (ARRA2009)	___	___
Listed property (SBJA 2010)	___	___
Capitalization of leased property	___	___
Additional first-year depreciation (SBJA 2010).	___	___
Amortization of goodwill and other intangibles	___	___
Like-kind exchange and involuntary conversion property rules	___	___
2. Consider amending returns to elect and/or revoke § 179 elections. (SBJA 2010)	___	___
3. Compute AMT depreciation.	___	___
4. Compute state depreciation, if different.	___	___

TAX COMPUTATION AND CREDITS

	Done	N/A
1. Reconcile income and expenses per return with books.	___	___
2. Consider the following:		
Schedule M-3 and Form 8916A for certain corporations	___	___
Tax on excess net passive income (For tax years beginning after 5/25/07, exclude capital gains on stock and securities.)	___	___
Tax on built-in gain (ARRA2009 and SBJA 2010)	___	___
Credit recapture tax	___	___
Estimated federal (SBJA 2010 and HIREA 2010) and state tax payments	___	___
Tax credits (HCERA 2010 and ARRA2009) Note expanded carryback and carryover provisions for certain taxpayers (SBJA 2010). See Section 509 of long form checklist for more details.)	___	_
Pre S Corporation NOLCarryforwards	___	___

SHAREHOLDER INFORMATION

	Done	N/A
1. Shareholder allocation/limitation:		
Determine that income, deductions, and credits are allocated to the shareholders on a per-share, per-day basis.	___	___
If complete termination occurred, consider specific cut off.	___	___
Attach shareholder consent and statement of election. (Prop. Reg. § 1.1377-1)	___	___
Consider transfer of attributes in a divorce property settlement.	___	___
2. Consider election to treat spouses as one shareholder.	___	___
3. Shareholder distribution/basis computations:		
Determine that equity increases and decreases (Schedule M) are properly segregated among:	___	___
Accumulated adjustment account (Rev. Rul. 2008-42)	___	___
Other adjustments account	___	___
Shareholders undistributed PTI	___	___
Determine proper reporting if distributions exceed accumulated adjustment account.	___	___
Consider electing distributions out of accumulated earnings and profits. (Form 5452 required) (For tax years beginning after 5/25/07, pre-83 earnings and profits are excluded).	___	___
Determine that gains are recognized and allocated to each shareholder for distribution of appreciated property.	___	___
If Corporation is bankrupt or insolvent, determine that basis is not increased for cancellation of debt that is not treated as an income item.	___	___
Equalize distributions among shareholders when state composite taxes are paid for shareholders by corporation.	___	___
4. Consider Shareholder Basis Practice Guide.	___	___

K-1 INFORMATION

	Done	N/A
1. Verify correctness of shareholders' names, addresses and identification numbers.	___	___

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MINI-CHECKLIST
S CORPORATION INCOME TAX RETURN
2010 – FORM 1120S

	Done	N/A
2. Properly reflect shareholders' shares of all items that affect tax liability. Note:		
Reporting requirements for dividends	___	___
Rules for charitable donations of patents and other intellectual property	___	___
Rules for deductibility of motor vehicles	___	___
The list of codes included with the current Schedule K-1 for other potential items	___	___
3. Segregate and report tax preference and adjustment items.	___	___
4. Determine that information relating to interest expense on debt-financed distributions has been provided. Consider optional allocation method under Notice 89-35.	___	___
5. Consider separate reporting of passive activities on K-1 schedules (Passive Activity Checklist) and disclosure statement for groupings of activities.	___	___
6. Consider at-risk rules.	___	___

OTHER

1. Consider elections and statements such as:		
Cash vs. accrual accounting method	___	___
Change in accounting method application/approval (Rev. Proc. 2009-39 amplifying, clarifying and modifying Rev. Proc. 2008-52)	___	___
Exception from economic performance for recurring items and 3½ month rule	___	___
Expense/amortize business start-up cost (SBJA 2010)	___	___
Expense/amortize organization expenses	___	___
Expense intangible drilling costs	___	___
Separate reporting of intangible drilling costs, mining development costs and circulation costs.	___	___
Method for valuation of inventory	___	___
Ratable accrual of real property taxes (first year only)	___	___
Research and experimental cost	___	___
2. Consider federal and state e-filing requirements. (See section 900 of the long S Corporation checklist.).	___	___
3. Consider risk of accuracy-related penalty. (§ 6662)	___	___
4. Consider new § 6699 penalty for failure to file timely S Corporation return or failure to contain information required under § 6037. (WHBAA 2009)	___	___
6. Inquire whether all required information returns have been filed. Note increased penalties for failure to timely file. (SBJA 2010)	___	___
7. Determine if OASDI taxes were properly determined for newly-hired qualified unemployed workers (HIREA 2010)	___	___
8. Notify taxpayers of recordkeeping requirements for tax credit for newly-hired retained workers—effective for 2011 tax return (HIREA 2010).	___	___
9. Inquire if foreign financial accounts exist. Note reporting requirements for June 30 filing deadline and increased IRS activity in this area.	___	___
10. Determine that shareholder loans will be treated as economic investments. See final regulation for determining basis on open account debt and gain on repayments of such debt. (T.D. 9428, 10/20/08)	___	___
11. Attach extension request.	___	___
12. Determine whether the corporation has any reportable transactions that should be disclosed on Form 8886. Note new relaxed penalty for failing to include with return (SBJA 2010).	___	___
13. If corporation purchased life insurance on employees or directors after 8/17/06, consider whether the corporation satisfied the notification and annual information reporting requirements. (Form 8925) (§§ 101(j) and 6039I)	___	___
___		
14. If the corporation is a party to an applicable asset acquisition, prepare Form 8594 and file with return.	___	___
15. If the corporation purchased stock of another corporation, consider §338(h)(10) election.	___	___
16. Consider disclosure requirements for written tax advice under Circular 230.	___	___
17. Consider preparer penalties. (Notice 2008-13, supplemented by Notice 2008-46). See also final regulations TD 9436, 12/16/08. Consider filing Form 8275 or Form 8275R to avoid penalties for non-shelters and non-reportable transactions.	___	___
18. Note tax planning/additional service suggestions.	___	___

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Tax Glossary

401(k) Plan—A qualified retirement plan to which contributions from salary are made from pre-tax dollars.

Accelerated Depreciation—Computation of depreciation to provide greater deductions in earlier years of equipment and other business or investment property.

Accounting Method—Rules applied in determining when and how to report income and expenses on tax returns.

Accrual Method—Method of accounting that reports income when it is earned, disregarding when it may be received, and expense when incurred, disregarding when it is actually paid.

Acquisition Debt—Mortgage taken to buy, hold, or substantially improve main or second home that serves as security.

Active Participation—Rental real estate activity involving property management at a level that permits deduction of losses.

Adjusted Basis—Basis in property increased by some expenses (for example, by capital improvements) or decreased by some tax benefit (for example, by depreciation).

Adjusted Gross Income (AGI)—Gross income minus above-the-line deductions (that is, deductions other than itemized deductions, the standard deduction, and personal and dependency exemptions).

Alimony—Payments for the support or maintenance of one's spouse pursuant to a judicial decree or written agreement related to divorce or separation.

Alternative Minimum Tax (AMT)—System comparing the tax results with and without the benefit of tax preference items for the purpose of preventing tax avoidance.

Amortization—Write-off of an intangible asset's cost over a number of years.

Applicable Federal Rate (AFR)—An interest rate determined by reference to the average market yield on U.S. government obligations. Used in Sec. 7872 to determine the treatment of loans with below-market interest rates.

At-Risk Rules—Limits on tax losses to business activities in which an individual taxpayer has an economic stake.

Backup Withholding—Withholding at a rate of 31 percent on interest or dividend payments by a payor that has not received required taxpayer identification number (TIN) information.

Bad Debt—Uncollectible debt deductible as an ordinary loss if associated with a business and otherwise deductible as short-term capital loss.

Basis—Amount determined to by a taxpayer's investment in property for purposes of determining gain or loss on the sale of property or in computing depreciation.

Cafeteria Plan—Written plan allowing employees to choose among two or more benefits (consisting of cash and qualified benefits) and to pay for the benefits with pretax dollars. Must conform to Sec. 125 requirements.

Capital Asset—Investments (for example, stocks, bonds, and mutual funds) and personal property (for example, home).

Capital Gain/Loss—Profit (net of losses) on the sale or exchange of a capital asset or Sec. 1231 property, subject to favorable tax rates, and loss on such sales or exchanges (net of gains) deductible against $3,000 of ordinary income.

Capitalization—Addition of cost or expense to the basis of property.

Carryovers (Carryforwards) and Carrybacks—Tax deductions and credits not fully used in one year and chargeable against prior or future tax years.

Conservation Reserve Program (CRP)—A voluntary program for soil, water, and wildlife conservation, wetland establishment and restoration and reforestation, administered by the U.S. Department of Agriculture.

Credit—Amount subtracted from income tax liability.

Deduction—Expense subtracted in computing adjusted gross income.

Defined Benefit Plan—Qualified retirement plan basing annual contributions on targeted benefit amounts.

Defined Contribution Plan—Qualified retirement plan with annual contributions based on a percentage of compensation.

Depletion—Deduction for the extent a natural resource is used.

Depreciation—Proportionate deduction based on the cost of business or investment property with a useful life (or recovery period) greater than one year.

Earned Income—Wages, bonuses, vacation pay, and other remuneration, including self-employment income, for services rendered.

Earned Income Credit—Refundable credit available to low-income individuals.

Employee Stock Ownership Plan (ESOP)—Defined contribution plan that is a stock bonus plan or a combined stock bonus and money purchase plan designed to invest primarily in qualifying employer securities.

Estimated Tax—Quarterly payments of income tax liability by individuals, corporations, trusts and estates.

Exemption—A deduction against net income based on taxpayer status (that is, single, head of household, married filing jointly or separately, trusts, and estates.

Fair Market Value—The price that would be agreed upon by a willing seller and willing buyer, established by markets for publicly-traded stocks, or determined by appraisal.

Fiscal Year—A 12-month taxable period ending on any date other than December 31.

Foreign Tax—Income tax paid to a foreign country and deductible or creditable, at the taxpayer's election, against U.S. income tax.

Gift—Transfer of money or property without expectation of anything in return, and excludable from income by the recipient. A gift may still be affected by the unified estate and gift transfer tax applicable to the gift's maker.

Goodwill—A business asset, intangible in nature, adding a value beyond the business's tangible assets.

Gross Income—Income from any and all sources, after any exclusions and before any deductions are taken into consideration.

Half-Year Convention—A depreciation rule assuming property other than real estate is placed in service in the middle of the tax year.

Head-of-Household—An unmarried individual who provides and maintains a household for a qualifying dependent and therefore is subject to distinct tax rates.

Health Savings Account (HSA)—A trust operated exclusively for purposes of paying qualified medical expenses of the account beneficiary and thus providing for deductible contributions, tax-deferred earnings, and exclusion of tax on any monies withdrawn for medical purposes.

Holding Period—The period of time a taxpayer holds onto property, therefore affecting tax treatment on its disposition.

Imputed Interest—Income deemed attributable to deferred-payment transfers, such as below-market loans, for which no interest or unrealistically low interest is charged.

Incentive Stock Option (ISO)—An option to purchase stock in connection with an individual's employment, which defers tax liability until all of the stock acquired by means of the option is sold or exchanged.

Income in Respect of a Decedent (IRD)—Income earned by a person but not paid until after his or her death.

Independent Contractor—A self-employed individual whose work method or time is not controlled by an employer.

Indexing—Adjustments in deductions, credits, exemptions and exclusions, plan contributions, AGI limits, and so on, to reflect annual inflation figures.

Individual Retirement Account (IRA)—Tax-exempt trust created or organized in the U.S. for the exclusive benefit of an individual or the individual's beneficiaries.

Information Returns—Statements of income and other items recognizable for tax purposes provided to the IRS and the taxpayer. Form W-2 and forms in the 1099 series, as well as Schedules K-1, are the prominent examples.

Installment Method—Tax accounting method for reporting gain on a sale over the period of tax years during which payments are made, that is, over the payment period specified in an installment sale agreement.

Intangible Property—Items such as patents, copyrights, and goodwill.

Inventory—Goods held for sale to customers, including materials used in the production of those goods.

Involuntary Conversion—A forced disposition (for example, casualty, theft, condemnation) for which deferral of gain may be available.

Jeopardy—For tax purposes, a determination that payment of a tax deficiency may be assessed immediately as the most viable means of ensuring its payment.

Keogh Plan—A qualified retirement plan available to self-employed persons.

Key Employee—Officers, employees, and officers defined by the Internal Revenue Code for purposes of determining whether a plan is "top heavy."

Kiddie Tax—Application of parents' maximum tax rate to unearned income of their child under age 18.

Lien—A charge upon property after a tax assessment has been made and until tax liability is satisfied.

Like-Kind Exchange—Tax-free exchange of business or investment property for property that is similar or related in service or use.

Listed Property—Items subject to special restrictions on depreciation (for example, cars, computers, cell phones).

Lump-Sum Distribution—Distribution of an individual's entire interest in a qualified retirement plan within one tax year.

Marginal Tax Rate—The highest tax bracket applicable to an individual's income.

Material Participation—The measurement of an individual's involvement in business operations for purposes of the passive activity loss rules.

Mid-Month Convention—Assumption, for purposes of computing depreciation, that all real property is placed in service in the middle of the month.

Mid-Quarter Convention—Assumption, for purposes of computing depreciation, that all property other than real property is placed in service in the middle of the quarter, when the basis of property placed in service in the final quarter exceeds a statutory percentage of the basis of all property placed in service during the year.

Minimum Distribution—A retirement plan distribution, based on life expectancies, that an individual must take after age 70 ½ in order to avoid tax penalties.

Minimum Funding Requirements—Associated with defined benefit plans and certain other plans, such as money purchase plans, assuring the plan has enough assets to satisfy its current and anticipated liabilities.

Miscellaneous Itemized Deduction—Deductions for certain expenses (for example, unreimbursed employee expenses) limited to only the amount by which they exceed 2 percent of adjusted gross income.

Money Purchase Plan—Defined contribution plan in which the contributions by the employer are mandatory and established other than by reference to the employer's profits.

Net Operating Loss (NOL)—A business or casualty loss for which amounts exceeding the allowable deduction in the current tax year may be carried back 2 years to reduce previous tax liability and forward 20 years to cover any remaining unused loss deduction.

Nonresident Alien—An individual who is neither a citizen nor a resident of the United States and who is taxed on income effectively connected with a U.S. trade or business.

Original Issue Discount (OID)—The excess of face value over issue price set by a purchase agreement.

Passive Activity Loss (PAL)—Losses allowable only to the extent of income derived each year (that is, by means of carryover) from rental property or business activities in which the taxpayer does not materially participate.

Pass-Through Entities—Partnerships, LLCs, LLPs, S corporations, and trusts and estates whose income or loss is reported by the partner, member, shareholder, or beneficiary.

Personal Holding Company (PHC)—A corporation, usually closely-held, that exists to hold investments such as stocks, bonds, or personal service contracts and to time distributions of income in a manner that limits the owner(s) tax liability.

Qualified Subchapter S Trust (QSST)—A trust that qualifies specific requirements for eligibility as an S corporation shareholder.

Real Estate Investment Trust (REIT)—A form of investment in which a trust holds real estate or mortgages and distributes income, in whole or in part, to the beneficiaries (that is, investors).

Real Estate Mortgage Investment Conduit (REMIC)—Treated as a partnership, investors purchase interests in this entity which holds a fixed pool of mortgages.

Realized Gain or Loss—The difference between property's basis and the amount received upon its sale or exchange.

Recapture—The amount of a prior deduction or credit recognized as income or affecting its characterization (capital gain vs. ordinary income) when the property giving rise to the deduction or credit is disposed of.

Recognized Gain or Loss—The amount of realized gain or loss that must be included in taxable income.

Regulated Investment Company (RIC)—A corporation serving as a mutual fund that acts as investment agents for shareholders and customarily dealing in government and corporate securities.

Reorganization—Restructuring of corporations under specific Internal Revenue Code rules so as to result in nonrecognition of gain.

Resident Alien—An individual who is a permanent resident, has substantial presence, or, under specific election rules is taxed as a U.S. citizen.

Roth IRA—Form of individual retirement account that produces, subject to holding period requirements, nontaxable earnings.

S Corporation—A corporation that, upon satisfying requirements concerning its ownership, may elect to act as a pass-through entity.

Saver's Credit—Term commonly used to describe Sec. 25B credit for qualified contributions to a retirement plan or via elective deferrals.

Sec. 1231 Property—Depreciable business property eligible for capital gains treatment.

Sec. 1244 Stock—Closely held stock whose sale may produce an ordinary, rather than capital, loss (subject to caps).

Split-Dollar Life Insurance—Arrangement between an employer and employee under which the life insurance policy benefits are contractually split, and the costs (premiums) are also split.

Statutory Employee—An insurance agent or other specified worker who is subject to social security taxes on wages but eligible to claim deductions available to the self-employed.

Stock Bonus Plan—A plan established and maintained to provide benefits similar to those of a profit-sharing plan, except the benefits must be distributable in stock of the employer company.

Tax Preference Items—Tax benefits deemed includable for purposes of the alternative minimum tax.

Tax Shelter—A tax-favored investment, typically in the form of a partnership or joint venture, that is subject to scrutiny as tax-avoidance device.

Tentative Tax—Income tax liability before taking into account certain credits, and AMT liability reduced regular tax liability.

Transportation Expense—The cost of transportation from one point to another.

Travel Expense—Transportation, meals, and lodging costs incurred away from home and for trade or business purposes.

Unearned Income—Income from investments (that is, interest, dividends, and capital gains).

Uniform Capitalization Rules (UNICAP)—Rules requiring capitalization of property used in a business or income-producing activity (for example, items used in producing inventory) and to certain property acquired for resale.

Unrelated Business Income (UBIT)—Exempt organization income produced by activities beyond the organization's exempt purposes and therefore taxable.

Wash Sale—Sale of securities preceded or followed within 30 days by a purchase of substantially identical securities. Recognition of any loss on the sale is disallowed.