

'S' CORPORATION

BY

TAX EDUCATORS

31869 HERMAN RD., COBURG, OR 97408-9483

TOLL FREE Voice/Fax: 1-866-755-2853

or

Voice: 541-915-4915

<http://www.tax-educators.com>

tax-ed@tax-educators.com

DISCLAIMER

This course is not for the preparation of S-Corporation returns.

This course is to acquaint the preparer of Personal Income Tax Returns with the information necessary to understand the S-Corporation application to the Personal Return.

The materials and forms in this manual are published by Tax Educators exclusively for the use of tax return preparers in completion of this course

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Each tax preparer must depend on his or her own knowledge of the law and expertise in the use or the modification of these materials. Preparers must be aware that the laws are constantly changing and that the information in this manual may be superceded at any time.

ACKNOWLEDGMENTS

Kleinrock - CCH

IRS: Forms & Publications

IRS: Letter Rulings

J. K. Lasser

Tax Educators

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2010 NEW & ITEMS OF INTEREST

1. **Small Employer Health Insurance Credit:** Eligible small employers (including S Corporations) may claim a 35% tax credit for premiums it pays toward health insurance coverage for its employees in tax years beginning 2010 through 2012. However, 2% shareholders of an S Corporation (as defined in IRC Par.1372(b)) of an S Corporation are not considered employees for purposes of the credit.
2. **Built-in Gain Holding Period:** The built in- gains holding period for C Corporations converting to S Corporation status is reduced temporarily for the tax years 2009 and 2010 if either of these years is the seventh year of the ten year recognition period.
3. **Haiti Relief:** Certain charitable contributions made after January 11, 2010, and before March 1, 2010, for Haiti relief can be deducted as if they were made on December 31,2009.
4. **Employer-sponsored Coverage:** Beginning in 2011 employers are required to disclose the aggregate cost of “applicable employer-sponsored coverage” provided to employees annually on the employee’s Form W-2, as added by the Patient Protection and Affordable Care Act.
5. **FUTA:** The temporary FUTA surtax has been extended, as amended by the Worker, Homeownership, and Business Assistance Tax Act of 2009. The gross FUTA tax rate of 6.2% will apply through June 30, 2011, after application of the FUTA credit for state unemployment tax paid.
6. **Foreign Financial Assets.** For tax years beginning after March 18, 2010, individuals who hold any interest in foreign financial assets during the tax year must attach to their tax returns for the year certain information with respect to each asset if the aggregate value of all the assets exceeds \$50,000, as added by the Hiring Incentives to Restore Employment Act.
7. **Penalties:** An S Corporation will be subject to an entity level penalty of \$125 per applicable month multiplied by the number of shareholders for tax years beginning after December 31, 2009 if any Form 1120S is incomplete or inaccurate.
8. **e-File Requirements:** Effective for all returns, including amended and superseding returns, filed after December 31, 2009, the IRS has updated the procedures that must be used to request a waiver of the requirement to electronically file Form 1120S. The guidance also reduces the perfection period for rejected e-filed returns from 20 days to 10 days.

SUBCHAPTER S CORPORATIONS

BASICALLY

Internal Revenue Code Sections 1371 to 1379 - "Subchapter S"

Provides a means to avoid the double taxation of regular corporation "C" Corp

Under Sub S - Corporation does NOT pay taxes on profits

Profits and Losses are "Passed Through" to shareholders in much the same manner as with a partnership.

The tax advantages should be carefully "weighed" based on the income/loss situation and whether the profits must remain in the corporation rather than be distributed.

Income once reported on the tax returns of the shareholders can be distributed by the S corporation without being taxed a second time

CAREFUL CONSIDERATION SHOULD BE GIVEN TO ACTUAL DISTRIBUTION OF ENOUGH CASH TO THE SUB S SHAREHOLDERS TO FUND THE TAX LIABILITY THEY WILL INCUR.

In most respects, an S corporation is just like any other corporation, with all the legal attributes and subject to all the rules, regulations, benefits, and burdens of the corporate form, except that —because of the election – it is not ordinarily subject to federal corporate income tax. (Some states may impose franchise or excise tax on S corporations)

Tax years ending on or after December 31, 2005, 'S' Corporations with assets of \$50,000,000. or more (\$10,000,000. or more for taxable years ending on or after December 31, 2006) that file at least 250 returns per year:

Must file Form 1120S electronically.
There is a waiver available.

S CORPORATION ADVANTAGES

Reasons to chose the S corporation as the form of doing business include:

- 1. Limited liability**
- 2. May have benefit of lower tax rate on individuals**
- 3. No separate tax on corporate income**
- 4. Deductibility of business start up losses available to individuals.**
- 5. Individual shareholder can deduct its share of net operating losses**
(Losses from “C” corporation are not deductible by shareholders but must remain in the corporation until profits are generated to offset or C corporation is dissolved.)
- 6. Capital gains generally not taxed at corporate level**
- 7. No accumulated earnings tax, C corporation accumulated earnings tax has been lowered to 15%**
- 8. No corporate alternative minimum tax**
- 9. More flexibility in choosing accrual or cash method of accounting**
- 10. Family member may be able to split income among other family members**
- 11. Shareholders, unlike partners, are not subject to FICA tax on the corporation net income (pass through amount)**
- 12. Passive S corporation shareholders can offset passive losses from other activities with their S corporation earnings.**
- 13. Business interest incurred by SHAREHOLDER to acquire the stock of the company are deductible as business interest expense if they materially participate.**
(Interest expense incurred on debt to acquire stock in a C corporation is treated as investment interest.)

S CORPORATION DISADVANTAGES

Reasons NOT to chose the S corporation status:

1. **Rules that govern election are inflexible**
2. **More perks (fringe benefits) subject to tax**
Fringe benefits received by 2% shareholders are not excludable from shareholders income.
3. **Employee stock ownership plans are not available**
4. **Passive activity losses and credits are sometimes limited**
5. **Some states do not recognize S Corporations for state income tax purposes.**
6. **Shareholders are subject to FICA tax and other payroll taxes on required reasonable salary.**

**(If shareholders take distributions of profits they MUST
take out reasonable salary)**

7. **Generally, an S corporation must use a calendar year**
Limits opportunity to shift income by use of fiscal year end
8. **S corporation income (as passed through) results generally results in a higher marginal tax rate than a C corporation**
Double taxation of the C corporation has been reduced due to the change in the taxation of dividends!!
9. **Shareholders who hold more than 5% of stock can borrow from the pension plan, but only under certain circumstances.**
10. **Limitation of use of cash basis**
An S corporation that has more than 35% of its losses allocated to the shareholders who do not actively participate in the management of the corporation will be treated as a “tax shelter” and therefore, be required to use accrual method of accounting (Section 1256(e)(3))
Carefully watch for situations that may lead to inactive shareholders owning more than 35% of stock (passive investors, minor children and retired shareholders)

REASONABLE SALARY REQUIREMENTS

NOTE:

This one item is one of the major oversights by S corporation shareholders.

If shareholders take out distributions of profit they must take out a reasonable salary. Failure to take out a reasonable salary can result in:

- ▶ IRS reallocation of income as compensation

(Imagine the repercussions!! - Amended Corporate return-
amended individual returns - Amended payroll tax reports)
- ▶ Payment of penalties, interest and payroll taxes

Compensation should be determined by reference to services provided.

Reasonable compensation must have the following characteristics

- ▶ Must be “ordinary and necessary” business expense
- ▶ Must be paid or incurred during the taxable year
- ▶ Must be for rendering of personal services
- ▶ Must be reasonable.

Maximum limits effective 1-1-94 -

A publically held corporation may not deduct compensation paid to certain employees in excess of \$1 million

Proposed Reg. 1.1366-3(a) -

In determining whether a stockholder or a family member has received reasonable compensation, all the facts and circumstances are considered, including the amount that ordinarily would be paid to obtain comparable services from a person who is neither a stockholder nor a family member of a stockholder in the corporation.

REASONABLE SALARY REQUIREMENTS

Section 1366(e) Reasonable salary requirements not only applicable to shareholders

If an individual who is a member of the family of one or more shareholders of an S corporation renders services to the corporation without receiving reasonable compensation, the secretary shall make such adjustments as may be necessary to reflect the value of such services.

IRS audit manual lists the following factors to consider for reasonable salary

- ▶ Nature of duties performed
- ▶ Background and experience of the officer
- ▶ Officer's knowledge of the business
- ▶ Size of the business
- ▶ Individual officer's contribution to profit making
- ▶ Time devoted to the business
- ▶ Economic conditions in general and locally
- ▶ Character and amount of responsibility given to the officer
- ▶ Time of year compensation is determined
- ▶ Relationship of stockholder officer's compensation to stockholdings
- ▶ Whether alleged compensation is in reality, in whole or part, payment for a business or assets acquired
- ▶ The amount paid by similar size businesses in the same area to equally qualified employees for similar services
- ▶ ETC!!!

Other items that may be considered

- ▶ Employees qualification
- ▶ Nature, extent and scope of employee's work
- ▶ Size and complexity of the business
- ▶ Comparison of salaries paid with sales and net income
- ▶ General economic conditions
- ▶ Comparison of salaries to distributions and shareholders and retained earnings
- ▶ Employer's salary policy to all employees
- ▶ Prevailing rates of compensation for comparable position in comparable companies
- ▶ Compensation paid in prior years
- ▶ Whether employee and employer dealt in arm's length
- ▶ Whether employee guaranteed employer's debt

COMPARISON PARTNERSHIPS AND S CORPORATIONS

ITEM	PARTNERSHIP	S CORPORATION
Entity Status	No election required	Must be elected
Number of Investors	No limits	100 or less
Eligible investors	No limits	Exclusion of corporations, non res. aliens partnerships, estates, certain trusts
Classes of Ownership	General and Limited Partners; different classes of limited ptrs permitted	One class of stock ONLY, but voting differences permitted
Tax Year	Tax year of partners with more than 50% aggregate ownership or of principal partners if same; otherwise calendar year.	Must use calendar year. May use a different year IF if business purpose established.
Note: Both may elect certain fiscal years if certain conditions are met		
Passive Investment Income Restriction	No	Possible tax or loss of S status in certain cases
Termination of entity status for tax purposes	Sale or exchange of 50% or more of partnership interests within 12 mo. period; or cessation of operations	Election of shareholders owning more than 50% of stock; or events causing failure to meet S Corp. eligibility requirement
Basis of interest	Money plus basis of contributed property and services less debt on property assumed by partnership; increased by partner's share of partnership liabilities assumed.	Money plus basis of other property contributed. For stock received for in exchange for services; basis is money paid plus any additional amount included in income

COMPARISON PARTNERSHIPS AND S CORPORATIONS

ITEM	PARTNERSHIP	S CORPORATION
Adjustments to Basis	Generally increased by partnership taxable income, capital expenditures; decreased by distributions, depreciation, return of capital, losses, expense deductions, tax credits and other items	Increased by corporate taxable income and certain other items: decreased by corporate losses, distributions and other items
Limited Liability	Yes, for limited partnerships, but one general partner must have unlimited liability	Yes
Limitation on deductions of losses	Limited to adjusted basis of partner's interest. Carryforward of unused losses permitted but ordinary loss may become capital loss if carried over after partner leaves partnership. Subject to passive loss limits.	Limited to adjusted basis of stock and basis in indebtedness owed to shareholders by corporation. Carryover of unused losses permitted but generally not allowed for period not an S Corp. Subject to passive loss limits
Special allocation of income and losses	Permissible if "substantial economic effect"	No. Allocation on on per share/per day basis
Distributions of property	Generally, gain not recognized	Gain not recognized extent of adjusted basis in stock for S Corp with no earnings and profits or to extent of accumulated adjustments account.
Distributions of appreciated property not in complete liquidation	Partners generally recognize no gain	Shareholders must recognize their share of gain realized by corporation.

COMPARISON PARTNERSHIPS AND S CORPORATIONS

ITEM	PARTNERSHIP	S CORPORATION
Expenses and interest owed to partners and shareholders	Transaction between partnership and partner acting in capacity other than as a partner permitted. Guaranteed payments to partner recognized for tax year that the partnership deducts them as paid or accrued.	Transactions between shareholder and corp. permitted. S Corp. placed on cash basis for deducting interest and expenses owed to shareholder
Denial of capital gain treatment on transactions between entity and partner/shareholder.	Denied to partner owning more than 50% of capital or profits interests for property not defined as a capital asset.	Denied to shareholder owning more than 50% of value of stock
Disallowance of losses on transactions between entity and partner or shareholder	Denied to partner owning more than 50% of capital or profits interests	Denied to shareholder owning more than 50% of value of stock
Amounts paid to or from accident or health plans	No exclusion available (Partner not an employee)	Excludable for shareholders owning 2% or less of stock
Group term life insurance	No exclusion (Partner not employee)	Cost of insurance for up to \$50,000 coverage excludable for shareholders owning 2% or less of stock
Death benefits exclusion	\$5,000 exclusion NOT available	\$5,000 exclusion of Death benefits to the deceased shareholder's beneficiary for shareholder owning 2% or less of stock

COMPARISON PARTNERSHIPS AND S CORPORATIONS

ITEM	PARTNERSHIP	S CORPORATION
General tax consequences on death of partner or shareholder.	Basis of interest stepped up to fair market value; Partnership not terminated. Decedent's share of income or loss for period ending With death taxable to the estate or successor interest.	Basis of stock stepped up to FMV. S status does not terminate. Income or loss allocated to decedent for period ending with death, included in his final return; Post death income is allocable to estate or beneficiaries
Cost of meals and lodging furnished for employer's convenience	No exclusion (Partner not an employee)	Excludable from for shareholders owning 2% or less of stock

ELIGIBILITY TO ELECT

SUB-CHAPTER 'S'

ELIGIBILITY TO ELECT SUB-CHAPTER 'S'

Must be a "small business" corporation and meet the following conditions:

✓ **Must be a DOMESTIC Corporation**

A real corporation that is organized in the United States

(NOT eligible - Domestic Internationals Sales Corp.--
Corporations that take Puerto Rico and possessions
tax credit ----**insurance companies**

✓ **Must not have more than 100 shareholders (was 35 prior to 1997)**

Regardless of how shares are owned, spouses are treated as one shareholder for this purpose.

If one spouse dies, the estate and surviving spouse are treated as one shareholder for this test.

A minor child is counted as a separate shareholder.

Members of one family to be counted as one shareholder.

When stock is held by a nominee, agent, guardian or custodian, the individual for whom the stock is being held is the shareholder.

An S corporation can be a partner in a partnership without loss of S status but may NOT form several S corporations into a partnership in order to circumvent the 100 shareholder limits.

Stock held by a qualified trust, each beneficiary is counted as a shareholder.

ELIGIBILITY TO ELECT SUB-CHAPTER 'S'

✓ **Only the following may be shareholders in an S corporation**

- Individuals
- Estates
- Certain Trusts
- Non profit organizations that qualify under IRC section 501(c)(3)
- Pension, profit sharing and stock bonus plans as described in IRC Section 401(a)

A financial institution that does NOT use reserve method of accounting for bad debts is eligible to be an S corporation

A **resident alien** may be a shareholder of an S corporation

The following are NOT permitted to be shareholders in S corporation

A charitable remainder trust can not qualify as S shareholder

S corporation stock may not be held by a self directed IRA

Corporations

Partnerships

ELIGIBILITY TO ELECT SUB-CHAPTER 'S'

Trusts that may own S corporation stock without destroying the election:

Grantor Trust

Trusts receiving stock under a will - **for two years** (was 60 days)

Voting trusts

Qualified Subchapter S trust - **Prior to 1997**

All of trust's income must be either actually distributed or required to be distributed under terms of the trust on a current basis to **one** individual who is a US citizen or resident.

AND Trust must meet four terms:

1. Only one income beneficiary of the trust
2. Any corpus of the trust that is distributed during the life of the current income beneficiary must be distributed ONLY to THAT beneficiary
3. Current income beneficiary's income interest in the trust must terminate at the earlier of his death or termination of the trust.
4. If trust terminates during life of current income beneficiary, all trust assets must be distributed to such beneficiary
 2. Must make special trust election
 3. May be revoked only with IRS consent

Electing Small Business Trusts (ESBT) **1997 and after**

Has 1 year, no longer 60 days, to dispose of stock after an ineligible share holder becomes a potential current beneficiary.

Powers of appointment to the extent not exercised, are disregarded in determining the potential current beneficiaries of an electing small business trust (ESBT)

May own stock in S corporation providing all beneficiaries are individuals, estates, or non profit organizations eligible to be S corporation shareholders

No interest in the ESBT can be acquired by purchase. Acquisition must be by gift, bequest or similar means

ELIGIBILITY TO ELECT SUB-CHAPTER 'S'

CONTINUED FROM PREVIOUS PAGE: Electing Small Business Trusts (ESBT)

Each income beneficiary is counted as a shareholder in the 100 shareholder limitation

Trust must ELECT to be an ESBT by following procedures in IRS notice 97-12

Income from an S is taxed to an ESBT at the highest rate applicable to trusts (35% on ordinary income and 15% on capital gain).

✓ **Must have only ONE class of outstanding stock.**

Generally, all shares must be common shares.

Common stock that differs only with respect to voting rights is treated as one class of stock. Code sec. 1361(b)(1)(D) and (c)(4)

Stock without voting rights or with lesser voting rights can be given to inactive shareholders, thus concentrating control of the corporation in the active shareholders.

Nonvoting shares may be given to children and other family members in connection with estate planning.

Outstanding stock is stock that has actually been issued to a shareholder.

Does NOT include stock that the charter permits it to issue but that the corporation has never issued.

May have had common and preferred shareholders at one time but may NOT have both at any period for which the S election is in effect.

Does NOT include treasury stock.

Disproportionate payment of dividends will not be deemed to create a second class of stock, unless they are required by governing provisions. (May cause other tax problems such as taxable gifts, being taxed to someone other than recipient etc)

ELIGIBILITY TO ELECT SUB-CHAPTER 'S'

✓ **Must have only ONE class of outstanding stock.** (Continued)

Shareholder agreements (buy and sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements) generally are disregarded in determining whether a second class of stock is present. (Careful planning required in this area)

Warrants, options, convertible debentures, or proxies are not treated as a second class of stock if the rights are issued for the corporation's one class of stock and all other conditions are met.

Stock appreciation right plans (deferred compensation plans)
Do not constitute a second class of stock if:

- ✓ Do not convey the right to vote
- ✓ Unfunded and unsecured promise to pay money or property in the future
- ✓ Issued to an individual who is an employee or independent contractor in connection with performance of services for the corporation and is not excessive by reference to service performed
- ✓ Issued pursuant to a plan with respect to which the employee or contractor is not taxed currently on income.

Stock option plans generally are not considered a second class of stock

**Loans to the corporation may be treated as a second class of stock
When the corporation is thinly capitalized and the loans are
disproportionate to their ownership of stock.**

Special safe harbor rules may apply

ELIGIBILITY TO ELECT SUB-CHAPTER 'S'

✓ **May not have any nonresident alien shareholders**

A **non resident** alien may **not** be a shareholder of an S corporation

If a resident alien gives up U.S. residence the S election will be terminated on the date the shareholder gives up U.S. residence.

A non resident alien shareholder who moves to a foreign country may continue his or her U.S. resident status in some cases.

Private letter rules that shares of an S corporation issued to a non resident alien as custodial for a resident minor will not disqualify S corporation status when the true shareholder is a resident minor.

If shareholder is a U.S. citizen or resident and the shares are not community property, it does not matter that the spouse of the shareholder is a nonresident alien. If shares are held as community property, they are deemed to be owned by both spouses and the nonresident alien spouse is ineligible to be an S corporation shareholder.

A foreign trust may not be an S corporation shareholder.

✓ **May not be a member of an "affiliated group" - (Code Section 1501 and 1504 related to consolidated returns)**

✓ **Must have a permitted tax year as required by Sec. 1378 or make an election (444) to have a tax year other than a permitted tax year.**

(Permitted tax year Dec. 31 or any other tax year for which corporation establishes a business purpose to IRS's satisfaction.)

ELIGIBILITY TO ELECT SUB-CHAPTER 'S'

✓ Must make proper election

See section on "elections" following

✓ S corporations can own subsidiary C corporations Since January 1, 1997. No longer a restriction on the percentage of another corporation's stock that an S corporation may hold.

S corporation can not be included in a consolidated tax return with another corporation

Dividends received from an 80% or more C corporation subsidiary actively involved in a trade or business, are not considered to be passive income for purposes of the excess net passive income tax

Generally, S corporations still can not have a corporate shareholder

As S corporation parent, can not have a Qualified Subchapter S Subsidiary

Subsidiary must be 100% owned and the parent must elect to treat the subsidiary as a QSSS.

QSSS is not treated as a separate corporation

Assets, liabilities, income, deductions and credits of a wholly owned subsidiary are treated as belonging to the parent S corporation.

(Prior to 1996 an S corporation could not own 80% or more of the stock of another corporation.)

Warning - If a qualified subchapter S corporation loses its eligibility as a QSSS it is treated as a new C corporation which acquired its assets from the parent S corporation This would be a taxable transaction in which gain or loss would be recognized by parent corporation.

Inadvertent 'Q' caused elections and terminations can be waived by the IRS.

The general rule treating a QSub as a subsidiary rather than as a separate corporation does not apply for purposes of information reporting.

ORGANIZING
'S' CORPORATION

CONTRIBUTIONS TO CAPITAL

TRANSFERS OF PROPERTY TO S CORPORATION IN EXCHANGE FOR STOCK

Some states, issuance of stock is subject to restriction requires a waiver of rights to receive distributions for a time – could result in more than one class of stock and disqualify S status

✓ Shareholder recognition of gain or loss

If shareholder is part of group that controls the corporation (generally 80% or more) - no gain or loss will be recognized {Sec. 351(a) }

If NOT part of control group - gain or loss may be recognized

If part of control group (section 351) and shareholder receives anything other than stock from the S corporation:

Shareholder recognizes gain to extent of amount of money received plus fair market value of other property received - but **no loss is recognized**

If property that is transferred is subject to indebtedness - no gain will be recognized unless the transaction had tax avoidance as its principal purpose or there is no bona fide business purpose.

However, if liabilities exceed shareholder's basis in the assets transferred, gain is recognized to extent of the excess.
Section 357(c)

✓ Gain or loss recognized by the S corporation

Regardless of “control interest” (section 351), the corporation does not recognize gain or loss on receipt of property in exchange for stock (Section 1032 -exchange rule)

CONTRIBUTIONS TO CAPITAL

TRANSFERS OF PROPERTY TO S CORPORATION IN EXCHANGE FOR STOCK

✓ **Shareholder basis for the stock**

Basis is equal to is or her basis in the assets transferred **reduced by**

- Any money and property received from the corporation
- Any liabilities assumed by the corporation in connection with the transfer

✓ **Corporations basis in property received**

Corporation generally takes a carryover basis from the transferor **with adjustments**

Same as basis in the asset in the hands of the transferor, increased by any gain recognized to the transferor on the transfer

S CORPORATION STOCK RECEIVED IN EXCHANGE FOR PERFORMANCE OF SERVICES

✓ **Shareholder recognizes income in an amount equal to the value of the stock received.**

✓ **Corporation receives a deduction for the value of stock given up**

Caution: Some states have restrictions requiring waiver of rights to distributions when stock is received in exchange for non-cash items (property or services) which could disqualify the S corporation status.

SECTION 1244 STOCK

Although Section 1244 stock is not a requirement for S corporation, it is advisable to consider making this stock election.

Definition 1244 Stock

Stock in a domestic corporation **if**

At the time such stock is issued, such corporation was a **small business** corporation. (See definition of small business corporation under S Corp)

If aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid in surplus, does not exceed \$1,000,000.

The determination shall be made as of the time of the issuance of the stock but shall include all amounts received for such stock and for all stock theretofore issued.

Such stock was issued by such corporation for money or other property
(Other than stocks and securities)

Such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50% of its aggregate gross receipts from sources **other than** royalties, rents, dividends, interests, annuities, and sales or exchanges of stock or securities.

Not been in existence for 5 years - substitute:

- ✓ The period corporations taxable years ending before such date or
- ✓ If not in existence for 1 taxable year ending before such date, the period such corporation has been in existence before such date.

SECTION 1244 STOCK

The designation must be made not later than the 15th day of the third month following the close of the transitional year..

The designation MUST be made by entering the numbers of the qualifying share certificates on the corporate records.

If corporation fails to designate qualifying shares in the transitional year and fails to designate certain shares of common stock as sec. 1244 stock in accordance with the rules:

- ◆ 1244 treatment is allowed for losses sustained on post Nov. 1978 common stock issued for money or other property in taxable years before the transitional year and NOT allowed for losses on post-Nov.1978 stock issued in taxable years after the transitional year.
- ◆ Post 1958 capital received before the transitional year is SUBTRACTED from the \$1,000,000.
- ◆ Subject to annual limitation in Reg. 1.1244d(b)-1, an ordinary loss on post Nov. 1978 common stock issued for money or other property in the transitional year is allowed in an amount which bears the same ratio to the total loss sustained by the individuals as
 - the amount described in 1.1244(c)-2(b)(3)(ii) bears to
 - The total amount of money and other property received by the corporation in exchange for stock, as a contribution to capital, and as paid in surplus in the transitional year.

SECTION 1244 STOCK

GENERAL RULE -1244 LOSSES:

In the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership which would (but for this section) be treated as a loss from sale or exchange of a capital asset shall, to the extent provided under section 1244, be treated as **ordinary loss**

Maximum Amount for Any Taxable Year

Aggregate amount treated by taxpayer by reason of section 1244 as ordinary loss shall not exceed:

- ▶ \$50,000 or
- ▶ \$100,000 in the case of a joint return for such year.

Special rules apply if stock was issued in exchange for property

In computing the amount of the loss on stock for purposes of section 1244, any increase in the basis of such stock (through contributions or otherwise) shall be treated as allocable to stock which is NOT section 1244 stock.

**ELECTIONS
AND
SHAREHOLDER CONSENTS**

ELECTIONS AND SHAREHOLDER CONSENTS

- ▶ All shareholders must sign consent form 2553
- ▶ Filed with Internal Revenue
- ▶ Filed Timely

Either:

- ▶ at any time during that portion of the first tax year the election is to take effect which occurs before the 16th day of the third month of that tax year

or

- ▶ in the tax year before the first tax year it is to take effect.

An election made after the 15th day of the third month but before the end of the tax year is treated as made for the next year

- ▶ IRS must approve the election.

DO NOT FILE TAX RETURNS AS SUB S (FORM 1120S) UNTIL ELECTION IS APPROVED BY IRS

Timely filing of form 2553 does NOT automatically mean that S corporation status is acceptable..

YOU MAY NOW FILE YOUR ELECTION WITH YOUR FIRST RETURN.

Use Form 2553. With Form 1120S
For Tax Years beginning On or After December 31, 2007

ELECTIONS AND SHAREHOLDER CONSENTS

Existing corporation (C) election to become “S” corporation

Election may be made for the **following year** at any time during the year.

For election to be effective for the **current year** all three conditions must be met:

- Must be made on or before the 15th day of the third month of the **taxable year**
- Corporation must have been eligible to make the election for all days during the taxable year that preceded the date of the election
- All persons who held stock of the corporation during the part of the year before the date of the election must consent to the election, regardless of whether they are still shareholders on the date of the election

If corporation fails any of the three conditions, the election will be treated as having been made for the following year.

Beginning of first taxable year (newly formed corporation)

When the FIRST of the following events occurs:

- Corporation first had shareholders
- Corporation first acquired assets
- Corporation began doing business

Failure by new corporation to meet deadline for filing election

Earliest possible effective date is first day of the NEXT taxable year.

Next taxable year does not have to be 12 months!! (Unless personal service corp)

Newly formed corporation may elect a short fiscal year for its first taxable year.

ELECTIONS AND SHAREHOLDER CONSENTS

15th day of third month

Calculation based on regulations:

- The first month ends on the day before the beginning date of the following month.
- The second month ends on the same **numbered** day in the following month
- After the end of the second month, 15 days are added.

Due date for filing election falls on a legal holiday

If falls on Saturday, Sunday, or day that is a legal holiday in the District of Columbia, filing is timely made if made on next succeeding business day.

ELECTIONS AND SHAREHOLDER CONSENTS

Extension for filing election - NONE

Election mailed on last day but postmarked next day - invalid

A timely instruction to an attorney or accountant to file and election will not salvage the election if the practitioner fails to make the timely filing.

However, the Small Business Job and Protection Act of 1996 provides for validation of late or nonexistent S elections.

IRS may now allow an S Corporation that has inadvertently made an invalid election to be treated as an S corporation for a specified period if the corporation takes the steps needed to perfect the election.

Late or Nonexistent S elections may be treated as made timely if IRS determines there was reasonable cause for failure to file on time.

Generally, this requires a request for private letter ruling and payment of a user fee . Private letter rulings take a lot of time and the cost is \$5,000 (\$500 if gross income is less than \$1 million.

NOT AUTOMATIC!!

Special no fee procedure for making late S election - Rev. Proc. 98-55

Eligible if corporation meets following requirements:

1. Corporation fails to qualify as an S corporation solely because the form 2553 was not filed timely
2. Due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation has not passed.

File form 2553 with "Filed Pursuant to Rev. Proc. 98-55" at top

Attach statement explaining reason for failure to file timely

ELECTIONS AND SHAREHOLDER CONSENTS

Automatic relief for late S elections (Rev. Proc. 97-48) granted under two situations

If ALL of the following are met:

- ✓ Corporation fails to qualify solely because form 2553 was not filed timely
- ✓ The corporation and all shareholders reported their income consistent with S status for the year the S election should have been made, and for every subsequent tax year
- ✓ At least 6 months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation
- ✓ Neither the corporation nor any of its shareholders was notified by IRS of any problem regarding the S corporation status within 6 months of the date on which the Form 1120S for the first year was timely filed.
- ✓ Corporation fails to qualify solely because form, 2553 was not filed timely for a tax year that began before January 1, 1997
- ✓ Corporation received notification from IRS that the form 2553 was not filed timely, that the corporation must file as a C corporation for the first tax year the corporation intended to be an S corporation, and that the corporation would be treated as an S corporation for the following year.
- ✓ The corporation and all its shareholders reported their income (if any) properly treating the corporation as a C corporation for the first year.
- ✓ The corporation and all its shareholders reported their income consistent with S corporation status for all subsequent years.
- ✓ The period of limitations on assessment has not lapsed for any of the tax years of the corporation or the shareholders beginning on or after the date the corporation intended to be an S corporation. To obtain automatic relief, corporation must file a completed form 2553 with "Filed Pursuant to Rev. Proc. 97-48" at the top – with attachments required under those procedures.

ELECTIONS AND SHAREHOLDER CONSENTS

Clerical errors on form 2553 may result in loss of S corporation status

In some cases, clerical errors will be overlooked

When corporation issues a smaller number of shares than is shown on form 2553, the election remains valid.

If some facts are wrong and such facts are not relevant to corporation's qualification to make the election or not relevant to the validity of the shareholder's consent, an otherwise valid election will not be invalidated.

If form 2553 indicates more shares issued and outstanding than the shareholder consent forms indicated - election invalidated.

Protecting against loss by IRS or Post Office

Hand deliver to IRS and request copy stamped by IRS "received and date"
Certified Mail - Return receipt requested

ELECTIONS AND SHAREHOLDER CONSENTS

Consent

Each individual, estate or trust that is a shareholder on date of election must consent.

When made within first two and one half month period and election is to be retroactive - persons who are no longer shareholders on the date of the election, but were shareholders at any time during the taxable year must also consent.

Stock held as community property - both spouses must file consents

Stock held by tenants in common, joint tenants, or tenants by the entirety. All such parties must sign the consent.

Stock held by a minor - can be signed by minor, legal representative, or minor's natural or adoptive parent.

Stock held by estate - consent made by personal representative (executor or administrator) of the estate

Stock held by a grantor trust or other trust of which a third part is deemed the owner -deemed owner of the trust must file consent

Trust holding stock transferred to it by a will or estate - personal representative of the estate must file the consent

Voting trust holding stock - EACH beneficiary must file consent

Beneficial owner must consent - if record owner of the stock has no beneficial interest in the shares of stock, not required to sign.

Missing shareholder - If shareholder can not be located, timely filed election may be made and request for extension of time **to file the missing consent** - but election not valid without consent of all shareholders.

ELECTIONS AND SHAREHOLDER CONSENTS

FORM 2553 CONSENT INFORMATION REQUIRED

- ✓ Name, address, and taxpayer identification numbers of shareholder
- ✓ Number of shares each shareholder owns
- ✓ Date or dates on which shares were acquired
- ✓ Month with which shareholders taxable year ends

NEW SHAREHOLDERS

New shareholders do not have to file a consent in order for corporation to maintain S Corp. status. (Unless new shareholder is a qualified subchapter S trust)

A new shareholder may not refuse to consent to the S election unless the new shareholder is a successive beneficiary of a qualified subchapter S trust.

SAMPLE SUBCHAPTER 'S' RESOLUTION

A statement similar to the following should be reflected in the corporate minutes.

The President suggested that the corporation consider electing to be taxed as a small business corporation under Internal Revenue Code subchapter S. The board then discussed the advantages of such an action and on motion, the following resolutions were adopted:

RESOLVED: That X Corporation elects to be taxed under IRC Sub. S as a small business corporation.

RESOLVED FURTHER: That the officers of X Corporation are authorized and directed to prepare, execute and file, or cause to be prepared, executed, and filed, I R S Form 2553, together with a statement by each share-holder consenting to this election, and to do all other acts that may be required to make this election effective.

Sub. S Corporation Election Form 2553 reproduced on the following two pages.

Election by a Small Business Corporation
(Under section 1362 of the Internal Revenue Code)

OMB No. 1545-0146

▶ See Parts II and III on back and the separate instructions.

▶ The corporation may either send or fax this form to the IRS. See page 2 of the instructions.

- Notes:** 1. *Do not file Form 1120S, U.S. Income Tax Return for an S Corporation, for any tax year before the year the election takes effect.*
 2. *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, and the exact name and address of the corporation and other required form information are provided.*
 3. *If the corporation was in existence before the effective date of this election, see Taxes an S Corporation May Owe on page 1 of the instructions.*

Part I Election Information

Please Type or Print	Name of corporation (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) ▶ / /

F Name and title of officer or legal representative who the IRS may call for more information

G Telephone number of officer or legal representative ()

H If this election takes effect for the first tax year the corporation exists, enter month, day, and year of the **earliest** of the following: (1) date the corporation first had shareholders, (2) date the corporation first had assets, or (3) date the corporation began doing business ▶ / /

I Selected tax year: Annual return will be filed for tax year ending (month and day) ▶
 If the tax year ends on any date other than December 31, except for a 52-53-week tax year ending with reference to the month of December, you **must** complete Part II on the back. If the date you enter is the ending date of a 52-53-week tax year, write "52-53-week year" to the right of the date.

J Name and address of each shareholder (and each spouse having a community property interest in the corporation's stock, and each tenant in common, joint tenant, and tenant by the entirety (A husband and wife and their estates) are counted as one shareholder in determining the number of shareholders who must sign in the manner in which the stock is owned.	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. (Shareholders sign and date below.)		L Stock owned		M Social security number or employer identification number (see instructions)	N Shareholder's tax year ends (month and day)
	Signature	Date	Number of shares	Dates acquired		

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 ▶

Part II Selection of Fiscal Tax Year (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 I, Part I.
 2. An existing corporation retaining the tax year entered in item I, Part I.
 3. An existing corporation changing to the tax year entered in item I, Part I.
- P** Complete item P if the corporation is using the automatic approval provisions of Rev. Proc. 2002-38, 2002-22 I.R.B. 1037, to request **(1)** a natural business year (as defined in section 5.06 of Rev. Proc. 2002-38) or **(2)** a year that satisfies the ownership tax year test (as defined in section 5.06 of Rev. Proc. 2002-38). 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 5.06 of Rev. Proc. 2002-38) and has attached a statement verifying that it satisfies the 25% gross receipts test (see instructions for content of statement). I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2002-38 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 5.06 of Rev. Proc. 2002-38) 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 I, Part I, and that such tax year satisfies the requirement of section 4.02 of Rev. Proc. 2002-38. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2002-38 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, you must 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 I, Part I, is requested under the prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1049. 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, you must check box R1 and you may also check box R2.
1. **Check here** ▶ to show the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item I, 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.



**S CORPORATION
INCOME
AND
EXPENSES**

INCOME AND EXPENSES

IN GENERAL

Shareholders report their pro rata share of the S corporation's income, loss deductions, and credits on their own personal tax returns.

Character of an item included in shareholder's pro rata share is determined as if the item were realized directly from the source from which the S corporation realized it.

SEPARATELY STATED ITEMS

Any item, the separate treatment of which could affect a shareholder's tax liability must be passed through separately. All other items are combined and referred to as non-separately stated income or loss.

Separately stated items are reported on Schedules K and K1. Items that MUST be separately stated includes, but is not limited to:

1. Net income or loss from rental real estate activities
2. Net income or loss from other rental activities
3. Portfolio income or loss
 - ✓ Interest income
 - ✓ Dividend income
 - ✓ Royalty income
 - ✓ Short term capital gain or loss
 - ✓ Longer term capital gain or loss
4. Section 1231 net gain or loss
5. Charitable contributions
6. **Section 179 expense**
7. Expenses related to portfolio income or loss
8. Credits
 - Low income housing credit
 - Qualified rehabilitation expenses
 - Other credits
9. Investment interest expenses and
10. Tax preference and adjustment items needed to figure Shareholder's alternative minimum tax

INCOME AND EXPENSES

SPECIAL ITEMS

Non business bad debt

S corporation must separately state the debt as a short term capital loss in the year in which it becomes totally worthless

Interest Expense - Debt Financed Distributions

If S corporation borrows money, which is distributed to shareholders

the ability to deduct interest expense depends on how the shareholder uses the funds. Interest paid on such debt by the corporation must

be separately stated on the K1 as “interest expense allocated to debt financed distributions.”

TAX PREFERENCE ITEMS

Tax preference items must be separately stated in order to allow the stockholders to figure their alternative minimum, tax.

If the S corporation was a regular “C” corporation for any of the 3 immediately preceding tax years, the S corporation must adjust its tax preference items.

(For more information see IRS Publ 589)

PASS THROUGH ITEMS

An S corporation may not pass through a deduction which would not be allowed if paid directly by the shareholder. For example an individual cannot avoid the 2% floor on miscellaneous itemized deductions or the 50% deduction for meals and entertainment by allowing the corporation to pay these items.

An S corporation is not considered an individual for purposes of section 1244.

Thus an S corporation can NOT take ordinary loss deduction on the sale of stock of a C corporation held by the S corporation.

INCOME AND EXPENSES

LIMITS ON CERTAIN ITEMS

Limits on following are applied to BOTH the S corporation and the shareholder

- ✓ The \$10,000 limit on reforestation costs
- ✓ Section 179 expense maximum
 - Election is made first at corporate level
 - Shareholder wages are added back in determining the taxable income limitation.
 - Expense passed through reduces shareholder's stock basis. Basis reduction applies even if the shareholder is unable to deduct the 179 expense.
 - **If the shareholder has over the maximum (\$100,000) in total section 179 expenses because of amounts allocated to him from the S corporation and from other trades or businesses, the excess over maximum is LOST (Rev. Rule 89-7)**

TAX ELECTIONS

The S corporation makes all elections that affect computation of items it has to report on the tax return, except:

- ✓ Elections on deduction and recapture of certain mining exploration costs.
- ✓ Election on whether to deduct or claim foreign tax credit

INCOME AND EXPENSES

CARRYOVERS AND CARRYBACKS

S corporation can not carry over or carry back any item from a year that the corporation is not an S corporation to a year that the corporation is an S corporation.

If corporation was a C corporation in it's first year and had a net operating loss, then became an S corporation in 2nd year – the net operating loss can not be carried from year one to year two.

Each year that the corporation is an S corporation does count as a year for purposes of the 15-20 year carryover period. If S corporation does not terminate before carryover period lapses – the NOL may not be used.

INCOME AND EXPENSES

RELATED PARTY TRANSACTIONS

Losses realized on sales or exchanges of property between related parties generally may not be deducted - later resale of the property, if at a gain - gain is recognized only up to the amount that is more than the disallowed loss.

Related:

- ▶ Two corporations that are members of the same controlled group of corporations determined by applying a 50% ownership test
- ▶ An individual and a corporation if more than 50% of the value of the outstanding stock is owned by the individual
- ▶ A trust fiduciary and a corporation if trust or grantor of trust owns more than 50% in value of outstanding stock of the corporation
- ▶ Grantor and a fiduciary of any trust
- ▶ A fiduciary of a trust and a beneficiary of the trust
- ▶ Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation
- ▶ An S corporation and a corporation that is not an S corporation if the same person owns more than 50% in value of the outstanding stock of each corporation.
- ▶ A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or profits interest, in the partnership

An accrual method S corporation must use CASH method to deduct business expenses and interest owed to cash method related parties.

For this purpose, related parties also include

- ▶ An S corporation and ANY person who owns, directly or indirectly, ANY of the stock of the S corporation.
- ▶ S corporation and any person who owns, directly or indirectly, ANY capital or profits interests of a partnership in which the S corporation owns directly or indirectly any capital or profits interest
- ▶ Any person related under the related party rules to a person described above.

INCOME AND EXPENSES

FRINGE BENEFITS

In general, S corporations are treated like partnerships with regards to fringe benefits.

Employee fringe benefits are deductible and are not included in gross income of the employee.

2% shareholders are NOT considered to be employees but are treated like partners in a partnership. The following items are deductible by the corporation

but must be included in gross income of the 2% shareholder who is an employee.

- ▶ Medical expenses under Section 105(b)
- ▶ Accident and health care insurance premiums
- ▶ Cost of \$50,000 group term life insurance
- ▶ Cost of meals or lodging furnished for the convenience of the employer.

The following items are NOT deductible to the S corporation and are treated as a distribution from the corporation to the 2% shareholder. They must be separately stated on the K1:

- ▶ Expenses for product of income - Schedule A misc items including fees for preparing tax returns of shareholders
- ▶ Medical expenses
- ▶ Taxes, Interest (Schedule A items)
- ▶ Moving expenses
- ▶ IRA contributions.

Accident and Health Insurance Premiums

If paid by corporation on behalf of 2% shareholder employees must be included in wages on the W2 but is excluded for purpose of Medicare and FICA

ALLOCATION TO SHAREHOLDERS

GENERAL RULE

S corporation income and expense (loss) items are allocated on a **DAILY** basis.

If no change in stock ownership during the year - allocated based on stock ownership at **end of year**.

A shareholder who disposes of stock or dies is treated as the shareholder for the day of disposition or death.

Exception to General Rule:

Corporation may ELECT to allocate gains and losses as if the corporation had two different taxable years IF:

A shareholder disposes of all his shares.

Dispositions include sales, exchanges, gifts, spousal transfers and redemptions.

This election is irrevocable.

SELF CHARGED INTEREST

If a passive S shareholder is recognizing interest income on a loan made to the corporation and correspondingly recognizes interest expenses on that loan as it is passed through on the K!- the passive shareholder can treat the interest income as passive (instead of portfolio) if certain conditions are met.

RETIREMENT PLAN CONTRIBUTIONS

S corporation may establish retirements plans in same manner as C corporations and must follow the same rules with regard to discrimination, top heavy plans, distributions, etc.

Pass through income is not considered as earned income. Only the salary paid to the shareholders is included in computing the amount of contributions allowed.

Stockholders can not use pass through income from S corporation for purposes of making contributions to a SEP or KEOGH plan since this income is not considered to be income from self employment.

Stockholders can only use W2 income received from S corporation for purposes of making a contribution to an IRA.

SHAREHOLDER BASIS

**SHAREHOLDER LOSS FOR ANY TAXABLE YEAR IS
LIMITED TO**

**SHAREHOLDER'S ADJUSTED BASIS OF STOCK
plus
ADJUSTED BASIS FOR ANY DEBT OF THE CORPORATION
OWED TO THE SHAREHOLDER**

- ✓ Losses not deductible in the current year can be carried over and deducted as if incurred in the succeeding years.
- ✓ If suspended loss consists of more than just one type of loss (e.g. ordinary and capital) then any loss is carried over pro rata to the following year.
- ✓ The beneficiary of a QSST is generally allowed to deduct suspended losses under the at risk rules and the passive loss rules when the trust disposes of the 'S' corporation stock.
- ✓ If a shareholder's stock is transferred to a spouse, or to a former spouse incident to a divorce, any suspended loss or deduction with respect to that stock is treated as incurred by the corporation with respect to the transferee in the subsequent taxable year.

Basis is important for determination of:

- ✓ The amount of loss that can be deducted by shareholders
- ✓ Gain or loss upon stock disposition
- ✓ When distributions are taxable

ORIGINAL BASIS

- ✓ Acquired by Purchase - cost of the acquired shares
- ✓ Acquired by Incorporation - Basis of property contributed plus any gain recognized.
- ✓ Acquired by Inheritance - Fair market value of acquired shares
- ✓ Acquired by Gift -
 - If sold at a gain - donor's basis
 - If sold at a loss, lesser of donor's basis or FMV at date of gift.

SHAREHOLDER'S BASIS

ADJUSTMENTS TO BASIS

Generally, adjustments are made per share, per day, in following order:

Increased for

- ▶ Income (including tax exempt)
- ▶ Excess of depletion deductions over the basis for non-oil and gas properties.

Decreased for

- ▶ Non capital, nondeductible expenses and certain oil and gas depletion deductions.
- ▶ Distributions not included in income
- ▶ Losses and deductions.

Taxpayer not allowed basis for unpaid wages owed him

Taxpayer's basis is reduced because of rent free use of corporate property by shareholder or related parties.

Discharge of indebtedness income that is excluded from an insolvent S corporation's income does not increase shareholder basis.

Non-Deductible expenses includes only those items for which no loss or deduction is allowable. (illegal bribes, kickbacks, fines, penalties etc)

Non-deductible expenses does NOT include items for which the deduction is deferred to later years (i.e. disallowed shareholder salary accrued but not paid)

SHAREHOLDER'S BASIS

ADJUSTMENTS TO BASIS-TIME FOR ADJUSTMENTS (EFFECTIVE DATE)

Determined as of the last day of the year.

If shareholder disposes of stock - adjustments with respect to that stock made immediately prior to disposition

Income, loss and deduction items apply to adjust basis before distributions except for loss years.

During loss years, distributions are deducted first before deducting losses and deductions.

If an election is made to terminate the year under either Section 1377(a)(2) (Termination of a shareholder's entire interest) or Reg. 1.1368-1(g)(2) (disposition of more than 20% of the stock), then the adjustment rules apply as if there were separate tax years.

SMALL BUSINESS PROTECTION ACT CHANGED ORDER IN WHICH LOSSES AND DISTRIBUTIONS ARE CONSIDERED TO IMPACT BASIS.

EXAMPLE

(no accumulated E & P)

Jacob owns 100% of a calendar year S corporation. At the beginning of the year Jacob's basis in the stock is \$1,000. During the year the corporation has a capital gain of \$200, and operating loss of \$900 and makes a distribution to Jacob of \$600

	<u>NEW LAW</u>	<u>PRIOR LAW</u>
Basis at beginning of year	\$1,000.	\$1,000.
Capital gain	<u>200.</u>	<u>200.</u>
	\$1,200.	\$1,200.
Distribution	<u>(600.)</u>	<u>N/A</u>
Adjusted Basis	\$600	\$1,200
Allowable ordinary loss	<u>(600.)</u>	<u>(900.)</u>
Adjusted basis	0	300.
Distribution	N/A	<u>(600.)</u>
Capital Gain on excess distribution	0	300.
Operating loss carried forward	\$300.	-0-

Prior to 1997, Jacob would have an ordinary loss of \$900 and a capital gain of \$300. Under new law he has an ordinary loss of \$600 and an operating loss carryforward of \$300.

SHAREHOLDER'S BASIS

Basis can never be reduced below zero

Excess loss is suspended and carried forward indefinitely until basis is restored

Shareholder only increases basis for items of income IF those items were included in income on the shareholder's tax return.

Basis increased by debt

For tax years beginning on or after 1-1-94 new regulations

(Prior to 1-1-94 any reasonable manner)

Once a shareholder's basis in stock has been reduced to zero, losses and deductions can still be taken to the extent the shareholder has basis in **direct loans** to the S corp.

Debts owed by the corporation to third parties, even if personally guaranteed by the shareholder can not be added to shareholder's adjusted basis.

Suspended losses are attributed to the shareholder who owned the stock when the loss occurred. Ability to deduct the loss ends when any of the following occur:

- ▶ shareholder disposes of the stock
- ▶ shareholder dies
- ▶ S corporation election is terminated

Increase in basis in stock for corporate income is made only after any basis in loans that have been previously reduced is restored.

All open account debt is treated as a single debt.

Reduction in debt basis only applies to debt held on the last day of the year.

Multiple loans - reduction is applied to each loan in the same proportion that the basis of each loan bears to the total basis in all loans.

SHAREHOLDER'S BASIS

EXAMPLE

Jim made 3 loans to his S Corporation totaling \$20,000. He has NO stock basis. His basis in loan #1 had been previously reduced to zero. The current year loss is \$6,000. His basis in loan number 2 has been previously reduced to \$5,000.

<u>Loan #</u>	<u>Original Amount</u>	<u>Loan Basis Beginning Of Year</u>	<u>Allocated Loss</u>	<u>Loan Basis End of Year</u>
#1	\$ 6,000	-0-	-0-	-0-
#2	\$10,000	\$5,000	(\$3,333)	\$1,667.
#3	\$ 4,000	\$4,000	(\$2,667)	\$1,333.
<u>Total</u>	<u>\$20,000</u>	<u>\$9,000</u>	<u>(\$6,000)</u>	<u>\$3,000.</u>

Allocated loss is based upon relative basis in each debt

#1 \$5,000 loan basis x \$6,000 (loss) = \$3,333
 \$9,000 total loan basis

#2 \$4,000 (loan basis) x \$6,000 (loss) = \$2,667
 \$9,000 total loan basis.

SHAREHOLDER'S BASIS

RESTORATION OF DEBT BASIS

Only applies to debt held on the **first** day of the year

Debt repaid in whole or in part is restored prior to the restoration of other debt

Timing of restoration

Generally on last day of the year or

Termination of the shareholder's interest (immediately prior to termination)

Repayment of debt in whole or in part (immediately prior to repayment)

EXAMPLE

Assume the same facts as in prior example. Assume also that on January 15 of the following year, the company pays back loan #1 for \$6,000 and that the company earns \$10,000 of net income for the entire year.

<u>LOAN #</u>	<u>ORIGINAL LOAN</u>	<u>LOAN BASIS BEG.YR</u>	<u>ALLOCATED INCOME</u>	<u>LOAN PAYBACK</u>	<u>LOAN BASIS END YR.</u>
#1	\$6,000	-0-	\$6,000	(\$6,000)	-0-
#2	\$10,000	\$1,667.	\$3,030	-0-	\$4,697
#3	<u>\$ 4,000</u>	<u>\$1,333.</u>	<u>\$ 970</u>	-0-	<u>\$2,303</u>
Total	\$20,000	\$3,000	\$10,000	(\$6,000)	\$7,000

First allocation of net income must be to debt #1 (\$6,000) which is the amount required to restore basis on the repaid debt.

Next allocation of net income is based on following formula:

$$\text{(Remaining net income increase)} \times \frac{\text{Loan Basis Reduction}}{\text{Total Loan Basis Reduction}}$$

Loan #2 \$4,000 x (\$8,333/11000) = \$3030

Loan #3 \$4,000 x (\$2,667/11000) = \$ 970
\$4,000

SHAREHOLDER'S BASIS

REPAYMENT OF REDUCED BASIS DEBT WILL RESULT IN RECOGNITION OF INCOME BY THE SHAREHOLDER.

If the debt is evidenced by a note, the repayment is treated as a sale or exchange and subject to capital gain rules.

EXAMPLE

Peggy is the sole shareholder in her gift shop, a calendar year S corporation. In 2008, she loans the corporation \$40,000. The company had a bad year and the 2008 loss was \$30,000. Peggy has no stock basis. Basis in debt was reduced in 2008 to \$10,000 (\$40,000-\$30,000 loss). In 2009 the business finally took off and had a net profit of \$20,000. The company paid back the \$40,000 loan in full. (Good deal if you can pay back this much debt with only \$20,000 profit!!! - Assume a bank loan provided funds)

Loan repayment	\$40,000
Loan basis 1-1-2008	\$10,000
2009 Income	<u>\$20,000</u>
Loan basis increased to	<u>\$30,000</u>
Income	<u>\$10,000</u>

2009 income is applied in total to repaid debt. Excess is additional income.

SHAREHOLDER'S BASIS

DISTRIBUTIONS - BASIS REDUCTION

Distributions from S Corporation never reduce *BASIS BY DEBT*.

The shareholder will recognize income to extent distributions exceed *STOCK BASIS*

EXAMPLE

Micky Mouse formed an S corporation for his Minnie Market in 2008. He contributed \$10,000 in stock and \$20,000 in loans. In 2008 the market lost \$10,000 leaving Micky with no stock basis and \$20,000 debt basis. Since Micky doesn't really understand all he should about this "S" corporation "stuff", he finds the market has some funds in 2009 and so he takes a distribution of \$5,000.

	<u>Stock Basis</u>	<u>Loan Basis</u>	<u>Total Basis</u>
1-1-2008	\$10,000	\$20,000	\$30,000
2008 Loss	<u>(10,000)</u>	<u>-0-</u>	<u>(10,000)</u>
1-1-2009	\$ -0-	\$20,000	\$20,000

The \$5,000 distribution will be treated as a capital gain because Micky had no STOCK basis. He should have treated the \$5,000 as a DEBT REPAYMENT! If he had done so, he would have not had income from the repayment transaction. Be aware of reduced basis debt repayment rules (prior)

SHAREHOLDER'S BASIS

SPECIAL ELECTION

Shareholders may make an election to decrease basis by deductible items before reducing basis by non-capital, nondeductible expenses and certain oil and gas depletion deductions.

If made, the election allows any excess costs (above) to be carried over to the next year.

Sec. 1366(d)(2) - no election - apparently no carryover.

Election cannot be revoked without permission from the commissioner.

Election is made on shareholder's timely filed original or amended return

Effect: More deductible items may be allowed.

STEP UP BASIS

Step up basis is available for surviving shareholders in cash basis S corporation. Shareholders may wish to terminate the S corporation year under Sec. 1377(a)(2) and file two tax years.

INHERITED STOCK

Basis of inherited S stock is reduced by income in respect of a decedent.

S CORPORATION BASIS WORKSHEETS

Table I - **Stock** basis

▶	Prior year basis (not less than zero)	_____
2.	Capital additions (contributions, purchases etc.)	_____
3.	Income items.....	_____
4.	Subtotal	_____
5.	Distributions (not more than line 4 - excess to schedule D)	_____
6.	Subtotal (Line 4 less line 5)	_____
7.	Nondeductible expenses (K1-line 19; loss not to exceed line 6 Excess loss to loan basis worksheet).....	_____
8.	Subtotal (line 6 less line 7)	_____
9.	Loss items (not to exceed line 8, excess to loan basis worksheet)	_____
10.	Subtotal (line 8 less line 9)	_____
11.	Loan restoration (from loan basis worksheet)	_____
12.	Stock basis - end of year (line 10 less line 11 -not less than zero)..	_____

Table II - **Shareholder Loans**

1.	Balance beginning of year	_____
2.	New loans	_____
3.	Loan paybacks (from Schedule K-1 line 21)	_____
4.	Balance end of year (Line 1 plus line 2 less line 3)	_____

Table III **Loan Basis**

1.	Prior year balance	_____
2.	Restoration of basis	_____
3.	New loans	_____
4.	Subtotal (add lines 1 - 3 ..)	_____
5.	Loan payback (not to exceed line 4 -excess is income)	_____
6.	Subtotal (line 4 less line 5)	_____
7.	Excess loss (nondeductible items) from Table 1, line 7 not to exceed line 6, excess loss to suspended loss)	_____
8.	Subtotalline 6 less line 7	_____
9.	Excess loss (deductible items) from Table I line 9 - not to exceed line 8, excess loss to suspended losses).....	_____
10.	Loan basis end of year (line 8 less line 9)	_____
11.	Total basis - stock and loans (Table 1, line 12 plus Table III Line 10	_____

**AT RISK RULES
AND
PASSIVE ACTIVITY
RULES**

AT RISK RULES

Even though shareholders have basis, losses are still only deductible if the shareholder is at risk for those amounts.

At risk rules apply only at shareholder level.

In general, basis and at risk amounts are the same except when the shareholder lends money to the corporation that was obtained from:

Non recourse borrowing

From another person who has an interest (other than a creditor) in the company.

Losses that are disallowed due to the At Risk rules can be carried over until At-Risk amounts are generated in subsequent years.

SALE OF STOCK

Sale of stock in an S corporation gain or loss is computed in the same manner as for the disposition of any other capital asset.

Losses which flow through on a K1 can reduce basis to zero but **not below**

If stock is sold with a zero basis, the gain is equal to the total proceeds.

Suspended losses are NOT used to reduce gain on disposition of stock. Neither are they deductible in year of disposition. They simply go away.

PASSIVE ACTIVITY RULES

Passive activity rules apply to S corporation shareholders **at shareholder level.**

S corporation must identify all items that may affect determination of passive activity loss and separately state these items to be passed through to the stockholders.

It is possible to be passive with regard to one or more activities of an S corporation and non-passive with regard to other activities of the same S corporation.

When S corporation passes through a passive loss which is disallowed to a shareholder under PAL rules, the amount of the shareholders pro rata share of the loss **still reduces basis of stock** in the corporation.

When a C corporation makes an S election, any previously suspended passive losses do not become available to the shareholders to be used on their returns. They remain locked in the corporation only to be used if the corporation terminates its S election.

Suspended PALS from C years are not freed up when S corporation sells rental properties.

When S corporation terminates its S election and continues as a C corporation, prior passive losses suspended at stockholder level become suspended losses of a fictitious activity called “a C corporation activity”. Unused losses are taken when taxpayer has passive income from other activities.

When Stockholder disposes of stock in S corporation, it is necessary (in order to compute allowable suspended losses) to pro rate any gain or losses between:

- Each trade or business activity
- Each rental activity
- Investment activities

Capital gains from sale or exchange of stock or securities not items of passive investment income after May 25, 2007 (2008 for calendar-year taxpayers.).

S CORPORATION

TAXES

S CORPORATION TAXES

As a general rule, S corporations pay no tax at the corporate level. All income and deduction items are “passed through” to shareholders in much the same manner as in a partnership.

EXCEPTIONS TO GENERAL RULE

TAX ON EXCESS NET PASSIVE INCOME

- ★ Corporation must have pre-S earnings and profits at end of the year
- ★ Corporation must have passive income in excess of 25% of gross receipts.

This tax will never apply to a corporation which has always been an S corporation

Gross receipts include:

- ✓ Total sales received or accrued before allowing for sales returns and allowances, Cost of goods sold, or deductions.
- ✓ Gain from sale of stock and securities. (Losses from these sales does not reduce gross receipts)
- ✓ Capital gain net income from disposition of assets other than stock and securities
- ✓ Gross dividends, interest, etc
- ✓ Rents and royalties.

Gross receipts does NOT include:

- ✓ Nontaxable sale or exchange except to extent gain is recognized
- ✓ Deferred portion of an unrecognized gain from installment sales except for installment sales of publicly traded stocks and securities.

Passive investment income includes:

- ✓ Dividends
- ✓ Interest (including tax exempt interest)
- ✓ Rents (except where rental is an active trade or business and the corporation provides services or incurs substantial costs in the rental business.
- ✓ Royalties
- ✓ Gain on sale of stock and securities (losses on these sales does not decrease passive income)
- ✓ Annuities.

Net passive income:

Passive investment income reduced by deductions directly connected with the production of passive investment income

Rate of Tax: 35% - Excess net passive income cannot be more than the taxable income for the year computed as if the corporation was a C corporation.

There is no tax on excess net passive income for a year that the corporation incurs a loss.

Tax paid on excess passive income used to reduce items of passive income passed through to shareholders.

IRS may waive tax on net passive income if corporation believed that it had no pre-S E&P and E&P were distributed within a reasonable period of time after realizing that it had E&P

AUTOMATIC TERMINATION OF S ELECTION OCCURS IF CORPORATION HAS EXCESS NET PASSIVE INCOME FOR THREE CONSECUTIVE YEARS AND HAS PRE-S CORPORATION EARNINGS AT THE END OF EACH YEAR.

S CORPORATION TAXES

TAX ON BUILT IN GAINS

Gain is recognized at the corporate level if appreciated property held at the same time of conversion is sold or distributed within ten years of date of the S election.

Not applicable to subsequent appreciation
Not applicable to property acquired after conversion.

Built in Gain - the amount by which the fair market value of an asset exceeds its basis at the time of conversion to S status.

Applies to:

- ✓ Assets held by C corporation that converted to S status after 1986
- ✓ Any other asset acquired from a C corporation in which the S Corporation's basis in the assets is determined by reference to the C corporation's basis in the asset.

The built in gains tax will not apply to corporations which made the S election prior to 1987 or which were formed after 1986 but have always been S corporations.

Exception - qualified corporations that converted to S status prior to January 1, 1989. "Qualified" - those that on August 1, 1986 and all times up to time of conversion were more than 50% owned by 10 or fewer persons and had a value of \$10,000,000 or less. Such qualified corporations can avoid the BIG tax on long term capital gain property only. Benefit phases out for corporations with values between \$5 million and \$10 million.

COMPUTATION OF BIG (built in gains) TAX

Net recognized built in gain
Minus Allowed NOL or capital loss carryovers
Equals - taxable amount
X applicable rate
Equals tentative tax
Minus allowed credit carryover
Equals BIG tax

S CORPORATION TAXES

TAX ON BUILT IN GAINS

Net recognized built in gain

Lesser of:

- ✓ Recognized built in gain for the year
- ✓ Taxable income as if corporation were still a C corporation
- ✓ Amount by which the net unrealized built -in gains computed at beginning of the first year as an S corporation exceeds the NRBIG for all prior years

Tax rate - 35%

Credits against tax Unused C corporation credit carryforwards can reduce BIG tax.

Passthrough - Tax is treated as a deductible loss passed on to the shareholder at the character of the gains that gave rise to the BIG tax

Built in losses - can only offset recognized built in gains to extent the loss and gain are recognized in the same year. No carryover provision for excess built in losses. No built in loss recognized if sold to related party.

Receivables and Payables - C corporation assumes accrual basis for items of income and expense.

Related parties - To be recognized as built in loss, for 5% or greater stockholders, the amount must be paid within the first 2 ½ months of the first S corporation year.
No built in loss is allowed for accruals to greater than 50% stockholders.

Cash basis personal service corporation that elects S status is subject to built in gains tax on accounts receivable outstanding at date of election. Can be reduced or eliminated by paying out compensation within 2 ½ months for up to 50% stockholders, or by making sure that the corporation does not have a net income for ten years after becoming an S corporation. (Adjusting compensation to stockholders)

Inventory valuation on conversion to S corporation - final Reg. 1.1374-4(c) - value generally will be less than retail but greater than replacement cost.

Installment sales made on or after 3-26-90 which occur either before or during the ten year recognition period are subject to the BIG tax even though the payments may be received outside the 10 year recognition period. Reg. 1.374-H(2)

Partnership Matters - If S corporation holds partnership interest at conversion the regulations require that for each year of the recognition period a look-through approach is adopted (Reg. 1374(d)

Not applicable to any year in which FMV of partnership interest is under \$100,000 AND the partnership interest is under 10% of the partnership capital and profits.

Applicable to years ending on or after Dec. 27, 1994

Completed contract Method- for work in progress under such method at time election is effective amount of built in gain or loss is amount that would have been included in income or allowed against income if corporation had been using the percentage of completion method of accounting

S CORPORATION TAXES

TAX ON CERTAIN CAPITAL GAINS

Conditions that must be present before this tax is applicable

- ✓ S election made prior to 1987 (or during 1987 and 1988 under transitional rule)
- ✓ Net long term capital gain exceeds net short term capital loss by more than \$25,000
- ✓ Excess capital gain is more than 50% of the corporation's taxable income
- ✓ Taxable income is more than \$25,000
- ✓ Part or all of the gain results from sale of substituted basis property
- ✓ For above, taxable income is figured with certain modifications as if the corporation was a C corporation.

Substituted basis property is

- ✓ Property acquired from a C corporation during the tax year, or three prior years
- ✓ Basis determined by reference to the basis in the hands of the C corporation.

Purpose of the tax

- ✓ To prevent a non-taxable transfer of property from "C" to "S" corporation before being sold at a gain by the S corporation.

Relationship to tax on net passive income

- ✓ If the corporation is liable for tax on excess net passive income as well as the tax on capital gains, the corporation must reduce its capital gains to the extent they are subject to tax on excess net passive income

The tax rate

- ✓ 35%

Long term capital gain amount	\$250,000
Short term capital loss amount	<u>(100,000)</u>
Excess	\$150,000
	<u>\$(25,000)</u>
Taxable Excess:	\$125,000
Tax at 35%	\$ 43,750

S CORPORATION TAXES

TAX FROM RECOMPUTING PRIOR YEAR INVESTMENT CREDIT

S corporation must complete form 4255 and pay the recapture tax if the S corporation was formerly a C corporation and had taken investment tax credit and the asset is disposed of prematurely.

LIFO RECAPTURE TAX

S Election must have been made after December 17, 1987
Corporation used LIFO for its last year before its S election became effective.

Excess of inventory amount using FIFO over inventory amount using LIFO at close of the C corporation's last year.

Tax is computed for pre-S corporation's last tax year

Paid in four equal installments
First due with the C corporation's final form 1120
Next three paid with 1120S for next three years

ESTIMATED TAX PAYMENTS

For taxable years beginning after 1989, S corporations must make estimated tax payments at corporate level for income tax of \$500 or more resulting from

- ✓ Built in gain tax
- ✓ Investment credit recapture tax
- ✓ Passive investment income tax
- ✓ Certain capital gains tax.

The LIFO recapture tax is not included in determination of amount of estimated tax payments.

Due dates for estimates are the same as for other corporations

THE 'LOOK THROUGH LIFO RECAPTURE'

A 'C' corporation that converts to 'S' corporation status must include in gross income the look-through LIFO recapture amounts attributable to partnerships in which it owns an interest. Effective 08/14/2004.

**DISTRIBUTIONS
TO
SHAREHOLDERS**

**AAA ACCOUNT
“C” EARNINGS AND PROFITS
OTHER ADJUSTMENTS ACCOUNT**

S CORPORATION RETAINED EARNINGS RECONCILIATIONS

ACCUMULATED ADJUSTMENTS ACCOUNT (AAA)

Because all income and expense items are passed through to shareholders, an S corporation generally has no earnings and profits. In accounting for this, all items are debited or credited to AAA.

Generally the AAA account is a credit account. It can, however, go below zero and have a debit balance.

Distributions can reduce AAA but not below zero. Distributions are tax free to the shareholder to the extent of shareholder's stock basis. Excess of basis is a capital gain.

Accumulated Adjustments Account	
Decreases (DR)	Increases (CR)
Non separately computed loss <u>Separately passed through items:</u> Capital losses Section 1231 losses Wagering losses Contributions Foreign taxes Circulation expenditures Research and experimental expenditures Intangible drilling costs Development expenditures Mining and exploration Schedule A deductions Investment Interest expense Section 179 expense deduction Other expenses not mentioned Distributions (AAA must be positive)	Non separately computed income <u>Separately passed through items:</u> Capital Gains Sec. 1231 Gains Wagering gains Dividends qualifying for exclusion Recovery of bad debts etc to which tax benefit rules apply Other items of income not mentioned above

Separate accounts for each shareholder are not required.

AAA belongs to corporation, not shareholders

At beginning of S corporation, the AAA is zero

AAA is reduced by all S corporation losses even if the losses are suspended at the shareholder level.

S CORPORATION RETAINED EARNINGS RECONCILIATIONS

“C” CORPORATION RETAINED EARNINGS ACCOUNT

C Corporations having earnings and profits which were not distributed prior to becoming an S corporation will have retained earnings account.

Distributions from this account are taxable to the shareholders as dividends.

OTHER ADJUSTMENTS ACCOUNT (OAA)

This account contains tax exempt items such as tax exempt interest and expenses incurred to receive tax exempt interest.

Distributions from this account are tax free.

DISTRIBUTIONS ORDERING

- 1st - From AAA account..... - not taxable
- 2nd - From C Corp Retained Earnings account..... - taxable as dividend
- 3rd - From OAA account..... - not taxable
- 4th - From capital contributed (basis)..... - return of capital

Excess distributions - capital gain

ADJUSTMENTS TO AAA SINCE SMALL BUSINESS JOB PROTECTION ACT

Prior to 1997 the AAA and shareholder basis accounts were generally made the same for determination of tax effect of distributions. First both increased for positive items, then both decreased for negative items and finally both decreased for distributions.

NEW LAW - adjustments are no longer the same

Shareholder basis now first increased by positive items regardless of negative items before considering distributions.

AAA is adjusted before distributions only if there is a net positive adjustment for the year and only to the extent of the net adjustment.

S CORPORATION RETAINED EARNINGS RECONCILIATIONS

EXAMPLE

Mary Lamb is sole shareholder of "Lamb Inc." She operates as a C corporation until 1-1-08 at which time she elects S status. At the time of conversion, the company is showing accumulated E & P of \$10,000. Her stock basis is \$15,000. For 2008 the company reports \$20,000 of taxable income and \$8,000 of tax exempt income. In 2009, the corporation shows a loss of \$9,000. The company distributes \$30,000 in 2008 and \$22,000 in 2009.

<u>2008</u>	<u>AAA</u>	<u>E&P</u>	<u>OAA</u>	<u>Total R/E</u>	<u>Stock Basis</u>
1-1-08	-0-	\$10,000	-0-	\$10,000	\$15,000
2008 Income	\$20,000		\$8,000	28,000	28,000
Distribution	<u>(20,000)</u>	<u>(10,000)</u>		<u>(30,000)</u>	<u>(20,000)</u>
<u>12-31-08</u>	<u>\$ -0-</u>	<u>-0-</u>	<u>\$8,000</u>	<u>\$ 8,000</u>	<u>\$23,000</u>
<u>2009</u>					
Distribution			(8,000)	(\$8,000)	(\$22,000)
2009 Loss	<u>(\$9,000)</u>			<u>(\$9,000)</u>	<u>(1,000)*</u>
<u>12-31-09</u>	<u>(\$4,000)</u>	<u>-0-</u>	<u>-0-</u>	<u>(4,000)</u>	<u>\$ -0-</u>

*2009 loss limited to \$1000 stock basis - balance of loss will be carried over

**S CORPORATION RETAINED EARNINGS
RECONCILIATIONS**

Lambs, Inc. has accumulated earnings and profits of \$1000 at the beginning of its first year as an S corporation (\$0 AAA) The corporation has a capital gain of \$400 and an ordinary loss of \$100 (a net positive adjustment of \$300). It makes a distribution of \$500 to the stockholders.

	<u>AAA</u>	<u>A E&P</u>
Beginning balance	\$ -0-	\$ 1000
Capital gain	\$400.	
Operating loss	(100.)	
<u>Net positive adjustment</u>	<u>\$300.</u>	
Amount which can be distributed tax free	\$300	
Distribution	(300.)	(\$ 200.)
Ending balance	-0-	\$ 800.
=====		

EXAMPLE BASIS CALCULATIONS

	<u>NEW LAW</u>	<u>OLD LAW</u>
Beginning of the year	\$ 200	\$200
Add positive items	\$ 400	\$400
Less negative items	<u>N/A</u>	<u>(100.)</u>
	\$ 600	\$500
Distribution tax free	(300)	(500)
Dividend taxable \$100	<u> </u>	<u>NA</u>
	\$ 300	-0-
Operating loss	<u>(\$100)</u>	
End of year	<u>\$ 200.</u>	

S CORPORATION RETAINED EARNINGS RECONCILIATIONS

Section 1368 - In applying this section to distributions made during any taxable year, the amount in the accumulated adjustments account as of the close of the year shall be determined without regard to any net "negative" adjustment.

Lambs, Inc. has accumulated earnings and profits of \$1000 at the beginning of its first year as an S corporation (\$0 AAA) The corporation has a capital gain of \$100 and an ordinary loss of \$400 (a net NEGATIVE adjustment of \$300). It makes a distribution of \$500 to the stockholders

	<u>AAA</u>	<u>A E&P</u>
Beginning balance	\$ 0-	\$1000
Distribution		(500.)
Capital gain	\$ 100.	
Ordinary loss	<u>(\$400.)</u>	
Net negative adjustment	(\$300.)	
 Ending balance	 (\$300)	 \$500.

Distribution considered before net negative adjustment resulting in the entire amount of the distribution being a dividend paid out of A E & P.

Intent of legislature? - To prevent a tax free distribution of the \$100 which has not been taxed to the shareholder due to net negative adjustments flowing to the form 1040.

S CORPORATION RETAINED EARNINGS RECONCILIATIONS

ELECTION TO DISTRIBUTE E & P BEFORE AAA (Reg. 1.1368-1)

Election would

- ▶ Eliminate tax on passive income
- ▶ Preserve "S" election where passive income has exceeded gross receipts by 25%
- ▶ Utilize a personal NOL
- ▶ Take advantage of investment interest expense that cannot be otherwise deducted.

Election made on year-to-year basis

Two elections provided:

- ▶ Election to bypass AAA
- ▶ Election to make a deemed dividend

STOCK REDEMPTIONS

AAA is adjusted to reflect ratable share of stock redeemed.

Homes, Inc., a calendar year corporation, is owned equally by Betty Home and Jeff Homeless. As of 12-31-08 the company had \$80,000 in AAA. During 2009 the company earned \$200,000. There were no distributions in 2009. On June 30, 2009 the company redeemed all of Betty's shares for \$140,000. The company elected to terminate the S year at 6-30-09.

AAA balance 12-31-08	\$80,000
Income 6-30-09 (6 mo/12 mo x \$200,000)	<u>100,000</u>
Subtotal	180,000
Redemption 50% x \$180,000	<u>(90,000)*</u>
AAA Balance 6-30-09	\$ 90,000

***Based on 50% ownership**

Book entry:

Capital stock	\$ 50,000
AAA	\$ 90,000
Cash	\$140,000

Assume the company made a \$60,000 distribution in March of 2009

AAA balance 12-31-08	\$80,000
Income	100,000
Distribution	<u>(60,000)</u>
Subtotal	120,000
Redemption	<u>(60,000)</u>
AAA balance 6-30-09	\$ 60,000

Book entry:

Capital stock	\$ 80,000
AAA	\$ 60,000
Cash	\$140,000

TERMINATING 'S' ELECTION

TERMINATION OF SUB S ELECTION

Once election is made under Sub S, it is in effect until it is terminated in one of the following ways:

- **Revocation** - by consent of shareholders who, at the time revocation is made, hold more than 50% of number of issued and outstanding shares of stock (including non-voting stock), effective on date of revocation or a date in the future

● **Disqualification:**

● **If corporation ceases to be "small business corporation"**

- more than 100 stockholders
 - nonresident alien shareholder acquires stock
 - another corporation, partnership or unqualified trust acquires stock
 - more than one class of stock issued
- Attach to form 1120S for final year of S corporation, a statement notifying IRS of the termination and date it occurred.

● **Passive Investment Income AND Accumulated Earnings and Profits**

If more than 25% of corporations gross receipts constitute passive investment income for each of three consecutive tax years.

Passive investment income: gross receipts from royalties, rents, dividends, interest and annuities and gain from sale or exchange of securities or stock.

Not applicable to electing corporation for first or second taxable year of active conduct of trade or business if passive income is less than \$3,000.

AND Has E&P from years when it was a C corporation
For first tax year beginning after 1996, an S corporation Earnings and profits is reduced (as of the first day of that year) by the E & P accumulated from any tax year beginning before 1983 when the corporation was a subchapter S corporation. Thus, an S corporations E& P after 1996 is solely attributable to tax years when the corporation did NOT have an S election in effect.

TERMINATION OF SUB S ELECTION

TERMINATION OF ELECTION SHOULD BE REFLECTED IN MINUTES OF THE CORPORATION

If election terminated under “disqualification rules” and the corporation believes the termination was inadvertent, the corporation may request permission from the IRS to continue to be treated as an S corporation for a specified period if the corporation takes the steps needed to perfect the election.

THERE IS NO MINIMUM NUMBER OF SHAREHOLDERS NEEDED TO INTENTIONALLY DISQUALIFY AN S CORPORATION STATUS

Any shareholder can cause the election to be terminated by transferring one of his or her shares to a disqualified shareholder.

S CORPORATION STATUS MAY BE PRESERVED IF IT IS ACCIDENTALLY TERMINATED

S corporation treatment may still apply if ALL conditions are met:

- IRS determines that the termination was inadvertent
- Within a reasonable time after discovery, steps are taken to correct so that the corporation again qualifies
- The corporation and each person who was a shareholder at any time during the period between terminating event and the corrective action agree to make the adjustments required by IRS

WHEN TERMINATION OCCURS IN MID YEAR TWO TAX RETURNS MUST BE FILED FOR THAT ‘TERMINATION YEAR’ (1120 AND 1120S)

REAPPLYING FOR S CORPORATION STATUS AFTER TERMINATION

After termination, neither corporation nor any successor corporation will be eligible for a new election until its fifth taxable year that begins after the first taxable year for which the termination was effective.

The small business job protection Act of 1996 - change
For purposes of the 5 year waiting period that generally applies to an election to be an S corporation after a prior termination, any termination in a tax year beginning before 1997 is not taken into account.

A short taxable year can count toward the five year waiting period

A former S corporation that files bankruptcy under Chapter 11 and wishes to reelect Subchapter S status after emerging from bankruptcy is subject to the five year waiting period.