National Society of Tax Professionals

presents

Introduction to and Overview of the Subchapter S-Corporation:
From Start-Up and Operation to Liquidation

Developed, Written and Presented by
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Suggested References:
   • IRS Form 1120S......................................................................................................................................................
   • IRS Form 2553 Election by a Small Business Corporation and Instructions ..............................................................................................................................................
   • IRS Form 8832 Entity Classification Election and Instructions ..............................................................................................................................................
• IRS Rev. Proc. 2013-30

• Relief for Late S Corporation Elections

• Relief for Late S Corporation and Entity Classification Elections for the Same Entity
I. Subchapter S-Corporation

A. Pass Through Entity

1. In 1958 Congress passed the Small Business Corporation Act which created an entity for tax purposes which would help safeguard the family owned business allowing legal protection and the pass-through of profits and losses to the individual owners without incurring taxes at the corporate level and again through the distribution of dividends to the owners of the family-owned business.

2. It also allowed the use of the business loss to be passed down to the owners instead of being locked in at the entity level. It was truly for small family businesses and the number of shareholders was limited to 5 individuals. The latest Statistics of Income Bulletin (SOI) reports the data on Tax Year 2013 and reports that there were 4,257,999 Subchapter S-Corporations in 2013 and the number of shareholders were 7,074,711. The total receipts generated in 2013 was over $6 trillion at $6,890,936,496,000. The business receipts generated were $6,745,095,028,000 with the balance coming from investment vehicles.

3. Total deductions were $6,507,752,631,000 and of that amount $253,983,002,000 was compensation of Officers. Rent on business property generated $168,701,179,000 of deductions. Net income generated $515,948,187,000.

4. The number of returns with net profits were 2,913,280 with 4,802,663 shareholders. It is obvious that the Subchapter S-Corporation is an entity that has evolved into an entity of choice for many small businesses.

5. In terms of the manner in which it functions for non-tax issues a Subchapter S-Corporation is just like a Subchapter C-Corporation. An S-Corporation combines the business and legal characteristics of a C-Corporation.

6. S-Corporations have the features of:
   a. Limited liability for the owners,
   b. Operates with a management group, and
   c. Has a board of directors and officers.

7. S-Corporations differ from C-Corporations in regard to income tax matters. An S-Corporation is a “pass through” entity. It has many of the federal income tax characteristics of a partnership. The corporation acts as a conduit through which the tax attributes flow through to shareholders on a pro-rata method. Large and public companies generally cannot elect S-Corporation status. Many small businesses have made it the entity of choice.

8. Double taxation of corporate earnings is avoided because there is generally no corporate-level income tax. Earnings are taxed only once at the shareholder level in the year when earned (regardless of when they are distributed).
9. §6072(b) provides that an S-Corporation must file an annual return on IRS Form 1120S, *U.S. Income Tax Return for a Corporation* by the 15th day of the third month following the close of the corporation’s tax year. The law provides that the return must be filed until liquidated. Therefore, even if there is no activity in the current tax year the return is required to be filed.

**TAX PROFESSIONAL RED ALERT:** There is a monthly penalty for the failure to file a Form 1120S. §6699 provides an S-Corporate level penalty of $195 per shareholder per month or fraction of a month up to 12 months for the failure to file an S-Corporation return. For tax years after 2014 the amount is indexed to inflation annually in $5 increments.

10. An automatic 6-month extension is granted for filing the Form 1120 by filing IRS Form 7004 by the 15th day of the 3rd month after the end of the tax year. The Form Code is 25. Since the Schedule K-1 is an information return §6721 provides for a $250 penalty for failure to file a Schedule K-1 with the IRS.

11. §6722 provides for a $250 corporate level penalty per shareholder for failure to provide Schedule K-1 to shareholders or failure to include all the required information. This penalty is indexed to inflation in $5 increments.

**Tax Professional Note:** For 2016 returns the penalty under §6721 and §6722 is $260.

**B. Formation**

1. Since a Subchapter S-Corporation is only a filing status for Federal Income Tax purposes the formation of the corporation is dictated by state statute the same way as is a regular C-Corporation. Therefore, the same formalities are required such as:

   a. Written Corporate Charter
   b. Articles of Incorporation
   c. Adoption of Written By-Laws
   d. Election of a Board of Directors
   e. Holding of Organizational Meetings
   f. Written Minutes of Organizational Meetings
   g. Stock Certificates
   h. Franchise Fees
   i. Registered Agent

2. The significant difference between a Subchapter S-Corporation and a regular C-Corporation is that a formal election must be made by the corporation to be treated as a Subchapter S-Corporation for Federal Income Tax purposes.

**Tax Professional Reminder:** The “election” is valid only if all shareholders “consent to the election.”
C. Form of Consent

1. §1362(a) (2) provides that all shareholders must consent to the election by signing IRS Form 2553, Election by a Small Business Corporation. The required consent may be provided on the Form 2553 or on a separate statement attached to the election. Once made, an election continues until a disqualifying act or shareholders affirmatively revoke the election.

2. §1362(b) (2) requires that the election must be filed with the Service by the 15th day of the third month of the taxable year in which the election is to take effect. The election must be signed by a person authorized to sign the corporation’s tax return.

3. The corporation must meet all of the eligibility requirements for the pre-election period of the tax year, and all persons who were shareholders during the pre-election period also must consent to the election.

4. §1362(b)(3) provides that if the election is filed after the 15th day of the third month then the S-Corporation status does not take effect until the beginning of the following tax year.

Example 1 No Prior Tax Year: A calendar year small business corporation begins its first tax year on January 7. The 2-month period ends March 6 and 15 days after that is March 21. Therefore in order to be an S corporation beginning with its first tax year, the corporation must file Form 2553 during the period that begins January 7 and ends March 21. Because the corporation had no prior tax year, an election made before January 7 will not be valid.

Example 2 Prior Tax Year: A calendar year small business corporation has been filing Form 1120 as a C corporation but wishes to make an S election for its next tax year beginning January 1. The 2-month period ends February 28 (29 in leap years) and 15 days after that is March 15. Therefore in order to be an S corporation beginning with its next tax year, the corporation must file Form 2553 during the period that begins the first day (January 1) of its last year as a C corporation and ends March 15th of the year it wishes to be an S corporation. Because the corporation had a prior tax year, it can make the election at any time during that prior tax year.
Example 3 Tax Year Less than 2 ½ Months: A calendar year small business corporation begins its first tax year on November 8. The 2-month period ends January 7 and 15 days after that is January 22. To be an S corporation beginning with its short tax year, the corporation must file Form 2553 during the period that begins November 8 and ends January 22. Because the corporation had no prior tax year, an election made before November 8 will not be valid.

D. Relief Provisions Available For Failing to Make a Timely Election

1. Relief for Late Elections

The following two sections discuss relief for late S corporation elections and relief for late S corporation and entity classification elections for the same entity. For supplemental procedural requirements when seeking relief for multiple late elections, see Rev. Proc. 2013-30, section 4.04.

When filing Form 2553 for a late S corporation election, the corporation (entity) must write in the top margin of the first page of Form 2553 “FILED PURSUANT TO REV. PROC. 2013-30”. Also, if the late election is made by attaching Form 2553 to Form 1120S, the corporation (entity) must write in the top margin of the first page of Form 1120S INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30.”

The election can be filed with the current Form 1120S if all earlier Forms 1120S have been filed. The election can be attached to the first Form 1120S for the year including the effective date if filed simultaneously with any other delinquent Forms 1120S. Form 2553 can also be filed separately.

- Relief for a Late S Corporation Election Filed by a Corporation

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

To request relief for a late election, a corporation that meets the following requirements can explain the reasonable cause in the designated space on page 1 of Form 2553.

1. The corporation intended to be classified as an S corporation as of the date entered on line E of Form 2553;
2. The corporation fails to qualify as an S corporation on the effective date entered on line E of Form 2553 solely because Form 2553 was not filed by the due date;

3. The corporation has reasonable cause for its failure to timely file Form 2553 and has acted diligently to correct the mistake upon discovery of its failure to timely file Form 2553;

4. Form 2553 will be filed within 3 years and 75 days of the date entered on line E of Form 2553; and

5. A corporation that meets requirements (1) through (4) must also be able to provide statements from all shareholders who were shareholders during the period between the date entered on line E of Form 2553 and the date the completed Form 2553 is filed stating that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and all subsequent years.

   Note: Completion of Form 2553, Part I, column K, Shareholder's Consent Statement (or similar document attached to Form 2553), will meet this requirement; or

6. A corporation that meets requirements (1) through (3) but not requirement (4) can still request relief for a late election on Form 2553 if the following statements are true.

   a. The corporation and all its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent tax year (if any);

   b. 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; and

   c. Neither the corporation nor any of its shareholders was notified by the 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.

   Note: To request relief for a late election when the above requirements are not met, the corporation generally must request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2014-1, 2014-1 I.R.B. 1 (or its successor).
Relief for a Late S Corporation Election Filed By an Entity Eligible To Elect To Be Treated as a Corporation

A late election to be an S corporation and a late entity classification election for the same entity may be available if the entity can show that the failure to file Form 2553 on time was due to reasonable cause. Relief must be requested within 3 years and 75 days of the effective date entered on line E of Form 2553.

To request relief for a late election, an entity that meets the following requirements can explain the reasonable cause in the designated space on page 1 of Form 2553.

1. The entity is an eligible entity as defined in Reg.§301.7701-3(a)
2. The entity intended to be classified as an S corporation as of the date entered on line E of Form 2553.
3. Form 2553 will be filed within 3 years and 75 days of the date entered on line E of Form 2553.
4. The entity failed to qualify as a corporation solely because Form 8832 was not timely filed under Reg.§301.7701-3(c)(1)(i) 8832, or Form 8832 was not deemed to have been filed under Reg.§301.7701-3(c)(1)(v)(C).
5. The entity fails to qualify as an S corporation on the effective date entered on line E of Form 2553 because Form 2553 was not filed by the due date.
6. The entity either:
   a. Timely filed all Forms 1120S consistent with its requested classification as an S corporation, or
   b. Did not file Form 1120S because the due date for the first year's Form 1120S has not passed.
7. The entity has reasonable cause for its failure to timely file Form 2553 and has acted diligently to correct the mistake upon discovery of its failure to timely file Form 2553.
8. The S corporation can provide statements from all shareholders who were shareholders during the period between the date entered on line E of Form 2553 and the date the completed Form 2553 is filed stating that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and all subsequent years. Completion of Form 2553, Part I, column K, Shareholder's Consent Statement (or similar document attached to Form 2553), will meet this requirement.

To request relief for a late election when the above requirements are not met, the entity generally must request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2014-1, 2014-1 I.R.B. 1 (or its successor).

E. Qualifying as a Small Business Corporation

1. Unlike a C-Corporation, an S-Corporation faces significant restrictions regarding the number and type of shareholders permitted to have ownership. A corporation is eligible to elect and be taxed as an S-Corporation only if it qualifies as a “small business corporation.”

2. §1361(b)(2) specifies that in order to qualify as a “small business corporation” the enterprise must meet the following tests:
   a. An S-Corporation can have only one class of stock (the stock may, however, carry different voting rights);
   b. The shareholders may only be individuals, estates and certain trusts (corporations, partnerships, most trusts, and nonresident aliens may not be shareholders);
   c. An S-Corporation must not be an “ineligible corporation” (defined as financial institutions, insurance companies, DISCs, and members of affiliated groups) and
   d. An S-Corporation must have no more than 100 shareholders.

3. For purposes of applying the 100 shareholder limitation there are situations where two or more shareholders can be deemed to be only one shareholder based on relationship of the shareholders to each other:
• §1361(c)(1) provides that spouses and their estates are counted as one shareholder.
• Qualifying members of a family who hold stock are deemed to be one shareholder.

4. A family is defined as a common ancestor, the lineal descendants of the common ancestor and the spouses (or former spouses) of the common ancestor and the descendants.

5. §1361(c)(1)(B) provides that the common ancestor can be no more than six generations removed from the youngest shareholder who is treated as a member of the family on the latest of:
   a. The date the S-Corporation election is made.
   b. The earliest date that a family member first holds stock in the corporation, or

6. §1361(c)(1)(C) further provides that any legally adopted child, any child lawfully placed with the individual for legal adoption and any eligible foster child are deemed to be a child by blood.

7. §1361(c)(1)(A) provides that the estate of a family member is also treated as a member of the family for purpose of determining the number of shareholders.

8. §1361(c)(2)(A) provides that the term “eligible shareholder” includes:
   a. A grantor trust (where the grantor is regarded as a shareholder).
   b. A Voting Trust (where each beneficiary is treated as a shareholder).
   And
   c. Any testamentary trust that receives S-Corporation stock.

   Note: The testamentary trust is treated as an eligible shareholder only for two years after the deemed owners death. (Reg. §1.1361-1(h)).

   Note: A single member LLC which is disregarded for federal income tax purposes can be a shareholder of an S-Corporation if the member is eligible to own S Corporation stock. The stock is considered held directly by the member. (IRS Letter Ruling 200107025).
F. No Double Taxation

1. The most significant advantage in electing the S-status is the single level of federal income taxation. There is no corporate level tax.

2. The taxation of corporate profits is assessed only once at the individual shareholder's level.

   **EXAMPLE #1:** Two corporations both have net taxable income of $100,000.

<table>
<thead>
<tr>
<th></th>
<th>C-Corporation</th>
<th>S-Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: Corporate Tax</td>
<td>(22,250)</td>
<td>(-0-)</td>
</tr>
<tr>
<td>Balance Available to Shareholders</td>
<td>$77,750</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

   **NOTE:** The income tax result of the balance available to shareholders will depend on each shareholder’s tax rate vs. the 0%, 15% and 20% qualified dividend rate.

3. An S-corporation is a “pass-through” entity. It is a conduit through which all profits, losses, deductions, credits, etc. flow through to the shareholders on a pro-rata method (per share, per day allocation).

   **EXAMPLE #2:** Based on the results in Example #1 above, Don is a 20% shareholder of the S-Corporation and he owed his stock for only 120 days during the current tax year. As a result his per-share per day allocation reported on his Schedule K-1 is calculated as follows:

   \[
   \text{Allocation} = \frac{\text{Net Income} \times \text{Percentage} \times \text{Number of Days}}{365} = \frac{100,000 \times 0.20 \times 120}{365} = \$6,575
   \]

   If he owned 20% for 120 days and then acquired another 5% for 20 days then the allocation would be as follows:

   \[
   \begin{align*}
   \text{Allocation} &= \frac{100,000 \times 0.20 \times 120}{365} = \$6,575 \\
   \text{Allocation} &= \frac{100,000 \times 0.05 \times 20}{365} = \$1,370 \\
   \text{Total reported on Schedule K-1} &= \$7,945
   \end{align*}
   \]

4. If new corporations are expected to generate losses in the early years then the use of the S-Corporation is often preferable to a C-Corporation because losses from an S-Corporation flow through to shareholders and can be used to offset other income of the shareholders and their spouses if a joint income tax return is filed.
**EXAMPLE:** Two corporations both have **net taxable losses** of $50,000.

<table>
<thead>
<tr>
<th></th>
<th>C-Corporation</th>
<th>S-Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Loss</td>
<td>$(50,000)</td>
<td>$(50,000)</td>
</tr>
<tr>
<td>Other Sources of income</td>
<td>-0-</td>
<td>$50,000</td>
</tr>
<tr>
<td>NOL Carryforward</td>
<td>$(50,000)</td>
<td>-0-</td>
</tr>
<tr>
<td>Deduction Current Year</td>
<td>-0-</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

5. A shareholder may not be able to claim a loss in a current year if the loss is prohibited by another provision in the Code such as §469 passive activity loss rules. Also a taxpayer cannot claim a deductible loss if there is insufficient basis in stock.

**EXAMPLE:** Don owns stock in an S-Corporation which reports a loss of $20,000. Don owns **25%** of the stock. His pro-rata share is **$5,000** composed of various items of deductions and losses. However, he can deduct *only* **$3,500** because his basis in his stock is **$3,500**. The excess **$1,500** is **deferred**.

The current year loss is **$5,000** with a Basis Limitation of **$3,500** therefore the unavailable loss in the current year is **$1,500** and carried forward.

<table>
<thead>
<tr>
<th></th>
<th>K-1</th>
<th>Calculate</th>
<th>Basis</th>
<th>Current Year</th>
<th>Carry Forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Loss</td>
<td>$2,500</td>
<td>$2,500/$5,000</td>
<td>X $3,500</td>
<td>= $1,750</td>
<td>$750</td>
</tr>
<tr>
<td>Short Term Capital Losses</td>
<td>1,250</td>
<td>1,250 / 5,000</td>
<td>X $3,500</td>
<td>= $ 875</td>
<td>375</td>
</tr>
<tr>
<td>Long Term Capital Losses</td>
<td>750</td>
<td>750 / 5,000</td>
<td>X $3,500</td>
<td>= $ 525</td>
<td>225</td>
</tr>
<tr>
<td>Charitable Contribution</td>
<td>500</td>
<td>$ 500/$5,000</td>
<td>X $3,500</td>
<td>= $ 350</td>
<td>150</td>
</tr>
<tr>
<td>Totals</td>
<td>$5,000</td>
<td>$500</td>
<td>X $3,500</td>
<td>= $3,500</td>
<td>$1,500</td>
</tr>
</tbody>
</table>

**G. Property Distributions By an S-Corporation**

1. When dealing with property distributions by an S-Corporation the distribution is a deemed sale.

Gain is measured at the corporate level using the following formula:
FMV of Asset on Distribution Date

Less: Adjusted Basis of Asset

Equals: Corporate Level Gain

2. An advantage of an S-Corporation over a C-Corporation is that the gain is not taxed at the corporate level.

3. The gain is passed through to the individual shareholders based on their pro-rata allocation on Schedule K-1. Therefore, the tax is imposed only once.

4. The gain recognized by the shareholder increases their individual stock basis.

5. The character of the gain is dependent on the character of the property in the hands of the S-Corporation.

Tax Professional Note: Losses on distributions of property are not recognized.

EXAMPLE: A Subchapter S-Corporation has an asset with an FMV of $14,000 and an adjusted basis of $8,000 which is distributed to Don a 50% shareholder. Don's stock basis prior to the distribution is $10,000.

<table>
<thead>
<tr>
<th>Corporate Level:</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of property</td>
</tr>
<tr>
<td>Less: Adjusted Basis</td>
</tr>
<tr>
<td>Corporate Gain</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shareholder Level:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Basis Prior to Distribution</td>
</tr>
<tr>
<td>Add: 50% of Corporate Gain - Schedule K-1</td>
</tr>
<tr>
<td>Adjusted Basis Prior to Distribution</td>
</tr>
<tr>
<td>FMV of Property Received</td>
</tr>
<tr>
<td>Less: Adjusted Basis of Stock</td>
</tr>
<tr>
<td>Capital Gain</td>
</tr>
</tbody>
</table>

H. Liquidation of an S-Corporation

1. When an S-Corporation liquidates it ceases to exist and the shareholders transfer their stock back to the corporation in exchange for the corporate assets:

The corporation can liquidate the assets by either:

a. Selling the assets and distributing the proceeds directly to the shareholders

or
b. Distributing the assets directly to the shareholders (“deemed sale”).

2. In either situation the corporation has a recognized gain or (recognized loss) under §336 by measuring the difference between:

FMV of Assets at Date of Liquidation

Less: Adjusted Basis of Assets

Equals: Corporate Level Gain (Loss)

3. **However**, there is **no tax** effect of the liquidation at the corporate level. The gain is passed-through to the individual shareholder on their **Schedule K-1** based on their individual pro-rata allocation. The **gain** is recognized by shareholders on their current year tax returns. Also, the individual's **stock basis is increased** by the amount of the gain in the year of liquidation.

4. Therefore, the shareholder's **gain or loss on the liquidation of their stock** is calculated as follows:

<table>
<thead>
<tr>
<th>Shareholder's Stock Basis Calculation:</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Balance @ 1/1/XX</td>
<td>$</td>
</tr>
<tr>
<td><strong>Add:</strong> Current Year <strong>Income</strong> (Schedule K-1)</td>
<td>$</td>
</tr>
<tr>
<td>Current Year Capital Contributions</td>
<td>$</td>
</tr>
<tr>
<td><strong>Less:</strong> Current Year <strong>Distributions</strong> to Shareholder</td>
<td>$(   )</td>
</tr>
<tr>
<td>Current Year <strong>Losses &amp; Deductions</strong> (Schedule K-1)</td>
<td>$(  )</td>
</tr>
<tr>
<td><strong>Equals:</strong> Stock Basis Prior to Liquidation of Stock</td>
<td>$</td>
</tr>
</tbody>
</table>

**Shareholder's §331 Gain (Loss) Calculation Reported on Schedule D:**

| FMV of Assets Received From Corporation | $ |
| Less: Basis of Stock Prior to Liquidation | $(  ) |
| **Equals:** Gain (Loss) on Liquidation of Stock | $ |

I. **Shareholder's Basis in the S-Corporation Stock: Determining Initial Basis**

1. The starting point for calculating basis in a conduit entity is to determine initial basis depending on whether the owner acquired the interest by purchase, capitalization of a newly-formed entity, gift or inheritance.

   - **Acquisition by purchase:** §1012 states that the shareholder's basis will be the purchase price of the stock on the date of acquisition: Cost.

   - **Acquisition in exchange for contributed property:** §351 provides that the initial basis will be the adjusted basis of the assets given up in exchange for the stock: Carryover Basis.
• **Acquisition by gift: §1015** provides that the donor's basis will be transferred to the donee: Carryover Basis.

• **Acquisition by inheritance: §1014** provides that the shareholder's stock basis will be stepped up at date of the decedent’s death: Fair Market Value.

2. Once the taxpayer determines the initial basis, it is adjusted each year. Generally basis adjustments are calculated at the close of the S-Corporation's taxable year.

3. There are two *exceptions* to this year-end calculation rule:

   a. If the S-election is terminated or revoked then the S-Corporation is required to treat the tax year as consisting of two separate years for purposes of allocating items to the shareholders;

   OR

   b. If a shareholder disposes the stock during the year, then the basis for gain or loss is determined *as of the day before* the ownership interest is sold.

   As a result, the basis adjustments are made as if the year consisted of several separate tax years.

**J. Annual Adjustments that Increase Stockholder Basis**

1. **§1367(a)(1)** provides that a shareholder’s S-Corporation stock basis is increased by:

   a. *Non-separately* stated ordinary income passed through by the S-Corporation as a result of its operations;

   b. *Separately* stated items of income passed through by the entity whether taxable or not; and

   c. Any subsequent *contributions of capital* by the shareholders to the corporation.

   **Tax Professional Reminder:** It is important to note that if an item of *taxable income* that should have been included as income on the return was not included in the gross income, then that item does not increase the shareholder's stock basis.
K. Annual Adjustments that (Decrease) Stockholder Basis

1. §1367(a)(2) provides that a shareholder’s S-Corporation stock basis is decreased by:
   
a. Non-separately stated ordinary loss passed through by the S-Corporation as a result of its operations;
   
b. Separately stated items of loss and expenses;
   
c. Nontaxable distributions to the shareholder; and
   
d. Nondeductible expenses not properly chargeable to a capital account, (such as meals, political contributions, penalties, etc.).

   **Tax Professional Reminder:** The basis of the shareholder's stock is decreased by the amount of any loss or deduction that is allowed for the taxable year, regardless of whether the loss or deduction is disallowed or deferred under another provision of the Internal Revenue Code, such as the passive loss rules under §469.

   **Tax Professional Reminder:** The annual adjustments to the stockholder's basis are generally made at end of the entity's tax year and have specific ordering rules.

2. §1367(b)(2) provides that if a shareholder’s stock basis is reduced to zero, then the remaining net decrease attributable to losses and deductions is applied to reducing the basis in any debt owed to the shareholder by the S-Corporation.

   **Tax Professional Reminder:** Distributions may not be applied against basis in debt.

3. Any net increase in basis in a subsequent year is first applied to restore debt basis before stock basis.

   **Tax Professional Reference:** There are detailed rules stated in IRS Reg. §1.1367-2 pertaining to adjustments in the basis of a shareholder’s corporate debt basis.

L. Entity Debt Does Not Create Basis

1. A shareholder's basis is not increased by the shareholder's pro-rata share of the S-Corporation debt.

2. This is true even if the shareholder has guaranteed the debt.
3. The reason is that there is **no** increase in basis **unless** the shareholder has an actual economic outlay.

4. If a shareholder wants to create basis **then** the shareholder should make an actual loan to the corporation.

5. If the shareholder does not have the money **then** shareholder should borrow the money directly from a bank and lend it to the corporation.

**Tax Professional Note:** Letter Ruling 8747013 provides that money loaned by the bank to the shareholder, and subsequently lent by the shareholder to the corporation, will constitute debt basis assuming all of the following are met:

   a. The **stockholder is personally liable** for the bank loan,

   b. The **corporation is not a guarantor or co-maker** on the loan,

   and

   c. The **interest rate** on the bank's loan to the stockholder is at the **bank's current rate**.

**Debt Substitution:**

Another technique is to **restructure the debt** of the corporation. Revenue Ruling 75-144 provides shareholders with additional basis when the shareholders guarantee obligations of the corporation and **substitute their own notes for those of the corporation.** This is true provided the creditor relieves the corporation from its liability on the old note and **substitutes the shareholders** as the primary obligors.

This lack of basis creation at the entity level is a great disadvantage of an S-corporation as opposed to the favorable treatment of entity debt available for creating basis for partners of a partnership.

**M. §1367 Pre 1/1/97 Ordering Rules to Shareholder Basis in the S-Corporation Stock**

1. A shareholder's stock basis is **first increased** for all positive basis adjustments, including current year cash and property contributions, income from operations, nontaxable income, etc.
2. A shareholder's stock basis is then **decreased** for nondeductible, non-capital expenses and certain oil and gas depletion deductions.

3. A shareholder's stock basis is then **decreased** for items of loss or deduction (not below zero) for the year including any carryovers from prior year, and

4. Finally, a shareholder's stock basis is then **decreased** (not below zero) for distributions of both cash and or property.

**N. Post 12/31/96 Ordering Rules to Shareholder Basis**

1. Effective for taxable years beginning *after* 1996, the Small Business Act of 1996 provides that the **adjustments for distributions** made during the year are taken into account **before** applying the **loss limitation** for the year.

2. Therefore, **distributions** during a year **reduce** the adjusted **basis** for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the year's distributions.

3. Consequently, these ordering rules for S stock basis will more closely resemble the partnership ordering rules as follows:

   a. A shareholder's stock basis is **first increased** for all positive basis adjustments, including current year cash and property contributions, income from operations, nontaxable income, etc;

   b. A shareholder's stock basis is then **decreased** (not below zero) for distributions of both cash and or property.

   c. A shareholder's stock basis is then **decreased** for nondeductible, non-capital expenses and certain oil and gas depletion deductions.

   d. Finally, a shareholder's stock basis is then **decreased** for separately stated and non-separately stated items of loss or deduction (not below zero) for the year including any carryovers from prior year.
**EXAMPLE:** Don owns 25% of an S-Corporation and his stock basis at the beginning of the year is $15,000 before the corporation distributes $8,000 and reports Schedule K-1 losses of $10,000. Don determines his allowable current year loss under the ordering rules follows:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Carryover</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance 1/1/XX</td>
<td>$15,000</td>
</tr>
<tr>
<td>Less: Distributions</td>
<td>$(8,000)</td>
</tr>
<tr>
<td>Balance Available</td>
<td>$7,000</td>
</tr>
<tr>
<td>Less: Current year loss</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Balance 12/31/XX</td>
<td>Zero</td>
</tr>
</tbody>
</table>

Unallowed loss carryforward $3,000

If Don had the same transactions occur in the subsequent tax year then the distribution would be greater than basis and he would have to recognize a capital gain and increase his unallowed loss to $13,000.

If Don sold his stock in the next tax year for $1,000 then he would recognize a capital gain on the sale of his stock and the $13,000 loss would be lost.

4. §1366(d)(2) provides that for tax years beginning after 2004 any unused losses are transferred with the transfer of S-Corporation stock to a spouse or former spouse incident to a divorce and the losses are deemed to be incurred by the Corporation in the year after the transfer of the stock. Therefore, the losses cannot be used in the year of the transfer by the spouse or former spouse.

**O. Disadvantages of an S-Corporation: Restrictions on Stock Ownership**

1. The Code imposes several restrictions as to who can be a shareholder of an S-corporation.

2. §1361(b) provides that the income taxation of the S-status can be lost if the corporation runs afoul to the rules pertaining to:
   
   a. Type of shareholders
   b. Number of shareholders
   c. Type of business operation
   d. Type of stock

3. If these strict rules are not adhered to then the S-election will be “terminated” as of the date of the “terminating event.”
4. As a result, the corporation will then be reclassified as a Subchapter C-Corporation for income tax purposes.

5. This will cause the corporation to have two short tax years; a “Short-S” tax year and a “Short-C” tax year.

6. The “Short-S” year would run from January 1 through the date prior to the “terminating event.”

7. The “Short-C” year would run from the date of the “terminating event” to the last day of the tax year.

8. The main issue is that in most cases the “terminating event” is not discovered until:
   a. The end of a tax year,
   b. After the filing of the tax return and the Schedule K-1's or
   c. Probably not until the audit of the return itself.

9. Therefore, the termination of the S-Corporation status could cause the imposition of a C-Corporate level tax and dividend income at the individual shareholder level and/or denial of losses, deductions and credits which had passed through to the shareholders individual income tax returns.

P. Built-In Gains Tax (B-I-G)

1. An S-Corporation that has always been an S-Corporation pays no entity-level tax.

2. Generally, the same treatment applies to C-Corporations that convert to “S” status. However, there is an exception.

3. §1374(a) provides a general rule that if a former C-Corporation had appreciated assets when it converted to “S” status and disposes of those assets within 10 years (recognition period) after its first day as an S-Corporation, then the S-Corporation could be liable for a tax at the highest corporate rate on the net built-in gains.

4. The tax is imposed on a Subchapter S-Corporation that has been converted from a Subchapter C-Corporation that disposes of the net appreciated assets before the “recognition period” has passed.
5. §1374(d)(7) provides a general rule that the “recognition period” means the 10 year period beginning with the first day of the first taxable year for which the corporation was an S-Corporation.

**Tax Professional Note:** The 5 year “recognition period” was permanently changed from 10 years as a result of the 2015 PATH ACT.

**EXAMPLE:** Don Corp. made an S-election, to be effective as of 1/1/XX. The corporation's sole assets are appreciated accounts receivable which on 1/1/XX had a fair market value of $60,000 and an adjusted basis of $-0-. In addition, the C-Corporation had a net operating loss carryover of $10,000. When the corporation collects the accounts receivable on 1/02/XX it would have a corporate tax of $17,500, computed as follows:

$60,000 (built-in gain) reduced by $10,000 (Net operating loss carryover)  
= $50,000 x 35% = $17,500.

<table>
<thead>
<tr>
<th>Corporation</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV @ S-election date 1/1/XX</td>
<td>$60,000</td>
</tr>
<tr>
<td>Less: Adjusted Basis</td>
<td>-0-</td>
</tr>
<tr>
<td>Built-In Gain</td>
<td>$60,000</td>
</tr>
<tr>
<td>NOL Carryover §1374(b)(2) deduction</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Gain subject to tax</td>
<td>$50,000</td>
</tr>
<tr>
<td>x Highest Corporate Rate</td>
<td>35%</td>
</tr>
<tr>
<td>Built-in Gains Tax Reported on Form 1120-S</td>
<td>$17,000</td>
</tr>
</tbody>
</table>

Don, the sole shareholder, will be taxed on the gain that flows through from the corporation, reduced by the built-in gains tax. Therefore, Don will be taxed on $32,500. The flow through is net of built in gains tax.

<table>
<thead>
<tr>
<th>Shareholder Level</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount Realized</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Less: Adjusted Basis</td>
<td>(0-)</td>
</tr>
<tr>
<td>Gain</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Less: NOL Carryover</td>
<td>$(10,000)</td>
</tr>
<tr>
<td>Net Realized Gain</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Less: Built-in Gains Tax</td>
<td>$(17,000)</td>
</tr>
<tr>
<td>Taxable Income Pass Through to Shareholder via Schedule K-1</td>
<td>$ 32,500</td>
</tr>
</tbody>
</table>
Q. One Class of Stock Restrictions

1. §1361(b) (1) (D) provides that an S-Corporation may only have one class of stock.

2. Reg. §1.1361-1(1) (i) states that a corporation will be considered to have one class of stock if all of its outstanding shares confer identical rights with regard to distribution and liquidation proceeds.

3. Therefore, S-Corporation stock cannot give some shareholders preferences regarding current or liquidating distributions.

4. Reg. §1.1361-1(1)(2) also states that differences with regard to timing or the amount of distributions will not cause a finding of a second class of stock as long as the governing instruments provide for identical distributions.

5. For this purpose, Reg. §1.1361-1(1)(2)(i) states that governing provisions include:
   a. The corporate charter, articles of incorporation and by-laws,
   b. Applicable state law, and binding agreements relating to distribution and liquidation proceeds.

**Tax Professional Note:** Taxpayers should be aware that shareholders and corporations can generally enter into employment contracts and lease or loan agreements without the agreements being treated as creating a second class of stock, which would result in a loss of the corporation's Subchapter S-Corporation status. Reg. §1.1361-1(1) (2) (i).

**EXAMPLE:** An S-Corporation has two equal shareholders, Don and Nanette. In accordance with the shareholder agreement and corporate by-laws (the governing provisions), Don and Nanette are entitled to equal distributions.

In the current year, the S Corporation distributes $50,000 to Don, but does not distribute $50,000 to Nanette until the following year. If the difference in timing did not occur by reason of a binding agreement, then it will not cause the S-Corporation to be treated as having more than one class of stock since the governing provisions state that Don and Nanette are entitled to equal distributions. Reg. §1.1361-1(1) (2) (ii) Example 2.


R. Allowance of Differing Powers

1. §1361(c) (4) provides that differences in voting power among classes of stock, do not violate the one class of stock requirement. As a result, an S-Corporation may have both voting and nonvoting common stock.

2. Also, note that Reg. §1.1361-1(1)(2)(iii) states that buy-sell agreements, agreements restricting the transferability of stock, and redemption agreements generally do not cause a corporation to violate the one class of stock requirement.

3. However, Reg. §1.1361-1(1)(2)(iii) further states that such agreements may result in a finding of a second class of stock if two conditions are met:

   a. A principal purpose of the agreement is to circumvent the one class of stock requirement; and

   b. The agreement established a purchase price that was significantly different from the FMV of the stock.

4. In determining whether a purchase price differs significantly from the FMV of the stock, neither the book value nor a price between FMV and book value is considered significantly different from the fair market value.

5. A good faith effort to determine the value will be respected unless the determination of value was not performed with reasonable diligence.

6. Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether there is a second class of stock.

**Tax Professional Recommendation:** In order to satisfy the requirement that there has been a good faith effort to determine the value of an S-Corporation's stock the shareholders should obtain an appraisal of the stock's value before entering into a buy-sell agreement, an agreement restricting the transferability of stock, or a redemption agreement.
S. Safe Harbor for Debt

1. When a corporation issues what in form is a debt instrument, the Service may claim that the debt should be reclassified as equity for tax purposes.

2. If the Service prevails then the debt will be reclassified as a second class of stock, and therefore the corporation will no longer qualify as an S-Corporation.

3. Reg. §1.1361-1(1)(4)(ii) states that purported debt will only be considered a second class of stock for purposes of the S-election if its principal purpose is to circumvent the rights to distribution or liquidation proceeds of outstanding shares.

4. In order to prevent the Service from reclassifying debt to equity, S-Corporations should be aware of three safe harbors:

   a. Unwritten Advances:

      1) Reg. §1.1361-1(1)(4)(ii)(B)(1) states that unwritten advances from a shareholder that are $10,000 or less at any time in a year are treated as debt.
      2) Also, it is expected that the debt will be repaid in a reasonable time.
      3) If the debt is greater than $10,000 on any day then it must be in writing.

   b. Proportionately Held Debt:

      1) Reg. §1.1361-1(1)(4)(ii)(B)(2) states that identical debt instruments owned only by shareholders of the corporation in the same proportion as their stock will not be considered a second class of stock.

   c. Straight Debt:

      1) §1361(c)(5) defines straight debt as a written unconditional promise to pay on demand or on a specified date a sum of money when:

         • The interest rate is not contingent on profits or the borrower's discretion,
         • There is no convertibility into stock, and
         • The creditor is an individual, an estate, or a trust that qualifies an S Corporation shareholder as defined under §1361(c) (2).
NOTE: Reg. §1.1361-1(1) (5) allows that the debt obligations to be subordinated to other debt of the corporation.

T. Service Can Waive Invalid Subchapter S-Election

1. For years the Service had the authority to waive the effect of an inadvertent termination of an S-election. The Service would grant the reinstatement of the Subchapter S status. As long as the corporation followed:

   a. The IRS procedures within a reasonable period of time from the discovery of the disqualifying event, and

   b. The shareholders agreed to make the required adjustments on their personal income tax returns.

2. It is important to note however that the Service could not waive the effect of an invalid S-“election.” In the Small Business Job Protection Act of 1996 (H.R. 3636) Congress finally gave the Service the authority to grant relief for inadvertent failures to make a qualified S-election.

3. §1362(f) provides that where an S-Corporation election is ineffective because it failed to:

   a. Qualify as a small business corporation or

   b. Obtain shareholder consent, the corporation will be treated as an S-Corporation during the period specified by the Service if the following conditions are met:

      (1) The Service determines that the facts and circumstances resulting in the invalidity of the election were inadvertent;

      (2) Within a reasonable period after discovering these circumstances which caused the invalidity steps are taken to qualify the corporation as a small business corporation or obtain the requisite shareholder consents; and

      (3) The corporation and each person who was a shareholder during the relevant period agree to the Service's prescribed adjustments consistent with the treatment of the corporation as an S-Corporation during the relevant period.
4. This authority includes retroactive inadvertent invalid elections. The effective dates of this provision is for retroactive for elections made for tax years beginning after December 31, 1982.

5. The Committee Report states that the reason for the change is that the Secretary of the Treasury should have the same authority to validate inadvertent defective Subchapter S-elections as it had for inadvertent Subchapter S terminations.

6. The Committee Report also states that the Service may consider relevant information provided by any affected shareholder, including a person who became a shareholder in a period after the S-election was made, before determining the validity of the S-election for the tax year.

**EXAMPLE:** If a person who acquired shares of the corporation with the understanding that the corporation was not an S-Corporation does not want to be taxed on the income of that corporation, then the taxpayer may be able to prevent the IRS from granting relief to treat the corporation as an S-Corporation.

Because of the adjustments required when retroactive relief is requested, conflicts among shareholders may often arise. In order to prevent a shareholder from holding up the retroactive relief, the corporation should resolve these conflicts before making its request for relief.

**U. S-Corporation Termination and The Five Year Waiting Period**

1. §1362 provides a general rule that if the S-Corporation election is terminated or revoked then the corporation cannot make another S-Corporation election without the consent of the IRS before the fifth tax year after the first tax year for which the termination or revocation was effective.

**V. Termination of S-Election**

1. Taxpayers who elect an S-Corporation must be aware of the termination rules. Taxpayers incur the risk of inadvertent termination of the organization's “S” corporation status.

2. §1362(d) provides that there are three events which can terminate a valid S-election:
• Voluntary revocation of the S-Election by those owning a majority of the corporation's stock;

• The corporation's ceasing to qualify as an S-Corporation; or

• An S-Corporation with old “Subchapter C-Corporation earnings and profits” having passive investment income that exceeds 25% of gross receipts for three consecutive taxable years.

3. §1362(e) provides that if an S-election is terminated during the corporation's taxable year, then the tax year is divided into two short years.

4. For the period ending before the first day on which the termination is effective, the corporation will be taxed as an S-Corporation.

5. For the remaining portion, beginning on the first day of the termination, the corporation will be taxed as a C-Corporation. Items of income and deduction are then allocated between the two periods. Reg. §1.1362-3.

a. Termination by Revocation: §1362(d) (1) provides that a Subchapter S-election will be considered revoked if the majority of shareholders file a notice of revocation with the Service. Reg. §1.1362-6(a) (3).

   (1) The revocation generally becomes effective in the following year.

   (2) However, the corporation may specify a prospective date on which it wishes the revocation to become effective. If the revocation is made on or before the 15th day of the third month of a taxable year, then it will be retroactive and effective as of the first day of the year. Reg. §1.1362-2(a).

b. Termination Through A Terminating Event:

   (1) An S-election may also be terminated if the corporation fails to meet any of the qualification requirements. For example, a transfer of shares to a nonqualifying shareholder, such as a corporation, will result in immediate loss of S status.

   (2) §1362(g) provides that if an election is terminated, or revoked then the corporation cannot make another Subchapter S-election for five years unless consent is obtained from the IRS.
c. Inadvertent Termination:

(1) §1362(f) provides that if there is an inadvertent termination of a Subchapter S-election, then the corporation may continue to be taxed as an S corporation, if it gets permission from the Service and if the appropriate remedial action is taken. Reg. §1.1362-4.

W. Employment Issues of an S-Corporation Shareholder:

1. Subchapter S-Corporation shareholders who are activity involved in the daily operations of the business are subjected to the employment provisions of the Code. The employer should pay a reasonable salary and withhold income taxes, social security and medicare and pay the required employer matching. The shareholder employee salaries are also included for purpose of FUTA and SUTA.

2. Unreasonably low wages relative to services provided can be challenged by the Service, causing the excess profits to be recharacterized as wages and subjected to additional social security and medicare taxes. In addition there will be interest assessed as well as penalties for failure to pay and failure to file employment tax returns.

3. §3121 provides that wages are defined as all renumeration for employment.

4. §3121(d) provides a definition of employee to include any officer of a corporation.

Tax Professional Note: Reg. §31.3121(d)-1(b) allows an exception to the employee status for an officer who performs no services or only minor services to the corporation.

X. Establishing Reasonable Compensation

1. In order for compensation to be deductible, it must be reasonable for the services actually rendered. The Code specifically empowers the IRS to reallocate an S-Corporation’s income in family income-splitting situations.

2. 1366(e) provides that a member of an S-Corporation shareholder’s family must receive reasonable compensation for services rendered or capital furnished to the corporation. This provision applies to family members whether or not they own shares in the corporation.

Tax Professional Note: The instructions to the Form 1120S, state: “Distributions and other payments by an S-Corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services render to the corporation.”
3. Under these rules, the Service can adjust income to reflect reasonable compensation for services rendered or capital furnished to the corporation. In addition, rent and interest payments to shareholders or family members could be reallocated by the IRS if ruled unreasonably high.

4. There is no definition for reasonable compensation. Each situation must be resolved based on its unique facts and circumstances.

**Several Tax Court decisions have focused on these factors:**

- The character and financial condition of the corporation,
- The role the shareholder-employee plays in the corporation, including position, hours worked and duties and responsibilities;
- Training and experience;
- The corporation’s compensation policy for all employees and the shareholder’s salary history, including the internal consistency in establishing the shareholder’s salary;
- How the compensation compares with similarly situated employees of other companies;
- Timing and manner of paying bonuses to key employees;
- Whether a hypothetical, independent investor would conclude that there is an adequate return on investment after considering the shareholder’s compensation;
- Compensation agreements;
- The employee’s qualifications and education;
- The size and complexity of the business;
- The use of a formula to determine compensation;
- A comparison of salaries paid in relation to sales and net income;
- General and specific economic conditions of the country, geographic area and the industry;
- Salaries versus distributions and retained earnings;
- Compensation paid in prior years;
- The corporation’s earning and distribution history;
- Whether employee and employer dealt at arm’s length and
• Whether employee guaranteed employer’s debt.

No single factor controls, but rather a combination of the factors must be considered. Furthermore, these factors are not all-inclusive (and may not be given equal weight).

5. The Service’s position as to the key for establishing reasonable compensation is determining what the shareholder-employee did for the S-Corporation. The Service instructs its auditors to look to the source of the S-Corporation’s gross receipts and they specify 3 major sources as follows:

   a. Services of shareholder,
   b. Services of non-shareholder employees, or
   c. Capital and equipment.

If the gross receipts and profits come from items 2 and 3, then that should not be associated with the shareholder-employee’s personal services and it is reasonable that the shareholder would receive distributions along with compensations.

On the other hand, if most of the gross receipts and profits are associated with the shareholder’s personal services, then most of the profit distribution should be allocated as compensation.

In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed for the other income producing employees or assets. For example, a manager may not directly produce gross receipts, but he assists the other employees or assets which are producing the day-to-day gross receipts.

Y. Health Insurance Premiums for Subchapter S-Corporate Shareholders: IRS Position Eased

1. In 2005 the IRS stated in Chief Counsel Advice (CCA) 200524001, that a self-employed individual who is a sole proprietor and who purchases health insurance in his or her own name may treat that as health insurance purchased in the name of the sole proprietor’s business.

2. Therefore, the insurance would qualify under the provisions of §162(l). Assuming the self-employed individual meets the other provisions of §162(l), the individual may claim a deduction for the health insurance premiums in arriving at adjusted gross income on Form 1040, Page 1.
3. However, if the business is operating as a Subchapter S-Corporation, then there is a different tax consequence if the individual who is the sole shareholder and sole employee, purchases the health insurance in the shareholder’s own name.

4. §1372(a) provides that for certain fringe benefits paid by the S-Corporation, including health insurance premiums, the S-Corporation will be treated as a partnership and any shareholder who owns more than 2% of the S-Corporation stock will be treated as a partner of such partnership.

5. Revenue Ruling 91-26 holds that accident and health insurance premiums paid by a partnership on behalf of a partner are guaranteed payments under §707(c) if the premiums are paid for services rendered in the capacity of a partner and to the extent the premiums are determined without regard to partnership income. As guaranteed payments, the premiums are deductible by the partnership under §162 and includible in the recipient-partner’s gross income under §61.

6. Therefore, the health insurance premiums paid by the S-Corporation would not be deductible by the S-Corporation as a fringe benefit but would be recharacterized and deductible by the S-Corporation as compensation to the 2% shareholder. The health insurance premiums paid by the S-Corporation for the 2% shareholder should be included in the 2% shareholder’s W-2 in Box 1 but not Boxes 3 and 5.

7. §162(l) (5) provides that a 2% shareholder that is treated as a partner under §1372 will be treated as a self-employed person and, assuming all of the other provisions of §162(l) are met, may deduct the health insurance premiums paid by the S-Corporation as an above-the-line deduction in determining AGI.

Tax Professional Note: There are some limitations under §162(1) (2). The limitation that often affects a 2% shareholder is the issue of other coverage. An above-the-line deduction is not allowed for any calendar month for which the shareholder is eligible to participate in any subsidized health plan maintained by any other employer of the shareholder or of the spouse of the shareholder.

8. If there are no other subsidized health plans, then the issue arises if a sole shareholder/employee purchases the health insurance in their own name instead of the S-Corporation. In this situation, if the S-Corporation has not established a plan to provide medical care coverage, then there is no fringe benefit paid to the 2% shareholder and the provisions of §1372 are not applicable.
9. If the provisions of §1372 are not applicable, then the S-Corporation is not treated as a partnership and therefore the shareholder is not treated as a partner.

10. If the shareholder is not treated as a partner, then the shareholder is not treated as self-employed and therefore is not eligible for the above-the-line deduction treatment under §162(l).

**NOTE:** The shareholder is still able to deduct the health insurance as an itemized deduction which is subject to the 7.5% AGI limitation.

**TAX PROFESSIONAL ALERT:** Some states do not allow a corporation to purchase a group health plan with only one participant. This prevents the S-Corporation from acquiring a health plan and therefore requires the shareholder to purchase the plan in their own name. This state law limitation does not override the requirements that the S-Corporation must provide fringe benefits to its employees in order to have the 2% shareholder qualify for the §162(l) benefits.

**Changes to the Rules**

**Notice 2008-1, 2008-2IRB**

In January 2008 the IRS released a new notice which explains when a 2% shareholder-employee in an S-Corporation is entitled to the §162(l) above-the-line deduction for health insurance premiums that are paid or reimbursed by the S-Corporation and included in gross income of the 2% Shareholder.

**NOTE:** Without affirmatively saying it, **Notice 2008-1** effectively overturns the 2005 position of the IRS Chief Counsel and guidance which appeared in an article on IRS’s website back in 2006. That position had concluded that an S-Corporation’s sole shareholder-employee could not buy health insurance in his own name and have the above-the-line deduction for the premium expense. However, if certain requirements are met, such a deduction is now possible and may be gained for a prior year by filing an amended return.

**IRS eased position.** The Service now states that a plan providing medical care coverage for a 2% shareholder-employee is deemed to be established by the S-Corporation if:

1. The corporation makes the premium payments for the health insurance policy covering the 2% shareholder-employee (and his spouse or dependents, if applicable) in the current tax year; or

2. The 2% shareholder makes the premium payments and furnishes proof of payment to the corporation and the corporation then reimburses the shareholder.
NOTE: If the health insurance premiums are not paid or reimbursed by the S-Corporation and included in the 2% shareholder-employee’s gross income, then a plan providing medical care coverage for the 2% shareholder-employee is not deemed to be established by the S-Corporation and the shareholder is not allowed the §162(1) deduction.

3. Notice 2008-1 states that in order for a 2% shareholder-employee to deduct the amount of the health insurance premiums, the S-Corporation must report the health insurance premiums paid or reimbursed as wages on Form W-2 in that same year. In addition, the shareholder must report the premium payments or reimbursements as gross income on Form 1040.

4. Notice 2008-1 provides four examples. The examples assume that each shareholder is a 2% shareholder-employee in an S-Corporation, whose earned income from the S-Corporation exceeds the amount of the premiums for the health insurance policies covering the shareholder, his spouse and dependents. No shareholder is eligible to participate in any subsidized health plan maintained by an employer of the shareholder or his spouse. All examples involved tax year 2008.

EXAMPLE #1: A shareholder obtains a health insurance policy in the shareholder’s own name and pays the premium on the policy. The S-Corporation makes no payments or reimbursement with respect to the premiums.

Result: A plan providing medical care for the shareholder is not established by the S-Corporation and therefore the shareholder may not deduct the premiums under §162(1).

EXAMPLE #2: The S-Corporation obtains a health insurance plan in the corporate name. The plan provides coverage for the shareholder, spouse and dependents. The S-Corporation pays all premiums and reports them as wages on shareholder’s Form W-2 for 2008 and shareholder reports them as gross income on Form 1040 for 2008.

Result: A plan providing medical care for the shareholder has been established by the S corporation and shareholder may take the §162(1) deduction for 2008.

EXAMPLE #3: The shareholder obtains a health insurance policy in the shareholder’s own name and the S-Corporation pays all premiums and reports them as wages on the shareholder’s Form W-2 for 2008.

Shareholder reports the premiums as gross income on the Form 1040 for 2008.

Result: A plan providing medical care for the shareholder has been established by the S-Corporation and shareholder may take the §162(1) deduction for 2008.
EXAMPLE #4: The shareholder obtains a health insurance policy in the shareholder’s own name and pays the premiums and furnishes proof of payment to the S-Corporation, which reimburses the shareholder for the payments. The S-Corporation reports the amount of the premium reimbursements as wages on shareholder’s Form W-2 for 2008 and shareholder reports the premiums as gross income on Form 1040 for 2008.

Result: A plan providing medical care for the shareholder has been established by the S-Corporation and shareholder may take the §162(1) deduction for 2008.

Amended returns for prior tax years. A taxpayer who did not claim a deduction for health insurance coverage described in Notice 2008-1 may file a timely amended tax return to claim the §162(1) deduction if he satisfies the notice’s requirements. The statement “Filed Pursuant to Notice 2008-1” should be written on the top of the amended return.

Effect on single class of stock requirement. Notice 2008-1 states that IRS does not consider payments of health insurance premiums by an S-Corporation on behalf of 2% shareholder-employees to be distributions for purposes of the single class of stock requirement of §1361(b)(1)(D).

TAX PROFESSIONAL ALERT: §162(l)(5)(B) provides that there shall be adjustments in the application of this provision as the Secretary may prescribe by regulation. As a result the IRS has written regulations which states that a more-than-2%-shareholder-employee must have some wages (i.e., must have as the IRS says “Medicare Wages”) in addition to medical insurance premiums “treated as” wages, to be able to take a deduction for the premium paid by the S corporations. Therefore, if the only wages from the S corporation being reported on the shareholder’s W-2 in Box 1 are the premiums the S corporation paid for the shareholder’s health insurance premiums then the earned income limitation would prevent the deduction under §162(l) for health insurance costs.

II. Corporate Life Cycle Includes Termination: Liquidation

A. General Review

1. One of the course objectives is to give a general background of the income tax consequences of a liquidation on both the shareholders and the corporate entity.

2. As part of the corporate life cycle, taxpayers may decide to discontinue the operations of a profitable corporation by liquidating it. As a result of this decision, the shareholders may receive liquidating distributions of the corporation's assets.

3. Preceding the formal liquidation, the corporation may sell part or all of the corporation's assets. The sale may take place in order to:
a. Dispose of assets which the shareholder(s) may not want to receive in a liquidating distribution, or

b. To obtain cash which can be used to pay off the corporation's liabilities and distribute the excess cash to the shareholder(s).

4. The small business client must consider all the tax issues of corporate liquidation.

5. The bases of the corporate assets are stepped-up or down to their fair market value (FMV) when distributed in a liquidating distribution. This permits a smaller gain to be recognized by the shareholder when appreciated properties are subsequently sold or exchanged.

6. The tax effect of this basis adjustment is that the liquidating corporation must recognize gain when making the distribution.

7. Sometimes a corporation is terminated because a buyer cannot be found or there are no family members who want to continue the daily operation.

8. Sometimes a corporation is terminated due to the fact that it is debt ridden and cannot continue to operate.

B. Income Tax Effects of Corporate Liquidations: Gain or Loss to Shareholders and Entity

1. The tax professional will need to assist their client in solving important issues when the entity liquidates such as:

   - What is the tax effect to the liquidating entity?
   - What is the amount and character of the shareholders' recognized gain or loss?
   - What is the adjusted basis of the property that is received by the shareholder?
   - When does the holding period commence for the property that is received by the shareholders?

2. When a corporation is liquidated the liquidating distribution is treated as an amount received in exchange for the shareholder's stock.

3. The shareholder recognizes a capital gain or loss on the excess of the money received plus the FMV of other property received from the entity over the adjusted basis of their stock.
4. §331(a) provides that when a corporation ceases to exist and it distributes assets to a shareholder the amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as full payment in exchange for the stock.

5. The corporation can liquidate the assets by either:
   a. Selling the assets and distributing the proceeds to the shareholder
      or
   b. Distributing the assets directly to the shareholders under a “deemed sale”.

C. Basis of Property Received by the Shareholder in Liquidation of the Corporation

1. The bases of the properties that are received are stepped-up or stepped-down to the property's FMV on the liquidation date. The holding period of the assets commences on the day after the liquidation date.

2. §334(a) provides a general rule that if property is received in a distribution in complete liquidation, and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the shareholder shall be the fair market value of such property at the time of the distribution.

D. Gain or Loss Recognized by the S-Corporation on Property Distributed in Complete Liquidation

1. The tax professional will also assist the corporate client in solving the income tax issues pertaining to the amount and character of the corporation's recognized gain or loss.

2. §336(a) provides a general rule that gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the shareholder at its fair market value.

3. §336(b) addresses the issue of any liabilities that may be attached to the property distributed. The law provides that if any property distributed in liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution then the fair market value of such property cannot be less than the amount of such liability assumed or acquired.

4. §336(b) was enacted because the corporation has an economic gain or benefit equal to the amount of the liability assumed or acquired by the shareholder (and not just the lower FMV of the property distributed) as part of the liquidation.
5. The shareholders of the liquidated corporation will have a basis in the distributed property equal to the amount of the liability assumed or acquired.

**EXAMPLE:** Don Corporation owns assets costing $300,000 which have been depreciated and the adjusted basis is $240,000. The property is secured by a $270,000 note. A plan of liquidation is adopted, and the property and the note are distributed to Don, the sole shareholder. The property's FMV is $220,000. Don Corporation must recognize a $30,000 gain ($270,000 - $240,000) on distributing the property since its FMV cannot be less than the $270,000 note on the property. Therefore the property's basis is also $270,000 to Don.

**Corporate Level:**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$300,00</td>
</tr>
<tr>
<td>Less: Accumulated Depreciation</td>
<td>$(60,000)</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$240,000</td>
</tr>
<tr>
<td>Less: Debt on Asset</td>
<td>$(270,000)</td>
</tr>
<tr>
<td>Debt Relief</td>
<td>$ 30,000</td>
</tr>
</tbody>
</table>

**E. Definition of a Complete Liquidation: Not Defined in the Code**

1. The term complete liquidation is not defined in the Code. However, Reg. §1.332-2(c) states that distributions made by a liquidating corporation must either:
   a. Completely cancel or redeem all of its stock in accordance with a plan of liquidation, or
   b. Be one of a series of distributions that completely cancels or redeems all of its stock in accordance with a plan of liquidation.

2. When there is more than one distribution, the corporation must be in a liquidation status at the time that the first liquidating distribution is made under the plan. This liquidation status must continue until the liquidation is completed.

**Tax Professional Sidebar Notation:** If operating a C-Corporation then a distribution that is made before a plan of liquidation is adopted will generally be taxed under the dividend distribution or stock redemption rules if operating a C-Corporation.

3. A liquidation status exists when the corporation ceases to be a going concern and its activities are merely for the purpose of:
   a. Winding up its affairs,
   b. Paying its debts, and
   c. Distributing any remaining properties to its shareholders.
4. A liquidation is completed when the liquidating corporation has divested itself of all properties.

5. The retention of a nominal amount of assets (e.g., to retain the corporation's name) does not prevent a liquidation from occurring for tax purposes.

6. **Tax Professional Note:** The liquidation of a corporation does not mean that a corporation has undergone dissolution. **Dissolution** is a legal term that implies that the corporation has surrendered the charter that it originally received from the state.

   A corporation may complete its liquidation prior to surrendering its charter to the state and undergoing dissolution. Dissolution may never occur if the corporation retains its charter in order to protect the corporate name from being acquired by another party.

   **EXAMPLE:** Don Corporation adopts a plan of liquidation in December 2014. All but a nominal amount of Don's assets are distributed to its shareholders in January 2015. The nominal assets are retained to preserve the corporation's existence under state law and to prevent others from acquiring the corporation's name. The retention of the nominal amount of assets does not prevent Don from having been liquidated for tax purposes in January 2015.

**F. Tax Effects of the General Liquidation Rules**

1. The coverage of the **general liquidation rules** is divided into the following issues:

   - **Amount and timing** of gain or loss recognition,
   - **Character** of the recognized gain or loss, and
   - **Basis** of property received in the liquidation.

**G. Amount of Recognized Gain or Loss**

1. §331(a) requires that amounts received by a shareholder as a distribution in complete liquidation of a corporation be treated as full payment in exchange for the stock.

2. The amount of the shareholder's recognized gain or loss equals the difference between the amount realized and the basis for the stock.

3. If a shareholder assumes or acquires liabilities of the liquidating corporation, then the amount of these liabilities **reduces** the amount realized by the shareholder.
EXAMPLE: Don Corporation is liquidated with Don receiving $10,000 and other property having a $12,000 FMV. Don's basis in his stock is $16,000. Don's amount realized is $22,000 ($12,000 + $10,000). He must recognize a $6,000 ($22,000 - $16,000) gain on the liquidation.

EXAMPLE: Assume the same facts as above except that Don also assumes a $2,000 debt attached to the other property. Don's amount realized is reduced by the $2,000 liability assumed and is $20,000 ($22,000 - $2,000). The recognized gain on the liquidation is now only $4,000 ($20,000 - $16,000).

H. Stock Acquired at Various Times

1. If the shareholder's stock basis has been acquired at different times, then the shareholder must compute the gain or loss separately for each share or block of stock that is owned.

I. Basis of Property Received in the Liquidation

1. §334(a) provides that the basis of any property received under the general liquidation rules is its FMV on the distribution date. The holding period for the asset starts on the day after the distribution date.

J. Subsequent Assessments Against the Shareholders

1. The shareholders may be required at a date subsequent to the liquidation to pay a contingent liability of the corporation or a liability that is not anticipated at the time of the liquidating distribution (e.g., an income tax deficiency determined after the liquidation is completed or a judgment that is contingent at the time the final liquidation distribution is made).

2. The additional payment does not affect the reporting of the original liquidating transaction.

3. The tax treatment for the additional payment depends on the nature of the gain or loss that was originally reported by the shareholder and not on the type of loss or deduction that would have been reported by the liquidating corporation if it had instead paid the liability.

4. If the liquidation results in a capital gain or loss being recognized, then any additional payment is deductible in the year paid as a capital loss.
**Tax Professional Note:** An amended tax return is **not** filed for the year in which the gain or loss from the liquidation was originally reported.

**EXAMPLE:** X Corporation is liquidated in the current year, with Don reporting a $30,000 long-term capital gain on the exchange of stock. In the subsequent year Don is required to pay $5,000 of unpaid liabilities incurred by X Corporation. An additional amount must be paid by all shareholders, because the liabilities exceed the amount of funds that X Corporation placed into an escrow account. The $5,000 additional payment is reported in subsequent year by Don as a **long-term capital loss**.

**K. Effects of Liquidation on the Liquidating Corporation**

1. At the time of liquidation the corporation must address two issues:

   a. The recognition of **gain or loss** by the liquidating corporation when it distributes property,

   b. The deductibility of the **expense of liquidating**.

2. In the recognition of gain or loss when property is distributed in redemption of stock, §336(a) provides that gain or loss must be recognized by the liquidating corporation when property is distributed in a complete liquidation.

3. The amount and character of the gain or loss are determined as if the property is sold at its FMV.

   **EXAMPLE #1:** Under West Corporation's plan of liquidation, a corporate asset is distributed to Don one of the shareholders. The asset has a $40,000 adjusted basis to West and a $120,000 FMV on the distribution date. West must recognize an $80,000 §1231 gain ($120,000 - $40,000) when it makes the liquidating distribution.

<table>
<thead>
<tr>
<th>Fair Market Value</th>
<th>$120,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Adjusted Basis of Asset</td>
<td>$(40,000)</td>
</tr>
<tr>
<td><strong>§1231 Corporate Level gain</strong></td>
<td><strong>$ 80,000</strong></td>
</tr>
</tbody>
</table>

   Don must recognize a gain to the extent that the asset's FMV exceeds his basis for the West stock. Don's basis for the asset is its $120,000 FMV. The distribution of the asset to Don produces the same tax burden as if West Corporation had sold the asset and distributed the cash proceeds.
KEY POINT: The general rule is that the liquidating corporation recognizes gain or loss on a distribution in a complete liquidation. The gain or loss is computed as if the liquidating corporation had sold all of its assets to the distribute shareholder at the property's FMV.

Note: The liquidating corporation can recognize a loss when the liquidated property that has decreased in value is distributed to its shareholders.

EXAMPLE #2: Assume the same facts as above except that the FMV of the asset is $10,000. West Corporation is permitted to recognize a $30,000 §1231 loss ($10,000 - $40,000 adjusted basis) when the asset is distributed to Don.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Market Value</td>
<td>$10,000</td>
</tr>
<tr>
<td>Less: Adjusted Basis of Asset</td>
<td>$(40,000)</td>
</tr>
<tr>
<td>§1231 Corporate Level (loss)</td>
<td>$(30,000)</td>
</tr>
</tbody>
</table>

Note: Don's basis for the asset is $10,000 (FMV).

L. General vs. Specific Expenses of the Liquidation

1. The corporation is permitted to deduct the general liquidation expenses incurred in connection with the liquidation transaction.

2. These costs include attorney's and accountant’s fees, costs incurred in drafting the plan of liquidation and obtaining shareholder approval, etc.

3. The specific liquidation expenses associated with selling the corporation's properties are treated as an offset against the sales proceeds. When a corporation sells an asset pursuant to its liquidation, the selling expenses reduce the amount of gain or increase the amount of loss reported by the corporation.

EXAMPLE: X Corporation adopts a plan of liquidation on July 15, 20XX, and shortly thereafter sells an asset on which it realizes a $60,000 gain before the deduction of a $6,000 sales commission.

X pays its legal counsel $1,500 to draft the plan of liquidation. All of the remaining properties are distributed to its shareholders in December 20XX. The $1,500 paid to legal counsel is deductible as a general liquidation expense in the 20XX income tax return.

The specific sales commission reduces the $60,000 gain realized on the asset sale, so that the corporation recognized gain is reduced to $54,000 ($60,000 - $6,000).
4. Any amounts of capitalized expenditures that are unamortized at the time of liquidation should be deducted if they have no further value to the corporation (e.g., unamortized organizational costs).

5. Capitalized expenditures that have value must be allocated to the shareholders receiving the benefit of such an outlay (e.g., prepaid insurance, prepaid rent, tax refunds, etc.).

6. Expenses related to the issuing of the corporation's stock are not deductible by the corporation, even at the time of liquidation. They are treated as a reduction in paid-in capital on the corporate books.

M. Corporate Filing Requirements

1. §6043(a) requires that every corporation shall make a return regarding its distributions in liquidation.

2. Within 30 days after the adoption by the corporation of a resolution or plan for the dissolution of the corporation, or the liquidation of the capital stock, the corporation must make a return setting forth the terms of such resolution or plan and such other information as the Secretary shall prescribe by forms or regulations (IRS Form 966).

3. The statement must include:
   a. Name and address of each shareholder,
   b. Number and class of shares owned by each shareholder, and
   c. The amount paid to each shareholder.

4. If the distribution is in property other than money, then the fair market value of the property must be reported as of the date the distribution is made to each shareholder.
III. EXHIBITS
<table>
<thead>
<tr>
<th>Increases</th>
<th>Decreases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original cost of shareholder’s stock</td>
<td>Distributions that are a return of basis</td>
</tr>
<tr>
<td>Shareholder loans to S corporation</td>
<td>Repayment of shareholder loans by S corporation</td>
</tr>
<tr>
<td>Separately states income/gain</td>
<td>Separately stated losses/deductions</td>
</tr>
<tr>
<td>Non-separately stated income/gain</td>
<td>Nondeductible expenses not properly charge to capital account</td>
</tr>
<tr>
<td>Excess depletion deductions over basis of property being depleted</td>
<td>Depletion deduction or oil and gas wells, to extent of shareholder’s basis in depletable property.</td>
</tr>
<tr>
<td>Additional capital contributions or stock purchases</td>
<td>Distributions not in excess of basis.</td>
</tr>
</tbody>
</table>
Statement of Revocation of S-Election

Date: _________________________

Internal Revenue Service Center
_____________________________________
_____________________________________
________________RE:____________________
_____________________________________
_____________________________________

Please be advised that the above corporation hereby revokes the Subchapter S-election it made under Section §1362(a) of the Internal Revenue Code. This revocation is intended to be effective on ____________. The corporation has ____________ shares of stock issued and outstanding at this time.

A statement signed by more than 50% of the corporation’s shareholders consenting to the revocation is attached.

Sincerely,

_________________________________

Title of Authorized Signor of Tax Return
Statement of Consent of Revocation of the S-Election

The undersigned, as shareholders of The ____________ Corporation, EIN ____________ on ____________, the date of revocation by that corporation of its election under §1362(a) to be an S-Corporation, hereby consent to that revocation. The shareholders are calendar year taxpayers. They acquired their shares in the corporation on ____________.

Under penalties of perjury, we declare that the statements made herein are to the best of our knowledge and belief, true, correct and complete.

Name, Address and Social Security No. of Shareholder

Number of Shares Held at Time Revocation is Made

Date of Signature

Signature

___________________________________________________________X
Statement of Consent to Rescind the Revocation of the S-Election

The undersigned, as shareholders of The ____________ Corporation, EIN ____________ on ____________, the date that is elected to rescind the revocation of its S-Corporation election under §1362(a) hereby consent to that recision. The shareholders are calendar year taxpayers. They acquired their shares in the corporation on

Under penalties of perjury, we declare that the statements made herein are to the best of our knowledge and belief, true, correct and complete.

Name, Address and Social Security No. of Shareholder

Number of Shares Held at Time Revocation is Made

Date of Signature

________________________________________________________X
Election Not To Apply Pro Rata Allocation

Corporation _________________________________________

EIN _________________________________________

Tax Year _________________________________________

The corporation elects (with the consent of all shareholders during the short S year and all shareholders on the first day of the C year under §1362(e) (3) not to apply the pro rata allocation method of 1362(e) (2) for determining the amounts of income, expense, and credit to be allocated to the S short period ended ____________ and to the C short period ended _____________. The corporation elects to close its books as of ____________ and to take into account under normal tax accounting rules the specific transactions that apply to each short period.

Cause of S Termination: _________________________________________

Date of Termination: _________________________________________

Date: _________________________________________

By: _________________________________________

Authorized Officer
Consent of Shareholders

The following shareholders, constituting each of the shareholders of the corporation during the S short period and each person who was a shareholder of the corporation on the first day of the C short year consent to the above corporate election.

<table>
<thead>
<tr>
<th>Date</th>
<th>Shareholder Signature</th>
<th>Social Security No.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tr>
</tbody>
</table>
PER-SHARE, PER-DAY ALLOCATION METHOD

The pro rata method assigns an equal amount of each of the S items to each day of the year. If a shareholder’s stock holding changes during the year, then the per-day method assigns the shareholder a pro rata share of each item for each day the stock is owned:

S-Corporation item X Percentage of Shares Owned X Percentage of Year Owned = Amount of item to be reported.
**Subchapter S-Corporation Checklist:**

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Is the entity incorporated?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. If incorporated did the entity file a timely Form 2553?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. If not incorporated is the entity an LLC that filed Form 8832?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Are all shareholders eligible to own Subchapter S stock?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Should bonuses be paid to employee shareholders before year-end?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Before making a §179 election did you verify that shareholders will be able to use the full pass through amount?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. If there is a current year loss do shareholders have sufficient basis to utilize loss?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Do shareholders have sufficient stock basis to avoid distributions treated as capital gains?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Is the entity using property of the owners which should be treated as a lease agreement (Rental of building or equipment)?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Have shareholders been reimbursed for out-of-pocket expenses paid on behalf of the entity? Is there an accountable plan in force?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Are there employee benefit plans in force?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Has any business property been distributed to shareholders?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Do shareholders have a buy/sell agreement?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14. Is there a need to revoke the S-election?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15. Have the basis of the assets transferred in the §351 transaction been properly accounted for by the entity and shareholders?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Tax Advocate’s Report Highlights Subchapter S-Corporation Issues

IR 2008-4, 01/08/2008

Over three million S-Corporations filed returns in 2006. Subchapter S-Corporations are the most common corporate entity. The National Taxpayer Advocate’s 2007 Annual Report notes that the IRS continues to struggle to develop an effective and comprehensive strategy to address noncompliance by S-Corporations. The Report focuses on some of the challenges in this area, including:

1. Insufficient data to assess compliance risks,

2. Undue taxpayer burden because of the S corporation election process, and


Specifically, the Report examined the avoidance of employment taxes because the entity reports shareholder wages as distributions.

The Report states that the continual growth in S corporation filings (which account for 65% of all corporate returns) may be due in part to:

1. Low individual tax rates,

2. Limited liability, and

3. The perceived opportunity for sole proprietors to avoid self-employment tax.

Compliance Data Difficulties.

1. The Service stratifies S-Corporation filings into three separate asset ranges (as compared with the 13 ranges for C-Corporations). This can make identifying returns with higher compliance risk more difficult, especially when 99% of all S-Corporations returns report assets of $10 million or less.

2. In fiscal year 2006, an S-Corporation faced only a 4 in 1000 change of being audited, compared to 8 in 1000 for C-Corporations.

3. The Report noted that the IRS increasingly identifies S-Corporation returns for examination to address abusive tax schemes and avoidance transactions, but identifying compliance risk associated with multi-entity return groups is challenging.
NOTE: IRS is also developing a high income taxpayer strategy to test the hypothesis that the highest income strata of **Forms 1040**, Individual Income Tax Return, are using a variety of tax products and entity structures to defer tax liability into future years, convert ordinary income into lower capital gain tax income or offset income with sham losses.

4. At the conclusion of an examination when the IRS proposes changes to S-Corporation returns it reports each shareholder’s share of the change as an adjustment to the individual shareholder’s tax return.

5. In addition to certain deficiencies with the audit process, IRS is unable to measure its effectiveness in S-Corporation examinations because it does not track the ultimate tax at the Form 1040 level. IRS records audit results at the S-Corporation level but never associates them with the tax assessment.

Subchapter S-elections and K-1 filings.

1. Taxpayers **elect** S-Corporation status by filing **Form 2553**, Election by a Small Business Corporation, on or before the 15th day of the third month of the tax year for which the election is to be in effect.

2. If the election is not timely filed or is incomplete, then the S-Corporation return is converted to a C-Corporation return when filed. In past years, roughly 14% to 16% of total new S-Corporation filings were unpostable (i.e., the S corporation election was not approved).

3. Approximately **20%** of S-Corporation returns are unpostable for multiple years because of missing information or IRS processing errors.

4. S-Corporations file a **Schedule K-1** each year to report profit and loss to their shareholders. IRS then matches income and loss information from **Schedules K-1** to individual tax returns and generates notices when differences arise.

5. Although returns are screened to eliminate unnecessary notices, the error rate is still high. IRS technicians who examine discrepancies have limited accounting and tax training, while S-Corporation returns contain many complex issues that may go undetected where employees only address flow-through income.

6. Further, since the **Schedule K-1** matching program is part of the Automated Underreporter (AUR) program unit which limits human involvement, many taxpayers are unable to reach a trained IRS employee to answer questions concerning mismatched K-1s because the AUR program’s level of service is poor and the program has no dedicated line for practitioners.
7. The Report concluded that IRS should focus on reducing taxpayer burden associated with the S-Corporation election process and the K-1 matching program. Taxpayers and return preparers have identified the S-Corporation election process as one of the most difficult for eligible small business corporations.

8. While efforts have been made to simplify the S-election process and reduce processing costs, the Report concluded that the best approach to reducing taxpayer burden is to permit the election to be considered timely filed with the first S-Corporation return.

**REMINDER:** This change was implemented for tax years ending on or after December 31, 2007.

**NOTE:** Taxpayers and practitioners also need access to knowledgeable IRS employees to deal with the often complex questions regarding S-Corporation and K-1 matching issues.

*Compensation vs. Corporate Distribution*

1. The earnings of an S-Corporation are taxed as ordinary income to its shareholders. Unlike partnership or sole proprietor earnings, S-Corporation earnings are not subject to self-employment tax.

2. This treatment gives rise to a tax planning strategy that recharacterizes shareholder compensation as distributions of profit to avoid payroll taxes. The S-Corporation owner pays employment taxes on only the portion of profits that the owners arbitrarily decide is “salary.”

3. The S-Corporation officer or shareholder, who takes no salary or a nominal salary, receives the remaining compensation as a tax-free distribution from self-employment. The corporation saves payroll taxes and the shareholder pays only income taxes on his share of the corporate profits, avoiding paying Social Security and Medicare taxes.

**NOTE:** In tax year 2005, almost one million S-Corporations with one shareholder paid no officers’ compensation. The Report calculates that if all profitable S-Corporations that reported no officers’ compensation had been Schedule C businesses, they would have paid an estimated **$4.9 billion** in self-employment tax.

4. The Report notes that the wage-to-distribution conversion strategy may reduce the shareholder’s future Social Security benefits which is an important part of most individuals’ retirement income. A taxpayer’s Social Security benefit depends on the amount of pre-retirement wages received and Social Security taxes paid.
5. Although the IRS has repeatedly litigated this issue and has won, taxpayers continue to use it as a tax planning strategy. The Service acknowledges this issue as a special compliance problem, featuring it in corporate classification guidelines for Form 1120S and including a reference to it in its notice of acceptance of S-Corporation status.

6. The IRS continues to audit returns based on this issue and reclassify distributions as wages subject to employment taxes. But establishing a fair and reasonable wage is difficult and time consuming. Examiners must consider:

a. The financial condition of the corporation,

b. The time worked by the shareholder,

c. The company’s compensation policy for other workers,

d. The salary structure in companies in similar industries, and

e. The return on investment.

NOTE: The easiest cases for the Service to litigate and win are those where a sole S corporation owner claims no salary or negligible salary subject to employment taxes despite the fact that he may serve in key roles in the business, providing management, sales, or service functions, controlling the day to day activities of the company and making decision affecting its future. The more difficult cases are those asserting that the amount of salary is not sufficient, i.e., reasonable.

CONCLUSION: The Report concludes that actions are needed to reverse the trends of electing S corporation status to avoid Social Security taxes. The employment tax strategy has an economic impact on the tax gap and erodes the Social Security and Medicare tax base. While acknowledging the challenges faced by IRS in dealing with this compliance issue (while reducing taxpayers’ burden), the Report concludes that the IRS must find the right balance of research, training, outreach and compliance activities to improve the quality of S corporation audits.