

Form 1120S Challenges for Tax Preparers

Navigating Computations-to-Adjustments Accounts and Determining Treatment of Dividends, Distributions and Fringe Benefits

WEDNESDAY, DECEMBER 10, 2014, 1:00-2:50 pm Eastern

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Form 1120S Challenges for Tax Preparers

Dec. 10, 2014

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S CORPORATION EQUITY ACCOUNTS AND DISTRIBUTIONS

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December 10, 2014

S Corporation Distributions

- Tax treatment of S corporation distributions is determined under §1368.
- A distribution is taken into account on the date the corporation makes the distribution, regardless of when it is treated as received by the shareholder.

S Corporation Distributions (cont'd.)

- Distribution equals the amount of cash and FMV of property distributed to shareholder(s).

Distributions of Property

- Unlike partnerships, an S corporation will recognize gain under §311 or §336 on the distribution of appreciated property.
 - If property transferred is subject to a liability, FMV may not be less than the amount of the liability.
 - Gain may be subject to §1245 or §1250 depreciation recapture.
 - §1239 will convert gain to ordinary if depreciable property is distributed to > 50% shareholder.
 - Distribution may be subject to §1374 built-in gains tax.
 - S corporation will not recognize loss on distribution of depreciated property. (§311(a))

General Ordering Rules for S Corporation Distributions

- Reduce AAA without regard to any “net negative adjustment” for the tax year (but not below zero)
- Reduce shareholders’ PTI
- Reduce accumulated E&P
- Reduce the other adjustments account (OAA).
- Reduce any remaining shareholders’ equity accounts.

Distributions Exceed AAA

- If distributions exceed AAA at the close of the year, a portion of each distribution is allocated to AAA pro rata based on the relative size of the distributions. (§1368(c))

Distributions from S Corporation Without Accumulated Earnings and Profits (§1368(b))

- S corporation without C corporation earnings and profits (“accumulated E&P”)
 - Taxation of distributions is wholly dependent upon recipient’s basis in S corporation stock

Distributions from S Corporation Without Accumulated Earnings and Profits (§1368(b)) (cont'd.)

- Cash and FMV of property received is nontaxable to extent of recipient's stock basis
- Excess distribution is taxable as gain from the sale or exchange of property

Treatment of S Corporation Distributions With Accumulated E&P (§1368(c))

- Distributions are applied in the following order if the S corporation has accumulated E&P:
 - As a distribution of AAA (nontaxable return of capital to the extent of the shareholder's stock basis);

Treatment of S Corporation Distributions With Accumulated E&P (§1368(c)) (cont'd.)

- As a dividend to the extent of the S corporation's accumulated E&P;
- As a nontaxable reduction of basis to the extent of any remaining basis in stock; and
- As a taxable capital gain from the deemed sale or exchange of stock.

Treatment of S Corporation Distributions With Accumulated E&P : Special Rule for PTI

- Under Reg. §1.1368-1(d)(2), amounts distributed in cash in excess of AAA come out of PTI before accumulated E&P.

C Corporation Accumulated E&P

- An S corporation does not generate E&P.
- C corporation accumulated E&P is generally frozen as of the effective date of the S corporation election.
- Exception: amounts that reduce accumulated E&P
 - Distributions out of accumulated E&P, which are taxed as dividends
 - Certain redemptions, reorganizations, liquidations, or corporate divisions in which the C corporation rules are applied
 - Tax paid at the corporate level because of business credit recapture
 - LIFO recapture payments

C Corporation Accumulated E&P (cont'd.)

- No retroactive recomputation rule
 - A change in estimates used in preparing a prior year C corporation income tax return does not affect accumulated E&P (*Cameron*, 105 T.C. 380 (1995), *aff'd sub nom.*, *Broadaway*, 97-1 USTC ¶50,355 (8th Cir. 1997).)

C Corporation Accumulated E&P (cont'd.)

- Amounts distributed from accumulated E&P are taxed as dividends.
 - Eligible for lower tax rate imposed on qualified dividends in 2012
- S corporation reports distributions on Form 1099-DIV, not as a distribution on Schedule K-1.

Computation of AAA

- Maintenance of AAA is recommended for all S corporations
 - AAA will be needed if the S corporation engages in a §381(a) transaction with a C corporation that has accumulated E&P.
- AAA is an account of the S corporation and is not apportioned among shareholders.
- AAA is relevant for all taxable years beginning on or after January 1, 1983, for which the corporation is an S corporation.

Computation of AAA (cont'd.)

- AAA starts at zero on the first day of the corporation's first year as an S corporation.
- Unlike shareholder basis, AAA balance can be negative at the end of the year.
- AAA balance disappears at the end of the post-termination transition period after an S election terminates.

Computation of AAA – Taxable Years Beginning On or After August 28, 1998

- For taxable years beginning on or after August 18, 1998, AAA is adjusted at the end of each S corporation tax year as follows:
 - First, increased by separately and nonseparately stated passthrough items of income and gain (other than tax-exempt income), certain depletion, and changes in asset basis due to certain business tax credit recapture.

Computation of AAA – Taxable Years Beginning On or After August 28, 1998 (cont'd.)

- Second, decreased by separately and nonseparately stated passthrough items of loss and deduction, certain depletion, nondeductible expenses (other than Federal taxes attributable to any taxable year the corporation was a C corporation and expenses related to tax-exempt income), and changes in asset basis due to certain business tax credit recapture.
 - The reduction in this step is limited to the increase in the first step.
 - “Net negative adjustment” is taken into account under step 4 on next slide.

Computation of AAA – Taxable Years Beginning On or After August 28, 1998 (cont'd.)

- Third, AAA is decreased (but not below zero) by nondividend distributions.
- Fourth, if the aggregate loss and deduction items in the second step are more than the aggregate income and gain items in the first step (i.e., there is a “net negative adjustment”), AAA is reduced by the excess of the loss and deduction over the income and gain items.
- Fifth, increased or decreased for redemption distributions qualifying under §302(a) or §303(a).

Computation of AAA – Taxable Years Beginning Before January 1, 1997

- For taxable years beginning before January 1, 1997, AAA was adjusted at the end of each S corporation tax year as follows:
 - First, increased by separately and nonseparately stated passthrough items of income and gain (other than tax-exempt income), certain depletion, and changes in asset basis due to certain business tax credit recapture.

Computation of AAA – Taxable Years Beginning Before January 1, 1997 (cont'd.)

- Second, decreased by separately and nonseparately stated passthrough items of loss and deduction, certain depletion, nondeductible expenses (other than Federal taxes attributable to any taxable year the corporation was a C corporation and expenses related to tax-exempt income), and changes in asset basis due to certain business tax credit recapture.

Computation of AAA – Transition Rule

- Reg. §1.1368-4 provides that return positions consistent with Reg. §§ 1.1368-1(e)(2), 1.1368-2(a)(5), and Examples 2, 4, and 5 of §1.1368-3, are reasonable for taxable years beginning on or after January 1, 1997, and before August 18, 1998.

Computation of AAA – Taxable Years Beginning Before January 1, 1997

- Third, AAA is decreased (but not below zero) by nondividend distributions.
- Fourth, increased or decreased for redemption distributions qualifying under §302(a) or §303(a).

Computation of AAA – cont.

- AAA is decreased by full amount of noncapital, nondeductible expenses even though such expenses –
 - may not reduce a shareholder's stock basis under the elective ordering rule of Reg. §1.1367-1(g), or
 - are not deductible by the shareholder because of basis, at-risk, or passive loss limitations.

Example

Sue has been the sole stockholder of S for five years. On January 1, 2012, Sue's basis in her stock is \$43,000, and the corporation shows a AAA balance of \$31,000 and accumulated E&P balance of \$25,000. Sue receives a \$40,000 distribution on during 2012. At the end of 2012, S passes through nonseparately stated income of \$2,000 and a capital loss of \$10,000.

Example – cont.

- What is S's AAA balance on December 31, 2012?
- What is S's accumulated E&P balance on December 31, 2012?
- What is Sue's stock basis on December 31, 2012?

Example – cont.

AAA balance on December 31, 2012 = (8,000),
computed as follows:

Balance at BOY	\$31,000
Nonseparately stated income	<u>2,000</u>
Balance before reductions	33 000
LTCL (limited to income items)	<u>(2,000)</u>

Example – cont.

Balance before distributions and other reduction items	31,000
Distributions to extent of AAA	<u>(31,000)</u>
Balance before other reduction items	0
Net negative adjustment	<u>(8,000)</u>
Balance at EOY	<u><u>\$(8,000)</u></u>

Example – cont.

Accumulated E&P balance on December 31, 2012 = \$16,000, computed as follows:

Balance at BOY	\$25,000
Nonseparately stated income	<u>0</u>
Balance before reductions	25 000
LTCL (limited to income items)	<u>0</u>

Example – cont.

Balance before distributions and other reduction items	25,000
Distributions of accumulated E&P	<u>(9,000)</u>
Balance before other reduction items	16,000
Net negative adjustment	<u>0</u>
Balance at EOY	<u><u>\$16,000</u></u>

Example – cont.

Sue's basis on December 31, 2012 = \$4,000, computed as follows:

Balance at BOY	\$43,000
Nonseparately stated income	<u>2,000</u>
Basis before distributions and other reduction items	45 000
Distributions to the extent of AAA	<u>(31,000)</u>
Basis before other reductions	14,000
LTCL	<u>(10,000)</u>
Sue's basis at EOY	<u>\$ 4,000</u>

Computation of AAA – Charitable Contributions

- For years beginning after December 31, 2005, and before January 1, 2012, AAA is decreased only by the adjusted basis of property donated to a charitable organization in a transaction qualifying under §170(c).

Computation of AAA – Charitable Contributions (cont'd.)

- Watch to see if this provision is extended to years beginning after December 31, 2011.

Other Adjustments Account (OAA)

- OAA is adjusted in the following order:
 - Increased for tax-exempt income;
 - Decreased for expenses related to tax-exempt income;
 - Decreased for federal taxes attributable to a C corporation tax year;
 - Decreased (but not below zero) for distributions in excess of AAA and accumulated E&P.
- Purpose of the OAA is prohibit an S corporation from distributing net tax-exempt income to a shareholder on a tax-free basis before the corporation distributes its accumulated E&P.

Other Adjustments Account (OAA)

- Tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. (Reg. § 1.1366-1(a)(2)(viii))
- Employer-owned life insurance – Rev. Rul. 2008-42
 - Premiums paid by an S corporation on employer-owned life insurance contract, of which the S corporation is directly or indirectly a beneficiary, reduce the OAA, and not AAA.
 - Benefits received by reason of death of the insured from an employer-owned life insurance contract that meets an exception under §101(j)(2) increase the OAA, and not AAA.

Previously Taxed Income (PTI)

- A corporation can have PTI only if it was an S corporation for its last taxable year beginning before January 1, 1983.
- The corporation must continuously maintain its S corporation election for all years beginning after 1982.
- PTI must be distributed in cash.
- No adjustments are made to the account after 1982 except to reduce it for distributions made under §1375(d) (as in effect before the Subchapter S Revision Act of 1982).
- PTI is personal and cannot be transferred to another person.
- S corporation is required to keep records of each shareholder's share of PTI.

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SPECIAL ELECTIONS

Election to Distribute E&P Before AAA

- Election is made pursuant to §1368(e)(3).
- Election is “all or nothing”
- S corporation must have consent of all affected shareholders.
 - “Affected shareholder” means any shareholder to whom a distribution was made during the taxable year.
- Election is irrevocable and effective only for the year for which it is made.
- Consider making this election in 2012 to take advantage of the lower tax rate for qualified dividends.

Election to Distribute E&P Before AAA – cont.

- Election can reduce or eliminate exposure to the tax on passive income and potential termination of the S corporation election.
- Note: Separate election must be made to distribute accumulated E&P before PTI.
- Tax years beginning before January 1, 1997

Election to Distribute E&P Before AAA – cont.

- An S corporation could have both subchapter C and subchapter S corporation E&P.
- Distributions were treated as first coming from subchapter C E&P, and then subchapter S E&P.
- Subchapter S E&P has been eliminated for tax years beginning on or after January 1, 1997.

Election to Forego PTI

- Election is made pursuant to Reg. §1.1368-1(f)(4).
- S corporation must have consent of all affected shareholders.
 - “Affected shareholder” means any shareholder to whom a distribution was made during the taxable year.
- Election is irrevocable and effective only for the year for which it is made.
- S corporation can make this election in conjunction with election to distribute accumulated E&P before AAA.

Deemed Dividend Election

- Election is made pursuant to Reg. §1.1368-1(f)(3).
- S corporation must have consent of all affected shareholders.
 - “Affected shareholder” means any shareholder who owns S corporation stock on the last day of the S corporation’s taxable year.
- S corporation is also deemed to have made the election to distribute accumulated E&P before AAA.
- Election is irrevocable and effective only for the year for which it is made.

Deemed Dividend Election (cont'd.)

- S corporation may specify the amount of the deemed dividend.
 - Amount of deemed dividend may not exceed the amount of accumulated E&P on the last day of the taxable year, reduced by actual distributions of accumulated E&P made during the taxable year.
- Deemed dividend treated as distributed in money pro rata to shareholders and immediately contributed back to the S corporation on the last day of the S corporation's taxable year.

Election to Terminate Year Under Reg. §1.1368-1(g)(2)

- Requires a “qualifying disposition”
 - “Qualifying disposition” means:
 - Disposition of $\geq 20\%$ of outstanding S corporation stock in one or more transactions by a shareholder within any 30-day period during the S corporation’s taxable year;
 - Redemption of $\geq 20\%$ of outstanding S corporation stock from a shareholder in one or more transaction within any 30-day period during the S corporation’s taxable year; and

Election to Terminate Year Under Reg. §1.1368-1(g)(2) (cont'd.)

- Issuance of $\geq 25\%$ of previously outstanding S corporation stock in one or more transactions within any 30-day period during the S corporation's taxable year.
 - Election is irrevocable.

Election to Terminate Year Under Reg. §1.1368-1(g)(2) (cont'd.)

- S corporation will treat the year of the termination as two separate tax years for purposes of allocating income, gain, loss, deduction, and credits, adjusting AAA, E&P, and basis, and determining the tax effect of distributions.
 - For purposes of computing AAA, first year terminates at the close of the day on which the substantial disposition occurs. (Reg. §1.1368-2(e))

Election to Terminate Year Under §1377(a)(2)

- Requires a complete termination of a shareholder's interest in the corporation
 - Termination can be by sale or exchange, redemption, gift, transfer pursuant to divorce, and death.
- Each “affected shareholder” must agree to the election.
 - “Affected shareholder” includes the shareholder whose interest was terminated and any shareholder to whom such shares were transferred
- Election is irrevocable.

Election to Terminate Year Under §1377(a)(2) (cont'd.)

- S corporation will treat the year of the termination as two separate tax years for purposes of allocating income, gain, loss, deduction, and credits, adjusting AAA, E&P, and basis, and determining the tax effect of distributions.
 - For purposes of computing AAA, first year ends at the close of the day on which the shareholder interest terminates. (Reg. §1.1368-2(e))
- The termination election rules under §1377 take precedence over the qualifying disposition rules under Reg. §1.1368-1(g)(2)(i).

**REDEMPTIONS, MERGERS,
ACQUISITIONS, ETC.**

AAA Adjustments for Redemptions

- Redemptions
 - AAA is adjusted to reflect an amount equal to the ratable share of the AAA attributable to the stock redeemed as of the redemption date.
 - AAA is first adjusted for ordinary distributions before being adjusted for redemption distributions when both are made in the same year.
 - Distribution must qualify as a sale or exchange under §302(a) or §303(a).

AAA Adjustments for Redemptions – cont.

Example

During 2012, XYZ, a calendar-year S corporation ratably earns \$100,000, none of which is distributed to its shareholders. AAA balance is \$200,000 on 1/1/2012. On June 30, 2012, XYZ redeems all of the stock owned by B, a 25-percent shareholder for \$25,000.

AAA balance as of December 31, 2012, is, computed as follows:

– Balance as of 1/1/12	\$	200,000
– Increase for 6/12 of earnings from 1/1/12 through 6/30/12		<u>50,000</u>
– Balance as of 6/30/12	\$	250,000
– Decrease for 6/30/12 redemption	(62,500)
– Increase for 6/12 of earnings from 7/1/12 through 12/31/12		<u>50,000</u>
– Balance as of 12/31/12	\$	<u><u>237,500</u></u>

- Query: How is the redemption taxed to B?

Accumulated E&P Adjustments for Redemptions

- Redemptions
 - Accumulated E&P is adjusted to reflect an amount equal to the ratable share of the accumulate E&P attributable to the stock redeemed. (§312(n)(7) and Reg. §1.1368-2(d)(1)(i))
 - Distribution must qualify as a sale or exchange under §302(a) or §303(a).

AAA and Accumulated E&P Adjustments for Redemptions

Example

On January 1, 2012, XYZ, a calendar-year S corporation, has \$100,000 of AAA and \$200,000 of accumulated E&P. XYZ has two shareholders, A and B, each of whom owns 50 shares of stock. For 2012, XYZ has \$160,000 of taxable income, which increases AAA to \$260,000 as of December 31, 2012 (before taking into account distributions made during 2012). On February 1, 2012, XYZ distributes \$100,000 to each shareholder. On December 31, 2012, XYZ redeems for \$13,000 all of B's stock in a redemption that qualifies as a sale or exchange under §302(a).

AAA and Accumulated E&P Adjustments for Redemptions

Example – cont.

AAA balance as of December 31, 2012, is computed as follows:

– Balance as of January 1, 2012	\$ 100,000
– Increase for 2012 taxable income	<u>160,000</u>
– Balance as of December 31, 2012, before distributions and redemption	\$ 260,000
– Decrease for 2/1/12 distributions	<u>(200,000)</u>
– Balance as of December 31, 2012, before redemption	24,000
– Decrease for 12/31/12 redemption	<u>(12,000)</u>
– Balance as of 12/31/12	<u><u>\$ 12,000</u></u>

AAA and Accumulated E&P Adjustments for Redemptions

Example – cont.

- Queries
 - How is the redemption taxed to B?
 - What is the balance in accumulated E&P on January 1, 2013?
 - What would be the balance in AAA on December 31, 2012, if XYZ had distributed \$150,000 to each shareholder on February 1, 2012? How would this change affect the taxation of the February 1 distributions and the balance in accumulated E&P as of January 1, 2013?

AAA and Accumulated E&P Adjustments for Liquidations and Reorganizations

- AAA
 - If an S corporation acquires the assets of another S corporation in a transaction to which §381(a) applies, the acquiring S corporation will succeed to and merge its AAA (whether positive or negative) with the AAA of the acquired S corporation as of the close of the date of the distribution or transfer.

AAA and Accumulated E&P Adjustments for Liquidations and Reorganizations (cont'd.)

- Accumulated E&P
 - §381(c)(2) provides that a deficit in accumulated E&P of the distributor, transferor, or acquiring corporation may only be used to offset earnings and profits accumulated after the date of the transfer.

AAA and Accumulated E&P Adjustments for Liquidations and Reorganizations (cont'd.)

- This rule will effectively prevent a deficit balance in accumulated E&P from a corporation a party to a §381(a) transaction from offsetting a positive balance in accumulated E&P from another corporation a party in the same §381(a) transaction to reduce future dividend distributions since accumulated E&P is generally frozen as of the effective date of the S election.

AAA and Accumulated E&P Adjustments for Divisive Reorganizations

- In a divisive reorganization (i.e., spin-off, split-off, and split-up under §355), AAA and accumulated E&P are generally allocated between the distributing corporation and the controlled corporation based on the relative FMVs of both corporations. (Reg. §§1.1368-2(d)(3) and 1.312-10(a))
 - Under the proper circumstances, the allocation may be made in proportion to the net basis of the assets transferred and of the assets retained or by any other reasonable method.

AAA and Accumulated E&P Adjustments for Divisive Reorganizations (cont'd.)

- The part of E&P and AAA of the taxable year of the distributing corporation in which the transaction occurs allocable to the controlled corporation shall be included in the computation of the AAA and accumulated E&P of the first taxable year of the controlled corporation ending after the date of the transaction.

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Form 1120S Challenges

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December 10, 2014

Part IV. Fringe Benefits

General Rule for C Corporations

One of the tax benefits of a C corporation is that an owner/shareholder can be treated/respected as an employee of the corporation. This contrasts to the partnership area which does not allow an owner/partner to be treated as an employee.

As a result, an owner/shareholder can participate in certain fringe benefits offered to employees. The C corporation can generally deduct the cost of fringe benefits provided to employee owners without the employee owner having to include the value of the fringe benefits in taxable income.

Special Rule for S Corporations

While the rules applicable to C corporations generally apply to S corporations as well, Section 1372 provides that, in applying the rules applicable to employee fringe benefits

- An S corporation is treated as a partnership, and
- any 2% or more shareholder is treated as a partner of the partnership.

Special Rule for S Corporations

A 2% shareholder is any person who on any day of the corporate year owns more than 2% of the outstanding stock or more than 2% of the voting power of all of the stock.

The constructive ownership rules of Section 318 apply. As a result, a person can be a 2% shareholder even if he does not own any stock directly.

- For example, Father owns 5% of stock in Y. Son works for Y but holds no stock. Under Section 318, stock ownership is attributed between members of a family (spouses, children, grandchildren and parents). Son is treated as a 2% shareholder because the stock of Father is attributed to Son.

What Does This Mean?

2% shareholders generally do not get the benefit of excluding fringe benefits from income, since the fringe benefit exclusion provisions generally only apply to “employees”.

Note that this rule is for 2% shareholders only. Less than 2% shareholders are caught by Section 1372.

What Fringe Benefits Are Covered?

Section 1372 does not specifically define what fringe benefits are covered. What does appear to be covered based on legislative history:

- Exclusion from income amounts received under accident and health plans (Section 105) (See Part V).
- Exclusion from an employee's income employer-provided coverage under an accident and health plan (Section 106) (See Part V).
- Exclusion from employee's taxable income of the cost (up to \$50,000) of group term life insurance provided by an employer on employee's life. (Section 79).
- Exclusion from employee's taxable income of meals or lodging provided by an employer to an employee for the convenience of the employer (Section 119).

What Fringe Benefits Are Not Covered/Impacted

The following benefits are generally not covered/impacted, as these provisions specifically define employees to include self-employed individuals (including partners).

- Defined contribution plans and defined benefit plans, including employee stock ownership plans (Sections 401-417).
- Qualified group legal services plans (Section 120).
- Dependent care assistance programs (Section 129).

Cafeteria Plans

A cafeteria plan allows employees to pay certain qualified expenses on a pre-tax basis (i.e., flexible spending accounts).

Section 125 provides that employee benefits provided under a cafeteria plan are not included in an employee's income merely because the employee had the chance, before the cash became available, to choose to receive the cash or nontaxable benefits under the cafeteria plan.

Section 125 requires that all participants in the cafeteria plan be employees. Based on Section 1372, the IRS has issued proposed regulations under Section 125 stating that 2% shareholders are not employees and thus cannot participate in cafeteria plans.

Part V. Health Related Fringe Benefits

Revenue Ruling 91-29

The IRS addressed how to apply Section 1372 to payments of health insurance premiums by an S corporation in Revenue Ruling 91-29.

In that ruling, the S corporation paid accident and health insurance premiums for both 2% shareholder employees and a less than 2% shareholder employee. The IRS held:

- The employee fringe benefits paid or furnished for the benefit of 2% shareholder employees were to be treated like a guaranteed payment under Section 707(c).
- The 2% shareholders had to include cost of the premiums in their gross income.
- The less than 2% shareholder employee could exclude the cost from income under Section 106.

Revenue Ruling 91-29

In addition, the IRS held that the S corporation could deduct the cost of providing the employee fringe benefits if the requirements under Section 162(a) were satisfied (i.e., if the cost was an ordinary and necessary expense paid or incurred in carrying on trade or business).

The IRS also stated that the 2% shareholders could deduct the cost of the insurance premiums if they satisfied the requirements of Section 162(l).

Announcement 92-16

In Announcement 92-16, the IRS reiterated its holding in Revenue Ruling 91-29.

It then stated that while the premium payments by the S corporation are included in the 2% shareholder's wages for income tax withholding purposes (i.e., listed on the W-2), they are not wages subject to the Social Security and Medicare taxes.

Notice 2008-1

The IRS provided rules regarding when a 2% shareholder is entitled to deduct accident and health insurance premiums under Section 162(l) in Notice 2008-1.

Section 162(l) provides that an employee (including a self-employed individual such as a partner) may deduct amounts paid for medical care insurance subject to the following limitations:

- Deduction shall not be allowed to the extent the deduction exceeds the individual's earned income from the trade or business with respect to which the plan providing the medical care coverage is established.
- Deduction is not allowed for amounts during a month in which the individual is eligible to participate in any subsidized health plan maintained by an employer of the individual or their spouse.

Notice 2008-1 Requirements

In addition to the Section 162(l) requirements, Notice 2008-1 requires:

- Plan providing medical coverage must be established by the S corporation. Either
 - S corporation makes the premium payments for the accident and health insurance policy in the current taxable year, or
 - 2% shareholder makes the premium payments and furnishes proof of payment to the S corporation and S corporation then reimburses the 2% shareholder in the current taxable year.

If premiums are not paid or reimbursed by S corporation and included in 2% shareholder's gross income, requirement is not satisfied and no deduction.

- S corporation must report the accident and health insurance premiums paid or reimbursed as wages on the 2% shareholder's Form W-2.

Earned Income

Section 162(l) provides that the deduction is limited to the amount of the individual's earned income from the trade or business with respect to which the plan providing the medical care coverage is established.

Wages paid to a 2% shareholder are deemed to be earned income for purposes of this Section 162(l) limitation.

Health Savings Account

An individual can generally, under Section 223, deduct contributions made to a health savings account (HSA) established to pay for qualified medical expenses. If the employer makes the contribution, the contribution is generally excluded from income and wages under Section 106(d).

In Notice 2005-8, the IRS stated that an S corporation's contribution to HSA of 2% shareholder is treated as a guaranteed payment under Section 707(c). The S corporation can deduct the contribution under Section 162 and the 2% shareholder must include it in gross income.

The deduction must be included in wages on W-2, but not subject to Social Security or Medicare tax.

In Short

2% shareholders often do not get the benefit of excluding fringe benefits from income, since the fringe benefit exclusion provisions generally only apply to “employees”.

The 2% shareholders must generally include the fringe benefit in gross income. A deduction may be available in some cases (e.g., Section 162(l)).

The S corporation should issue the 2% shareholder a W-2 with respect to the fringe benefits, although Social Security and Medicare generally do not apply.

The S corporation may be able to deduct the cost of the fringe benefits as a business expense under Section 162.

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Part VI. Common S Corporation Mistakes

Payroll Requirements

Shareholders will receive a Schedule K-1 showing the shareholders' pro rata share of S corporation items. However, if the shareholders are also employees, the S corporation must appropriately apply the payroll provisions to the employee shareholders.

This includes making payroll tax deposits, filing quarterly payroll tax returns, and issuing W-2s.

Employee shareholders must be paid reasonable compensation.

If there are fringe benefits, S corporation should include the fringe benefits in the W-2 as discussed earlier in the presentation.

Subchapter S Election

Certain elections, such as the REIT election, are made when you file the tax returns. This is not the case with the S election.

Form 2553 (the election form) provides that the effective date for the election may be no more than 75 days prior to the date that the election was filed.

File the Form 2553 before the start of the tax year to which you want the election to apply or within the first 75 days of that tax year.

For newly formed entities, file the election within 75 days of the date that the entity was formed. Do not file before the entity is formed as the election will not be valid.

Subchapter S Election

Form 2553 must be signed by all shareholders to be effective.

If the entity is an LLC, the check the box regulations by default treat the LLC as a partnership or a disregarded entity. However, the filing of the Form 2553 will result in a deemed corporate election for the LLC. A separate Form 8832 will not be required. Treas. Reg. sec. 301.7701-3(c)(1)(v)(C).

Late elections may qualify for relief under the provisions found in Treas. Reg. sec. 301.9100-1 et seq.

QSUB Election

An S corporation can elect to treat eligible subsidiaries as a qualified subchapter S subsidiary (QSUB), which means that it is disregarded as a separate corporation for federal income tax purposes.

Election is made by filing Form 8869 with IRS.

Election can be made any time, but it can be effective no more than 75 days before the date on which the election is filed or more than twelve months after the election is filed.

QSST Election

Only certain trusts can be shareholders in an S corporation, and these trusts include a qualified Subchapter S trust (QSST) and an electing small business trust (ESBT).

A QSST is a trust all of which is treated as owned by an individual that is a U.S. citizen or resident (i.e., treated as a grantor trust). The beneficiary must make an election to treat the trust as a QSST.

The election must be made within 16 days and 2 month period (i.e., of the entity becoming an S corporation, of the stock being transferred to the trust, etc.).

QSST Election

Form 2553 is also used to make the QSST if the entity is making an S election.

If a Form 2553 is not being filed, then the election must be made by filing a statement with the IRS Service Center where the S corporation files its federal income tax return.

QSST Statement

Statement is signed by the income beneficiary or his representative and includes:

- contains the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the S corporation,
- identifies the election as an election under Section 1361(d)(2),
- specifies effective date of election,
- specifies date of stock transfer to trust, and
- provides certain information and representations establishing that the trust should be treated as a grantor trust.

ESBT

An ESBT is a trust that

- does not have beneficiaries other than individuals, estates or certain charitable organizations,
- no interest in the trust may have been acquired by purchase,
- no QSST election has been made with respect to any stock held by the trust,
- the trust is not tax-exempt, a charitable remainder annuity trust or a charitable remainder unitrust, and
- an ESBT election has been made.

ESBT Statement

Election statement is signed by trustee and filed with IRS Service Center where the S corporation files its federal income tax return within 16 days and 2 month period:

- contains the name, address, and taxpayer identification number of all potential current beneficiaries,
- identifies the election as an election under Section 1361(e)(3),
- States the first date on which the trust owned stock in S corporation,
- specifies effective date of election (no earlier than 75 days), and
- representations that (a) trust meets all requirements of an ESBT and (b) that the potential current beneficiaries meet the shareholder requirements.

ESBT Statement

ESBT can hold stock in more than one S corporation.

If it does, may have to file election statement with multiple IRS Service Centers depending on where S corporations file their federal income tax returns.

Disproportionate Distributions

One of the requirements for an S Corporation is that the entity have only one class of stock. This requires that all corporate distributions to shareholders be pro rata.

Providing benefits to certain shareholders (e.g., use of corporate property) or excessive compensation to certain shareholders may result in the transaction being recharacterized as a distribution to those shareholders.

Disproportionate distributions could result in the entity having more than one class of stock and losing its S qualification. If S status is revoked, there is a 5 year waiting period to reelect.

Section 1366 Basis Limitation

Section 1366(d) provides that a shareholder may not utilize losses or deductions in excess of the shareholder's basis in (i) its stock of the S corporation, and (ii) any debt owed by the S corporation to the shareholder.

Simply because the shareholder's K-1 shows a pro rata share of items of deductions and losses does not mean they can be utilized.

Losses and deductions in excess of basis will be suspended until the shareholder has sufficient basis. However, if the shareholder sells or transfers its interest without utilizing the suspended losses or deductions, they are permanently lost.

Stock Basis

- Generally, initial basis equals the cost paid for the stock. If property was contributed for stock, then basis equals basis of property contributed, adjusted for gain recognized and boot distributed.
- Increased by
 - Additional capital contributions
 - Share of S corporation income (including exempt income)
 - Excess of depletion deductions over basis
- Decreased by
 - Share of S corporation losses, deductions, and depletion
 - Share of noncapital, nondeductible expenses (e.g. penalties or bribes).
 - Certain distributions

Debt Basis

Debt basis – General rule

- Initial basis equals the cost of the debt.
- Decreased by the repayment of principal.
- Reduced to zero if the debt becomes worthless.

When making the adjustments listed in the previous slide, the adjustments are generally made to the shareholder's stock basis, not its debt basis. However, stock basis can only be reduced to zero. If there are additional decreasing adjustments to be made, the adjustments will then be made to reduce debt basis. If this occurs, when the S corporation later has income items, the basis increase will first restore the debt basis before increasing stock basis.

Debt Basis

For example, Shareholder A has stock basis of \$25 and debt basis of \$100. A's pro rata share of loss items is \$50.

A's stock basis is reduced to \$0, and A's debt basis is then reduced to \$75.

In the next year, A has a pro rata share of income items of \$30.

The first \$25 of the \$30 of income is applied to increase A's debt basis back to \$100. The remaining \$5 is then applied to increase A's stock basis.

Debt

Shareholders get basis for debt owed by the S corporation to the shareholder, not for debt owed by the S corporation to some party other than the shareholder. This is the case even if the shareholder guarantees the debt. This is a substantial divergence from partnerships.

If an S corporation is incurring debt to make acquisitions such as to purchase equipment, consider having the shareholder incur the debt then loan the money to the S corporation, especially if (i) Section 1366 is hindering the shareholder's ability to utilize losses and deductions and (ii) lender is requiring personal guarantee from shareholder anyway.

Debt

Be careful that the terms of the loan are respected as debt. If debt is recharacterized as equity, the result is often a second class of stock (revoking S status). For example, debt with an annual interest payment of 8% could be treated as preferred stock if it has many equity features.

Section 1361(c)(5) provides straight debt safe harbor.

- Interest rate and payments not contingent on profits or borrower's discretion,
- No convertibility of debt into stock or equity, and
- Creditor is an individual, estate, ESBT, QSTT or a person (other than an individual) that is actively and regularly engaged in business of lending money.

Any shareholder loans should be properly reflected on Schedule L.