Mastering S Corporation At-Risk Loss Limitations: Beyond Calculations to Proactive Planning

WEDNESDAY, JANUARY 13, 2016, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.

- **Listen on-line** via your computer speakers.

- **Respond to five prompts during the program plus a single verification code**. You will have to write down only the final verification code on the attestation form, which will be emailed to registered attendees.

- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT

For Additional Registrations:
- Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

For Assistance During the Program:
- On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.


**Tips for Optimal Quality**

**Sound Quality**
When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

**Viewing Quality**
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Mastering S Corporation At-Risk Loss Limitations

January 13, 2016

Robert S. Barnett, Partner
Capell Barnett Matalon & Schoenfeld
rbrnett@cbmslaw.com

Darren J. Mills, Managing Director
Alvarez & Marsal Taxand
dmills@alvarezandmarsal.com
Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS’ FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
CONTENTS

I. At-risk Limitation Rules
II. What provides S corporation Shareholders with At-Risk Basis
III. Separate, Aggregating, & Tracing At-Risk Amounts by Activity
IV. Bio
AT-RISK LIMITATION RULES
The SC holding in Crane v. Commissioner, 331 US 1 (1947), paved the way for tax-sheltered investments. In Crane, the SC held that a taxpayer may include a nonrecourse liability (i.e., a liability for which the taxpayer is not personally liable) in the depreciable basis of property.

- Non-recourse leverage enabled taxpayer’s to make more investments than possible as compared to cash.
- Ability of taxpayers to generate tax losses without economic risk
- IRC § 465 was enacted in 1976 in an attempt to combat tax sheltered investments
  - “Tax shelter” – offsetting income with deductions and credits related to investments in such things as real estate, cattle, equipment leasing, research and development, and oil and gas ventures.
  - “Tax shelters took advantage of a basic structural feature of the federal income tax system, so pervasive that it is virtually taken for granted: Generally, all income and all deductions are amalgamated in computing taxable income. This global concept of taxable income allowed tax shelter deductions to be taken against salaries, professional fees, dividends, interest, and business income of all types, resulting in dramatic reductions in tax liabilities and correspondingly large increases in spendable funds.” Bittker & Lokken: Federal Taxation of Income, Estates, and Gifts (WG&L), ¶28.1. Introductory
- Generally results in tax deferral not permanent

AT-RISK LIMITATION RULES
AT-RISK LIMITATION RULES CONT’D

- At-risk rules applied before passive activity loss
  - IRC 469, enacted in 1986, significantly reduced the importance of the at-risk rules
  - S Corporation generates a taxable loss. Is that loss deductible by the shareholder?
    - Does the taxpayer have basis in the S Corporation? IRC § 1366(d)
    - Does the taxpayer have at-risk basis? IRC § 465
    - Do the PAL rules apply? If so, is the loss allowed? IRC § 469

- “When a loss is disallowed by the at-risk rules, it is ignored for purposes of the passive activity loss rules. But it is not necessarily disallowed forever; it is carried forward, and may become allowable in a future year, if the [IRC] § 465 at-risk rules are satisfied for that year. When and if it becomes allowable under [IRC] § 465 as a deduction for a later year, it will be subject to the passive activity loss rules for the later year, with its status as a passive activity deduction determined on the basis of the facts for the earlier year.” Starczewski, 550-4th T.M., At-Risk Rules

- Not limited to tax-shelter activities
- In the case of an individual…engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk…for such activity at the close of the taxable year. IRC § 465(a)(1)
- Any loss from an activity to which the at-risk rules applies and not currently allowed for the taxable year shall be treated as a deduction allocable to such activity in the first succeeding taxable year. IRC § 465(a)(2)

- Taxpayer incurs investment interest expense that is disallowed under IRC § 163(d). This amount would not factor into the at-risk limitation rule since it has already been limited by another IRC provision.

- “Under section 465 the amount of the loss is allowed as a deduction only to the extent that the taxpayer is at risk with respect to the activity at the close of the taxable year.” Prop. Treas. Reg. 1.469-1(a)

- Recapture
  - “If zero exceeds the amount for which the taxpayer is at risk in any activity at the close of any taxable year the taxpayer shall include in his gross income for such taxable year (as income from such activity) an amount equal to such excess, and an amount equal to the amount so included in gross income shall be treated as a deduction allocable to such activity for the first succeeding taxable year [i.e., automatically creates a suspended loss for the following year].” IRC § 465(e)

- Cash distributions and reduction in liabilities

- Recapture income excluded in determining “loss” for purposes of IRC § 465
• Applicability of the at-risk rules to flow-through entities?
  • Only applicable to individuals and certain C Corporations.
  • Legislative history indicates applicability to estates and trusts.
  • Not applicable to S Corporations and Partnerships
    • In 1982, the applicability of the at-risk rules to S Corporations was repealed.
    • “The rules do, however, apply to S corporation shareholders, partners, and LLC members for purposes of determining whether their share of loss is deductible.” Starczewski, 550-4th T.M., At-Risk Rules; see, also, Pub. L. No. 97-354, § 5(a)(31).
  • Each shareholder/partner computes their at-risk amount separately
  • See Prop. Reg. § 1.465-10(a) providing that the at-risk rules apply at the S corporations shareholder level [also makes reference to the S Corporation itself but not updated for statutory changes].
  • IRC § 465(c)(1) lists five types of activity to which the at-risk rules apply; however, subsection (c)(3) provides that the at-risk rules apply to each activity “(i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and(ii) which is not” one of the five previously listed activities.
  • Publication 925, Passive Activity Loss and At-Risk Rules
WHAT PROVIDES S CORPORATION SHAREHOLDER WITH AT-RISK BASIS
AT-RISK BASIS

• IRC § 465(b) provides the general rule regarding the determination of the taxpayer’s at-risk basis amount
  • Money contributed;
  • Adjusted basis of property contributed; and
  • Amounts borrowed.

• Limitation on basis increase for money and adjusted basis of property contributed
  • IRC § 465(b) states that, “a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.”
  • Taxpayer and another individual bought films of separate programs in same television series. Each paid part of purchase price with note at maturity date of which they were personally liable for any unpaid balance on their respective notes and had right to equal unpaid balance on other's note. Taxpayer is “protected against loss” by arrangement and, therefore, isn't at risk. Rev. Rul. 78-413, 1978-2 CB 167
  • Limited partner, personally liable on partnership note, not at risk to extent protected against loss by state law on contribution. Melvin v Comm. (1990, CA9) 65 AFTR2d 90-508, 894 F2d 1072, 90-1 USTC ¶50,052, aff'g (1987) 88 TC 63.

• Money contributed
  • Personal funds – funds that (1) are owned by the taxpayer; (2) are not acquired through borrowing; and (3) have an adjusted basis equal to their fair market value.
  • If acquired through a “borrowing” then the taxpayer must satisfy the at-risk rules applicable to a borrowing.
• **Amounts Loaned to a S Corporation**
  • The amount at risk of a shareholder of a S Corporation shall be adjusted to reflect any increase or decrease in the adjusted basis of any indebtedness of the S Corporation to the shareholder. Prop. Treas. Reg § 1.465-10(c).

• **Adjusted Basis of Property Contributed**
  • If unencumbered then equal to adjusted basis of the property contributed (similar to IRC § 358). For example, A contributes property worth $150,000 with an adjusted basis of $75,000 to his wholly owned S Corporation in a transaction qualifying under IRC § 351. A increases his at-risk and stock basis by $75,000.
  • If encumbered then the taxpayer’s at-risk amount is increased by the amount of the liability for which the taxpayer remains personally liable.
  • “Example: Individual B and Individual C form an equal general partnership to which B contributes property with a fair market value of $150,000 and an adjusted basis of $75,000. The property is subject to a $25,000 nonrecourse debt secured only by the property. The remaining $50,000 of basis represents an investment of personal funds. Upon contribution of the property, B's amount at risk is increased by $75,000 (the adjusted basis in the contributed property) and decreased by $25,000 (the amount of the nonrecourse debt secured by the contributed property). Thus, the net increase to B's amount at risk is $50,000.” Starczewski, 550-4th T.M., At-Risk Rules
• **Amounts borrowed**
  
  • Is the taxpayer personally liable or has the taxpayer pledged property, other than property used in the activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer’s interest in such property)?

  • Is the obligation “debt” for tax purposes? If equity then it does not factor into the at-risk basis amount. See, e.g., IRC § 385; see, also, Waddell v. Commissioner, 86 TC 848 (1986), aff’d on other grounds, 841 F.2d 264 (9th Cir. 1988)

• **Pledged Property**
  
  • Taxpayer considered at-risk to the extent of the FMV of the pledged property and only to the extent of the taxpayer’s interest therein

  • No property is considered pledged property if it is financed directly or indirectly by debt secured by contributed property.

• **Personally Liable**
  
  • Two tests

  • Test one – is the taxpayer personally labile?

    • “Payor of last resort analysis.” Test – “fixed and definite obligation to use personal funds to pay a debt in a worst case scenario.” For example, taxpayer guarantees a loan but retains an indemnification from the primary obligator, taxpayer is not at-risk due to the indemnification.

  • Universally adopted by the courts.

  • Generally non-recourse debt does not give rise to at-risk basis. Exception for certain qualified non-recourse financing.
• **Amounts Borrowed – Cont’d**
  
  • **Personally Liable**
    
    • Test two – not otherwise protected from loss.
    
    • “[T]here is currently a split in the Courts of Appeal with respect to the standard to be applied to determine whether a taxpayer is protected from loss (test two). On the one hand, the Ninth Circuit— which is followed by the Second, Eighth, and Eleventh Circuits, as well as the Tax Court and the IRS— applies an “economic realities” test (also referred to as a “realistic possibility” test). That is, the taxpayer is not considered at risk if the financial arrangement has the effect of removing any realistic possibility of economic loss. A theoretical possibility that the taxpayer will suffer an economic loss is insufficient to avoid application of the § 465(b)(4) anti-avoidance rule. In contrast to this approach, the Sixth Circuit applies a “payor of last resort” test holding that a taxpayer is at risk as long as in a worst-case scenario, the taxpayer would suffer economic loss. Thus, the Sixth Circuit applies the “payor of last resort” analysis to both the § 465(b)(2) test (test one) and the § 465(b)(4) test (test two). Recent cases in the Sixth Circuit have suggested, however, that its approach may be changing.” Starczewski, 550-4th T.M., At-Risk Rules
  
  • Individual created a trust by transferring $100 to the trust. The trustee purchased an interest in an oil and gas activity with cash and a note with full recourse against the trust. State law provided that the taxpayer was not personally liable for debts of the trust. Settlor of grantor trust is considered owner of entire trust and for purposes of determining allowable loss, is treated as engaged in trust's oil and gas activity. See Treas. Reg. § 1.671-3(a)(1). However, he is at risk only for amount of cash transferred to trust since he doesn't have personal liability for debts of trust. Rev. Rul. 78-175, 1978-1 CB 144
• **Amounts Borrowed – Cont’d**

  • No at-risk amount arises if the taxpayer borrows from a person who has an interest in the at-risk activity or a person related to a person having such an interest. IRC § 465(b)(3)

  • Generally the repayment of debt for which the taxpayer is personally liable does not affect her amount at risk. Prop. Treas. Reg. § 1.465-24(b)(1). The repayment must be with personal funds of the taxpayer that if contributed directly to the activity would have resulted in an at-risk basis amount. Prop. Treas. Reg. § 1.465-24(b)(2). If the taxpayer repays the debt with property used in the activity there is a decrease to the at-risk amount. Id.

  • *Example.* In 1977 A, an individual calendar year taxpayer, borrows $10,000 from a bank, assuming personal liability for repayment, for use in partnership AB, which is engaged solely in an activity described in section 465(c)(1). At the close of 1977 A's amount at risk in the activity is $10,000. In December of 1978 A borrows $3,000 for which A is not personally liable and which is secured by property used in the activity, and uses the funds to pay the bank. If no other factors occur during the year to affect A's amount at risk in the activity, A's amount at risk will be decreased by the amount of the repayment because A used funds for the repayment which would not have increased A's amount at risk had they been contributed to the activity. Therefore, at the close of 1978 A's amount at risk is $7,000. The result would be the same if the $3,000 used for the repayment of the loan were withdrawn from AB. See Prop. Treas. Reg. § 1.465-22.
Exception for qualified non-recourse financing – if secured against the real estate used in the activity if all five requirements below are satisfied:

- Borrowing must relate to the holding of real property;
- The real property must secure the borrowing (there are a few limited exceptions);
- The lender must be a “qualified person” (generally a person actively engaged in the lending of money; see IRC § 49(a)(1)(D)(iv) for complete definition);
- No one is personally liable for the debt; and
- Cannot be a convertible instrument.
AT-RISK BASIS CONT’D

• Increases to Amount At-Risk
  • Further contributions of money or other property;
  • Excess of all income received or accrued related to the activity over the taxpayer’s share of allowable deductions allocable to the activity; and
  • TP’s share of tax-exempt income from the activity.

• Decreases to Amount At-Risk
  • Allowable loss under the at-risk rules;
  • Distributions of money;
  • Distributions of property equal to the adjusted basis of the property less the amount of liabilities; and
  • TP’s share of non-deductible expenses relating to the production of tax-exempt income.

• S Corp shares acquired by gift: The taxpayer transfers or disposes of such taxpayer's entire interest in the activity or the entity conducting the activity; (2) The basis of the transferee is determined in whole or in part by reference to the basis of the transferor; and (3) The transferor has an amount at risk which is in excess of losses from the activity then at the close of the transferor’s taxable year in which the transfer or disposition occurs, the transferor's amount at risk in the activity (after being reduced by the transferor's losses from that activity for that taxable year) shall be added to the transferee's amount at risk. In addition, the transferee's amount at risk shall be increased by the amount that the transferee's basis is increased under section 1015(d) (relating to gift tax paid by the transferor). Prop. Treas. Reg. § 1.465-68
AT-RISK BASIS CONT’D

• Purchase of S Corp shares: taxpayer is at risk to the extent of money paid to the seller plus any note for which the buyer is personally liable. Prop. Treas. Reg. § 1.465-22(d)

• Inheritance of S Corp shares: “If after the close of the taxable year in which a decedent dies, the decedent's amount at risk in the activity (after being reduced by losses previously suspended under section 465(a)) is greater than zero, such amount shall be added to the successor's amount at risk. However, this amount must be adjusted to reflect changes, if any, in the amount at risk occurring as the result of the decedent's death.” Prop. Treas. Reg. § 1.465-69(a)
SEPARATE, AGGREGATING, & TRACING AT-RISK AMOUNTS BY ACTIVITY
SEPARATE, AGGREGATING, ETC.

- What is an “activity?” The PAL also use “activity.” The PAL regulations provide for a “facts & circumstances” test in determining an activity. Five factors are set forth in the PAL regulations: 1. similarities & differences in types of trades or businesses; 2. extent of common control; 3. extent of common ownership; 4. geographical location; and 5. interdependences between or among the activities. Likely that the courts and IRS would look to the PAL regulations for guidance in defining an “activity” for purposes of the at-risk rules.

- Cannot offset losses from one activity against income from other activities. For example, an individual invests in two oil and gas properties, one of which produces a profit and the other produces a loss. He must treat each one separately in determining his at-risk limitation with respect to the loss activity. IRC § 465(c)(2); see, also, S Rept No. 94-938 (PL 94-455) p. 51.

- Where a taxpayer actively participates in the management of a trade or business, the taxpayer is permitted to aggregate all of the activities that compromise a trade or business for purposes of the at-risk rules. In essence, this shifts the focus to separate trades or business versus separate activities.

- In PLR 9035005, the taxpayer attempted to argue that his negative at-risk amount in an oil partnership should be aggregated with his positive at-risk amount in a restaurant partnership resulting in a net positive at-risk amount. “Ordinarily, a taxpayer must determine his amount at risk separately with respect to each activity. However, under certain circumstances, sections 465(c)(2)(B) and 465(c)(3)(B) permit taxpayers to aggregate activities “which constitute a trade or business,” and treat them as one activity for at risk purposes. However, these aggregation provisions allow aggregation only within a SINGLE trade or business. There is no provision in section 465 that would permit aggregation of activities between two or more trades or businesses.” No emphasis added.
• If at least 65% of any losses from different trade or businesses are allocable to individuals who actively participate in management and those trade or businesses are carried on through a S Corporation then all of the activities compromising the trade or business are aggregate

• Not the same definition as “active participation” for purposes of the PAL rules.

• Factors that indicate active participation include (1) making decisions relevant to the day-to-day operation and management of the business, (2) performing services within the business, and (3) hiring and discharging employees. Negative factors include (1) minimal involvement in the day-to-day management and operations of the business; (2) a lack of authority to hire and discharge employees; and (3) the employment of a business manager who is acting as an independent contractor. See H.R. Rep. No. 1445, 95th Cong., 2d Sess. 69–70 (1978).

• An S Corporation shareholder may also aggregate and treat as a single activity: (1) The holding, production, or distribution of more than one motion picture film or video tape by the S corporation,(2) The farming (as defined in IRC § 464(e)) of more than one farm by the S corporation,(3) The exploration for, or exploitation of, oil and gas resources with respect to more than one oil and gas property by the S corporation, or (4) The exploration for, or exploitation of, geothermal deposits (within the meaning of IRC § 613(e)(3)) with respect to more than one geothermal property by the S corporation.

• Example – An S corporation is engaged in the activity of exploring for, or exploiting, oil and gas resources with respect to 10 oil and gas properties, the S corporation shareholder may aggregate those properties and treat the aggregated oil and gas activities as a single activity. If that S corporation also is engaged in the activity of farming with respect to two farms, the shareholder may aggregate the farms and treat the aggregated farming activities as a single separate activity. Generally, the shareholder cannot aggregate the farming activity with the oil and gas activity. Treas. Reg. § 1.465-1T(a)
• Applicability of tracing.
  • No clear authority
  • May be required to apply tracing rules (similar to the interest expense tracing rules of Treas. Reg. § 1.163-8T.
  • Significant difference from basis calculation, which determines one basis amount for each shareholder regardless of the number of activities.
The following example and Exhibits 1 & 2 are from Murphy, *Managing S Corporation At-Risk Loss Limitations*, Journal of Accountancy, February 1, 2010

“Example: Taxpayer A had the following facts:

1. Outside basis in S Corporation B’s common stock - $100,000
2. B’s two activities in which A has the following at-risk basis amounts:
   1. Dry cleaning – A actively participates: $25,000
   2. Billboard rental – A does not actively participate: $15,000
3. The activities generate the following losses for 2009:
   1. Dry cleaning – $(10,000)
   2. Billboard rental - $(25,000)

The two active businesses cannot be combined because they are separate types of businesses. See section 465(c)(3)(A) and Private Letter Ruling 9035005. Under the at-risk rules, Taxpayer A will be able to deduct $10,000 related to the dry cleaning activity and $15,000 related to the billboard rental (see Exhibit 1). The billboard rental will be separately stated as rental income on the S corporation Schedule K and is not combined with the other activities for at-risk purposes. Note that this conclusion pertains to the section 465 at-risk testing; the passive activity rules of section 469 may apply to further limit the loss deduction related to the billboard rental activity.”
### Exhibit 1

**Tracing At-Risk Amounts by Activity**

<table>
<thead>
<tr>
<th>Activity</th>
<th>Dry Cleaning</th>
<th>Billboard Rental</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active participation?</td>
<td>Yes</td>
<td>No—must be stated separately</td>
</tr>
<tr>
<td>Basis</td>
<td>$50,000 (presume pro rata)</td>
<td>$50,000 (presume pro rata)</td>
</tr>
<tr>
<td>Amount at risk</td>
<td>$25,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Loss</td>
<td>($10,000)</td>
<td>($25,000)</td>
</tr>
<tr>
<td>Deductible at-risk loss</td>
<td>($10,000)</td>
<td>($15,000)</td>
</tr>
</tbody>
</table>
“Presume the same facts as above for S corporation B, but also say that Taxpayer A has another wholly owned S corporation, C, in which he actively participates, with the following attributes:

1. Outside basis in C: $40,000
2. At-Risk amount in C’s dry cleaning business: $25,000
3. Taxable loss in dry cleaning for 2009: $(50,000).

The loss was funded partially by a nonrecourse banking line of credit; the at-risk amount is less than shareholder basis because the shareholder made cash contributions that included $15,000 obtained from nonrecourse loans secured by the corporate stock.

In this example, the two active dry cleaning businesses would be combined to produce a loss of $60,000, of which $50,000 is deductible under the stock-basis limitation—$10,000 from B and $40,000 from C. The entire $50,000 would be deductible under the at-risk limitation rules, by aggregating active businesses in the same activity (see Exhibit 2). The remaining $10,000 loss will carry over on Taxpayer A’s individual return as a loss suspended due to at-risk limitations. This example shows the importance of analyzing the client’s business activities and looking for grouping opportunities at the shareholder level, not just within the corporate entity.”
### Exhibit 2: Aggregating Businesses in the Same Activity

<table>
<thead>
<tr>
<th>Activity</th>
<th>Dry Cleaning (B)</th>
<th>Dry Cleaning (C)</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active participation?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Basis</td>
<td>$50,000 (presume pro rata)</td>
<td>$40,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Amount at risk</td>
<td>$25,000</td>
<td>$25,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Loss</td>
<td>($10,000)</td>
<td>($50,000)</td>
<td>($60,000)</td>
</tr>
<tr>
<td>Deductible at-risk loss</td>
<td></td>
<td></td>
<td>($50,000)</td>
</tr>
<tr>
<td>Suspended loss carryover</td>
<td></td>
<td></td>
<td>($10,000)</td>
</tr>
</tbody>
</table>
BIO
Darren Mills is a Managing Director with Alvarez & Marsal Taxand in New York. Mr. Mills advises clients on international tax, M&A issues, complex ASC 740 Accounting for Income Taxes questions and best practices for using tax data to add value to organizational decision making.

Mr. Mills brings more than 20 years of experience working with large and middle market multi-national corporations on federal and international tax issues, including cross border M&A and foreign tax credits assignments. Additionally, he has significant expertise structuring investments outbound from and inbound to the United States and managing issues surrounding consolidated return regulations.

Mr. Mills has worked across a variety of sectors including chemical, pharmaceutical, manufacturing, distribution and technology. He has served as a technical resource on international tax issues including Subpart F and repatriation. Mr. Mills has worked in assisting large multi-nationals implement the fair market value election for interest expense apportionment and analysis of overall foreign loss and overall domestic loss.

Mr. Mills is a recognized industry thought leader with articles published in leading journals including “Preventing Duplicated Losses: No More than One Bite at the Apple,” TAXES – The Tax Magazine Vol. 92, No. 4 (April 2014) and “Revisiting the Finalized Uniform Stock Loss Regulations,” Practical Tax Strategies Vol. 90, No. 5 (May 2012). Mr. Mills has also served as an Adjunct Professor in graduate taxation courses at the University of Baltimore and Seton Hall University.

Prior to joining A&M, Mr. Mills served as a partner at a large national accounting firm. Previously, he was a Managing Director at KPMG LLP. Mr. Mills is a Certified Public Account (CPA) in the States of Florida and New Jersey and a licensed attorney in the State of New Jersey (inactive in the Commonwealth of Pennsylvania).

Mr. Mills earned a bachelor’s degree in accounting from Seton Hall University, a master’s degree in taxation from Fairleigh Dickinson University and a J.D degree from Seton Hall University, School of Law.
LOSS UTILIZATION

1. IRC §1366(d)(1)
   - **LIMITS** use of S corp losses and deductions to extent of shareholder’s **basis in stock**
   - **PLUS** corporate debt to shareholder

2. 465 At-Risk Rules

3. Passive Activity Losses
QSub Election

• S corp subsidiary
• 100% owned subsidiary
• Form 8869 and NYS CT-60 (2 ½ Months)
• Deemed liquidation §332 – Tax free
• Form 966 NOT required
• Consider for Brother/Sister groups
• Effective – asset protection & loss utilization
Form 8869

• One for each Qsub
• Election at any time of year
• Election cannot be:
  ➢ > 12 months after filing date
  ➢ Effective > 2.5 months before filing date
• Once made, effective until terminated
QSub Election (Cont)

- Deemed §332 liquidation immediately before election
- Nonrecognition under §337
- If multiple elections on same date, S corp may specify order
  ➢ Even if QSubs come from different tiers
QSub Election (Cont)

• Treas. Reg. §1.1361-4
• Not treated as separate corp
• All assets, liabilities, income, deductions are treated as P’s
• P can transfer assets to QSub
• Timely Election – From Inception
§332 Liquidation Example

• P owns 100% M
• M capital asset, CA (basis = $300)
• M merges into P
• No gain/loss for P
• No gain/loss for M
• P owns CA, basis $300 (§334(b))
Employment Taxes

• QSub separate corporation for payroll taxes
• QSub w/ employees need EIN
§357(c)

- A owns 100% S corp & Y corp
- Y’s Liabilities > AB Property
- A contributes 100% of Y to S
- S makes QSub Election for Y
- §357(c) – Gain
Step Transaction

• May Apply – Special Rule
• If related under §267(b)
• Prior to acquisition
• Step transaction will not apply
Example

• A owns 100% of S
• S owns 79% of Y (A owns 21%)
• A contributes Y stock to S
• S makes QSub Election
• §351 met & no gain recognized
• Same result if A owned 100% Y
Watch Liabilities

• Z Merges into S
  ➢ Z’s Liabilities ➔
  ➢ Obligations of S
Use Holding Co

Holding Co S Corp

• Make QSub election for S & Z
LOSSES - UTILIZATION

1. First §1366(d)(1) Stock Basis
2. Then reduces basis in debt to corp
3. Remainder carried forward

• REMEMBER – basis does not include guarantees or circular loans
• Back-to-Back – must be bona fide
• See §1.1366-2(a)(2)(i) & (iii), ex. 2
465 At-Risk Rules

• Loss limited to amount at risk in activity
• Amount at risk = money + AB property + amounts borrowed
➢ Must be personally liable for repayment
• Unused losses carry forward
465 At-Risk Rules (Cont)

• Allocate loss based on activity
  ➢ Leasing 1245 property
  ➢ Oil and gas
  ➢ Geothermal deposits
  ➢ Motion pictures and video tapes
  ➢ Farming
  ➢ Other T/B or Production of Income

• Aggregation
At-Risk Aggregation

• General Rule – Separate Activity
• May elect for film, farm, oil, geothermal
• Leasing 1245 property – Special Rules
• § Other related T/B if:
  ➢ TP actively participates in management
  ➢ Partners and S corp SH – 65% of losses allocable to TP active in management
At-Risk & S Corp

  ➢ Corp must be At-Risk
  ➢ SH must be At-Risk

• PL 97-354:
  ➢ Removed S corp
  ➢ Retained individual
At-Risk & Related Party

• Excluded if borrowed from:
  ➢ Person with interest in activity OR
  ➢ Interested related party

• Related party (inter alia):
  ➢ Siblings, spouse, ancestors, etc.
  ➢ Corp >10% ownership
  ➢ S corps with common (>10%) owner
At-Risk & Related Party

• At-Risk:
  ➢ SH loans to Corp
  ➢ Lender only a Creditor

• Not At-Risk
  ➢ Interested related party with only
  ➢ Capital or Profits Interest
BACK TO BACK LOANS

• Treas. Reg. §1.1366-2 (7/23/14)
• “Bona fide indebtedness”
• All facts & circumstances considered
• General tax principles
• MAGUIRE, TCM 2012-160
  ➢ Auto dealer and finance company
  ➢ A/R distributed then contributed
• Substitutions - State Law Formalities
Example based on Maguire

Owners

Distribute $600 AR

FB

$6,000 profit

Contribute $600 AR

AB

$400 basis
$1000 loss
Maguire Example (Cont.)

• IRS: No economic outlay, no cost
• Court: Economic outlay
• Legitimate loans
  ➢ SH resolutions
  ➢ Formalities – documentation
  ➢ Consistency and timing
  ➢ Distribution reduced basis in FB
  ➢ Exposure to AB’s creditors
Maguire Example (Cont.)

• Application of At-Risk Rules:

• Owner at risk?

  ➢ Related party but to borrower
  ➢ Interest as a creditor
  ➢ Interested in activity?
Maguire Example, modified

- DIRECT LOAN

- FB
  - $6,000 profit

- Loan $600

- AB
  - $400 basis
  - $1,000 loss
Maguire Example, modified

• Owner at risk?
  ➢ No; not personally liable & no contribution to AB

• Also, §1366(d) ➔ No basis
QSub & At-Risk Rules

• To deduct S Corp losses:
  1. Shareholders – At-Risk AND
  2. Qsub – At-Risk
• PL 97-354
  ➢ Removed S corp
  ➢ Retained individual
QSub At-Risk Example

Shareholder

S Corp.

FB QSub
$6,000 profit

Loan $600

AB QSub
$400 basis
$1,000 loss
QSub & At-Risk Example

• SH At-Risk?
  ➢ Perhaps – Facts and Circumstances
  ➢ Active participation in both operations
  ➢ Aggregation? Perhaps

• §1366(d) Basis ➞ QSub attributes to S
QSub At-Risk Example

Shareholder

S Corp.

Loan $600

FB QSub

$6,000 profit

Guarantee

Loan

AB QSub

$400 basis

$1,000 loss
QSub & At-Risk Example

• SH at risk? Yes, if:
  ➢ Bona fide and enforceable
  ➢ No contribution/reimbursement
  ➢ Not otherwise protected
  ➢ *Goatcher* – state law
• Also, consider aggregation
What if:

Shareholder

S Corp.

Ford QSub
$6,000 profit

BMW QSub
$400 basis
$1,000 loss

VW QSub
$400 basis
$3,000 loss

• Aggregation?
• Single TorB
TERMINATION OF QSub

• Treated as new corporation
• Issue subsidiary stock for assets
• TAX FREE IRC §351
• Requires parent control (80%)
2007 LAW CHANGE

• Treatment of sale of QSUB Interest
• Parent sells 21% - QSUB TERMINATES
• SUB is new Corp, but will not qualify for §351
• 21% of Gain is recognized
• Step transaction may apply