

**Strafford**

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# **S Corporation Tax Compliance Challenges**

**Overcoming Hurdles for 1120S Filers: Loan Treatment, Entity Formation, Tax Rate Planning and Others**

**A Live 110-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

William C. Staley, **Law Offices of William C. Staley**, Woodland Hills, Calif.  
C. Wells Hall III, Partner, **Mayer Brown**, Charlotte, N.C.  
George Spaeth, Managing Director, **KPMG**, Washington, D.C.

**Thursday, April 1, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

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# **S Corporation Tax Compliance Challenges**

**April 1, 2010**

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# Today's Program

Initial Entity Election <i>(William C. Staley)</i>	Slides 5-25
Maintaining The S Corp Election <i>(C. Wells Hall III and George E. Spaeth)</i>	Slides 26-56
Using S Corp Losses To Offset Shareholder Income <i>(C. Wells Hall III and George E. Spaeth)</i>	Slides 57-66
Distribution Issues <i>(William C. Staley)</i>	Slides 67-91
Distressed S Corps <i>(George E. Spaeth)</i>	Slides 92-106
Sect. 469 Grouping Disclosures <i>(George E. Spaeth)</i>	Slides 107-113

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# **Initial Entity Election**

**William C. Staley, Law Offices of  
William C. Staley**

*This presentation should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.*

*Date prepared: March 24, 2010*

# Advantages Of S Corps



# Advantages Of S Corps

- Vs. C corp
  - No federal tax on income
  - Low or no state tax
  - No tax on cash distributions of S corp income
  - No accumulated income or personal holding company tax

# Advantages Of S Corps (Cont.)

- Vs. C corp (Cont.)
  - Can reduce employment taxes – but not to zero
- Vs. LLC
  - Can issue incentive stock options
  - Can do tax-free stock swaps

# Disadvantages Of S Corps



# Disadvantages Of S Corps

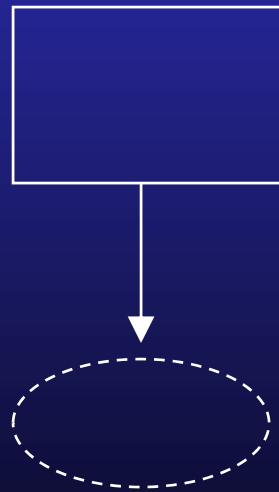
- Vs. C corp
  - Can't use lowest tax rates
  - Income taxed to shareholders, whether they get distributions or not
  - Eligibility limits
  - Fringe benefits

# Disadvantages Of S Corps (Cont.)

- Vs. LLC
  - Eligibility limits
    - Can become a C corp
  - Built-in gain tax
  - Excess passive receipts tax
    - Although this problem can be managed with sufficient cash



# Organizing A Subsidiary



# Organizing A Subsidiary

- **Brother-sister structure** – Eliminates need for a subsidiary, but complicates ownership arrangements (buy-sell agreements, etc.) and might trigger taxes to move an asset out of an existing corporation.
- **Parent-subsidiary** – Sub stock is available to creditors of the operating parent.
- **Holding company owning operating companies**
  - **SMLLCs vs. Q-subsidiaries**

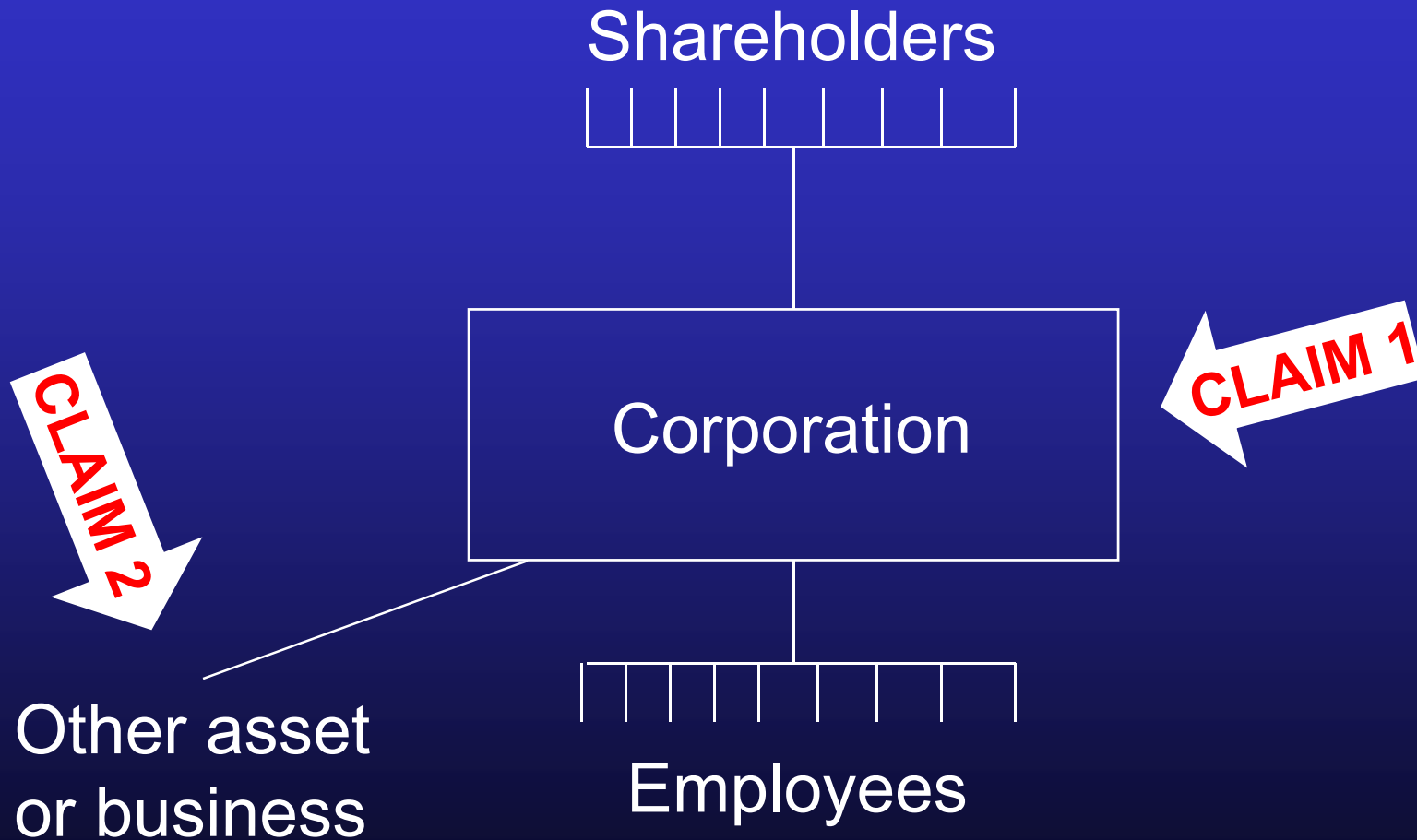
# Organizing A Subsidiary (Cont.)

Situation: Existing corp (C or S) has operating business and other appreciated assets (maybe real estate, art, a second or third business) in the corporation.

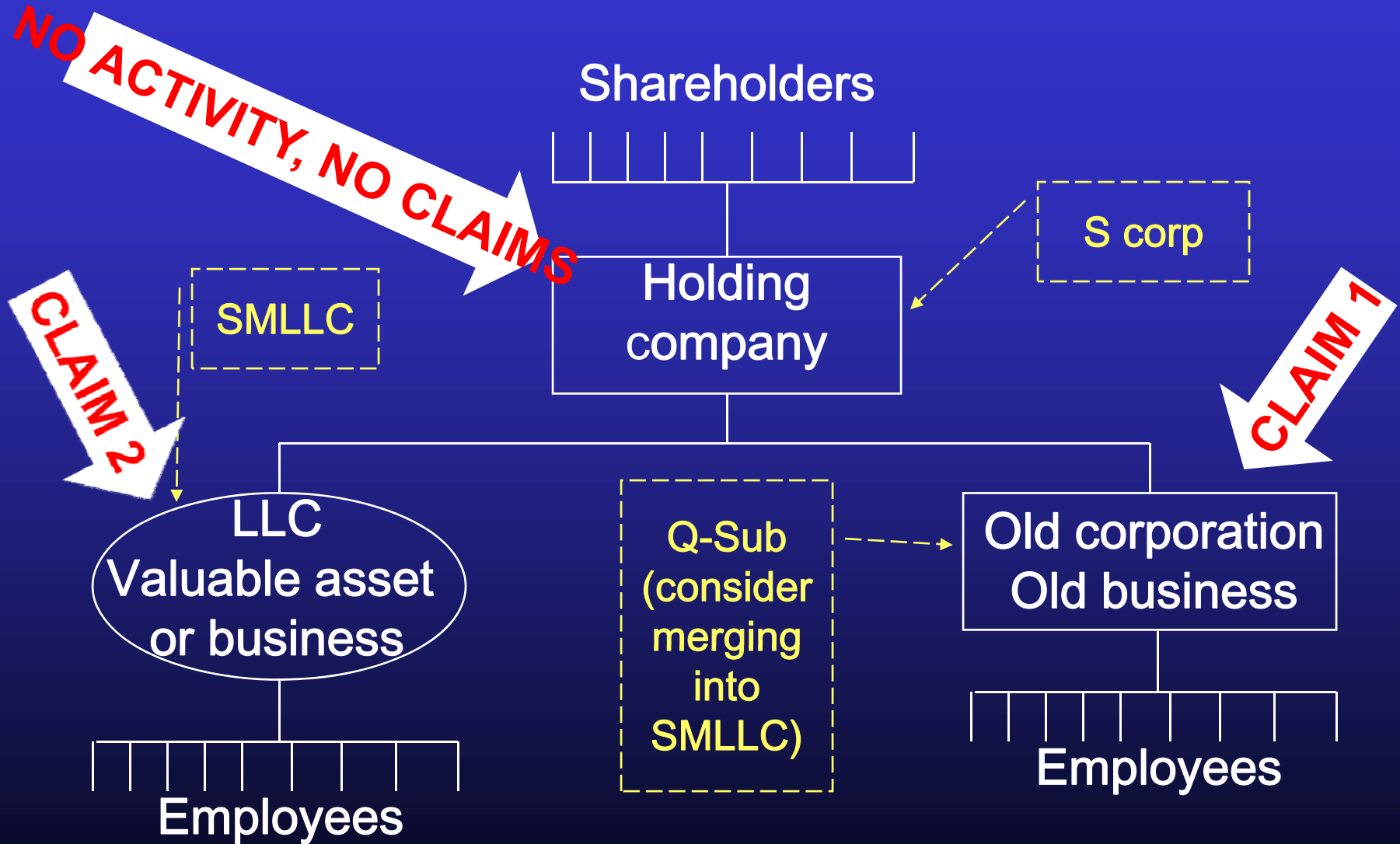
Concern: A claim against the operating business can be satisfied with the other valuable assets.

*Tip: Create a holding company structure to isolate the operating business from the valuable assets.*

# Old Structure



# New Structure



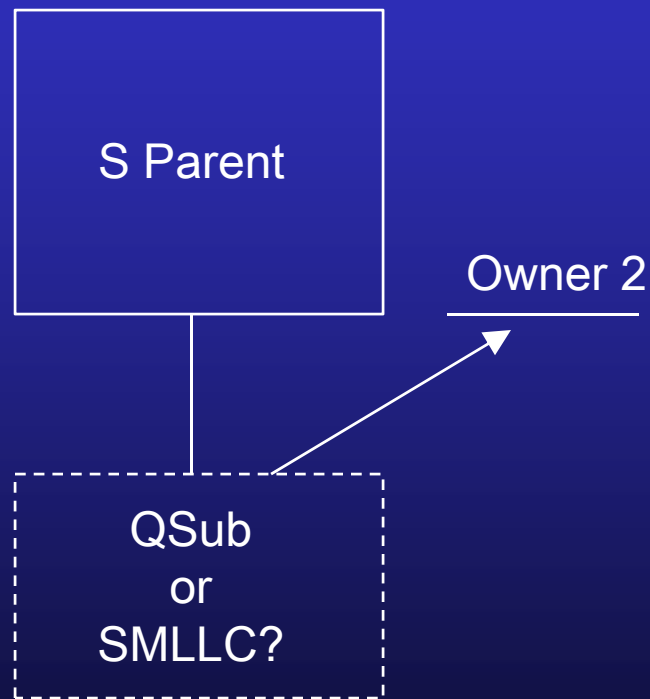
# SMLLC



# Single-Member LLC

- Disregarded for all federal and most state tax purposes
- Great to upgrade a sole proprietorship in an estate plan
- Perfect subsidiary
- Great for a liability-prone activity of a well-funded non-profit organization

# Terminating “Disregarded” Status



# Terminating “Disregarded” Status

- Adding a second owner to an SMLLC or Q-Sub terminates the “disregarded” status
- SMLLC → Partnership
  - No problem
- Qsub → C corporation
  - Big problems!



# Terminating “Disregarded” Status (Cont.)

- The transaction is treated as a good Sect. 351 exchange by S parent
  - But ... gain can be recognized by the S parent under Sect. 357(c) if the liabilities “assumed” by the subsidiary (its “real” liabilities) exceed the basis of the assets “transferred” to the subsidiary (its “real” assets) in the termination.

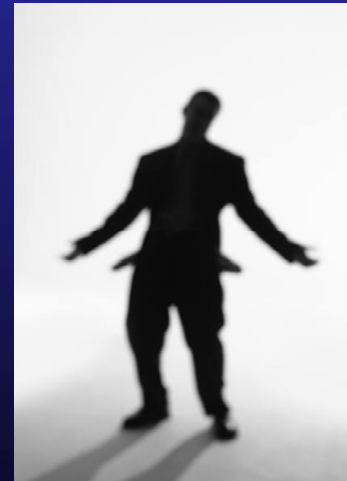


# Terminating “Disregarded” Status (Cont.)

- And, the subsidiary will be a C corporation if the S parent retains any of its stock.
- *These results can be tax disasters.*
- To eliminate these risks, a Q-Sub should be merged into a SMLLC (a disregarded transaction).
  - Or, consider authorizing only one share of Q-Sub stock, and adding a legend to the Q-Sub stock certificate about getting tax advice before issuing or transferring any shares.



# Effects Of Proposed Tax Rate Increases



# Effects Of Proposed Tax Rate Increases

- C corporations earnings will continue to be subject to a double-federal tax when distributed as dividends or when the business is sold and the proceeds distributed.
- Even at proposed higher individual federal income tax rates and less favorable long-term capital gain rates, flow-through entities will result in substantially less tax on dividends and when a business is sold.

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# **Maintaining The S Corp Election**

**C. Wells Hall III, Mayer Brown  
George E. Spaeth, KPMG LLP**

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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.

# Restrictive Eligibility Requirements For S Corporation Status

- 100-shareholder limitation
- Family aggregation rule – Six generations of individuals treated as one shareholder
- Only individuals, estates, eligible trusts or certain exempt organizations permitted as shareholders
- Non-resident aliens not permitted as shareholders
- One class of stock

# The American Jobs Creation Act Of 2004

## S Corporation Provisions

- Number of shareholders increased from 75 to 100
- Members of family treated as one shareholder
  - Common ancestor and six generations removed
  - Spouses and former spouses
  - No limit on number of families
- Relief for invalid Q-Sub elections
- Suspended losses transferred incident to divorce
- Disposition of stock by QSST treated as disposition by beneficiary for purposes of triggering suspended losses under sections 465 and 469

# The American Jobs Creation Act Of 2004

## S Corporation Provisions (Cont.)

- Potential current beneficiaries of ESBT do not include potential appointees under unexercised powers of appointment
- Distributions from S stock to leveraged ESOP may be used to make payments on ESOP loan
- IRA may hold bank director stock
- Passive investment income does not include interest income and certain dividends on assets held by a bank, bank holding company or financial company electing S status
- IRS authorized to require informational returns for Q-Subs

# The Small Business Work Opportunity Act Of 2007

## S Corporation Provisions

- Gain from sale or exchange of stock or securities eliminated from definition of passive investment income
- Certain bank director stock not considered outstanding for purposes of subchapter S
- 481 adjustment resulting from change from reserve method of accounting when bank elects S status may be taken into account in last C year

# The Small Business Work Opportunity Act Of 2007

## S Corporation Provisions (Cont.)

- Termination of Q-Sub election when stock sold treated as sale of assets followed by deemed Sect. 351 transfer to new corporation
- AE&P eliminated for years beginning before 1983
- Deduction for interest on indebtedness to acquire S stock available in computing taxable income of ESBT

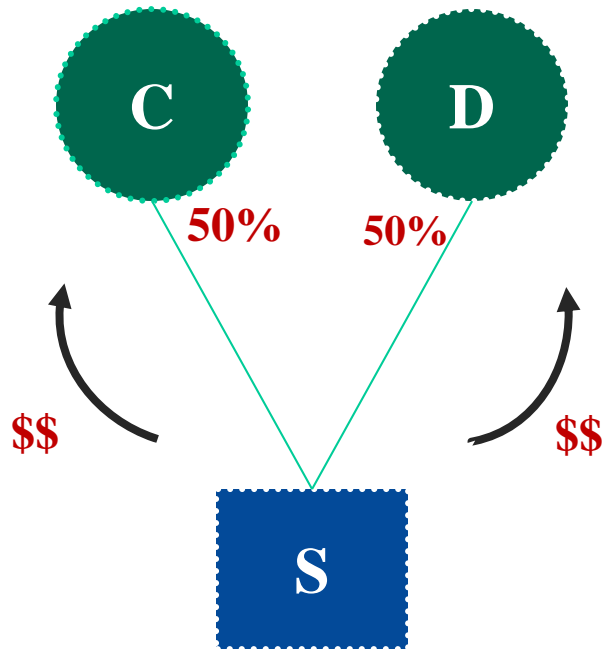
# Single Class Of Stock Requirement For S Corporations

- An S corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.
- Differences in voting rights permitted
- Non-conforming distributions sanctioned
- Some stock and equity disregarded
  - Restricted stock if no 83(b) election
  - Deferred compensation plans
  - Straight debt
- Only governing provisions considered
- State tax withholding not considered
- Varying interests from change in stock ownership

# Single Class Of Stock Requirement For S Corporations (Cont.)

- Buy-sell, redemption and other stock restriction agreements
  - Death, divorce, disability or termination triggers
  - Substantially non-vested stock disregarded
  - Principal purpose and price significantly in excess of below FMV
- Special rule for 338(h)(10) elections
- Shareholder loans
  - Short term unwritten advances
  - Open account debt regulations
  - Proportionately held debt
  - Straight debt

# Example – One Class Of Stock



- C and D are equal shareholders, each with a binding employment agreement with S.
- The compensation paid by S to C is reasonable.
- The compensation paid by S to D is unreasonable, is found to be excessive, and is treated as a distribution.
- *Is the excessive compensation paid by S to D a second class of stock?*

# One Class Of Stock:

## Other Instruments, Obligations, or Arrangements Straight Debt Safe Harbor

- Debt that satisfies the following requirements (straight debt) is not a second class of stock. The debt must be a written unconditional obligation to pay a sum certain on demand or on a specified due date, which:
  - Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;
  - Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and
  - Is held by an individual (other than a non-resident alien), an estate, or trust that is an eligible shareholder or a person which is actively and regularly in the business of lending money.
- If the debt is materially modified so that it no longer satisfies the definition of straight debt or is transferred to an ineligible shareholder, it no longer qualifies as straight debt.

# One Class Of Stock

## Other Instruments, Obligations or Arrangements Pro Rata Debt and Short Term Unwritten Advances

- Short-term, unwritten advances from a shareholder that do not exceed \$10,000 (in the aggregate) at any time during the tax year are not treated as a second class of stock, even if they are equity under general principles of tax law.
- Obligations of the same class held only by shareholders in proportion to their stock ownership, and that are considered equity under general principles of tax law, are not treated as a second class of stock.

# Types Of Trusts Eligible To Hold S Stock

- Grantor and deemed owner trusts
  - Citizen or resident grantor or deemed owner
- Qualified subchapter S trusts (QSSTs)
- Electing small business trusts (ESBTs)
- Grantor trusts for two years after death of grantor
- Testamentary trust for two years after stock transferred under will
- Voting trusts
- IRA (or ROTH IRA) which owned stock in S corporation bank or depositary holding company pre-Oct. 22, 2004

# Grantor Or Deemed Owner Trust As A Permitted S Corporation Shareholder

- Grantor trust under Subpart E of Part I of Subchapter J (sections 671-678 of the Code) with single grantor or deemed owner
- Grantor trusts are perhaps the most common trust holding S corporation shares
  - Revocable trusts
  - Crummey withdrawal powers and section 678
  - GRATs, GRUTs, IDGTs, may qualify as grantor trusts

# Gift Planning For S Corporation Stock

- Outright gifts
- Uniform Transfer to Minors accounts
- Sect. 2503(c) trusts
- Crummey trusts
- GRATs and GRUTs
- Sale to IDGT for installment note, SCIN or private annuity

# Post-Mortem Planning For S Stock

- Estate as eligible shareholder
- Sect. 645 election to treat revocable trust as part of estate
- Decedent's final return- includes S income through date of death
- Return of estate or beneficiary- includes S income after date of death
- Basis adjusted for IRD items

# Distribution Of S Stock To Trusts During Estate Administration Process

- Grace period of two years after death of grantor for wholly owned grantor trust
- Grace period of two years for testamentary trust that receives stock under terms of will
- Otherwise, trust must elect QSST, ESBT status or meet requirements of grantor trust
- Trapping distribution- distribution of corpus carries out DNI, which is taxed to recipient trust

# Other Post-Mortem Planning Techniques

- Deferral of estate taxes under Sect. 6166
- Redemptions to pay estate taxes and administrative expenses under Sect. 303
- Maximize benefits of basis step up by liquidation of S corporation

# Qualified Subchapter S Trust, Or QSST

- Only one income beneficiary during the life of the current income beneficiary
- Corpus distributions must be made to current income beneficiary only
- All income must be distributed, or required to be distributed, currently
- Income interest must terminate on death of beneficiary, or earlier termination of trust
- Upon termination during life of current beneficiary, all assets must be distributed to current beneficiary
- Current beneficiary is taxed on all S income, regardless of whether distributed

# QSST Election

- Requirements
  - Election made by income beneficiary
  - Timing: 2 ½ months after transfer of stock to trust
  - Separate election for each S corporation
- Income beneficiary treated as deemed owner under Sect. 678
- Relief for late elections available

# Types Of Trusts Qualifying As QSSTs

- Marital deduction trusts
  - QTIPs
  - Income and testamentary power of appointment
  - Estate trust if income distributed currently
  - Inter-vivos power of withdrawal – Sect. 678 trust
- Separate trusts for children, grandchildren
- Separate share trusts

# The Electing Small Business Trust, Or ESBT

- Multiple beneficiaries, sprinkle powers permitted
- S income taxed to ESBT at highest individual rate
- Non-S income taxed under subchapter J rules
- Trust, not beneficiary, makes ESBT election
- Late election relief available

# Special ESBT Rules

- Charitable deduction passed through from S corporation allowable as deduction in determining tax on S portion
- State and local taxes and administrative expenses are deductible by S portion
- Interest paid on indebtedness incurred in purchase of S stock deductible by S portion under 2007 Act
- Non-grantor charitable lead trust may elect ESBT status

# ESBT Qualification Requirements

- All beneficiaries must be individuals, estates or certain nonprofit organizations
  - i.e., state or local government agencies, 501(c)(3) organizations, war veteran posts, fraternal lodges organized exclusively for charitable purposes, and non-for-profit cemetery companies
- No interest in trust may have been acquired by purchase
- ESBT election required (late election relief available)
- No QSST election in place (although conversion from QSST to ESBT permitted)
- Trust must not be exempt from tax

# Definition Of Beneficiary

## Final ESBT Regulations – Reg. §1.1361-1(m)

- Definition of “beneficiary”
  - Downstream distributee trusts ignored prior to receipt of income or principal
  - Ignores unexercised powers of appointment
  - Ignores beneficiary “so remote as to be negligible”
  - Non-resident alien beneficiary permitted, until becoming a PCB

# Potential Current Beneficiary

## Final ESBT Regulations – Reg. §1.1361-1(m) (Cont.)

- “Potential current beneficiary”
  - Eligible to receive a current distribution of income or principal
  - Unexercised powers of appointment disregarded
  - Distributee trusts must qualify as permitted shareholder only when funded
  - PCBs considered as shareholders for purposes of determining eligibility of S corporation; if non-resident alien beneficiary becomes PCB, divestiture of S stock required within one year

# ESBT Election Mechanics

- Statement of ESBT election must be filed with Service Center where S corporation files its return
- One election for trust; may apply to multiple S corporations
- New S election: ESBT election must be attached to Form 2553
- Signed by trustee with authority to bind the trust (no consent of beneficiaries required)
- Time for filing: 2 ½ months after effective date, or not prior to 12 months in advance of effective date
- Inadvertent late election relief available
- Protective ESBT elections not permitted

# Partial Grantor Trusts As ESBTs

- Grantor portion taxed to grantor under grantor trust rules
- S portion taxed under ESBT rules
  - Taxed at highest individual rate
  - Distribution to beneficiaries not double taxed
- Non-S portion taxed under subchapter J rules
  - Distributions carry out DNI
  - Undistributed DNI taxed to trust

# Conversion Of QSST To ESBT

- Trust must meet all requirements of ESBT
- Trustee and current income beneficiary must make ESBT election
- Must not have converted from ESBT to QSST within 36 months preceding effective date
- Effective date must be 2 ½ months prior or 12 months after election filed

# Termination Of ESBT Status

- Trust fails to meet requirements of ESBT
- Disposition of all S stock by trust
- Ineligible potential current beneficiary -12 months to dispose of stock
- Conversion to QSST
- Otherwise, consent of commissioner required

# Relief For Late Elections

- Extension of time to file S election
- Relief for late S corporation election
- Relief for inadvertent invalid S election
- Relief for late QSST, ESBT election
- Protective QSST election
- No protective ESBT election

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# **Using S Corp Losses To Offset Shareholder Income**

**C. Wells Hall III, Mayer Brown**

**George E. Spaeth, KPMG LLP**

# Back-To-Back Loans

- **Issue:** Does a back-to-back loan arrangement create indebtedness of an S corporation to the shareholder, within the meaning of Sect. 1366(d)(1)(B)?
- If so, the amount of the loan is included in the shareholder's basis, to facilitate the use of pass-through losses.
- The Service and some courts appear to take the position that back-to-back loans are abusive, especially if the source of the funds is an entity related to the shareholder.

# Back-To Back Loans

## Senate Finance Committee Report on Predecessor Statute

The purpose of Sect. 1366(d)(1)(B) (formerly 1374(c)(2)) is to limit the amount of the S corporation loss that can be deducted by a shareholder to the **“adjusted basis of the shareholder’s *investment in the corporation.*”**

# Back-To-Back Loans: The Dilemma

- The indebtedness must run directly to the shareholder in order to increase the shareholder's basis
- What difference does it make where the shareholder obtained the funds?
  - His money market fund
  - His home equity line of credit
  - Separate bank loan
  - Loan from another entity controlled by the taxpayer

What if the shareholder controls the bank?

# Perry v. Commissioner

54 T.C.1293(1970)

*aff'd* 8<sup>th</sup> Cir. 1971

- Facts: Shareholder borrowed money from the S corporation and then loaned the same money back to the same S corporation.
- No cash actually changed hands.
- Court concluded that the shareholder's basis should be limited to his "actual economic outlay," and the facts yielded an "aroma of an alchemist's brew."
- Limited to its facts, *Perry* is good law.
- Other cases have ignored perfectly legitimate back-to-back loans based on the shareholder's "economic outlay" and that he is not "poorer in a material sense."

# Back-To-Back Loan Cases

- A number of cases decided against taxpayers have involved poorly documented or undocumented loans, backdating of documents, and after-the-fact journal entries.
- If there is no bona fide indebtedness, no basis increase is warranted.
- **Rev. Rul. 75-144, *Gilday***: Basis found when loan by an unrelated third party was restructured to go through the shareholder.
- ***Miller, Rose***: Basis found where the funds were provided by a related party.
- ***Culnen, Yates, Frankel, Burnstein, Robertson***: Funds from related parties and indirect loans did not produce basis.

# Stock Basis – In General

- The basis in S corporation stock is used to determine:
  - The deductibility of losses;
  - The taxability of operating or liquidating distributions from S corporations; and
  - The gain or loss on the sale of the stock.
- Initial stock basis can be established in a variety of ways
  - Contribution of cash and property
  - Purchase
  - Gift
- Must be adjusted to prevent double -taxation of income or double deductions

# Adjustments To Stock Basis

- Beginning basis of stock
- Add positive adjustments
  - Non-separately and separately stated income items (includes non-taxable income)
- Subtract negative adjustments
  - Non-taxable distributions
  - Non-deductible expenses
  - Separately and non-separately stated losses and deductions

# Stock Basis

- Order of adjustments
  - (1) Increase for income flow-through items
  - (2) Decrease for non-taxable distributions
  - (3) Decrease for non-capital, non-deductible expenses (and certain oil and gas depletion deductions)
  - (4) Decrease for other losses and deductions
- A shareholder may elect to reverse (3) and (4) so that deductible expenses reduce basis before non-deductibles
  - The election binding for future years
  - Non-deductible expenses carry forward.

# Stock Basis – Loss Carryforward

- Stock basis cannot be negative
  - Distributions in excess of stock basis treated as received in exchange for the stock
  - Generally, deductible losses and deductions that exceed basis are carried forward to future years.
  - Election to reverse ordering of basis reductions causes both deductible and non-deductible non-capitalizable losses and deductions to carry forward to future years.

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# **Distribution Issues**

**William C. Staley, Law Offices of  
William C. Staley**

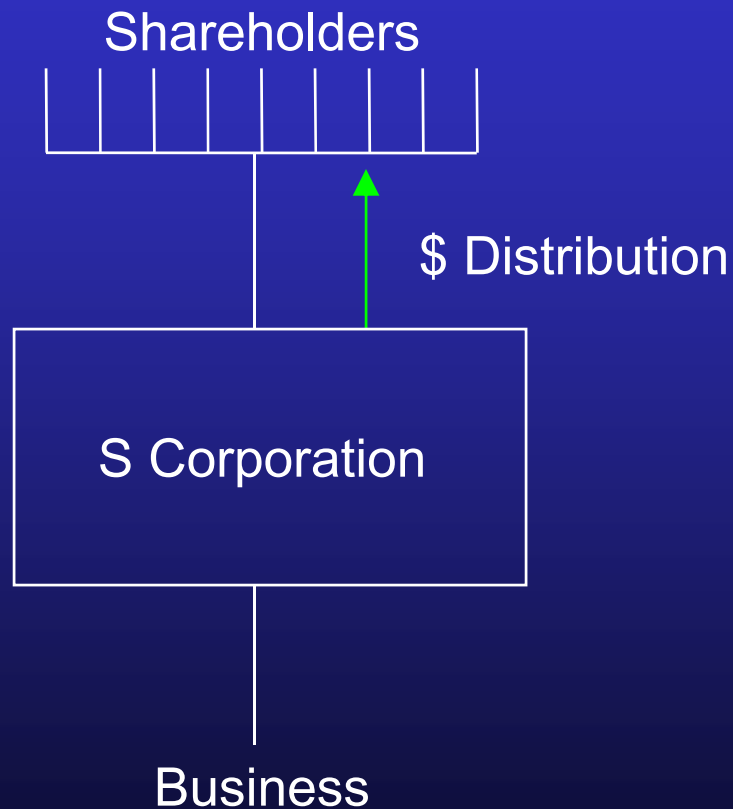
# Corporate Law Issues



# Corporate Law Limits On Distributions

- Distributions reduce cash and retained earnings.
- Balance sheet tests
- Creditors can recover excess distributions from:
  - ⇒ Shareholders
  - ⇒ Directors (possibly)
- Risky transaction: Share buy-back

# S Corporations Allow Tax-Free Cash Distributions



# S Corporation Distributions

- One level of tax on income earned while S corporation election in effect
- Vs. double-tax on C corp “earning & profits”
- So, must keep the valuable S corporation status

# Distributions And Salary



## Distributions And Salary

- Zero salary from an S corporation is too little for a shareholder who is a full-time employee.
  - ⇒ Must take a reasonable salary
- Don't reduce from C corporation salary too fast
- Don't make distributions every payday
  - ⇒ Not more often than quarterly
  - ⇒ Pay salary on paydays

# One Class Of Stock



# One Class Of Stock

- To be eligible to make and keep an S corporation election, the corporation must have only one class of stock.
  - ⇒ This means the same number of dollars per share must be distributed at the same time to each shareholder.
  - ⇒ Different voting rights are okay.
- The IRS cares.
- It is important to know exactly how many shares are outstanding and who owns them.

# Distributions To Pay Estimated Taxes



# Distributions To Pay Estimated Taxes

- The corporation should transfer \$ *to its shareholders.*
  - ⇒ Not to IRS or state or local tax authorities
  - ⇒ Distribute the exact same number of dollars per share to each shareholder, even if tax needs differ.
- Unequal distributions can = more than one class of stock = blown S corporation election.



# One Class Of Stock

- Special case: Required state payments or withholding of income tax
  - ⇒ Will not create a second class of stock – if:
    - All of the shareholders get the same number of dollars per share when these payments are treated as distributions
  - ⇒ Timing differences are OK for these “distributions.”
    - But, best to minimize any timing differences

## Distributions To Pay Estimated Taxes (Cont.)

- No law requires the S corporation to pay dividends to enable shareholders to pay their estimated taxes.
  - ⇒ The board of directors decides.
  - ⇒ There is a risk for minority shareholders – they might be pressured to sell at a low price if dividends are turned off.
  - ⇒ Best to have a written agreement on this



# Fixing Bad Distributions



# Fixing Bad Distributions

- Equalize ASAP
  - ⇒ One year later in example in IRS regs
- Treat higher distributions as loans?
  - ⇒ From the corporation? No, they were not booked that way.
  - ⇒ From one shareholder to another? There is no documentation that they were loans, and the evidence of the fix is not in the corporation's records.



## Fixing Bad Distributions (Cont.)

- IRS has approved only one method – equalize *up* to the highest distribution per share
  1. For each distribution, find each shareholder's actual distribution per share.
  2. Who got the highest \$/share?
  3. How much would each other shareholder have received at that \$/share?

## Fixing Bad Distributions (Cont.)

- Equalize up (Cont.)
  4. How much does each other shareholder need to get that amount?
  5. Repeat for each distribution
  6. What is the total amount each shareholder needs to be equalized?
  7. Can the S corporation make that distribution now, tax-free and legally? Does it have the cash?

## Fixing Bad Distributions (Cont.)

- Equalize up (Cont.)
  8. Have the board of directors adopt resolutions authorizing the equalizing distribution -- and explaining why \$/share differs for this distribution.
  9. Have the corporation write the checks and have the shareholders deposit them.
    - ⇒ OK to loan cash back to the corporation
      - Document it with a promissory note.

# Fixing Bad Distributions (Cont.)

- Equalize up (Cont.)
  - ⇒ Okay to show “declared but unpaid” distribution on the balance sheet as a liability
  
  - ⇒ But, better to pay it

# Distributions After Share Transfers



# Distributions After Share Transfers

- Don't transfer shares before getting the cash distribution to pay the taxes.
  - ⇒ Corporation can only make distributions to shareholders of record on record date.
  - ⇒ This arises with gifts, exercise of stock options, sales of shares.
    - Stock option plan for S corp: Issue stock 30 or 60 days after exercise, to allow time for a distribution
    - Sale of shares – Increase price by available tax-free dividend?

## Distributions After Share Transfers (Cont.)

- Note that a distribution reduces tax basis in shares, so not getting a distribution results in a higher tax basis.
  - But, it won't make your client very happy that he lost a dollar but saved a quarter in taxes.
  - Unless the client sold the shares, it might be a long time before the higher tax basis produces any tax benefit.

# Advisors



# The Advisor's Duties

- Accountants
  - ⇒ File Form 1120 or 1120S? Are you opining on the S corporation status?
  - ⇒ Tell the client if there is a one-class-of-stock risk.
  - ⇒ Don't condone distributions as payroll or distributions paid to IRS or SALT authorities to pay estimated taxes.

## The Advisor's Duties (Cont.)

- Attorneys
  - ⇒ Preparing minutes – document all distributions
  - ⇒ Be alert to sloppy corporate formalities
  - ⇒ Caveat your assumption about S corporation status

**Strafford**

# **Distressed S Corps**

**George E. Spaeth, KPMG LLP**

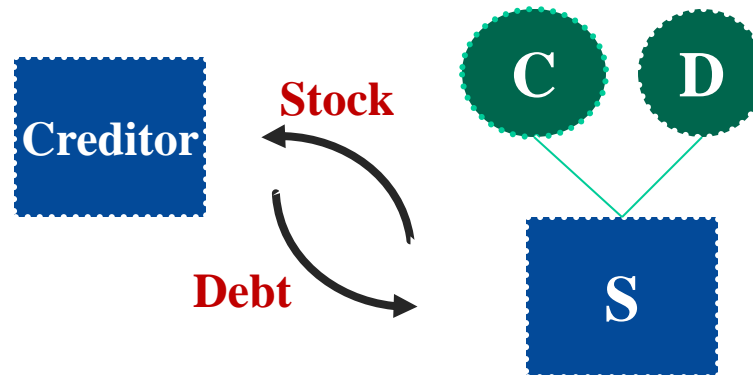
# Considerations For Distressed S Corps

- An S corporation can be insolvent and not lose S status. Further, an insolvent corporation can elect S status.
- Bankruptcy of the S corporation or a shareholder does not affect S status. A corporation considering bankruptcy can elect S status.
- Termination of the S election will occur if:
  - An impermissible shareholder acquires stock (e.g. creditor/bank),
  - A second class of stock is issued, or
  - The S election is revoked.
    - Note that bankruptcy courts have sometimes rejected revocation of S election.

# Considerations For Distressed S Corps (Cont.)

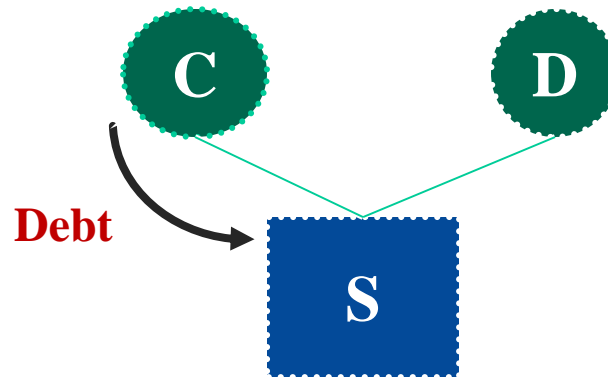
- Cancellation of debt (COD) income can be created through:
  - Discharge of indebtedness in a Chap. 11 bankruptcy proceeding
  - Cancellation of the entire debt
  - Cancellation of a portion of the debt
  - Certain acquisitions of the debt
  - Certain significant modifications of the debt
- COD income is ordinary income under Sect. 61(a)(12) that passes through to shareholders under Sect. 1366, and increases shareholder basis under Sect. 1367 and AAA under Sect. 1368.

# Exchange Of Debt For Equity – Sect. 108(e)(8)



- Exchange of debt for stock in the S corporation
  - S corp treated as satisfying debt for an amount equal to the fair market value of the S corporation stock received by the creditor
    - Debtor S corporation (and its shareholders) recognize COD income equal to the difference between the adjusted issue price of the debt and the stock's FMV.
  - Issuance of stock may result in termination of S election if:
    - Creditor is ineligible shareholder.
    - If creditor is an eligible shareholder, but second class of stock is issued

# Contribution To Capital Of S Corporation – Sect. 108(e)(6)



- Capital contribution of the debt to the corporation
  - Debtor S corporation treated as satisfying the debt for an amount equal to the shareholder's basis in the debt
    - S corporation recognizes COD if there is a difference between the shareholder's basis in the debt and its adjusted issue price.
    - For this purpose, debt basis is not reduced for losses and deductions that were passed through under Sect. 1367(b)(2).
  - Compare consequences if S corporation issues stock.

# Sect. 108 And S Corporations

- Sect. 108 excludes COD income to the extent of the taxpayer's insolvency or if the discharge occurs in Chap. 11 bankruptcy proceedings.
  - In the case of a discharge of indebtedness excluded due to insolvency, the amount excluded may not exceed the amount by which the taxpayer is insolvent under Sect. 108(a)(3).
  - For S corporations, bankruptcy and insolvency are determined at the S corp level.
- Attribute reduction under Sect. 108(b)(2) is required if COD income is excluded under section 108(a)(1)(A) (bankruptcy), (B) (insolvency), or (C) (qualified farm indebtedness).

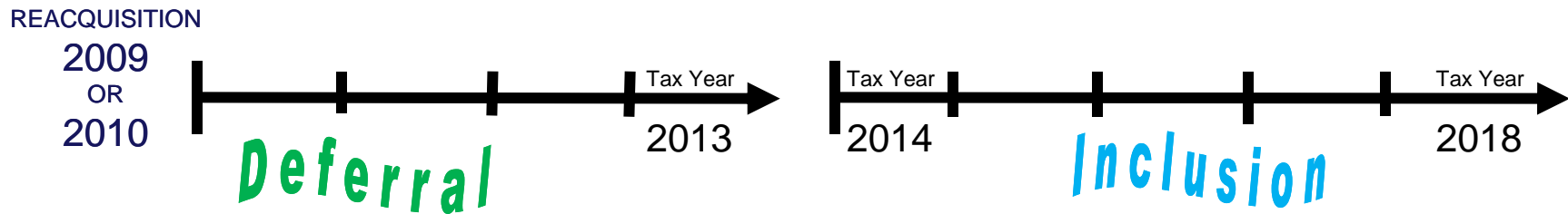
# Sect. 108 And S Corporations (Cont.)

- An S corporation does not have tax attributes at the entity level (unless it was previously a C corporation). Therefore, Sect. 108(d)(7) includes special rules for S corporations.
  - Shareholder suspended losses are treated as NOLs
- The S corporation may elect under Sect. 108(b)(5) to first reduce the basis of depreciable property before reducing any other tax attributes.

# Sect. 108(i) - Deferral

- The American Recovery and Reinvestment Act of 2009 added new Sect. 108(i). Under this section, an S corporation may make an election to defer the recognition of COD income with respect to debt incurred in connection with a trade or business. COD income incurred on the reacquisition of a debt instrument may be deferred five tax years and then included ratably over a five-tax-year period.
- Applies to:
  - Acquisition of debt in exchange for cash
  - Debt-for-debt exchange
  - Equity-for-debt exchange
  - Contribution of debt to capital
  - Complete forgiveness of debt by the holder of the indebtedness

## Sect. 108(i) Deferral (Cont.)



- The five-year period ends with the fifth tax year following the tax year in which the reacquisition occurs (for a reacquisition occurring in 2009), or in the fourth tax year following the tax year in which the reacquisition occurs (for a reacquisition occurring in 2010).
- The election is made by the S corporation on a debt-by-debt basis, and is irrevocable.

## Sect. 108(i) Deferral (Cont.)

- The debt instrument must be reacquired by the S corporation, or a person related to the debtor through a relationship specified in Sect. 267(b). The reacquisition must occur after Dec. 31, 2008 and before Jan. 1, 2011 to qualify.
- Certain events may trigger accelerated recognition of the deferred COD income, including:
  - Death of the taxpayer
  - Liquidation or sale of substantially all the assets of the taxpayer (including bankruptcy)
  - Cessation of business by the taxpayer
  - Sale, exchange or redemption of S corporation stock

# The Sect. 108(i) Election Statement

- The election reporting process is outlined in Rev. Proc. 2009-37.
- Attach a statement titled “Section 108(i) Election” to the timely filed (including extensions) S corporation original return for the tax year in which the debt reacquisition occurs.

# The Sect. 108(i) Election Statement (Cont.)

- Rev. Proc. 2009-37, Section 4.05, outlines what is required to be included in the election statement. For each debt instrument, the statement must include the following:
  1. Issuer name, taxpayer identification number
  2. Description of the debt instrument, including issue and maturity date
  3. Description of connected trade or business (if issuer is not a C corp)
  4. Date and general description of debt reacquisition transaction
  5. Total COD income and description of how it was calculated
  6. The amount of COD income that is being deferred
  7. A list of all S corp shareholders with a deferred COD amount, and their identifying information and deferred amounts
  8. If a new debt instrument is issued or deemed issued in exchange for the applicable debt instrument, the following information: issuer name, issuer TIN, description of new debt instrument, indication of whether the new debt instrument has OID, and schedule of expected annual OID accrual and expected annual OID deferral under Sect. 108(i)(2)
- Protective additional deferral amount (if applicable)

# Sect. 108(i) Election Information Statement For Shareholders

- The S corporation must attach an information statement to each Schedule K-1 provided to shareholders
  - Statement not filed with the IRS
  - Retained by the S corporation and its shareholders
- For each debt instrument, the information statement must disclose five items

# Annual Sect. 108(i) Information Statement Of An S Corporation

- Annual information statement required to be attached to S corporation tax return for up to nine years:
  - Beginning in the year the Sect. 108(i) election is made
  - Ending in the year that all deferred items have been included
- Annual information statement must have the following information for each ADI:
  1. COD income included in the current tax year under regular deferral
  2. COD income accelerated
  3. COD income deferred and not yet included
  4. OID deduction allowed in the current tax year under regular deferral
  5. OID deduction allowed under acceleration rule
  6. OID deduction deferred and not yet deducted

# Annual Sect. 108(i) Information Statement For Shareholders

- Annual information statement required to be attached to shareholders' Schedules K-1 (but not filed with IRS)
  - Beginning the year the Sect. 108(i) election is made
  - Ending the year that all deferred items have been included.
- Per Rev. Proc. 2009-37, section 5.04, the shareholder's annual information statement should be labeled, "Section 108(i) Annual Information Statement for Shareholders" across the top and must have the following information for each applicable debt instrument:
  1. Shareholder's deferred COD amount that has not been included in income as of the end of the prior tax year
  2. Shareholder's COD income included in the current tax year under regular deferral
  3. Shareholder's COD income accelerated
  4. Shareholder's COD income deferred and not yet included
  5. Shareholder's OID deduction allowed in the current tax year under regular deferral
  6. Shareholder's OID deduction allowed under acceleration rule
  7. Shareholder's OID deduction deferred and not yet deducted.

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# **Sect. 469 Grouping Disclosures**

**George E. Spaeth, KPMG LLP**

# Rev. Proc. 2010-13

## Sect. 469 Grouping Disclosures

- Generally, net passive losses from an activity can only offset gains from other passive activity in a tax year.
- A passive activity is defined as:
  - A trade or business activity in which the taxpayer *does not materially participate*, or
  - Any rental activity except where the taxpayer is in a real property trade or business, as defined in Sect. 469(c)(7)
- Treas. Reg. Sect. 1.469-4(c)(1) provides that one or more passive activities can be treated as a single activity, if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of Sect. 469.

# Rev. Proc. 2010-13

## Sect. 469 Grouping Disclosures (Cont.)

- Activity groupings can be significant for purposes of determining material participation and triggering suspended losses when the activity is sold.
- Reg. Sect. 1.469-4(e) requires consistent treatment of activity groupings. Specifically, the regulation provides that, once activities are grouped, they may not be regrouped unless either:
  1. There is a material change in the facts and circumstances that make the original grouping clearly inappropriate ,or
  2. The original grouping was clearly inappropriate.

# Rev. Proc. 2010-13

## Sect. 469 Grouping Disclosures (Cont.)

- Sect. 469 does not directly apply to S corps, but the section is relevant because it applies to most eligible S corporation shareholders.
- S corps must group activities under the rules of Treas. Reg. Sect. 1.469-4 and must comply with the instructions for Form 1120S. The instructions provide for reporting the entity's groupings of activities on attachments to Schedule K-1 (Form 1120S) and provide that certain information must be included for each activity.
- Rev. Proc. 2010-13 describes these reporting instructions as grouping disclosures, for purposes of Reg. Sect. 1.469-4.

# Rev. Proc. 2010-13

## Sect. 469 Grouping Disclosures (Cont.)

- For tax years beginning on or after Jan. 25, 2010, Rev. Proc. 2010-13 requires written annual return disclosures
  1. In the first year in which two or more passive activities are grouped as a single activity
  2. In a year in which a passive activity is added to the grouping
  3. In a year in which the taxpayer determines that the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate
- However, an S corp shareholder need not make any additional disclosures unless the shareholder groups S corp activities not grouped by the S corp or groups S corp activities with other activities conducted directly or indirectly through other Sect. 469 entities.

# Rev. Proc. 2010-13

## Sect. 469 Grouping Disclosures (Cont.)

- Grandfather rule: Individual taxpayer groupings prior to the effective date of Rev. Proc. 2010-13 need not be disclosed unless the taxpayer:
  - 1) Adds a new passive activity to the group;
  - 2) Determines that the original grouping was clearly inappropriate, or
  - 3) There has been a material change to the facts and circumstances that makes the original grouping clearly inappropriate.
- If a taxpayer fails to disclose a grouping that is required to be disclosed under Rev. Proc. 2010-13, each trade or business will be treated as a separate activity (*unless the IRS regroups under anti-avoidance rule of Treas. Reg. Sect. 1.469-4(f)*).











# Rev. Proc. 2010-13

## Sect. 469 Grouping Disclosures (Cont.)

- A taxpayer will be treated as having timely disclosed if it has filed all affected income tax returns consistent with the claimed grouping of activities, and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered.
- If the failure to disclose is first discovered by the IRS, however, the taxpayer must also have reasonable cause for not making the required disclosure.
  - Sect. 9100 relief is not available for untimely disclosure, since Rev. Proc. 2009-13 provides for other relief.

Effective Combined Federal and California Tax Rates (with President's 2010 Budget Proposals )

(Accounts for federal deduction for state income tax)

	C Corp				S Corp					
	2009		Pres. Proposals		Ordinary income		Net LT Capital Gain			
						Pres. Proposals		Possible legislation	Pres. Proposals	
Income	\$ 100.00		\$ 100.00		\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
California tax rate	8.84%				1.5%		1.5%			
California tax	\$ 8.84				\$ 1.50		\$ 1.50	\$ 1.50	\$ 1.50	
Fed taxable income	\$ 91.16				\$ 98.50		\$ 98.50			
Fed tax rate	<b>34% under \$10M</b>				0%		0%			
Fed tax	\$ 30.99				\$ -		\$ -			
Total tax	\$ 39.83									
Effective Inside tax rate	<b>40%</b>				<b>1%</b> (deductible for federal tax purposes)		<b>1%</b> (deductible for federal tax purposes)			
After tax distribution	\$ 60.17		\$ 60.17		\$ 98.50	\$ 98.50	\$ 98.50	\$ 98.50	\$ 98.50	\$ 98.50
Shareholder California tax rate	<b>10.55% over \$1M</b>		<b>10.55%</b>		<b>10.55%</b>	<b>10.55%</b>	<b>10.55%</b>	10.55%	10.55%	<b>10.55%</b>
Shareholder California tax	\$ 6.35		\$ 6.35		\$ 10.55	\$ 10.55	\$ 10.55	\$ 10.55	\$ 10.55	\$ 10.55
Shareholder fed taxable income	\$ 53.82	\$ 53.82	\$ 53.82		\$ 87.95	\$ 87.95	\$ 100.00	\$ 87.95	\$ 87.95	\$ 100.00
Shareholder fed tax rate - ordinary income - dividend	<b>35%</b>		<b>40%</b>		<b>35%</b> Ordinary income	<b>39.6%</b>				*
Shareholder fed tax rate - long-term capital gain - liquidating distribution		<b>15%</b>		<b>24.0%*</b>			<b>15%</b> LT Cap. Gain	<b>38%</b>	<b>32%</b>	<b>24.0%*</b>
Shareholder fed tax	\$ 18.84	\$ 8.07	\$ 21.31	\$ 12.92	\$ 30.78	\$ 34.83	\$ 15.00	\$ 33.42	\$ 28.14	\$ 24.00
After taxes to shareholder	\$ 34.98	\$ 45.75	\$ 32.51	\$ 40.90	\$ 57.17	\$ 53.12	\$ 72.95	\$ 54.53	\$ 59.81	\$ 63.95
Effective tax rate	<b>65.0%</b>	<b>54.3%</b>	<b>67.5%</b>	<b>59.1%</b>	<b>42.8%</b>	<b>46.9%</b>	<b>27.1%</b>	<b>45.5%</b>	<b>40.2%</b>	<b>36.1%</b>
Compare:										
* Adds the 3.8% Self-Employment tax on investment income.										
Note: Ignores the various current and proposed itemized deduction limits										

# Choice of Business Entity Flowchart

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March, 2010

