

CRITICAL FEDERAL INCOME TAX CONSIDERATIONS OF  
S CORPORATIONS

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Spring 2016

Syllabus  
Law 984, TAXA 684,  
January 11, 2016 – April 25, 2016  
Wednesday 5:45 – 7:35  
Location: AL 403

1. Important Dates
  - a. First day of class – January 13, 2016
  - b. Last day of class – April 20, 2016
  - c. Exam – Take home
  - d. Grades due – May 20th
  - e. Spring break - March 13 - 20
2. Background, Eligibility, Mechanics & Termination – 1.13.16 & 1.27.16
  - a. IRC §§ 1361 – 1362, 1371
  - b. Treas. Reg. § 1.1361-1, 3, 4, & 5
  - c. Treas. Reg. § 1.1362- 1, 2, 3, & 6
3. Organization, Capitalization & Shareholder's Agreements – 2.10.14 & 2.14.16
  - a. IRC §§ 351, 357, 358 & 362
4. Taxation of Income, Loss, Deductions & Credits -3.9.16
  - a. IRC §§ 1363, 1366, 1374
  - b. Treas. Reg. § 1.1363-1
  - c. Treas. Reg. § 1.1366-1 & 2
  - d. Treas. Reg. § 1.1374-1, 2, 3 & 4
5. Distributions, Basis of Stock & Debt – 3.23.16
  - a. IRC §§ 1367 – 1368
  - b. Treas. Reg. § 1.1367-1 & 2
  - c. Treas. Reg. § 1.1368-1 & 2
6. Corporate Reorganizations – 4.06.16
  - a. IRC §§ 354, 355, 356, 361, 368
7. Liquidations, Sec. 338(h)(10), Sec. 336(e)- 4.20.16
  - a. IRC §§ 331, 338(h)(10) & 336(e)

The above topics and time line are subject to change. There will be no text book for this class. We will use the enclosed outline, handouts, the Code and regulations. Students are encouraged to read the Code and regulations in advance of class.

- I. Background
  - a. What is an S Corporation?
    - i. It a creature created by statute; can be a corporation or even an LLC treated as an association taxable as a corporation under the CTB regulations.
  - b. Partnership vs. S Corporation
    - i. Elasticity vs. rigor mortis
    - ii. Formal election
    - iii. Most states don't require the filing of a formal certificate of formation to create a GP.
    - iv. Limits on ownership v. unlimited
    - v. Net earnings from self-employment?
  - c. Reserved
- II. S Corporation Eligibility
  - a. Overview
    - i. A domestic corporation;
    - ii. No more than 100 shareholders;
    - iii. Individuals and certain trusts and estates (no NRAs); and
    - iv. Only one class of stock
  - b. Types of Shareholders
    - i. Why restrict the types of shareholders?
    - ii. U.S. natural person (i.e., a living breathing person)
    - iii. No NRA as defined in sec. 7701(b)(1)(B)
      - 1. NRA spouse – “If a U.S. shareholder's spouse is a nonresident alien who has a current ownership interest (as opposed, for example, to a survivorship interest) in the stock of the corporation by reason of any applicable law, such as a state community property law or a foreign country's law, the corporation does not qualify as a small business corporation from the time the nonresident alien spouse acquires the interest in the stock. If a corporation's S election is inadvertently terminated as a result of a nonresident alien spouse being considered a shareholder, the corporation may request relief under section 1362(f).” Treas. Reg. § 1.1361-1(g)(1)(i)
  - iv. Decedent's Estate
    - 1. Estate – “The property one leaves after death; the collective assets and liabilities of a dead person.” Black's Law Dictionary. Are formal documents required to create an estate?
    - 2. An estate is one of the four taxpaying entities. The other three are an individual, a corporation and a trust. What about an S-Corp with NUBIG?
    - 3. For tax purposes, an estate is deemed to have a limited existence.
      - a. “...contrary to popular belief, estates do not last forever. If an executor delays too long in funding a testamentary trust, the IRS may argue that the estate has, in effect, become the trust and that the “estate” and its beneficiaries out to be tax accordingly.” Ascher & Danforth, Federal

Income Taxation of Trusts and Estates, Cases, Problems & Materials (3<sup>rd</sup> Ed. Carolina Academic Press)

v. Trusts

1. “Under current §1361(c)(2), the following trusts are permitted as S corporation shareholders: • trusts treated as owned by a U.S. citizen or resident individual under §§671–679 • trusts that immediately before the death of the deemed owner were treated as owned by a U.S. citizen or resident individual under §§671–679, but only for a period of two years beginning on the day of the deemed owner's death; • trusts to which stock has been transferred by a will, but only for two years (60 days for tax years beginning before 1997); • voting trusts; • qualified subchapter S trusts (QSSTs); • electing small business trusts (ESBTs); and • in the case of a corporation that is a bank (as defined in §581) or a depository institution holding company (as defined in §3(w)(1) of the Federal Deposit Insurance Act), an IRA or Roth IRA trust, but only to the extent of the amount of stock that the trust held in the bank or holding company on October 22, 2004. Starr, et. al., Portfolio 730: S Corporations: Formation and Termination
2. Grantor Trust – Under sec. 671 the income, deductions, and credits of a grantor trust are attributed to its “owner.” Essentially, a grantor trust is ignored for tax purposes.
  - a. Sec. 678: A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
    - (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
    - (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.
3. “In order to qualify as a QSST, the terms of the trust must require that: during the life of the current income beneficiary, there will only be one income beneficiary of the trust (thus, a spray or sprinkle trust for multiple beneficiaries cannot qualify); corpus distributions during the current income beneficiary's life can only be made to that beneficiary; the current income beneficiary's income interest must terminate on the earliest of the current beneficiary's death, or the termination of the trust; and if the trust terminates during the current income beneficiary's life, the trust's assets are all distributed to the current income beneficiary.” Starr, et. al., Portfolio 730: S Corporations: Formation and Termination
  1. ESOPs
  2. Reserved

c. Number of Shareholders

- i. Currently 100

- ii. Husband and wife treated as one shareholder for purposes of the 100 limitation.
  - iii. Attribution generally does not apply except for members of the same family. See Rev. Rul. 59-187 and Sec. 1361(c)(1)
  - iv. Who is the owner? "Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation." Treas. Reg. § 1.1361-1(e)(1)
  - v. Tax law generally looks to beneficial ownership which could be different than legal ownership.
- d. QSUB
  - i. Generally disregarded from the S Corp parent. Treas. Reg. § 1.1361-4(a)(1)
  - ii. Separate election required.
  - iii. Elements – Treas. Reg. § 1.1361-2(a)
    - 1. Domestic corporation;
    - 2. Not an ineligible corporation;
    - 3. S parent must own 100%;
    - 4. Must file the election.
  - iv. "In general. If an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Thus, for example, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the transfer of assets to the subsidiary and the deemed liquidation are disregarded, and the corporation will be deemed to be a QSub from its inception." Treas. Reg. § 1.1361-4(a)(2)
    - 1. Generally viewed as a sec. 332/337 liquidation.
  - v. "An S corporation that makes a qualified stock purchase of a target may make an election under section 338 with respect to the acquisition if it meets the requirements for the election, and may make a QSub election with respect to the target." Treas. Reg. § 1.1361-4(b)(4)
  - vi. What if the S corporation sells the stock of the QSUB?
  - vii. Reserved
- e. Second Class of Stock
  - i. "[A] corporation is 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 are generally disregarded. Treas. Reg. § 1.1361-1(l)(1)
  - ii. Review governing documents
    - 1. Corporate charter
    - 2. Articles of incorporation
    - 3. By-laws
    - 4. State law

#### 5. Shareholder agreements

- f. "S corporation income and loss items must be allocated on a pro rata daily basis to shareholders as required by §1377(a). While nothing in the statute literally requires distributions to be made on a proportional basis to shareholders, non-pro rata distributions raise the question of whether the stock differs with respect to economic rights, and if so, whether a second class of stock is created. The statute may be silent on the matter as disproportionate distributions, with respect to the same class of stock, are often impermissible under state corporate law. Under Regs. § 1.1361-1(l)(2)(i), distributions, whether actual, constructive or deemed, that differ in timing or amount do not, in themselves, create a second class of stock. However, they are given appropriate tax effect for other purposes." Starr, et. al., Portfolio 730: S Corporations: Formation and Termination, II. F.4
    - i. Work to correct the disproportionate distributions. PLR 200125091
    - ii. What about constructive distributions? Can they create a second class of stock? For example, an owner-operator must be paid a reasonable salary.
      - 1. Review Rev. Rul. 74-44 1974-1 CB 287
      - 2. Suppose, in the unlikely event, the owner-operator takes an excessive salary.
    - iii. Sec. 385
      - 1. What happens when a debt obligation is treated as equity for federal income tax purposes?
    - iv. Buy-sell agreements
- III. S Corporation Election
- a. Form 2553
    - i. Review Form 2553
  - b. Sec. 1362
    - i. Review sec. 1362
    - ii. All shareholders must consent.
      - 1. Executor or administrator of shareholder's estate may consent to corp.'s election on behalf of deceased shareholder. Executor acts in fiduciary capacity for both decedent and decedent's estate, so may decide to consent. Rev. Rul. 92-82, 1992-2 CB 238
    - iii. When made?
      - 1. During the year for the succeeding year.
      - 2. Before March 15<sup>th</sup> for the preceding year.
    - iv. Reasonable cause.
      - 1. Automatic procedures.
        - a. Rev. Proc. 97-48; 2003-43; 2004-48 (late S election and CTB)
    - v. Reserved
  - c. Shareholder consents
    - i. By-laws
    - ii. Operating Agreement
  - d. Are separate state elections needed?
    - i. Depends on the state.
  - e. Review Treas. Reg. § 1.362-2 – Termination of Election.
    - i. Affirmative revocation.

- ii. No longer eligible
  - iii. Too much passive income.
    - 1. A corporation's election under section 1362(a) terminates if the corporation has subchapter C earnings and profits at the close of each of three consecutive taxable years and, for each of those taxable years, has passive investment income in excess of 25 percent of gross receipts. See section 1375 for the tax imposed on excess passive investment income. Treas. Reg. § 1.1361-2(c)(1)
    - 2. Review Examples in regulation.
- f. Election after termination.
  - i. Absent the Commissioner's consent, an S corporation whose election has terminated (or a successor corporation) may not make a new election under section 1362(a) for five taxable years as described in section 1362(g). However, the Commissioner may permit the corporation to make a new election before the 5-year period expires. The corporation has the burden of establishing that under the relevant facts and circumstances, the Commissioner should consent to a new election. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination tends to establish that consent should be granted. In the absence of this fact, consent ordinarily is denied unless the corporation shows that the event causing termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation and was not part of a plan on the part of the corporation or of such shareholders to terminate the election. Treas. Reg. § 1.1362-5
- g. Is the filing of an election a taxable event?
  - i. Review sec. 1363
  - ii. Computation of S Corporation Taxable Income
    - 1. Review Form 1120-S/K-1
  - iii. LIFO Recapture
    - 1. "After enacting the built-in gains tax, Congress was concerned that LIFO method C corporations electing S status could easily avoid tax on the built-in gain attributable to LIFO inventory as long as they did not have a decrement in pre-election LIFO layers during the recognition period." Portfolio 731: S Corporation Operations, I.F.
  - iv. Reserved
- h. Coordination with Subchapter C
  - i. Review sec. 1371
    - 1. Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders
  - ii. Inconsistent provisions
    - 1. Sec. 301 (discussed further when we review sec. 1368)
    - 2. Sec. 302(b)(4)
    - 3. Sec. 304
    - 4. Sec. 306

5. Sec. 312 (except for historical C corporation E&P that existed prior to the S election)
  6. Arguably sec. 316 for the same reasons as sec. 301.
- i. NUBIG
    - i. Review sec. 1374
    - ii. Look at the asset side of the balance sheet.
      1. Did the asset exist immediately prior to the effective date of the S election?
      2. Formal valuation?
      3. Treas. Reg. § 1.1374-3(c), Ex. 1
      4. The amount of tax paid by an S corporation during the recognition period is the highest rate of tax specified in §11(b). This tax is assessed on the lesser of the corporation's net recognized built-in gain or taxable income. The regulations outline a four-step process in computing tax on built-in gains:
        - a. (1) Step One — The corporation must determine its net recognized built-in gain for the current tax year pursuant to §1374(d)(2) and Regs. §1.1374-2. (2) Step Two — The net recognized built-in gain is reduced by the amount of any NOLs and capital loss carryforwards allowed under § 1374(b)(2) and Regs. §1.1374-5. (3) Step Three — The S corporation computes its tentative tax using the appropriate rate of tax determined under §1374(b)(1) to the amount determined in Step 2. (4) Step Four — The S corporation computes its final tax by reducing tentative tax calculated in Step 3 (but not below zero) by any credit allowed under §1374(b)(3) and Regs. §1.1374-6.<sup>1</sup>
  - a. Reserved
- IV. Organization & Basis
- a. IRC § 351 Overview
    - i. Boot
    - ii. Assumed Liabilities
      1. Sec. 357(c)
  - b. Outside basis
    - i. Purpose
      1. Loss limitation;
      2. Taxability of distributions; and
      3. Gain/loss on subsequent distribution.
    - ii. Starting Point
      1. Sec. 358
      2. Sec. 1012
      3. Sec. 1014
      4. Sec. 1015
    - iii. § 1367 Adjustments
    - iv. Distributions in excess of basis

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<sup>1</sup> Starr and Sobol, 731-2nd T.M., *S Corporations: Operations*



v. Suspended Losses – Sec. 1366(d)(2)

1. *Example:* T is the sole shareholder of X, an S corporation. During 2005, X incurred and passed through to T \$6,000 in nonseparately stated loss and \$4,000 in capital loss. However, T was unable to deduct any of the losses due to a lack of basis. In this situation, both losses are suspended, carry forward to 2006, and pass through again with respect to T. In 2006, X incurred and passed through \$5,000 in nonseparately stated income and \$2,000 in capital gain. This means that T is deemed to have \$1,000 in ordinary loss (\$6,000 – \$5,000) and \$2,000 in capital loss (\$4,000 – \$2,000) from X in 2006. These amounts must be compared with T's basis at the end of 2006 to determine if any of these amounts may be deducted. If not deductible, those amounts again carry forward and are combined with 2007's passthrough results.<sup>2</sup>

2. With respect to that shareholder.

a. *Example:* T is the sole shareholder of X, an S corporation. During X's first three years of operations, it incurred losses totaling \$100,000 that passed through to T. However, because T only had basis of \$20,000 in X, \$80,000 of the losses were suspended. In the fourth year of operations, T sold his stock to B. In this situation, T's suspended losses are lost forever (nor are they available to offset any gain from the sale of X stock).<sup>3</sup>

3. Reserved

c. Inside basis

i. Sec. 362

ii. Loss Importation Rules

1. Sec. 362(e)

V. Allocable Share

- a. "An S corporation must report, and a shareholder is required to take into account in the shareholder's return, the shareholder's pro rata share, whether or not distributed, of the S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2), (3), and (4) of this section. A shareholder's pro rata share is determined in accordance with the provisions of section 1377(a) and the regulations thereunder. The shareholder takes these items into account in determining the shareholder's taxable income and tax liability for the shareholder's taxable year with or within which the taxable year of the corporation ends. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return." Treas. Reg. § 1.1366-1(a)(1)
- b. "Corporation X uses a fiscal year ending on September 30. A, the sole shareholder of X, uses a calendar year. X incurs a loss evenly throughout its taxable year starting October 1, 1999. A deducts that loss on A's tax return for

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<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

2000. Thus, the deduction of the part of the loss incurred in October, November, and December 1999, is deferred until 2000.” Eustice & Kuntz, *Federal Income Taxation of S Corporations* (WG&L), ¶7.07

- c. “[T]he taxable year of an S corporation shall be a permitted year.” § 1378
- d. “Sec. 444 may allow an S corporation to elect to use a fiscal year. Generally, that fiscal year must be one that defers no more than three months of income for the shareholders. To avoid revenue loss to the Treasury from such an election, the S corporation must make an interest-free deposit with the Service roughly equal to the taxes that are being deferred for the shareholders. The corporation adjusts the amount of the interest-free deposit each year to reflect its level of income. If and when the deferral ends (or is reduced for the shareholders), the corporation receives a refund of all or part its deposit.” *Federal Income Taxation of S Corporations* (WG&L), ¶3.09[3][a]. “[A]n election may be made under subsection (a) only if the deferral period of the taxable year elected is not longer than 3 months.” Sec. 444(b)(1)
- e. “Death ends an individual's taxable year. A portion of the income or loss of an S corporation passes through with respect to the period ending on the date of death. That income or loss is reported on the decedent's final income tax return. An S corporation generally determines the amount of income or loss allocated to the decedent's final short taxable year by taking the income or loss for the corporation's *entire* taxable year and allocating on a per-share, per-day basis. As discussed below, however, the corporation with certain shareholders may elect to close the books on the date of death.” Eustice & Kuntz, *Federal Income Taxation of S Corporations* (WG&L), ¶15.03[1]
- f. Review sec. 465 & 469
- g. Reserved

## VI. Distributions, Redemptions & Liquidations

- a. C corporation distributions
  - i. Ordering Rule
    - 1. Review sec. 301(c)
    - 2. Dividend to the extent of current and/or accumulated E&P
      - a. Sec. 316(a) “For purposes of this subtitle, the term “dividend” means any distribution of property made by a corporation to its shareholders – (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

3. Return of capital
4. Capital gain
- ii. Basis to distributee
- iii. E&P
  1. Economic taxable income; therefore, as a general rule, nondeductible expenses and losses reduce E&P. Conversely, non-economic deductions generally do NOT reduce E&P (e.g., DRD).
  2. A dividend reduces E&P but not below zero. Treas. Reg. § 1.316-1(a)(2)
  3. “[I]f a corporation with an accumulated E&P deficit generates income in a later year, the positive earnings must be used to reduce the deficit in accumulated E&P, unless the subsequent earnings are distributed in the year they are earned.” Portfolio 762: Earnings and Profits, 1:II.E
  4. Nimble Dividend:
    - a. *“Example: X corporation, a calendar year corporation, made a \$15,000 distribution to its shareholders on July 1, 2007. X had a \$60,000 deficit in post-1913 E&P at the beginning of 2007. During 2007, X had a net profit of \$75,000 for the period Jan. 1 through June 30, 2007, and an operating deficit of \$70,000 for the second half of the year, resulting in total E&P for 2007 of \$5,000. Applying the rules of Regs. §1.316-2, \$5,000 of the \$15,000 distribution is out of current E&P and is a dividend. Because X corporation had no accumulated E&P available at the time of the distribution, the balance of the distribution is not a dividend and, instead, under §301(c)(2) must be applied to reduce the adjusted basis of the stock in the hands of the shareholders. To the extent that the distribution exceeds the adjusted basis of the stock, the excess is gain from the sale or exchange of property under §301(c)(3).*
      - i. The foregoing example reinforces the concept in §316(a)(2) that current E&P is determined at the end of the year of distribution, not at the point in the year that a distribution is made. It also illustrates the “nimble dividend” rule that a corporation can pay a dividend if it has current E&P, despite the fact that it has an accumulated deficit in E&P.” Emphasis Added. Id.
  5. Distributions of Appreciated Property
    - a. Review sec. 311(b)
    - b. *“Example: A corporation with an accumulated E&P of \$120 makes a non-liquidating distribution to its shareholders of property with a fair market value of \$150 and an adjusted basis for E&P purposes of \$100. Under §312(b)(1), the corporation's E&P, after increase by the \$50 excess of the fair market value over adjusted basis of the distributed*

property, becomes \$170. Because the corporation has accumulated and current E&P in excess of the fair market value of the distributed property, the entire \$150 fair market value of the property is treated as a dividend to the shareholders. Finally, under §312(b)(2), the corporation's \$170 E&P is reduced by the \$150 fair market value of the property to \$20." Portfolio 762: Earnings and Profits, 1:II.B

6. Review E&P WS

b. Redemptions

- i. Conversion of ordinary income into capital?
- ii. Review sec. 302.
- iii. Bail-out of corporate earnings?
  1. Sec. 302(b) transactions
- iv. Sec. 304 transactions
  1. Parent-subsidiary
  2. Brother-sister
  3. Fictional sec. 351 followed by a redemption; hence, sec. 304 kicks you into sec. 302 to test for sale or exchange treatment

c. Distributions by S Corporations

- i. Review sec. 1368 & Treas. Reg. § 1.1368-1.
- ii. "For S corporations with accumulated E&P, the accumulated adjustments account (AAA) tracks the corporation's ability to make tax-free distributions to shareholders. The AAA represents the earnings of the corporation that have been previously taxed to shareholders for all S years, less any amounts already distributed, i.e., the AAA is generally the accumulation of previously taxed, but undistributed, earnings of the S corporation. Therefore, to the extent the corporation has a positive balance in the AAA, tax-free distributions can be made to shareholders. Under Regs. §1.1368-2(a)(1), the AAA is an account of the S corporation and is not apportioned in any manner to the shareholders."
- iii. Review examples at Treas. Reg. § 1.1368-3.

d. Liquidations

- i. Taxable
  1. Sec. 331/336
  2. Sec. 165
- ii. Tax-free
  1. Sec. 332/337

VII. Reorganizations & IRC § 338(h)(10)

- a. Sale or Exchange – Sec. 1001
- b. Shareholder Provisions
  - i. Sec. 354 & 356
- c. Corporate Provisions
  - i. Sec. 361
- d. Definitions
  - i. Type A (asset acquisition)
    1. State law merger provisions; some foreign now qualify
    2. Backwards or forwards?

- ii. Type B (stock acquisition)
    - 1. NO BOOT IN A "B"
    - 2. Overlap with sec. 351
  - iii. Type C (asset acquisition)
    - 1. Boot relaxation rule
  - iv. Type D (asset acquisition)
    - 1. Divisive vs. Acquisitive
    - 2. Different control test for acquisitive – sec. 304(c)
    - 3. Sec. 357(c) only in a divisive D
    - 4. D trumps a C
  - v. Type E
    - 1. Recapitalization
    - 2. S election concerns
  - vi. Type F
    - 1. Asexual
    - 2. A mere change in identity or place of incorporation
- e. Tax-free deferred
  - i. Basis adjustment
- f. The (h)(10) fiction
  - i. One level of gain!
  - ii. Legal transfer of stock/membership interest
  - iii. Watch NUBIG
  - iv. QSP
  - v. Require as part of SPA

VIII. Reserved