Avoiding traps when electing S corporation status for an LLC—

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Classification of eligible business entities. Treasury regulations classify "eligible business entities," such as LLCs, for federal income tax purposes. Reg. § 301.7701-3(b)(1) provides that if an LLC has two or more owners, it will be classified as a partnership for tax purposes, and if it has only one owner, the entity will be disregarded for tax purposes.

Why convert an LLC to an S corporation? The most common reason that the author has encountered for electing S status is the belief that the payroll tax treatment of shareholder-employees is more certain than the self-employment (SE) tax treatment of members of an LLC. In addition, although S corporations, relative to the partnership form, add complexity with technical eligibility requirements, they also offer a more simple approach to taxation based on the entity approach to taxation.

Electing S corporation status. The regulations allow an LLC that would be classified as a partnership or a disregarded entity under the default rules to elect to be taxed like a corporation. Corporate status is achieved by filing Form 8832, Entity Classification Election, electing to treat the entity as an "association." An association is treated as a corporation for federal income tax purposes. Once the LLC elects association status, its owner(s) may also choose to have it taxed as an S corporation. To simplify the election process in such cases, it is not necessary to file both Form 8832 to elect association status and Form 2553 to elect S corporation status. Reg. § 301.7701-3(c)(1)(v)(C) allows a single election to be made on Form 2553. A timely filed Form 2553 will constitute a deemed filing of Form 8832. This deemed association election is effective only if the electing entity meets all of the requirements to be an S corporation. Form 2553 also is not effective if the entity fails to qualify as an S corporation as of the election date.

Eligibility issues for S election. While not required of the LLC form, most LLC entities begin their life with an operating agreement prepared by a business attorney. As most LLC entities default to partnership tax treatment, a standard form operating agreement will contain language addressing the federal income tax issues that one typically sees with a partnership. A variety of provisions in a standard form operating agreement must be reviewed before an S election is made for an LLC. Many of these typical LLC operating agreement provisions are not permitted if the entity is to be taxed as an S corporation.

S corporations are subject to specific eligibility rules under the tax laws, including the requirement that the
corporation have a single class of stock (SCOS). Generally, a second class of stock will exist if shareholder equity rights differ with respect to distribution rights and liquidation rights. Also, all allocations of profit and loss must follow share ownership. Reg. § 1.1361-1(l)(2) explains that the "governing provisions" of the entity, including the operating agreement, must be examined to determine if there are differences in liquidation or distribution rights. The standard LLC operating agreement, not designed for an entity taxed as an S corporation, will have no reference to "stock" ownership. §7701(a)(7) states that "stock" includes shares in an association, and §7701(a)(8) states that a "shareholder" includes a member in an association. However, if the operating agreement includes the (standard) language about §704(c) , a qualified income offset, and a minimum gain chargeback overriding otherwise prescribed allocations, the agreement violates the per-share, per-day allocation scheme applicable to S corporations. Priorities on cash distributions, or provisions that require distributions on liquidation of a member's interest to follow capital accounts, would also violate the SCOS requirement. These concerns must be addressed with modifications to the operating agreement.

**Modifications of the standard operating agreement.** The most significant modification to the standard operating agreement would be to provide that no member has priority over any other member with respect to distributions, either during operations or upon liquidation of a member's interest. This would require deletion of any references to capital accounts maintained under Reg. § 1.704-1(b)(2)(iv) , which are generally maintained when the agreement also provides for a qualified income offset, a minimum gain chargeback, and for distributions on liquidation to follow the capital accounts.

It will also be necessary to eliminate the standard references to §704(c) allocations for pre-contribution or pre-admittance ("reverse §704(c) " gains and losses). Any preference or guaranteed returns for capital will also need to be eliminated, with all distributions following only member ownership interests. Of course, it is also necessary to define ownership interests, which will replace the stock ownership of a corporation. Members may define ownership in such a way that it is the economic equivalent of stock ownership, forming the basis for satisfying the SCOS requirement. It is common for LLC operating agreements to provide for capital calls, with remedies available when one (or more) member fails to timely make a capital call. Similar provisions may be incorporated into an agreement of an entity that plans to be an S corporation, with the remedy being changes in the defined ownership interests of members who default on calls, forcing others to make up for the defaulting member. The revised ownership interests would
continue to form the basis for allocations of profit and loss and for post-change distribution rights, as is required by the SCOS requirement. Similarly, a buy-sell or redemption agreement incorporated into the operating agreement (or a side agreement) needs to be tested for compliance with safe harbors under the §1361 regulations.

As is the case with an S corporation formed under state corporate law, members of an LLC electing S status may be paid different amounts for the services they provide to the entity and may receive payments for property leased to the entity or money loaned to the entity. The standard approaches used to protect against violations of a second class of stock with such arrangements (e.g., the straight debt safe harbor of §1361(c)(5) or safe harbors provided in the §1361 regulations for proportionately held debt and de minimis open account debt) should be considered when designing the capital structure of the entity.

The agreement may also include language often found in S corporation shareholder agreements to prevent a termination of the election, such as restricting transfers to ineligible shareholders, permitting an examination of any trusts for compliance with the eligible shareholder requirement, and perhaps a general statement that the members understand that the entity is to be taxed under subchapter S and will act in accordance with that intent.

**Consequences of failure to modify operating agreement before election.** *Reg. § 301.7701-3(c)(1)(v)(C)* states that a timely election under Subchapter S is a deemed association election, provided that, at the effective date of the election, the entity meets all other requirements to be an S corporation. The preamble to *T.D. 9139, 7/21/04* notes that if the eligible entity's S election is not timely and valid, the default classification rules provided in *Reg. § 301.7701-3(b)* will apply to the entity unless IRS provides late S corporation election relief or inadvertent invalid election relief. The default status would then be a partnership if the LLC has two or more members, or a disregarded entity if it has only one owner.

For those taxpayers following the simplified election procedure, the (defective) S election would have been filed using only Form 2553. However, *Reg. § 301.7701-3(c)(1)(ii)*, and the instructions to Form 8832, require it to be attached to the entity's return for the year that the association election is to be effective. This copy need not be signed. Failure to attach Form 8832 does not invalidate the election, but may subject the non-filer to penalties.
It is not clear if one should attach a "dummy" Form 8832 to the entity's initial Form 1120S when it was never originally filed. The regulations seem to open the door to this approach by stating that the copy of Form 8832 attached to the return need not be signed. If Form 8832 was actually filed, a copy of that original filing would include the signatures required for that form to constitute an effective association election. If, however, Form 8832 was not filed due to use of the simplified filing procedures, it would not be possible to file a copy of it, but one could prepare a Form 8832, without signature (the signature consents to the elective status indicated on Form 8832), to attach to the return. Presumably a non-signed form would not (independent of Form 2553) be effective as an entity association election. Thus, even if the LLC owners attached an unsigned dummy Form 8832 to the initial Form 1120S filing, that form alone should not be effective to establish association status for the entity. This issue would be significant because the failure to qualify as an S corporation would make the entity a C corporation if the Form 8832 attached to the initial return was deemed to be an association election. The status should otherwise default to a partnership.

Planning considerations: agreement not modified. The most obvious approach to use when electing S corporation status for an LLC is to review the operating agreement and make suggestions to change any provisions inconsistent with subchapter S. However, understanding that the obvious approach is either not always obvious or is not always followed, the tax advisor then needs to consider the fallback treatment of an entity that has filed a defective Form 2553.

If a Form 8832 was never filed in any manner, including as an unsigned attachment to the initial Form 1120S, the entity classification would, as previously stated, default to the classification rules of Reg. §301.7701-3(b). If the only Form 8832 filed was as an attachment to Form 1120S, it could be reasonably argued that, even if the form was signed, the election would not be effective in the manner filed. At worst, it could be effective only prospectively because it must be filed within the first 75 days of the tax year for which it is to be effective. Late election relief may be available, but only on the taxpayer's request, which would not be done when no association treatment was desired. If unsigned, which would likely be the case for a Form 8832 prepared solely as an attachment, it would be difficult for the IRS to argue successfully that the entity had elected association status. The default classification status would then apply to the LLC. Many advisors do not file a Form 8832 with the entity's return when the form was not previously filed to elect association status affirmatively. For those who choose to attach a Form 8832 to the original
Form 1120S, the form should not be signed (which is permitted by the regulations).

**Conclusion.** It is clear that flow-through entities are the most popular form of business entity in the U.S., but what is less clear is whether the S corporation or the partnership form is best suited for a particular business venture. Without addressing the "proper" choice, this article focuses on the mechanics of treating an entity formed as a state law LLC as an S corporation for federal tax purposes and ways to avoid potential traps. These include needed revisions to a standard operating agreement as well as compliance with the election mechanics. If a taxpayer undertakes the election mechanics without first modifying the operating agreement, the resulting entity may be a partnership or a C corporation. How the election is made may offer a safeguard in the event it is later discovered that an eligibility failure occurred.

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**Unused basis from the past couldn't be restored to deduct current passthrough losses--Barnes, (CA DC 04/05/2013) 111 AFTR 2d ¶ 2013-611**

The Court of Appeals for the District of Columbia, affirming the Tax Court, has held that S corporation shareholders weren't entitled to fully deduct passthru losses because they didn't have sufficient basis in their stock. The taxpayers' past failure to take into account suspended losses that became available didn't operate to restore the unused basis for use in the year at issue. This was so even though the taxpayers never claimed a deduction for those suspended losses, and they were now barred by the statute of limitations from doing so.

**Background.** An S corporation's income is taxed directly to its shareholders by allocating the corporation's items of income, loss, deduction and credit for each day in its tax year pro rata among the persons who were shareholders on that day. ( §1366(a)(1) , Reg. § 1.1366-1(a) )

Thus, deductions and losses of an S corporation are passed through to shareholders and (except as otherwise limited by the Code) claimed on their own returns. However, a shareholder can deduct his pro rata share of S corporation losses only to the extent of the total of his basis in (a) the S corporation stock, and (b) debt owed him by the S corporation. ( §1366(d) , Reg. § 1.1366-2 ) A deduction or loss that can't be claimed for lack of basis may be carried over and used in the future to the extent the shareholder then
has basis. ( §1366(d)(2) , Reg. § 1.1366-2(a)(2) )

A shareholder's basis in the stock of an S corporation is increased by his pro rata share of the following corporate income items that are passed through to him: (1) separately computed items of income (including tax-exempt income) required to be taken into account by the shareholder in computing his federal income tax liability; ( §1367(a)(1)(A) ) (2) nonseparately computed income; ( §1367(a)(1)(B) ) and (3) the excess of deductions for depletion over the basis of property subject to depletion. ( §1367(a)(1)(C) )

Basis in stock is decreased (but not below zero) by: the shareholder's share of the corporation's items of deduction, loss and nondeductible expenses (except those chargeable to the capital account); the shareholder's depletion deduction for oil and gas property; and distributions to the shareholder that aren't taxable as dividends. ( § 1367(a)(2) , Reg. § 1.1367-1(c) )

Facts. Marc and Anne Barnes, husband and wife, were shareholders in an S corporation, Whitney Restaurants, Inc. (Whitney). The Barneses' 2003 tax return claimed a deduction for their $279,289 pro rata share of Whitney's 2003 losses. However, IRS determined that their remaining basis in Whitney at that time was just $153,283. Accordingly, under §1366(d) , IRS limited their deduction to that amount and disallowed the deduction claimed for the remainder ($123,006) of the Barneses' share of Whitney's 2003 losses.

Failed argument. The Barneses claimed that IRS and the Tax Court erroneously calculated their basis in Whitney. The D.C. Circuit said that the issue boiled down to the following question: "Is a taxpayer's basis in an S corporation reduced by the amount of any suspended losses in the first year the basis is adequate to absorb those losses, regardless of whether the taxpayer claims a tax deduction for those losses in that year?" The Barneses, who in '97 failed to claim a deduction for a suspended loss even though they had adequate basis to absorb it, said "no: no deduction claimed, no basis reduction."

The D.C. Circuit held that IRS and the Tax Court were correct in finding that §1367(a)(2) requires an S corporation shareholder to reduce basis by any losses that he is required to take into account under §1366(a)(1) . Basis is reduced even if the shareholder doesn't actually claim the passthrough losses on his return. The plain language of §§1366 and 1367 supported the Tax Court's and IRS's interpretation of the Code. Accordingly, the Barneses' 2003 passthrough losses were limited as IRS contended. © 2013 Thomson Reuters/RIA. All rights reserved
Stock received on option exercise was taxable to individual and deductible by company--Allen L. Davis, et al., (CA 11 5/16/2013) 111 AFTR 2d ¶ 2013-729

In a case involving a family-owned S corporation, disharmony among family members, and whipsaw deficiency notices issued by IRS, the Eleventh Circuit, affirming the Tax Court, has held that the family patriarch had income of $36,962,694 under §83(a) from stock he received on exercise of an option. It also held that the company could deduct this amount under §83(h).

**RIA observation:** The father and his two sons took opposite positions. He did not include the value of the stock in income while the company deducted it, to the benefit of the sons as pass-through shareholders. To protect itself, IRS issued whipsaw deficiencies stating that it was taxable to the father but not deductible by the company. Ultimately, the deficiency fell upon the father, as the unsuccessful party.

**Background.** When property is transferred in connection with the performance of past, present or future services, a taxpayer must include in gross income the excess of the property's fair market value over the amount paid for the property. (§83(a), Reg. § 1.83-3(f)). In the case of options without a readily ascertainable fair market value, §83 applies to the stock received upon exercise of the options rather than at the time of receipt. (§83(e), Reg. § 1.83-7(a)) If an option is not traded on an established market, the option's value is not readily ascertainable when the option is nontransferable. (Reg. § 1.83-7(b)(2)(i)) Under §83(h), the company may deduct the amount included under §83(a) in the gross income of the provider of the services.

**Facts.** IRS determined an over $13 million deficiency with respect to Allen L. Davis and an over $4.7 million deficiency with respect to each of his sons, Jared and David, as well as a smaller deficiency with respect to an unrelated party. All of them were shareholders of CNG Financial Corporation (CNG), an S corporation. The controversy concerned an option that CNG granted to Allen in 2002. The taxpayers sought relief in the Tax Court. CNG operated a payday loan business through its subsidiary. Jared founded CNG in '94. His brother David became a shareholder in '95. In '97, the brothers got cash from Allen to expand the business. In exchange for the cash, they each gave Allen options to purchase from each of them 188.86 shares of CNG stock (the '97 options). Allen promised David that he would not
exercise the '97 options unless he experienced financial distress.

In '97 Jared, David, Laura (their sister who also owned shares) and Allen also entered into a stock transfer restriction agreement that, in the event of certain attempted transfers of CNG stock by a CNG shareholder, gave the other shareholders a right of first refusal to purchase the stock at net book value. The list of triggering events included a forced sale pursuant to a divorce decree or other legal process.

In January 2000, two years after retiring as President and CEO of Provident Financial Group, Allen exercised the '97 options. He got majority voting control, removed David from the board, and elected himself, president, CEO, and chairman of the board. Later that year, CNG got a large line of credit from a bank syndicate. The credit was advanced, in part, because of Allen's experience at Provident and the bank group insisted on his continued involvement in the company.

Allen's wife, Judith, filed for divorce in 2001 claiming that she was entitled to half of his shares. The divorce was acrimonious. Jared got a court to agree that he could buy Allen's shares at book value under the stock transfer restriction agreement. Because this would have reduced the marital estate, the parties agreed to a plan to resolve the conflict. Under this plan, Allen transferred half of his CNG shares to Judith, subject to an option allowing Allen to repurchase the shares for $16 million (the Judith Option). CNG then redeemed the 188.86 shares from Judith and amended the Judith Option (the Allen Option) by adding a cashless exercise provision. The cashless exercise provision allowed Allen to avoid paying any portion of the exercise price and to instead receive a number of shares (determined according to a formula) that were worth $16 million less than the value of 188.86 shares. The Allen Option was not transferable.

In 2004, Allen exercised the Allen Option through the cashless exercise provision & received $131,8055 shares of CNG stock worth $36,962,694. CNG treated the stock as compensation to Allen and Jared, David, & the unrelated shareholder (collectively the CNG parties) each claimed their share of the company's $36,962,694 compensation deduction on their returns for 2004. Allen, did not treat the Allen Option's exercise as taxable & did not include the stock's value in his gross income for 2004. The parties disagreed as to whether the CNG stock Allen received in 2004 was transferred in connection with the performance of services. The CNG parties argued that it was. Allen and IRS argued that it was not.

The Tax Court found that the CNG stock was transferred to Allen in connection with his performance of services because CNG granted the Allen Option with the intention of securing Allen's participation in the
day-to-day management of CNG. The Court then found the value of the shares that Allen received was $36,962,694. Lastly, it held that, under §83(h), CNG could deduct $36,962,694 as reasonable compensation to Allen in 2004.

**Parties appeal the Tax Court’s findings.** Allen appealed the Tax Court's findings. To ensure consistent treatment of the transaction, IRS appealed the Tax Court's decision with respect to the CNG taxpayers.

**RIA observation:** IRS did not want the company to get a deduction if the Eleventh Circuit were to find that the transaction wasn't taxable to Allen.

Allen argued on appeal that the Tax Court erred in determining that the Allen Option was granted to him in connection with his performance of services and in valuing the shares he received upon the option's exercise.

**Stock transferred in connection with performance of services.** The Eleventh Circuit determined that the Tax Court properly found that the Allen Option was granted to Allen in connection with his performance of services for CNG. The Appeals Court noted that Allen arranged for the creation of the Judith Option without Judith's involvement, and all of the parties knew that CNG would immediately cash-out Judith's CNG shares and grant Allen an option to purchase shares directly from the company. Despite the form of the transaction, Allen never intended to exercise the Judith Option to purchase shares from Judith; he intended to purchase shares from CNG. In reality, CNG, not Judith, always bore the burden of providing Allen with additional shares when he exercised the option.

The record supported the Tax Court's finding that CNG granted Allen the Allen Option to ensure his continued involvement with the company. Allen had conditioned his continued involvement in CNG's management on the receipt of an option to purchase shares to replace those he had to give to Judith. CNG, believing his threats, granted the Allen Option in order to retain his services.

Allen did not dispute that CNG granted the option to him to ensure his continued involvement with the company. Rather, he asserted that the Judith Option, which, after amendment, became the Allen Option, served additional purposes, such as stabilizing control of CNG and resolving family strife. The Eleventh Circuit said that the Allen Option undoubtedly also provided these benefits. However, it stressed that the presence of additional benefits or motivating factors did not alter the nature of the option grant.
Allen contended that, because he received the Judith Option from Judith, it could not have been in connection with the performance of services. The Eleventh Circuit disagreed. CNG was the de facto counter-party under the Judith Option and, more importantly, CNG granted Allen the Allen Option. He also argued that §1041, providing for nonrecognition of gain on divorce-related transfers between spouses, shielded his exercise of the option from tax. The Eleventh Circuit disagreed. While the transfer of an option between spouses or former spouses incident to divorce is shielded by §1041, it said that exercise of an option is not.

*Valuation upheld.* The Eleventh Circuit concluded that the Tax Court did not err in its valuation methodology. The Tax Court was tasked with valuing the shares Allen received in their cashless sale. It was reasonable for the Tax Court to use the parties' own valuation of the shares on the exercise date in assessing fair market value. Therefore, the Tax Court's valuation was not clearly erroneous and Allen should have included $36,962,694 in ordinary income in 2004.

*Deduction sustained.* Because of its finding as to the income taxable to Allen, the Eleventh Circuit also concluded that the CNG taxpayers' deductions were proper under §83(h).

The Tax Court has rejected IRS's contention that the taxpayers' net operating loss (NOL) deduction was limited under the passive activity loss (PAL) rules because they didn't materially participate. However, the Court upheld IRS's conclusion that the taxpayers' passthru losses from their S corporation were limited because their guaranteeing a bank loan to the corporation didn't increase their basis so as to allow the loss.

*Background on PALs.* Under §469(c)(1), the PAL disallowance rules apply to any trade or business in which the taxpayer doesn't materially participate. A taxpayer is treated as materially participating in an activity by meeting at least one of the seven tests in Reg. §1.469-5T. For example, an individual is treated as materially participating if: (1) the individual participates in the activity for more than 500 hours...
during the year (first test); or (2) on the basis of all of the facts and circumstances, the individual's participation was regular, continuous, and substantial during the year (seventh test). In determining whether any of the seven tests are satisfied, the participation of the individual's spouse is taken into account. (§ 469(h)(5), Reg. § 1.469-5T(f)(3))

An individual can demonstrate his participation in an activity by any reasonable means. Contemporaneous daily time reports, logs, or similar documents aren't required. "Reasonable means" includes but isn't limited to the identification of services performed over a period of time and the approximate number of hours spent performing the services during the period, based on appointment books, calendars, or narrative summaries.(Reg. § 1.469-5T(f)(4))

Background on S shareholder’s losses. An S corporation shareholder may deduct his pro rata share of any loss sustained by the company. (§1366(a) ) However, the shareholder's deduction is limited to the sum of his adjusted basis in his stock and corporate debt owed to him. (§1366(d)(1) ) Numerous cases have established that an S corporation shareholder's guarantee of a loan made by a third person to the S corporation is not treated as a debt from the S corporation to the shareholder for this purpose. (Underwood (1975), 63 TC 468)

In Gilday, TC Memo 1982-242 , the Tax Court found that a debt had been created between an S corporation and shareholders who guaranteed a loan by a bank to the S corporation. However, in Gilday the shareholders of the S corporation that owed the debt to the bank gave the bank a personal note for the amount of the S corporation's debt. In exchange, the bank canceled the S corporation's debt. The shareholders thus moved from positions as guarantors of corporate debt to positions as primary obligors.

Facts. Patrick and Patricia Montgomery, husband and wife, were shareholders in an S corporation, Utility Design, Inc. (Utility Design), which performed engineering work on telephone-related infrastructure. Patricia was also a 40% member of UDI Underground, LLC (UDI Underground) that Patrick started in 2007 to perform construction work on telephone-related infrastructure. UDI Underground was treated as a partnership for federal income tax purposes. Patricia acted as an office manager for UDI Underground, while Patrick, managed the company's operations and worked to secure a contract with AT&T. Both Patricia and Patrick were integral in the process of setting up and establishing UDI Underground. The company began in April of 2007 with no employees. The Montogmerys hired 250 employees on behalf of UDI
Underground by the end of 2007. Although they performed some services for Utility Design during 2007 this older company already had established its business operations.

In 2006 and 2007, Utility Design borrowed: (1) $1 million from SunTrust Bank, which the Montgomerys personally guaranteed; and (2) $105,000 from Patrick. In 2008, Utility Design defaulted on the $1 million loan from Sun Bank. In 2009, a judgment was imposed on the Montgomerys as a result of their guarantee of the $1 million loan SunTrust Bank in 2006.

In calculating their joint net operating loss for 2007, the Montgomerys included: (1) losses UDI Underground incurred in 2007 that were passed through to Patricia as a 40% member of UDI Underground; and (2) losses Utility Design incurred in 2007 that were passed through to Patrick and Patricia, who were both shareholders in Utility Design.

On audit, IRS challenged the amount of the net operating loss for 2007 on two grounds: (1) that Patricia did not materially participate in UDI Underground; and (2) that part of Patrick and Patricia’s passthru losses from Utility Design were disallowed under §1366(d)(1).

Court’s conclusion. The Tax Court found that the Montgomerys met the first and seventh tests in Reg. § 1.469-5T for 2007—they participated in UDI Underground for more than 500 hours and participated in UDI Underground on a regular, continuous, and substantial basis. Patricia handled all of the office functions, managed payroll, prepared documents, met with members of the company and attended business meetings. She also worked on company matters daily and discussed the company’s business with Patrick daily. Patrick started the company and brought in other individuals as investors. He also secured a contract with AT&T. He handled various operational aspects of the business including arranging the construction work, buying equipment, and hiring and firing employees.

While the Montgomerys did not maintain reports or logs of their hours, the Tax Court rejected IRS’s contention that the proof they offered didn’t satisfy Reg. § 1.469-5T(f)(4). The Montgomerys were creditable witnesses who provided details of the nature of the activities they conducted in starting and managing UDI Underground. They credibly testified that they worked thousands of hours for UDI Underground during 2007.

S shareholder’s guarantee. The Tax Court concluded that an S corporation shareholder’s guarantee of a loan made by a third person to the S corporation wasn’t treated as a debt from the S corporation to the
shareholder in determining the limits on the shareholder's right to deduct his pro rata share of losses and deductions passed through to him. The Court relied on Underwood, to find that it was only the payment by the guarantor that gave rise to indebtedness on the part of the debtor to the guarantor. The mere fact that the debtor defaulted and so rendered the guarantor liable wasn't sufficient. Patrick did not make any payments on the SunTrust Bank loan, and so his guarantee of the loan did not give rise to a debt to him from Utility Design during 2007.

The Court also rejected the Montgomerys' reliance on Gilday. The Court found that, unlike the taxpayer in that case, Patrick didn't change his position to that of the primary obligor in 2007.

In addition, the Court noted that the limited exception to the guarantor rule in Selfe v. U.S., (CA 11 1985) 57 AFTR 2d 86-464, didn't apply. There, the Eleventh Circuit found that a shareholder's guarantee of a loan could be treated as an equity investment in the S corporation (increasing the shareholder's basis) if: the creditor looked primarily to the shareholder as the primary obligor; the notes were issued by a thinly capitalized corporation; and the notes had more equity characteristics than debt characteristics. The Montgomerys didn't attempt to come within this exception and offered no evidence that the bank looked primarily to the shareholder as the primary obligor.

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**QSST beneficiary could deduct interest on trust debt incurred to buy S corp**

- **Chief Counsel Advice 201327009**

In Chief Counsel Advice (CCA), IRS has concluded that, where S corporation stock was a qualified Subchapter S trust (QSST)'s only asset, interest on debt incurred by the trust to purchase that stock was deductible, as business interest, by the trust's beneficiary.

**Facts.** A QSST purchased S corporation stock from a third party (not the beneficiary) in exchange for a note, and the QSST made payments under the note, including interest payments. Cash from the S corporation was the sole source of the payment of interest. The only asset owned by the QSST was the S corporation stock.

**Background.** §1361(d)(1) provides, in relevant part, that: a) an electing QSST is permitted to be a
shareholder of an S corporation; b) such a QSST is treated as a wholly-owned grantor trust; and (c) the beneficiary of the QSST is treated as the owner of the portion of the trust which consists of stock in the S corporation, under the rules of §678(a).

Reg. §1.1361-1(j)(7)(i) provides, in part, that a QSST beneficiary is treated as an S corporation shareholder for purposes of §1366. §1366 is the provision under which an S corporation's income, etc. passes through to its shareholders.

§671 provides, in part, that where the grantor is treated as the owner of any portion of a trust, he is subject to the rules for computing income, deductions, and credits that apply to an individual taxpayer. Reg. §1.671-3(a)(2) provides that if the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion.

Under Reg. § 1.652(b)-3(a), for trusts, all deductible items directly attributable to one class of income are allocated to that one class of income. For example, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business.

The general rule of "interest tracing" is that "interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated." (Reg. § 1.163-8T(a)(3)) In other words, to trace the interest, one must follow the debt proceeds. Interest allocated to a trade or business expenditure is fully deductible under §163.

Notice 89-35, 1989-1 CB 675, provides that where debt is used to purchase an interest in a passthrough entity, the debt proceeds and associated interest are allocated among the assets of the passthrough entity. Notice 88-37, 1988-1 CB 522, provides that interest related to debt-financed acquisitions that is allocated to trade or business expenditures (within the meaning of Reg. § 1.163-8T(b)(7)) is deductible without limitation.

CCA's conclusion. IRS found that the interest expense is deductible by the beneficiary. It reasoned that the debt incurred by the QSST was used to acquire the S corporation stock, and the interest is fully traceable to that purchase under Reg. § 1.163-8T and Notice 89-35. The interest expense is then traced to the income from the S corporation business; as a result, the rules under Reg. § 1.652(b)-3(a) cause that expense to be directly appointed to the portion representing the S corporation income. Therefore, Reg. § 1.671-3(a)(2) requires that, based on Reg. § 1.652(b)-3, the interest expense deduction is attributable to
the S portion of the QSST and, thus, deductible by the beneficiary.

The CCA went on say that its advice does not address:

... a situation where a QSST has significant income-producing assets other than S corporation stock and co-mingles the S corporation distributions with its other income before paying the interest on the debt. In that case, the answer may depend on the particular facts of the case;

... or the treatment of debt and associated interest under either the at-risk rules of §465 or the passive activity loss/credit rules of §469.

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<box>RIA observation:</box> Note that if the trust in this case was an electing small business trust (ESBT), which is another type of trust that is permitted to be an S corporation shareholder, the Code, i.e., §641(c)(2)(C)(iv), would apply and would specifically permit the ESBT to deduct the interest on the debt incurred to purchase the S corporation stock.
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S corporation members aren’t subject to controlled group Sec. 179 limitations--Information Letter 2013-0016

In an information letter, IRS has determined that S corporations that are members of a controlled group are not subject to the rule that limits the controlled group’s maximum annual §179 expense deduction. Accordingly, these S corporations are treated as separate entities for purposes of that limit and can make §179 elections up to the maximum election amount.

Background. §179(a) provides that a taxpayer may elect to treat the cost of any "§179 property" as a deduction for the tax year in which the property is placed in service, as opposed to depreciating the cost of the property over time. §179 property includes most tangible personal property and certain other property used in the active conduct of a trade or business.

§179(b) provides a dollar limit on the amount of the aggregate cost which may be taken into account under §179(a). For tax years beginning in 2013, the maximum amount that can generally be expensed in $500,000. This dollar limit is scheduled to fall to $25,000 for tax years beginning after 2013. (§179(b)(1))

§179(d)(6)(A) provides that, for purposes of §179(b) 's limit, all "component members" of a controlled
group are to be treated as one taxpayer. §179(d)(7) provides that, for purposes of §179(d)(6), the term "controlled group" has the meaning assigned to it by §1563(a) with certain modifications that are not relevant here.

§1563(a) defines four types of controlled groups of corporations. In order for a corporation to be included in one of these controlled groups under §1563(a), it must satisfy the stock ownership test for that type of group. §1563(b) describes which corporations are component members of a §1563(a) controlled group in part by excluding certain corporations, such as S corporations (excluded members). (§1563(b)(2) and Reg. § 1.1563-1(b)(2)(ii)) However, even though a corporation that is treated as an excluded member is not a component member, it is nevertheless treated as a member of the group if the relevant stock ownership test is satisfied. (Reg. § 1.1563-1(a)(1)(ii))

Conclusion. IRS determined that an S corporation member of a controlled group can make a §179 election up to the maximum election amount and is not subject to the group's overall §179(b) limit, even if the S corporation is otherwise a member of the group for purposes of §1563(a).

IRS reasoned that §179(d)(6)(A) applies the controlled group rules of §1563(a) by only taking into account the component members of a controlled group. Since an S corporation is not a component member of a controlled group, §179(d)(6)(A) does not apply.

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Sec. 108(i) deferral of COD income for partnerships and S corporations clarified in final regs--T.D. 9623, 07/02/2013; Reg. § 1.108(i)-2

IRS has issued final regs that provide guidance on the elective deferral of cancellation of debt (COD) income and on original issue discount (OID) deductions by a partnership or an S corporation with respect to reacquisitions of applicable debt instruments under §108(i). The regs apply to the reacquisitions of applicable debt instruments in 2009 and 2010.

Background. For debt discharges in tax years ending after Dec. 31, 2008, a taxpayer may elect to have any cancelled COD income from the reacquisition of an applicable debt instrument (i.e., any debt instrument issued by a C corporation or other person in connection with the conduct of a trade or business,
such as a bond or debenture) after Dec. 31, 2008, and before Jan. 1, 2011, included in gross income ratably over five tax years beginning with: (1) for repurchases occurring in 2009, the fifth tax year following the tax year in which the repurchase occurs, and (2) for repurchases occurring in 2010, the fourth tax year following the tax year in which the repurchase occurs. (§108(i))

A "reacquisition" generally means the acquisition of the debt instrument by the debtor that issued it. (§108(i)(4)(A)) The term "acquisition" for this purpose includes, among other things, the acquisition of the debt instrument for cash and the exchange of the debt instrument for another debt instrument for a partnership interest.

When a debt instrument is issued (or treated as issued) as part of the reacquisition, some or all of any original issue discount (OID) expense accruing from the debt instrument in a tax year prior to the first tax year of the inclusion period may also be required to be deferred (deferred OID deduction). The aggregate amount of deferred OID deductions is limited to the amount of COD income deferred with respect to the applicable debt instrument for which the §108(i) election is made, and the aggregate amount of deferred OID deductions is taken into account ratably over the inclusion period.

In general, COD income deferred under §108(i) and related deferred OID deductions with respect to an applicable debt instrument that have not been previously taken into account (deferred items) are accelerated and taken into account in the tax year in which an "acceleration event" occurs. Acceleration events include the death of the taxpayer, the liquidation or sale of substantially all the taxpayer's assets, and other similar events. Upon the occurrence of such an event, any item of income or deduction that is deferred under the above rules (and hasn't previously been taken into account) is generally taken into account in the tax year in which that event occurs. This acceleration rule for deferred COD income also applies in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-through entity by a partner, shareholder, or other person holding an ownership interest in the entity. (§108(i)(5)(D)(ii))

Under §108(i)(6), a partnership must allocate the COD income that is deferred under §108(i) to the partners that were partners immediately before the transaction giving rise to the COD income in the same manner the income would be allocated without regard to §108(i). The 2nd sentence of §108(i)(6) provides that any decrease in a partner's share of partnership liabilities as a result of the discharge isn't
taken into account for purposes of the §752 partnership liability rules to the extent it would cause the partner to recognize gain under §731.

**Earlier guidance.** In 2009, IRS released Rev Proc 2009-37, 2009-36 IB 309, which explained how to make a §108(i) election and required electing taxpayers to provide specified additional information when filing their returns.

IRS issued temporary and proposed regs in 2010. The 2010 regs included safe harbors under which a debt instrument issued by a partnership or an S corporation would be considered an applicable debt instrument for purposes of §108(i).

The 2010 regs provided methodology for determining the portion of each partner's allocable share of COD income resulting from a reacquisition of an applicable debt instrument that is deferred under §108(i) and the portion that is currently included. The 2010 regs also contained rules for how and when a partner's basis is adjusted. Corresponding rules were provided for S corporations and S corporation shareholders.

**New final regs**—largely adopt the 2010 regs with certain modifications and clarifications.

**S corporation rules.** Reg. §1.108(i)-2(c) provides rules that apply to S corporations which are generally similar to the partnership rules. Under Reg. §1.108(i)-2(c)(1), an electing S corporation's deferred COD income must be shared pro rata on the basis of stock ownership among those shareholders that held stock in the electing S corporation immediately before the transaction giving rise to the COD income. Any COD income deferred under §108(i) is taken into account under §1366(a) by those shareholders in the inclusion period, or earlier upon the occurrence of an acceleration event. Reg. § 1.108(i)-2(c)(1))

Additionally, an S corporation shareholder's stock basis isn't increased under §1367 to account for the shareholder's share of the S corporation's deferred items at the time of the reacquisition, but is adjusted when the deferred items are recognized. An S corporation's accumulated adjustments account isn't adjusted to account for the deferred items at the time of the reacquisition, but is adjusted in the tax year in which the deferred items are recognized. (Reg. § 1.108(i)-2(c)(2))

**Acceleration events.** Upon certain "acceleration events," a shareholder's share of an electing S corporation's deferred items is accelerated and must be taken into account by the shareholder in the tax year of the event. Entity-level acceleration events include when the electing entity liquidates; sells, exchanges,
transfers, or gifts "substantially all" of its assets (meaning at least 90% of the FMV of its net assets, or at least 70% of the FMV of the gross assets); stops doing business; files a Title 11 bankruptcy petition; and for an S corporation, loses S status. (Reg. § 1.108(i)-2(c)(3)(i))

Shareholder-level acceleration events include the shareholder's death; sale, exchange, transfer, or gift of all or a portion of its interest in the electing entity; or abandonment of its interest. (Reg. § 1.108(i)-2(c)(3) (ii)) The regs also provide examples of events that don't trigger acceleration, including §1031 exchanges and §381 transactions. (Reg. § 1.108(i)-2(c)(3)(iii))

If a shareholder sells, exchanges, transfers, or gifts only a portion of its interest in an S corporation, only a proportionate amount of its share of the entity's deferred items is accelerated. (Reg. §§ 1.108(i)-2(b)(6)(ii)(B)(1) & 1.108(i)-2(c)(3)(ii)(B))

Safe harbors-"applicable debt instrument." The final regs provide that a debt instrument issued by an S corporation is an applicable debt instrument deemed to have been issued in connection with the entity's trade or business for purposes of §108(i) if the entity shows that it meets one of the following five safe harbors:

... The gross fair market value (FMV) of the trade or business assets of the S corporation that issued the debt instrument represented at least 80% of the gross FMV of that S corporation's total assets on the date of issuance;

... The trade or business expenditures of the S corporation that issued the debt instrument represented at least 80% of the S corporation's total expenditures for the taxable year of issuance;

... At least 95% of interest paid or accrued on the debt instrument issued by the S corporation was allocated to one or more trade or business expenditures under Reg. § 1.163-8T for the tax year of issuance;

... At least 95% of the proceeds from the debt instrument issued by the S corporation were used by S corporation to acquire one or more trades or businesses within six months from the date of issuance; or

... The S corporation issued the debt instrument to a seller of a trade or business to acquire the trade or business. (Reg. § 1.108(i)-2(d)(1))
If none of the safe harbors is met, then the determination of whether a debt instrument is an "applicable debt instrument" is made based on all facts and circumstances.

**Deferral of OID.** For each tax year during the deferral period, an issuing entity determines the amount of its deferred OID deduction with respect to a debt instrument, if any. This deduction is the lesser of: (i) the OID that accrues in a current tax year during the deferral period with respect to the debt instrument (less any of such OID that is allowed as a deduction in the current tax year as a result of an acceleration event), or (ii) the excess, if any, of the electing entity's deferred COD income (less the aggregate amount of such deferred COD income that has been included in income in the current tax year and any previous tax year during the deferral period) over the aggregate amount of OID that accrued in previous tax years during the deferral period with respect to the debt instrument (less the aggregate amount of such OID that has been allowed as a deduction in the current tax year and any previous tax year during the deferral period).

If an acceleration event during a tax year in the deferral period results in an issuing entity's aggregate deferred OID deduction for previous tax years with respect to a debt instrument exceeding the amount of the electing entity's deferred COD income, the excess deferred OID deduction shall be allowed as a deduction in the tax year in which the acceleration event occurs. ([Reg. § 1.108(i)-2(d)(2)](https://www.courts.ca.gov/2013AFTR2d1125164.html))

**Effective/applicability dates.** [Reg. § 1.108(i)-2](https://www.courts.ca.gov/2013AFTR2d1125164.html) is effective on July 3, 2013 (i.e., the publication date). [Reg. § 1.108(i)-2](https://www.courts.ca.gov/2013AFTR2d1125164.html) applies on or after July 2, 2013 (i.e., the filing date) to reacquisitions of applicable debt instruments in tax years ending after Dec. 31, 2008.

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**Production of gift baskets gave rise to domestic production activities deduction--Dean, (2013 DC CA) 112 AFTR 2d ¶ 2013-5164**

A district court has determined that an S corporation’s production process for putting together gift baskets of various food and wine items qualified it for the domestic production activities deduction under §199. In so holding, the court found that the process effectively transformed the individual items into a new and distinct product. Accordingly, the 2 shareholders of the corporation were entitled to the §199 deductions.
claimed on their amended returns, and IRS's action to recover the refunds issued to them was denied on summary judgment.

**Background on the DPAD.** Under §199(a), the domestic production activities deduction (DPAD) is determined by applying a percentage (3% for tax years beginning in 2005 and 2006, 6% in 2007-2009, and 9% in later years) to the lesser of the taxpayer's qualified production activities income (QPAI) or taxable income determined without regard to the §199 deduction.

QPAI is domestic production gross receipts (DPGR) less cost of goods sold allocable to DPGR, less other expenses, losses, or deductions properly allocable to DPGR. (§199(c)(1)) DPGR includes the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of qualified production property (including tangible personal property and computer software) which was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the U.S. (§199(c)(4)(A)(i)(I) & Reg. § 1.199-3(j))

The Code doesn't define MPGE, but the regs broadly define it as including "manufacturing, producing, growing, extracting, installing, developing, improving, and creating [qualified production property]; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles." (Reg. § 1.199-3(e)(1)) The regs further specify that "[i]f a taxpayer packages, repackages, labels, or performs minor assembly of QPP and the taxpayer engages in no other MPGE activity with respect to that QPP," these activities don't qualify as MPGE.

**Background on erroneous refunds.** Under §7405, any portion of a tax that has been erroneously refunded may be recovered by a civil action brought in the name of the U.S. To recover an erroneous refund, the Government must establish (1) that a refund was paid to the taxpayers; (2) the amount of the refund; (3) that the government's recovery action was timely; and (4) that the taxpayers were not entitled to the refund which the government seeks to recover. (U.S. v. Shannahan, (DC CA, 2000) 85 AFTR 2d 2000-1317)

**Facts.** Timothy Dean and John O'Brien owned Houdini, Inc., which designs, assembles, and sells gift baskets and gift "towers" (stacked decorative boxes of food). Houdini has two facilities and maintains about 300 employees, with an additional 4,000 temporary workers during its busy holiday season. During
the years at issue (2005 and 2006), Houdini was an S corporation.

Houdini’s production process involves, among other things, selecting the basket and the items to be placed inside, such as candy or wine. Houdini contends that designing a gift basket is a complicated process that involves steps like determining appropriate container sizes and colors, selecting materials, ensuring quality control, and reviewing packaging. The actual production is outsourced.

The food items in the baskets are either purchased in individually wrapped packages or in bulk. Items bought in bulk are shipped directly to and repackaged by a co-packer contracted by Houdini, and other food items that are already in “food-safe” containers are placed by Houdini’s packaging department in decorative boxes.

Houdini’s assembly line consists of workers who place the individual food items into baskets in accord with Houdini’s detailed instructions. Then, the baskets are shrink-wrapped and decorated with bows. The gift towers are made by placing food-safe packages into decorative boxes, which are then connected through cardboard tabs or adhesive.

**Parties’ positions.** Houdini’s original return for its 2005 tax year didn’t claim any §199 deduction, but it did claim that deduction on an amended return filed in 2009 in the amount of $275,982. The Deans reflected Houdini’s §199 deduction on their amended return, also filed in 2009, on which they claimed a $206,987 deduction equal to 75% of the amount claimed by Houdini. They claimed that they were entitled to a $74,618 refund for 2005, and IRS issued them a refund check on Dec. 28, 2009, for $94,364.39 (i.e., the amount claimed plus interest).

Houdini similarly didn’t claim a §199 deduction on its original 2006 return, but did claim that deduction on an amended return filed in 2010. The Deans claimed a $394,770 deduction on their 2006 return and a tax refund due of $140,933. IRS issued them a refund of $172,884.67 in 2011. O’Brien also filed an amended 2006 return claiming a $135,146 §199 deduction and a refund due of $48,247. IRS paid him a refund of $58,829.69.

On Dec. 21, 2011, IRS filed the instant action to recover the tax refunds issued for years 2005 and 2006. It asserted that Houdini merely packaged and repackaged the items in its gift baskets and towers, and thus wasn’t entitled to a §199 deduction. The Deans and O’Brien, on the other hand, argued that Houdini manufactured or produced the baskets and towers and thus was so entitled.
The issue in the case was whether the Deans and O'Brien were entitled to the refunds, which turned on whether the production activities associated with the gift baskets and towers were MPGE. Both sides filed motions for summary judgment.

**Taxpayer victory.** The district court found that Houdini's activities qualified as MPGE, and that the Deans and O'Brien were entitled to the tax refunds that they received based on §199.

As noted in the background above, §199 doesn't define MPGE, but the regs provide an expansive definition. The court focused in particular on the language in the regs that "packaging, repackaging, labeling, or minor assembly" doesn't qualify as MPGE if the taxpayer engages in no other MPGE activity with respect to that QPP. (Reg. § 1.199-3(e)(2))

Looking to the dictionary definitions of these terms, the court determined that Houdini's production process may qualify as manufacturing or producing (and thus MPGE), but may also qualify as packaging or repackaging. Thus, the court looked beyond these "common definitions" and found that Houdini's production process changes "the form of an article" under Reg. § 1.199-3(e)(1), Notably, Houdini selects the items and assembles the gift basket or tower-a "complex process" that uses assembly line workers and machines-and ultimately produces a final product (i.e., a gift) that is distinct in form and purpose from the individual items inside (i.e., grocery-type items). The court rejected IRS's argument that Houdini's packaging and repackaging are mere services that add value to the final product, as well as its alternative argument that Houdini is merely combining or assembling two or more articles. These arguments were believed by the court's conclusion that, rather than merely enhancing an existing product, Houdini creates a new product with a different demand.

Because Houdini engaged in MPGE, it, as well as the Deans and O'Brien, were entitled to §199 deductions. Therefore, the tax refunds were proper, and the Deans and O'Brien were granted summary judgment.

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**Distributions from S corporation to its president were wages, not loan repayments--Glass Blocks Unlimited, TC Memo 2013-180**
The Tax Court has held that distributions from an S corporation to its president/sole shareholder were taxable wages. IRS’s determination that the president was an employee was uncontested, and the S corporation failed to show that any portion of the distributions reflected repaid loans or that recharacterizing all of the distributions as wages would result in unreasonable compensation to him.

**Background.** The proper characterization of transfers by shareholders to corporations, as either loans or capital contributions, is made by reference to all the evidence, and the burden of proving that a transfer is a loan falls on the taxpayer. ([Dixie Dairies Corp.](https://www.irs.gov/uac/Dixie-Dairies-Corp-) (1980) 74 TC 476)

Courts have established a nonexclusive list of factors to consider when evaluating the nature of transfers of funds to closely held corporations. Such factors include:

1. the names given to the documents that would be evidence of the purported loans;
2. the presence or absence of a fixed maturity date;
3. the likely source of repayment;
4. the right to enforce payments;
5. participation in management as a result of the advances;
6. subordination of the purported loans to the loans of the corporation’s creditors;
7. the intent of the parties;
8. the capitalization of the corporation;
9. the ability of the corporation to obtain financing from outside sources;
10. thinness of capital structure in relation to debt;
11. use to which the funds were put;
12. the failure of the corporation to repay; and
13. the risk involved in making the transfers. ([Calumet Indus., Inc.](https://www.irs.gov/uac/Calumet-Indus-Inc-) (1990) 95 TC 257)

That is, the inquiry before a court is "whether the transfer... constitutes risk capital entirely subject to the fortunes of the corporate venture or a strict debtor-creditor relationship." ([Dixie Dairies Corp.](https://www.irs.gov/uac/Dixie-Dairies-Corp-) ) Transfers to closely-held corporations by controlling shareholders are generally subject to heightened scrutiny.

**Facts.** Glass Blocks Unlimited (GBU) is an S corporation that, during 2007 and 2008, sold and distributed glass blocks for the real estate market in North America. During those years, Fredrick Blodgett was GBU's president and sole shareholder. GBU had no other full-time employees. Mr. Blodgett was respon-
sible for all of GBU's operational and financial decisions, and he performed nearly all of the work necessary to run the business.

GBU began to experience financial difficulties following the downturn in the real estate and construction markets, and Mr. Blodgett transferred funds to GBU in order to cover operating expenses and other costs. In 2007, he transferred $30,000. His then fiancée contributed $15,000 in 2007 and $10,000 in 2008. There was no collateral given or promissory notes issued reflecting the transfers.

For the 2007 and 2008 tax years, GBU didn't report paying Mr. Blodgett any salary or wages, despite the fact that it distributed money to him as cash was available and when he asked for it (not less than $30,844 in 2007 and $31,644 in 2008). For 2007, GBU reported repayment of $29,132 of loans from shareholders and, on Form 1120S, Schedule L (Balance Sheet per Books), reported that it had no outstanding loans from shareholders at the beginning of the year and had a balance of $12,868 in loans from shareholders at the end of the year. For 2008, GBU reported repayment of $8,391 of loans from shareholders (a decrease in its reported loans from shareholders balance from $12,868 at the beginning of the year to $4,477 at the end of the year) and dividend distributions totaling $21,078.

Mr. Blodgett did not have any other employment during 2007 or 2008. On his 2007 return, he reported $877 of subchapter S income from GBU and $11 in taxable interest. For 2008, he reported $8,950 of subchapter S income from GBU.

IRS audited GBU's 2007 and 2008 tax years and determined that Mr. Blodgett should be classified as an employee and the distributions should be characterized as wages for employment tax purposes. GBU didn't object to IRS's determination that Mr. Blodgett was an employee, but it asserted that some of the distributions represented the repayment of loans to Mr. Blodgett and shouldn't be characterized as wages. IRS, in turn, argued that the funds were contributions to capital and the distributions were wages.

GBU also argued that if all of the distributions made to Mr. Blodgett were characterized as wages, such would constitute unreasonable compensation. In support of its argument, GBU claimed that he worked only 20 hours per week and performed only "undemanding" duties that didn't require any training or special skills.

Transfers weren't loans. Applying the factors outlined above, the Tax Court found that the transfers in this case were capital contributions and not bona fide loans. Notably, there were no written agreements...
or promissory notes, and while a portion of the transfers was reported as loans from shareholders on GBU's Form 1120S, that factor carried little weight absent other supporting criteria. Further, not even Mr. Blodgett treated the transfer from him to GBU as a loan.

Other factors supporting the Court's conclusion included the lack of interest, security, or a fixed repayment schedule. Mr. Blodgett withdrew funds based on GBU's ability to pay, thus rendering repayment dependent on the success of the business rather than on an unconditional obligation.

*Recharacterized wages were reasonable compensation.* The Tax Court also easily concluded that recharacterizing all distributions to Mr. Blodgett as wages wouldn't constitute unreasonable compensation to him. GBU failed to show that the salary information that it submitted was for positions comparable to Mr. Blodgett's. Specifically, it submitted salary statistics for positions like a shipping clerk and accounts payable clerk, but Mr. Blodgett's role was more substantial than any of the supposedly analogous positions. In effect, he performed each of those roles.

The Court also dismissed the claim that Mr. Blodgett worked only 20 hours per week. It was inconsistent with what Mr. Blodgett told the tax examiner who audited GBU, and it was further undermined by the hours posted on GBU's website.

**RIA observation:** The Tax Court's opinion doesn't explain why GBU raised this argument. In general, a business can only deduct reasonable compensation under 162(a)(1), so if a portion of the amount paid to Mr. Blodgett was deemed unreasonable compensation, this would actually be a worse result for GBU since it would lose a portion of its deduction. It appears as though Mr. Blodgett, who represented GBU before the Court, may have misunderstood the law and thought that only reasonable compensation would be treated as taxable wages, and the excess, if any, would be treated as loan repayments.

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In a Revenue Procedure, IRS has provided the exclusive simplified methods for taxpayers to request relief for late S corporation elections; electing small business trust (ESBT) elections under §1361(e); qualified Subchapter S trust (QSST) elections under §1361(d); qualified Subchapter S subsidiary (QSub) elections under §1361(b)(3); and late corporate classification elections under Reg. § 301.7701-3(c)(1)(v)(C) (collectively, "elections under Subchapter S") which the taxpayer intended to take effect on the same date that the taxpayer intended that an S corporation election for the entity should take effect. The Revenue Procedure consolidates relief previously provided and in certain circumstances extends that relief.

**Background.** A corporation may make an election to be treated as an S corporation (1) at any time during the preceding tax year, or (2) at any time during the tax year and on or before the 15th day of the third month of the tax year, by filing a completed Form 2553 (Election by a Small Business Corporation). 

**(§1362(b)(1) & Reg. § 1.1362-6(a)(2))** Under §1362(b)(3), if an S corporation election is made for a tax year after the 15th day of the third month of that tax year and on or before the 15th day of the third month of the following tax year, then the S corporation election is treated as made for the following tax year.

Under §1361(b)(1)(B), the permitted shareholders of an S corporation are limited to domestic individuals, estates, certain trusts, and certain exempt organizations. §1361(d)(1)(A) provides that a QSST is a permitted S corporation shareholder if the beneficiary of the QSST makes an election by signing and filing an election statement with the applicable Service Center. Reg. § 1.1361-1(j)(6)(iii) provides that the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S corporation stock is transferred to the trust.

§1361(c)(2)(A)(v) provides that an ESBT is a permitted S corporation shareholder if the trustee of the trust makes an election by signing and filing an election statement with the applicable Service Center. The election must be filed within the same time requirements as prescribed for filing a QSST election. (Reg. § 1.1361-1(m)(2)(iii))

Under §1361, an S corporation may elect to treat certain wholly owned subsidiaries as QSubs electing to do so on Form 8869 (Qualified Subchapter S Subsidiary Election). The election may be filed at any time during the tax year. Reg. § 1.1361-3(a)(4) provides that the effective date of the election is the date specified on the form (provided the date specified is not earlier than two months and 15 days before the date of the filing and the date specified is not more than 12 months after the date of the filing), or the date the
election form is filed if no date is specified. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

Reg. § 301.7701-3(c)(1)(i) provides that, except as specified in the regs, an eligible entity may elect to be classified other than as provided in Reg. § 301.7701-3(b) by filing Form 8832 (Entity Classification Election) with the applicable Service Center. Reg. § 301.7701-3(c)(1)(iii) provides that the entity classification election will be effective on the date specified by the entity on the Form 8832 or on the date filed if no date is specified on the election form. The effective date specified on Form 8832 can't be more than 75 days prior to the date on which the election is filed and can't be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, the election will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, the election will be effective 12 months after the date the election was filed.

New guidance. Rev Proc 2013-30 provides a simplified method for taxpayers to request relief for late S corporation, ESBT, QSST, QSub, and corporate classification elections intended to be effective on the same date as the S corporation election for the entity. To qualify for relief, all late elections under Subchapter S must meet the general requirements in Rev Proc 2013-30, Sec. 4. Additional requirements apply for relief where one or more taxpayers request relief for multiple late elections with respect to a single S corporation. The guidance includes a flowchart designed to help taxpayers in applying Rev Proc 2013-30.

In addition, specific requirements in Rev Proc 2013-30, Sec. 5, through Rev Proc 2013-30, Sec. 7, apply to certain taxpayers seeking relief. Rev Proc 2013-30, Sec. 5, provides a simplified method for taxpayers to request relief for late S corporation elections (which may or may not include a deemed entity classification election (i.e., where an eligible entity that timely elects to be an S corporation is treated as having made an election to be classified as an association)). Rev Proc 2013-30, Sec. 6, provides a simplified method for taxpayers to request relief for late ESBT &QSST elections. Rev Proc 2013-30, Sec. 7, provides a simplified method for taxpayers to request relief for late QSub elections.
The simplified method for requesting relief is in lieu of the letter ruling process ordinarily used for a late election under Subchapter S and no user fees apply. A taxpayer that doesn't meet Rev Proc 2013-30's requirements or is denied relief under its procedures may seek relief by requesting a letter ruling.

The taxpayer requesting relief (i.e., the "Requesting Entity")-the corporation or eligible entity seeking to be treated as an S corporation, the trustee seeking to treat a trust as an ESBT, a trust beneficiary seeking to treat a trust as a QSST, or a parent S corporation seeking to treat a subsidiary as a QSub-must generally request relief under Rev Proc 2013-30 within 3 years and 75 days after the date the election is intended to be effective. (Rev Proc 2013-30, Sec. 4.02(2)) This time limit isn't applicable to a corporation that fails to qualify as an S corporation solely because Form 2553 wasn't timely filed where the corporation and its shareholders consistently reported their income as if it was an S corporation; and neither the corporation nor its shareholders was notified by IRS of the problem within 6 months of the date on which the Form 1120S for the first year was timely filed. (Rev Proc 2013-30, Sec. 5.04)

In addition, the failure to qualify as an S corporation, ESBT, QSST, or QSub must have resulted from the election under Subchapter S not being timely filed by the due date applicable to the election. (Rev Proc 2013-30, Sec. 4.02(3)) For relief for a late S corporation or QSub election, the requesting taxpayer must have reasonable cause for the failure to make the timely election under Subchapter S and have acted diligently to correct the mistake upon its discovery. For relief for an inadvertently invalid S corporation election or the termination of an S corporation election due to the failure to make the timely ESBT or QSST election, the failure to file the timely election under Subchapter S must have been inadvertent and the S corporation and the person or entity seeking relief must have acted diligently to correct the mistake upon its discovery. (Rev Proc 2013-30, Sec. 4.02(4))

**Electing process.** A taxpayer requests relief under Rev Proc 2013-30 by properly completing the proper election form(s), attaching the required supporting documents, and filing it with the appropriate IRS Service Center. This is done by (a) attaching the form to the S corporation's current year Form 1120S (as long as the current year Form 1120S is filed within 3 years and 75 days after the effective date, without considering extensions); (b) attaching the Form to one of the S corporation's late filed prior year Forms 1120S; or (c) filing the Form independent of Form 1120S. (Rev Proc 2013-30, Sec. 4.03)

For purposes of Rev Proc 2013-30, the proper election form used is Form 2553 for S corporation elec-
tions (including a deemed entity classification election under Reg. § 301.7701-3(c)(1)(v)(C)); separate statements made by electing ESBTs under Reg. § 1.1361-1(m)(2); Form 2553 and separate statements made by electing QSSTs under Reg. § 1.1361-1(j)(6); and Form 8869 for QSub elections. The election form must indicate at the top that it is filed “pursuant to Rev Proc 2013-30.” Supporting statements, including a “Reasonable Cause/Inadvertence Statement” indicating compliance with Rev Proc 2013-30, Sec. 4.03(3), must be signed under penalty of perjury. (Rev Proc 2013-30, Sec. 4.03)

On receipt of a completed request for relief, IRS will determine whether the requirements for granting additional time to file the election under Subchapter S have been satisfied and will notify the requesting taxpayer of its determination. (Rev Proc 2013-30, Sec. 4.05)


Under a transition rule, if an entity has filed a request for a letter ruling seeking relief for a late election under Subchapter S covered by Rev Proc 2013-30 that is pending in the National Office on Sept. 3, 2013, it may rely on Rev Proc 2013-30, withdraw that letter ruling request, and receive a refund of its user fee. However, the National Office will process letter ruling requests pending on that date, unless, prior to the earlier of Oct. 18, 2013, or the issuance of the letter ruling, the entity notifies the National Office that it will rely on Rev Proc 2013-30 and withdraw its letter ruling request. (Rev Proc 2013-30, Sec. 8)

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**Shareholder dispute didn’t shift beneficial interest of S corp shares—Kumar, TC Memo 2013-184**

The Tax Court has held that a doctor with a minority ownership interest in a medical practice organized as an S corporation, who was excluded by the majority owner from participation in the corporation's acti-
vities, wasn't deprived of the economic benefit of his share ownership. Accordingly, he was obligated to report his share of the corporation's undistributed profits and interest income.

**Facts of the case.** The taxpayer, Dr. Kumar, owned 40% of PSLV, an S corporation that conducted a radiation oncology practice; Dr. Woody owned the remaining 60% of the PSLV shares, and was its president and chairman.

In 2004, disputes arose between Dr. Kumar and Dr. Woody, resulting in Dr. Kumar's being shut out of PSLV's operation and management.

PSLV made no distributions to its shareholders during tax year 2005, during which it paid wages to Dr. Woody and another doctor. Dr. Kumar did not receive any wages from PSLV during 2005 or any year thereafter. Nor did he take part in the operation or management of PSLV during any of those years; he was prevented from doing so by Dr. Woody. PSLV issued a Schedule K-1 to Dr. Kumar for tax year 2005, reporting his shares of PSLV's ordinary business income as $215,920 and interest income as $2,344. Dr. Kumar and his wife listed the PSLV S corporation stock interest on the Schedule E attached to their 2005 Form 1040, but did not report any of the income reported on the Schedule K-1. Dr. Kumar claimed that he was not liable for tax on PSLV's 2005 income because he was not the beneficial owner of his PSLV shares in 2005.

**S corporation rules.** An S corporation's items of income, gain, loss, deduction, and credit, whether or not distributed, flow through to the shareholders, who must report their pro rata shares of such items on their individual income tax returns for the tax year within which the S corporation's taxable year ends. (§1366(a) & Reg. § 1.1366-1(a)) When the record owner of S corporation stock holds that stock for the benefit of another, such as a nominee, an agent, or a passthru entity, then income, losses, deductions, and credits of the corporation are passed through not to the record owner but to the beneficial owner of the stock. (Reg. § 1.1361-1(e))

**Tax Court's decision.** The Tax Court traced case law involving the application of the beneficial ownership test to arrangements between parties who had some agreement or understanding regarding their relationship with each other—such as creditor vs. debtor, nominal shareholder vs. creditor, donor vs. donee, etc.—and concluded that it was not aware of any case where one shareholder was able to take beneficial ownership of stock away from another shareholder absent an agreement between them or a
provision in the corporation’s governing articles to that effect. On the contrary, it held in Hightower, TC Memo 2005-274, that when one shareholder merely interferes with another’s participation in the corporation as a result of a poor relationship between them, such interference does not amount to a deprivation of the economic benefit of the shares.

Because there was no agreement giving Dr. Woody any rights to Dr. Kumar’s stock during the year at issue, the Court found that Dr. Woody’s interference with Dr. Kumar’s participation in PSLV did not deprive Dr. Kumar of the economic benefit of his PSLV shares. Therefore it concluded that the beneficial ownership test did not relieve Dr. Kumar from passthru of PSLV profits, which he was required to report.

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Court rejects straight gross receipts analysis for S corp's shareholder's reasonable wages--Sean McAlary Ltd, Inc., TC Summary Opinion 2013-62

In a Summary Opinion, the Tax Court has determined the reasonable compensation of the president, secretary, treasurer, sole director, and sole shareholder of an S corporation engaged in the real estate business. The Court, rejecting a salary amount proposed by IRS’s expert based solely on an analysis of the company’s gross receipts, found that the question of what is reasonable compensation was to be resolved on the basis of all the facts and circumstances, with no single factor being decisive.

Facts. Sean McAlary was the president, secretary, treasurer, sole director, and sole shareholder of an S corporation engaged in the real estate business, Sean McAlary Ltd, Inc. (McAlary Ltd). He also was the only person working for the firm that held a real estate broker’s license. He managed all aspects of the company’s operations, including recruiting and supervising sales agents, conducting real estate sales, procuring advertising, purchasing supplies, and maintaining basic books and records. McAlary often worked 12-hour days with few days off.

A compensation agreement between McAlary and his firm set his annual base pay at $24,000 and provided additional compensation of $10,000 for each additional 10 sales agents and associate brokers he recruited. McAlary hoped to grow the company’s operations by increasing the number of sales agents and associate brokers on staff, but he discovered that many sales agents wanted to work for larger, es-
Established real estate brokerage firms.

Most of McAlary Ltd's gross receipts were attributable to sales commissions generated by McAlary, as opposed to the firm's other sales agents. McAlary Ltd's sales agents operated as independent contractors, earning between 60% and 85% of the sales commissions generated on real estate sales they initiated and closed, with the company retaining the balance. During 2006, McAlary supervised eight sales agents, four of whom generated sales commissions for that year.

McAlary Ltd's 2006 Form 1120S reported $518,18 of gross receipts, $286,735 of deductions, and $231,454 of net income. McAlary Ltd neither issued a Form W-2 (Wage and Tax Statement) to McAlary, nor claimed a deduction for any compensation paid him. Nor did it file Form 940 (Employer's Annual Federal Unemployment (FUTA) Tax Return) for 2006 or Form 941 (Employer's Quarterly Federal Tax Return) for any quarterly period ending in 2006. During 2006, McAlary transferred $240,000 from McAlary Ltd's account to his personal account. On audit, IRS challenged the S corporation's return.

On his 2006 Form 1040, McAlary didn't report any wages or salaries or any self-employment tax. On Schedule E, he reported a loss of $15,035 (Part I); $200,877 of income (Part II); and total income of $185,842.

**Background.** Under §§3111 and 3301, Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) employment taxes are imposed on employers in connection with wages paid to their employees. (Reg. § 31.3121(a)-1(b) & Reg. § 31.3306(b)-1(b)) For employment tax purposes, an employee includes any officer of a corporation. (§§ 3121(d)(1) & 3306(i)) An officer who performs more than minor services for a corporation and who receives remuneration in any form for those services is considered an employee whose wages are subject to employment taxes. (Reg. § 31.3121(d)-1(b))

In general, an S corporation shareholder is taxed on the shareholder's pro rata share of the corporation's income, regardless of whether the shareholder actually receives a distribution. (§1366(a)(1))

**RIA observation:** Reasonable compensation paid by an S corporation to an employee who is also a controlling shareholder is a long standing compliance issue with IRS; many service professionals try to minimize Medicare and Social Security taxes by routing what would otherwise be self-employment income through an S corporation and
then paying themselves a nominal salary. Since the amount of compensation that an S corporation pays such an employee-shareholder is within the employee-shareholder's discretion, he may have an incentive to claim less than a reasonable salary and take from the S corporation other payments (e.g., dividends) that aren't subject to employment taxes.

IRS has warned S corporations not to attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages. On its website, IRS says that S corporations must pay "reasonable compensation" to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee.

The key to establishing reasonable compensation is determining what the shareholder-employee has done for the S corporation, looking to the source of its gross receipts. If most of the firm's gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation. In addition, the shareholder-employee should also be compensated for administrative work performed for the other income-producing employees or assets.

Courts have weighed various factors in assessing the reasonableness of compensation, including:

- the employee's qualifications;
- the nature, extent, and scope of the employee's work;
- the size and complexity of the business;
- the prevailing general economic conditions;
- the employee's compensation as a percentage of gross and net income;
- the employee/shareholder's compensation compared with distributions to shareholders;
- the employee/shareholder's compensation compared with that paid to non shareholder/employees;
- prevailing rates of compensation for comparable positions in comparable concerns; and
- comparable compensation paid to a particular shareholder/employee in previous years where the corporation has a limited number of officers. (Charles Schneider & Co. v. Comm., (CA 8 1974) 34 AFTR 2d 74-5422; K & K Veterinary Supply, TC Memo 2013-84)

Parties' positions. IRS contended that $100,755 of the $240,000 that McAlary received from McAlary
Ltd during 2006 should be treated as his wages for the various services that he performed in his capacities as its sole officer and real estate broker.

On the other hand, McAlary Ltd contended that the Court should respect the compensation agreement which set McAlary's annual base pay at $24,000 (with increased compensation if he recruited additional sales agents and associate brokers). McAlary Ltd also argued that the fact that its operation was modest should be taken into account.

**Court's conclusion.** The Tax Court, considering the totality of the facts and circumstances—including the pertinent wage and labor statistics cited in the IRS expert's report, general market conditions, McAlary's somewhat limited experience, and the S corporation's modest operations—found that an hourly rate of $40 (i.e., annual compensation of $83,200) was reasonable compensation for the various services that McAlary performed.

The Court gave little weight to the compensation agreement with its $24,000 salary, reasoning that it neither represented a true measure of the value of the services that McAlary provided nor was the result of an arm's-length negotiation. Further, there was no evidence that McAlary Ltd actually paid McAlary any amount under the agreement, suggesting that it was forgotten, ignored, or adopted as mere window dressing.

During 2006, McAlary single-handedly conducted the company's daily business operations, making all management decisions while also engaging in real estate sales transactions on its behalf as both broker and a sales agent. While the firm's financial success was attributable in no small part to favorable real estate market conditions, the commissions that McAlary earned represented most of the firm's gross receipts. He was committed to the success of the operation and worked long hours with few days off. While its operation was modest and the number of agents that McAlary supervised was small, McAlary Ltd's profit margin during 2006 slightly exceeded the average of its peers in the industry.

The Tax Court did not completely accept the opinion of IRS's expert that McAlary's hourly rate should be $48.44 (i.e., annual compensation of $100,755 or 19.4% of the firm's gross receipts). This hourly rate represented the median hourly wage for real estate brokers in southern California at the time. The expert argued that statistics showed that officers/directors/owners at comparable real estate businesses were compensated in a range of 7% to 18.9% of net sales, with a median of 11% of net sales. However, the
Information on S corp return wasn’t treated as disclosed by shareholder--

Chief Counsel Advice 201333008

In Chief Counsel Advice (CCA), IRS has concluded that for purposes of §6501(e)(1)(A) ’s six-year limitation on assessment, information contained in an S corporation return that is filed after a shareholder of that corporation files his own return cannot be considered to be adequately disclosed on the shareholder’s return.

Facts. A taxpayer filed a Form 1040 showing income from an S corporation. More than three years after the filing of the Form 1040, the S corporation filed a Form 1120-S that reported that the taxpayer’s distributive share of S corporation income was in excess of 125% of the sum reported on the taxpayer's Form 1040.

Background. §6501(a) generally provides that a valid assessment of income tax liability may not be made more than 3 years after the later of the date the tax return was filed or the due date of the tax return. For purposes of §6501(a), a "return" is the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit). (§ 6501(a))

§6501(e)(1)(A) provides an exception to the 3-year rule of §6501(a) ; it provides that a 6-year period of limitations applies when a taxpayer makes a substantial omission, i.e., when he omits from gross income an amount that's greater than 25% of the amount of gross income stated in the return.

Items which are adequately disclosed in the return (or attachments and schedules) are not considered omissions for purposes of determining a substantial omission. (§ 6501(e)(1)(B)(ii)) In order to meet this test, the disclosure "must be sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one." (Estate of Fry, (1987) 88 TC 1020)
When an individual's return contains a reference to other documents or returns, those references can serve as notice to IRS. (Benson, TC Memo 2006-55; Reuter, TC Memo 1985-607) Specifically, when a return includes a reference to an S corporation, "the corporate information return on Form 1120-S must be considered along with taxpayers' individual returns in resolving the issue of adequate disclosure."

(Benderoff, CA-8, 1968 22 AFTR 2d 5222)

Where a return is filed within the statutory period for filing a return, it, and not any amended return filed thereafter, is treated as the return for purposes of §6501(e)(1). (Houston, (1962) 38 TC 486; Goldring, (1953) 20 TC 79) For purposes of these rules, information discovered by IRS during an audit should be treated as information filed on an amended return. (Insulglass Corp., (1985) 84 TC 203)

Issue. Whether the Form 1120-S constituted a disclosure for purposes of §6501, since it was referenced in the original Form 1040.

The S corporation return couldn't be considered when determining whether there was adequate disclosure. In concluding that the S corporation return could not be considered when determining whether there was adequate disclosure, IRS noted:

... For a Form 1120-S to be read as incorporated by reference in the return of the taxpayer, the Form 1120-S must be in existence and within the possession of IRS. Where a Form 1120-S is not filed until after the return of the taxpayer, the Form 1120-S should be treated like information found in an amended return (see above) and disregarded for purposes of §6501(e)(1) disclosure.

... Gross income can only be disclosed within the meaning of §6501(e)(1)(B)(ii) if the information necessary to place IRS on notice of the nature and amount of gross income from the item is in the possession of IRS when the return is filed. The Form 1120-S had not yet been submitted to IRS and at the time the taxpayer's return was filed, it provided no information as to the nature or amount of gross income. Therefore, the Form 1120-S could not constitute a disclosure. IRS cannot be said to be on notice of information contained in documents, incorporated by reference, when those documents do not yet exist (or at least have not yet been filed).

The taxpayer misstated his net income from the S corporation, and the S corporation failed to provide IRS with the Form 1120-S, which included the information necessary to determine whether that calculation was correct. Taken together these facts constituted a strong indication that IRS was not on notice of
the nature and amount of the item of gross income and that, therefore, the income was not disclosed for purposes of §6501(e)(1).

IRS said that, in order to determine whether or not there was a substantial omission of gross income for the purpose of applying the six-year statute under §6501(e)(1)(A), the only S corporation income that it could consider as being disclosed was the amount on the Form 1040. Any gross income relating to the S corporation that was not listed on the face of the Form 1040 was an omission.

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The Court of Appeals for the Sixth Circuit, affirming the Tax Court, has found that a cellular service entrepreneur couldn't deduct pass-through losses from his S corporation because he lacked the required basis in his S corporation. The Court also denied the business expenses and §197 amortization deductions taken by license-holding entities (which were taxed as partnerships) because they weren't engaged in an active trade or business.

**Background on S corporation shareholder's deductions.** Deductions and losses of an S corporation are passed through to shareholders and (except as otherwise limited by the Code) claimed on their own returns. However, a shareholder can deduct his pro rata share of S corporation losses only to the extent of the total of his basis in (a) the S corporation stock, and (b) debt owed him by the S corporation. (§1366d & Reg. § 1.1366-2) A deduction or loss that can't be claimed for lack of basis may be carried over and used in the future to the extent the shareholder then has basis. (§1366(d)(2), Reg. § 1.1366-2(a)(2))

**Background on business deductions.** To be deductible under §162, ordinary and necessary business expenses must be directly connected with or pertain to the taxpayer's trade or business. The enterprise must be functioning as a business when the expenses are incurred. Until the business is functioning as a going concern, expenses related to it are not ordinary and necessary §162 expenses but, rather, startup expenses that may be deductible over a period of time under §195.

In Briarcliff Candy Corp. v. Comm., (CA2 1973) 31 AFTR 2d 73-935, the Second Circuit found that a tax-
payer who expanded his business in the same corporate entity wasn't compelled to show that he was actively conducting business in the expanded areas. The Second Circuit held that expenditures by an already established and going concern in developing a new sales territory were deductible under §162.

In Bennett Paper Corp. v. Comm., (CA8 1983), 51 AFTR 2d 83-805, the Eighth Circuit denied a taxpayer's deductions, concluded that the taxpayer was in a different position than the one in Briarcliff Candy, where the taxpayer was a continuing corporation which merely expanded its existing business. The Eighth Circuit-saying that it rejected the suggestion that IRS had a legal duty to pierce the corporate veil-held that a taxpayer who adopted a particular form of doing business couldn't escape the tax consequences of that chosen form.

**Background on § 197.** The cost of most acquired intangible assets is amortized ratably over a 15-year period. In general, taxpayers claim deductions for an "amortizable section 197 intangible" by amortizing the adjusted basis (for purposes of determining gain) of that intangible ratably over a 15-year period beginning with the month in which it was acquired. (§197(a) & Reg. § 1.197-2(f)(1)) An amortizable section 197 intangible is any section 197 intangible acquired by a taxpayer after Aug. 10, '93, and held in connection with the conduct of a trade or business. (§197(c)(1)) A section 197 intangible includes, among other items, goodwill, going-concern value, business books and records, trade names, and covenants not to compete entered into in connection with the acquisition of an interest in a trade or business. (§197(d))

**Facts.** Robert Broz operated a cellular telephone business through his wholly owned S corporation, RFB Cellular, Inc. In '91, he purchased an FCC license to operate a cellular network. He later expanded his cellular telephone business by forming additional entities: Alpine PCS, Inc. (Alpine PCS), an S corporation; several Alpine license-holding entities (limited liability companies (LLCs) that were taxed as partnerships); Alpine Investments, LLC, a financing intermediary; and Alpine PCS Operating, LLC (Alpine Operating), both LLCs wholly owned by Broz and disregarded for tax purposes.

Alpine PCS (99% owned by Broz, 1% by his brother) was created to bid on more FCC licenses and to construct and operate digital networks servicing new license areas. The Alpine license-holding entities were formed to hold and lease the additional FCC licenses Broz acquired. Alpine Investments was a financing intermediary, and Alpine Operating was an equipment-holding entity.

Alpine PCS never operated any on-air networks during the years at issue. RFB operated the only on-air
networks. RFB used Alpine PCS’s licenses, on a limited basis, to provide digital service in geographic areas that RFB’s analog licenses already covered. Only two Alpine entities (Alpine PCS and Alpine Michigan F) reported any income—$1,312 and $67,423, respectively, allocated by RFB for RFB’s use of the FCC licenses in 2001. Alpine PCS didn’t report income during any of the other years at issue, but claimed depreciation deductions, interest deductions on debt owed to the FCC, and interest deductions on debt owed to RFB, even though Alpine PCS never made any interest payments. Alpine PCS also amortized and deducted startup expenses, even though Alpine PCS hadn’t made a formal election under §195(b). The Alpine license-holding entities each claimed amortization deductions related to the licenses and deducted interest paid on amounts borrowed to service the FCC debt. Alpine PCS and the license-holding entities ceased all business activities by the end of 2002.

RFB used CoBank loan proceeds to expand its existing business through Alpine and the related entities. CoBank specifically acknowledged that RFB would advance the proceeds directly or indirectly to the Alpine entities. Alpine allocated some of the funds to other Alpine entities. Broz pledged his RFB stock as additional security but he never personally guaranteed the CoBank loan, which was secured by the assets of the Alpine license holding entities. Several of the Alpine entities also guaranteed the loan. Broz deducted Alpine PCS’s flow-through losses on his individual return, as well as interest, depreciation, startup costs, and other business expenses of the Alpine entities. In addition, he deducted the amortization cost of the FCC cellular licenses acquired and held by the Alpine license-holding entities.

**On audit IRS challenged these deductions.**

**Tax Court decision.** The Tax Court found that: (1) Broz lacked debt basis in Alpine PCS to deduct its flow-through losses; (2) Broz wasn’t at risk with respect to his investments in Alpine PCS and the Alpine license-holding entities, and for that additional reason could not deduct for flow-through losses; (3) Alpine PCS and Alpine Operating weren’t entitled to deductions for business expenses because they weren’t actively engaged in a trade or business; & (4) the Alpine license-holding entities weren’t entitled to amortization deductions because they weren’t engaged in an active trade or business. (Broz (2011), 137 TC 46)

**Appellate decision.** The Sixth Circuit concluded that the Tax Court didn’t clearly err when it found that the purported back-to-back loan arrangement, which ran from RFB to either Broz or Alpine Investments, and then on to Alpine PCS, did not establish bona fide indebtedness between Broz and Alpine.
For Broz to claim deductions for Alpine PCS's losses and expenses, he needed to have a debt basis in Alpine PCS, and its debt had to run directly to him. Instead, the recurring transactions by which Alpine PCS received funding involved the following three steps: (1) RFB obtained a loan from CoBank; (2) RFB advanced the CoBank loan proceeds to Alpine PCS; (3) using year-end accounting adjustments and postdated promissory notes, Broz recharacterized the second part of the transaction so that it appeared the CoBank loan proceeds were advanced from RFB to Broz and then loaned by Broz (or Alpine Investments, which for tax purposes is treated the same as Broz) to Alpine PCS.

The Court concluded that Broz served as a mere conduit for loans from RFB to Alpine PCS, and Alpine PCS was never directly indebted to Broz. The intent at the time the money was loaned was that the debt run between Alpine PCS and RFB. Broz's post facto effort to insert himself as an intermediary did not increase his basis in Alpine PCS, and was of no tax consequence.

In addition, the Sixth Circuit found that the Tax Court didn't err in concluding that RFB did not make the loans to Alpine PCS on Broz's behalf. While a taxpayer can obtain debt basis in an S corporation through payments made by a wholly owned corporate entity if that entity functions as the shareholder's "incorporated pocketbook"—i.e., where the taxpayer has a habitual practice of having his wholly owned corporation pay money to third parties on his behalf—Broz failed to show this was the case. (Yates, *TC Memo 2001-280*)

**Business expenses.** The Sixth Circuit found that the Tax Court's disallowance of Broz's business expense deductions because the Alpine entities weren't engaged in carrying on an active trade or business wasn't clearly erroneous.

The facts showed that Alpine PCS never operated any networks. The Alpine license-holding entities didn't lease any licenses to Alpine PCS. Alpine Operating did not lease any equipment to Alpine PCS. While RFB did lease some of the Alpine-entity licenses on a limited basis in 2001, the income was minimal and not sufficient to constitute an active trade or business.

The Court reasoned that each entity's activity must be evaluated individually and not in conjunction with any other entity. Accordingly, the Alpine entities' activities couldn't be viewed in connection with RFB's. The Court rejected Broz's reliance on *Briarcliff Candy* and his contention that the Alpine entities were merely a business expansion for which he only used distinct corporate entities because he was compell-
ed to do so by CoBank as a condition for continued financing. The Court concluded that Broz wanted the best of both worlds by having the Alpine entities treated as separate for purposes of avoiding or distinguishing liabilities, but treated as one entity together with RFB for tax purposes. Broz formed separate corporate entities to build his cellular telephone business, and whether he did so freely or out of necessity in order to obtain financing was not determinative.

Amortization. The Sixth Circuit also held that the Tax Court correctly determined that because the Alpine license-holding entities weren't engaged in an active trade or business, they weren't entitled to amortization deductions under §197 for the FCC licenses they acquired. The FCC licenses were amortizable only upon the commencement of a trade or business because §197 has an active trade or business requirement.

At risk issue. Because of these holdings, the Court found no reason to decide whether the taxpayer wasn't at risk under §465 when he pledged stock of a related corporation. The §465 at risk rules are designed to ensure that a taxpayer deducts losses only to the extent he is economically or actually at risk for the investment.