**Chapter 11 Notes**

**S Corporations**

**I. Overview**

An S corporation is a hybrid entity that shares some characteristics with C corporations and partnerships:

* get their name from Subchapter S of the Internal Revenue Code
* incorporated under state law and thus have legal protections as C corporations
* governed by the same corporate tax rules that apply in the organization, liquidation, and reorganization of C corporations.
* flow-through entity and shares many tax similarities with partnerships
* basis calculations for shareholders and partners
* income or loss flows through to the owners
* distributions are generally not taxed to the extent of the owner’s basis

i. *Formation*

* deferral of realized gains on the transfer of appreciated property to a corporation in exchange for stock, if:

- one or more persons transfer property to a corporation (C or S) in return for stock; and

- immediately after the transfer, these persons control the corporation.

ii. *Qualification Requirements*

* only U.S. citizens or residents, estates, certain trusts, and certain tax-exempt organizations may be shareholders
* corporations or partnerships cannot be shareholders
* may have no more than 100 shareholders
* large, publicly traded corporations cannot elect to be treated as S corporations

Example 1: Suppose Island Life, Inc. was formed with Sean, Nina, and Margaritaville, Inc., a C corporation owned by Chance, as shareholders. Would Island Life be eligible to elect S corporation status?

No. One of its shareholders is a C corporation.

iii. *S Corporation Election*

An eligible corporation must:

* make formal election using Form 2553
* all shareholders must consent
* be a domestic corporation (created or organized in the U.S. or under U.S. law)
* not be a specifically identified ineligible corporation (e.g., insurance companies)
* have only one class of stock

**II. S Corporation Terminations and Reelections**

S election remains in effect until the election is terminated – voluntarily or involuntarily

* A corporation must wait until the beginning of the fifth taxable year after the election was terminated to elect S corporation status again.

i. *Voluntary Terminations*

* shareholders holding more than 50% of the stock must agree
* file a statement with the IRS revoking the election

Example 2: Suppose Island Life, Inc. was initially formed as an S corporation with a calendar year-end. After a couple of years, the company was doing so well that Sean and Nina (each one-third shareholders) wanted to terminate the S election and take the company public. However, Chance (also a one-third shareholder) was opposed to the S election termination. Can Sean and Nina terminate the S election without Chance’s consent?

Yes. Sean and Nina together own 66.7%, more than the 50% threshold required.

ii. *Involuntary Terminations*

Most common reason is 1) failure to meet requirements, or 2) from an excess of passive investment income (e.g., dividends, royalties)

1. Failure to Meet Requirements

- automatic termination effective on the date it fails the S corporation requirements

Example 3: Suppose Island Life, Inc. was formed as a calendar-year S corporation with Sean, Nina, and Chance as equal shareholders. On June 15, 2018, Chance sold his Island Life shares to his solely owned C corporation, Margaritaville, Inc. Is Island Life’s S election still in effect at the beginning of 2019? If not, when was it terminated?

No, the election was automatically terminated on June 15, 2018, when Margaritaville became a shareholder because S corporations cannot have corporate shareholders.

1. Excess of Passive Investment Income (PII)

- termination effective on first day of the year following the third consecutive tax year with excess passive investment income.

- If an S corporation has E&P from a previous C corporation year, its election is terminated if:

* it has passive investment income in excess of 25% of gross receipts for three consecutive years.

- If an S corporation never operated as a C corporation or does not have C corporation E&P:

* PII provision does not apply

Passive Investment Income Test

* gross receipts: total amount of revenues received (including capital gains from the sale of capital assets and gain from the sale of stock and securities) or accrued under the corporation’s accounting method
* not reduced by returns, allowances, COGS, or deductions.
* PII includes: royalties, rents, dividends, interest (including tax-exempt), and annuities

Example 4: Suppose Island Life, Inc. was initially formed as an S corporation with a calendar year-end. During its first three years, it reported passive investment income in excess of 25 percent of its gross receipts. Is Island Life’s election terminated under the excess passive investment income test? If so, what is the effective date of the termination?

No. The excess passive investment income test does not apply to Island Life because Island Life never operated as a C corporation.

iii. *Short Tax Years*

* S corporation election termination generally creates an S corporation short tax year (reporting year less than 12 months) and a C corporation short tax year.
* Corporation must allocate its income for the full year between the S and the C corporation.
* **daily method**:number of days in each short year; OR
* **specific identification method**: allocate income to the actual period in which it is earned
* Both short tax year returns are due on the corporation’s customary tax return due date.

Example 5: Suppose that on June 15, 2018, Chance sold his Island Life shares to his solely owned C corporation, Margaritaville Inc., terminating Island Life’s S election on June 15, 2018. Assume Island Life reported the following business income in 2018:

|  |  |
| --- | --- |
| **Period** | **Income** |
| January 1 through June 14 (165 days) | $100,00 |
| June 15 through December 31 (200 days) | 265,000 |
| January 1 through December 31, 2018 (365 days) | $365,000 |

If Island Life uses the daily method of allocating income between the S corporation short tax year (January 1 – June 14) and the C corporation short tax year (June 15 – December 31), how much income will it report on its S corporation short tax year return and its C corporation short tax year return for 2018?

S corporation short tax year: $165,000 = ($365,000 / 365 days x 165 days);

C corporation short tax year: $200,000 = ($365,000 / 365 days x 200 days)

If Island Life uses the specific identification method to allocate income, how much will it allocate to the S corporation short year and C corporation short year?

S corporation short tax year = $100,000

C corporation short tax year = $265,000

Observation: if the entity wanted to minimize the income subject to tax as a C corporation, it would use the daily method of allocating income.

**III. Operating Issues**

i. *Accounting Methods and Periods*

Similar to partnerships, S corporations determine their accounting periods and make accounting method elections at the entity level.

* all prior accounting methods carry over to the S corporation if the entity previously operated as a C corporation.
* may use the cash, accrual, or hybrid method of accounting (recall that C corporations and partnerships face restrictions on using the cash method)
* generally required to adopt a calendar tax year unless they can establish a business purpose for an alternative year-end or a natural business year-end.

ii. *Income and Loss Allocations*

* profits and losses are allocated pro rata to shareholders based on the number of outstanding shares each shareholder owns on each day of the tax year.
* S corporation determines each shareholder’s share of ordinary business income (loss) and separately stated items
* *ordinary business income*: all income (loss) exclusive of any separately stated items of income (loss)
* *separately stated items*: tax items that are treated differently than a shareholder’s share of ordinary business income (loss) for tax purposes
* similar to partnerships (see chapter 9) with a couple exceptions: guaranteed payments and self-employment income – not reported by S corporations.

Example 6: Using the facts from Example 5, with the exception that Chance sold his shares to Sean, rather than to Margaritaville Inc., how much income is allocated to each shareholder if Island Life uses the daily method of allocating income?

|  |  |  |  |
| --- | --- | --- | --- |
|  | **(1)** | **(2)** | **(1) + (2)** |
|  | **January 1 – June 14** | **June 15 – December 31** | **Total 2018 Allocation** |
| Sean | $55,000 | $133,333 | **$188,333** |
|  | ($365,000/365 x 165 x 1/3) | ($365,000/365 x 200 x 2/3) |  |
| Nina | $55,000 | $66,667 | **121,667** |
|  | ($365,000/365 x 165 x 1/3) | ($365,000/365 x 200 x 1/3) |  |
| Chance | $55,000 | $0 | **55,000** |
|  | ($365,000/365 x 165 x 1/3) |  |  |
| Totals | $165,000 | $200,000 | $365,000 |

How much 2018 income is allocated to each shareholder if Island Life uses the specific identification method to allocate income?

Sean: $210,000 = [($100,000 x 1/3) + ($265,000 x 2/3)]

Nina: $121,667 = ($365,000 x 1/3)

Chance: $33,333 = ($100,000 x 1/3)

iii. *Reporting and Compliance*

* Form 1120S: required to file annually
* Schedule K: reports each shareholder’s pro rata share items
* Schedule K-1: provided to each shareholder and details the amount *and* character of items of income and loss
* shareholders must report these items on their individual tax returns even if they do not receive cash distributions during the year.
* S corporations may hold stock in C corporations
* dividends received flow through to shareholders
* not entitled to dividend received deduction (DRD) as corporations are

**IV. Shareholder’s Basis**

S corporation shareholders must determine their bases in the S corporation stock to determine:

* gain or loss recognized when they sell the stock
* taxability of distributions
* deductibility of losses

i. *Initial Basis*

- Stock received in exchange for property

* basis in stock = (tax basis of property transferred less any liabilities assumed by the corporation on the property contributed)
* increased by: gains recognized
* reduced by: FMV of any property received other than stock

- Stock received by purchase from entity or from another shareholder

* basis in stock = purchase price of the stock

Example 7: At the beginning of 2018, Sean contributed $30,000 of cash and land with a FMV of $130,000 and an adjusted basis of $125,000 to Island Life. The land was encumbered by a $40,000 mortgage executed three years before. Nina and Chance each contributed cash of $120,000 to Island Life. What tax bases do Sean, Nina, and Chance have in their Island Life stock at the beginning of 2018?

Sean’s basis: $115,000 = ($30,000 cash + $125,000 AB of land - $40,000 mortgage assumed)

Nina’s basis: $120,000 cash

Chance’s basis: $120,000 cash

ii. *Annual Basis Adjustments*

* C corporation rules govern the initial stock basis of an S corporation shareholder
* Partnership rules closely resemble subsequent basis adjustments

Key Facts:

* A shareholder increases the tax basis in her S corporation stock for:
* Contributions
* Share of ordinary business income
* Separately stated income/gain items
* tax-exempt income
* A shareholder decreases the tax basis in her S corporation stock for:
* Cash distributions
* Share of nondeductible expenses
* Share of deductible expenses
* Share of ordinary business loss
* Separately stated expense/loss items
* A shareholder’s tax basis may not be negative.
* unlike partners in a partnership, S corporation shareholders are not allowed to include any S corporation debt in their stock basis.

So, all else equal, an S corporation shareholder’s basis will be lower than a partner’s basis

iii. *Loss Limitations*

S corporations have loss limitation rules similar to those for partnerships. I decided to discuss loss limitations for this chapter rather than for the partnership chapter because we covered a lot of information for Exam 2 and the final is only on S corporations, so we can dig a little deeper in this chapter.

A loss must clear three hurdles to be deductible for shareholders: 1) tax-basis limitation; 2) at-risk amount; and 3) passive activity.

1) tax-basis limitation

* shareholders cannot deduct losses in excess of their stock basis
* losses allocated in excess of a shareholder’s basis must be suspended and carried forward indefinitely until the shareholder has sufficient basis to utilize the losses.
* shareholders can mitigate the disadvantage of not including S corporation debt in their stock basis by loaning money directly to their S corporation.

- these loans create **debt basis**

* losses are limited: 1) first to shareholders’ tax bases in their shares (i.e., stock basis) **and then** 2) to their bases in any direct loans made to the S corporation (i.e., debt basis).
* any net increase in basis for the year (in subsequent years): 1) first restores the shareholder’s debt basis up to the outstanding debt amount **and then** 2) the shareholder’s stock basis
* any loan repayment by the S corporation in excess of the shareholder’s debt basis will trigger a taxable gain to the shareholder (this is usually only an issue if the shareholder does not restore her debt basis before the S corporation repays the loan)

**Example (8a)**: Suppose at the beginning of 2018, Sean’s basis in his Island Life stock was $14,000. During 2018, Island Life reported a $60,000 ordinary business loss and no separately stated items. How much of the ordinary loss is allocated to Sean? Remember that Sean owns 1/3 of Island Life’s stock.

Answer: loss allocation is $20,000 🡨 ($60,000 x 1/3)

**Example (8b)**: How much of the $20,000 loss clears the tax-basis hurdle for deductibility in 2018?

Answer: The amount of Sean’s basis in his Island Life stock, i.e., $14,000. The remaining $6,000 loss does not clear the tax basis hurdle; it is suspended until Sean generates additional basis.

**Example (9a)**: Suppose at the beginning of 2018, Sean’s basis in his Island Life stock was $14,000. During 2018, Sean loaned $8,000 to Island Life, and Island Life reported a $60,000 ordinary business loss and no separately stated items. How much of the $20,000 ordinary loss allocated to Sean clears the tax basis hurdle for deductibility in 2018?

Answer: All $20,000. The first $14,000 of the loss reduces his stock basis to $0, and the remaining $6,000 reduces his debt basis to $2,000 ($8,000 - $6,000).

**Example (9b)**: Suppose in 2019, Island Life allocated $9,000 of ordinary business income to Sean and no separately stated items. What are Sean’s Island Life stock basis and debt basis at the end of 2019?

Answer: His stock basis is $3,000; his debt basis is $8,000. The income first restores debt basis to the outstanding debt amount (i.e., $8,000), and then increases his stock basis.

2) at-risk amount

* losses are deductible up to a shareholder’s at-risk amount in the S corporation

- at-risk amount = sum of shareholder’s stock and debt basis.

3) passive activity loss limitation

* passive activity: “any activity which involves the conduct of a trade or business, and in which the taxpayer does not materially participate”

- example: rental real estate

* limits the ability of S corporation shareholders to deduct losses of the S corporation unless the shareholders are involved in actively managing the business.

**V. Distributions**

S corporations face special rules when accounting for distributions.

i. *Operating Distributions*

* Shareholder level tax consequences depend on the history of the S corporation:

- whether the S corporation had accumulated earnings and profits (AE&P) from a previous year as a C corporation at the time of the distribution.

i.a. No C Corporation AE&P

Two sets of historical circumstances could apply here: 1) entity may have always been an S Corporation; or 2) entity converted from a C corporation and did not have AE&P at time of distribution.

* partnership rules apply:

- distributions to shareholders are tax free up to shareholders’ stock basis

- excess distribution over stock basis is treated as capital gains.

i.b. With C Corporation AE&P

* Rules are more complex and are designed to ensure that shareholders cannot avoid the dividend tax on dividend distributions out of the C corporation AE&P by simply electing S corporation status and then distributing the AE&P.
* Tax laws require S corporations to maintain an **accumulated adjustments account (AAA)**

- determines taxability of S corporate distributions

- represents the cumulative income or losses for the period the corporation has been an S corporation.

**Calculating AAA**

|  |  |
| --- | --- |
|  | Beginning of year AAA balance |
| + | Separately stated income/gain items (excluding tax-exempt income) |
| + | Ordinary income |
| – | Separately stated losses and deductions |
| – | Ordinary losses |
| – | Nondeductible expenses that are not capital expenditures (except deductions related to generating tax-exempt income) |
| – | Distributions out of AAA |
| = | End of year AAA balance |

* AAA may have a negative balance

- distributions may not cause or extend a negative balance

Example 10: Island Life was originally formed as a C corporation and reported 2017 taxable income (and E&P) of $40,000. Effective the beginning of 2018, it elected to be taxed as an S corporation. In 2018, Island Life reported $249,000 of overall income (including separately stated items $6,000 interest income and $3,000 dividends). What is the amount of Island Life’s AAA for 2018 before considering the effects of distributions?

(1) separately stated items: $ 9,000

(2) ordinary business income: 240,000

$249,000

Assume that during 2018, Island Life distributed $300,000 to its shareholders. What is Island Life’s AAA at the end of 2018?

$0. A distribution cannot cause AAA to be negative.

Instead of reporting $249,000 of income during 2018, assume that during 2018 Island Life reported an ordinary business loss of $45,000, a separately stated charitable contribution of $5,000 and a $6,000 distribution to shareholders. What is Island Life’s AAA at the end of 2018?

$45,000 + $5,000 = $50,000 negative AAA.

Key Facts:

Distributions are deemed to be paid from (order matters):

1) accumulated adjustments account (AAA)

* tax-free to the extent of basis

2) existing AE&P

* taxable as dividends

3) shareholder’s remaining basis in the S corporation stock, if any

* tax-free to the extent of basis
* excess over basis taxed as capital gains

Example 11: Assume at the end of 2018, before considering distributions, Island Life’s AAA was $24,000 and its AE&P from 2017 was $40,000. Also assume that Sean’s basis in his Island Life stock is $80,000. If Island Life distributes $60,000 on July 1 ($20,000 to each shareholder), what is the amount and character of income Sean must recognize on his $20,000 distribution, and what is his stock basis in Island Life after the distribution?

$12,000 dividend income and $72,000 stock basis after distribution.

|  |  |  |
| --- | --- | --- |
| **Description** | **Amount** | **Explanation** |
| (1) total distribution | $60,000 |  |
| (2) Island Life’s AAA beginning balance | 24,000 |  |
| (3) distribution from AAA | 24,000 | lesser of (1) or (2) |
| (4) distribution in excess of AAA | 36,000 | (1) – (3) |
| (5) Sean’s share of AAA distribution | 8,000 | (3) x 1/3 (nontaxable reduction in stock basis) |
| (6) Sean’s beginning stock basis | 80,000 |  |
| **(7) Sean’s ending stock basis** | **72,000** | (6) – (5) |
| (8) Island Life’s E&P balance | 40,000 |  |
| (9) dividend distribution (from E&P) | 36,000 | lesser of (4) or (8) |
| **Sean’s share of dividend** | **12,000** | (9) x 1/3 |

ii. *Property Distributions*

Key Facts:

* S corporations recognize gains but not losses when they distribute property to their shareholders.
* treated as though S corporation had sold the appreciated property for its FMV just prior to the distribution.
* distribution amount to shareholders = FMV of the property received (less any liabilities the shareholder assumes on the distribution).
* rules of taxability to shareholders on property distributions are the same as those for cash distributions
* shareholders take a FMV basis in the property received in the distribution.

Example 12: Assume that at the end of 2018, Island Life distributes LTCG property (FMV of $24,000, basis of $15,000) to each shareholder (aggregate property distribution of $72,000 with an aggregate basis of $45,000). At the time of the distribution, Island Life has no corporate E&P and Sean has a basis of $10,000 in his Island Life stock. How much gain, if any, does Island Life recognize on the distribution? How much income does Sean recognize as a result of the distribution?

|  |  |  |
| --- | --- | --- |
| **Description** | **Amount** | **Explanation** |
| (1) FMV of distributed property | $72,000 |  |
| (2) Island Life’s basis in distributed property | 45,000 |  |
| **(3) Island Life’s LTCG on distribution** | **27,000** | (1) –(2) |
| (4) Sean’s share of LTCG from Island Life | 9,000 | (3) x 1/3 |
| (5) Sean’s stock basis after gain allocation | 19,000 | $10,000 beginning basis + (4) |
| (6) distribution to Sean | 24,000 | (1) x 1/3 |
| (7) Sean’s stock basis after distribution | 0 | (5) – (6) limited to $0 |
| (8) LTCG to Sean on distribution in excess of stock basis | 5,000 | (6) in excess of (5) |
| **Sean’s total LTCG on distribution** | **14,000** | (4) + (8) |

iii. *Liquidating Distributions*

* follow corporate tax (rather than partnership) rules
* complete liquidation:

- recognize gain or loss on each asset

but remember that that S corporations recognize gain but not loss on operating distributions of noncash property

- allocated to shareholders

- increases (gains) or decreases (losses) stock basis

- gain: FMV of property exceeds stock basis

- loss: stock basis exceeds FMV of property

Example 13: Assume that at the end of 2019, Island Life liquidates by distributing LTCG property (FMV of $20,000, basis of $12,000) to each shareholder (aggregate property distribution of $60,000 with an aggregate basis of $36,000). At the time of the distribution, Island Life has no corporate E&P and Sean has a basis of $25,000 in his Island Life stock. How much gain, if any, does Island Life recognize on the distribution? How much gain or loss does Sean recognize as a result of the distribution?

|  |  |  |
| --- | --- | --- |
| **Description** | **Amount** | **Explanation** |
| (1) FMV of distributed property | $60,000 |  |
| (2) Island Life’s basis in distributed property | 36,000 |  |
| **(3) Island Life’s LTCG on distributed** | **24,000** | (1) –(2) |
| (4) Sean’s share of LTCG from Island Life | 8,000 | (3) x 1/3 |
| (5) Sean’s stock basis after gain allocation | 33,000 | $25,000 beginning basis + (4) |
| (6) distribution to Sean | 20,000 | (1) x 1/3 |
| (7) Sean’s LTCL on liquidating distribution | (13,000) | (6) – (5) |
| **Sean’s net LTCL on distribution** | **(5,000)** | (4) + (7) |

**OTHER (Generally) Corporate Level Taxes:**

1. Built in Gains Tax – 5 years
2. Excess Net Passive Income Tax
3. LIFO Recapture Tax