

A Roundup of Recent Tax Developments for S Corporations

In recent years, the proliferation of S corporations was somewhat eclipsed by the growing popularity of limited liability companies (LLCs). Still, S corporations continue to abound. According to the Spring 2005 Statistics of Income Bulletin, as of tax year 2002 (the latest year for IRS statistics), 3.2 million S corporations accounted for nearly 60 percent of all corporate returns compared to 1.09 million LLCs in tax year 2003.

Recent federal legislation, court decisions and IRS rulings made changes in the tax rules for S corporations. Here is a survey of some key developments.

Overview

S corporations, formed under state law, make a special federal election to have corporate income, expenses, credits and other items passed through to shareholders and taxed on their personal returns. The election is made by timely filing IRS Form 2553, Election by a Small Business Corporation with the IRS.

A separate election can be made at the state level in most states. For example, in New York, the S corporation election is made with the NYS Department of Taxation and Finance on Form CT-6, Election by Federal S Corporation to Be Treated as a New York S Corporation.

An LLC that wants to elect to be treated as an association (taxed as a corporation under federal tax law) can now do so using the so-called "check-the-box" regulations and filing IRS Form 8832, Entity Classification Election. However, if the LLC also wants to make an S corporation election, it accomplishes both goals by filing one form: Form 2553. Instructions to Form 8832 were revised to say it need not be filed if the LLC is filing Form 2553.

An LLC might elect S corporation status because forming an LLC offers greater creditor protection for an owner than an S corporation. A successful creditor can obtain the shareholder's shares and enjoy the right to vote in an S corporation, while only obtaining a charging order against an LLC member's interest. Existing S corporations that want to become LLCs can do so using an "F" reorganization.

Shareholder Basis

S corporation shareholders can deduct losses (corporate expenses in excess of corporate income) passed through to them only to the extent of their basis in S corporation stock and loans to the corporation. If there is not sufficient basis in the current year, it can be carried forward and used to the extent of basis in future years.

Transfers incident to divorce. A spouse or former spouse may transfer stock in an S corporation with respect to which there



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are carryover losses. The American Jobs Creation Act of 2004 (P.L. 108-357) allowed the new shareholder to deduct carryover losses in tax years beginning after Dec. 31, 2004. However, a technical correction in the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) modified this effective date. The rule applies to transfers after this date, rather than tax years beginning after this date.

Third-party loans: To increase basis by a loan, there must be an economic outlay by the shareholder. Thus, the shareholder can usually only include loans in basis that are made directly to the corporation. A shareholder who guarantees a third-party loan to the corporation can include this in basis only when called upon to pay the loan.

For example, a shareholder who borrowed money from a bank, deposited it in the account of his S corporation and then transferred the funds to two related S corporations he owned and which distributed the funds back to him, could not increase basis by this circular transaction (Kaplan, TC Memo 2005-218). There was no economic outlay in this case.

However, in another case where two brothers, each 50 percent shareholders in an S corporation and 50 percent partners in a partnership, could increase their basis in loans to the S corporation for funds advanced to the corporation indirectly from their partnership (Ruckriegel, TC Memo 2006-78). The partnership made a wire transfer of its funds to the brothers, who then advanced the money to the S corporation. The arrangement in this case had the requisite economic substance to create basis.

Also, in yet another case, an S corporation shareholder who gave a third-party lender a full recourse promissory note for a loan made to the corporation was entitled to include the loan in his basis, along with funds he borrowed personally from the same lender and loaned directly to the corporation (Miller, TC Memo 2006-125). The reason? The terms of the promissory note made him responsible for repayment. Using a "substance

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New Schedule M-3 for Larger Sub S Corporations

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over form” analysis, the Tax Court concluded that the taxpayer had an economic outlay by virtue of the promissory note.

Health Insurance Coverage

Health insurance coverage for shareholders owning more than 2 percent of the S corporation is not a tax-free fringe benefit. Instead, shareholders report coverage as additional compensation and then deduct their premiums as an adjustment to gross income on their personal returns.

However, the IRS warned that the policy must be purchased by the corporation and not by the shareholder individually (IRS Headliner Volume 163, 5/15/06), even if state law prohibits a one-shareholder S corporation from purchasing health insurance coverage in the corporate name. Note that sole proprietors can deduct health coverage as an above-the-line deduction even if purchased in their name and not in the name of the business (IRS Chief Counsel Advice 200524001).

As a result, the S corporation must purchase the healthcare policy and report the premiums as compensation to the shareholder. The S corporation deducts the compensation and reports this on Form W-2 to the shareholder. The shareholder then report the compensation as income, but claims the above-the-line deduction to create a wash. If a shareholder purchases coverage in his or her own name, the premiums are deductible only as an itemized medical expense, to the extent medical costs exceed 7.5 percent of adjusted gross income.

Built-in Gains Tax

While S corporations are largely pass-through entities, they can become taxpayers in certain situations. One of these situations is where a C corporation converts to S status and sells assets it owned prior to the conversion at a gain within 10 years of the conversion. The gain attributable to the period before the conversion (a built-in gain) is taxed to the S corporation.

In one recent case, an S corporation overpaid tax for its recognized built-in gains. The question before the Tax Court was to consider the appropriate rate of interest on the overpayment, and there were three choices: 1) the federal short-term rate plus three percentage points (the rate enjoyed by non-corporate taxpayers), 2) the federal short-term rate plus two percentage points (the rate for corporate overpayments that do not exceed \$10,000), or 3) the federal short-term rate plus 0.5 percentage points for overpayments exceeding \$10,000 by C corporations.

The Tax Court held that the appropriate rate for S corpora-

tion overpayments, regardless of amount, is the federal short-term rate plus two percentage points [Garwood Irrigation Company, 126 TC No. 12 (2006)]. Code Sec. 6621(c)(3)(A), which governs the interest rate on large corporate overpayments, specifically refers to C corporations only, and so is inapplicable to S corporations.

Because of the potential liability for the built-in gains tax, it is vital that C corporations that convert should obtain an appraisal for assets to lock in potential future gains. In one case, the Tax Court refused to accept the valuation prepared by Andersen’s valuation group, which was being used to fix the

amount of built-in gain without the author of the report testifying about it because of questions concerning the report [Van Der Aa Investments, Inc., 125 TC No. 1 (2005)].


Domestic Production Activities Deduction

Businesses that produce items domestically, through manufacturing, growing, extracting or otherwise, may be entitled to deduct 3 percent of net income derived from these activities (Code Sec. 199). S corporation shareholders claim the deduction on their personal returns with respect to their share of the corporation’s qualified production activities income (QPAI) and expenses. However, the domestic production activities deduction is limited to 50 percent of W-2 wages.

The Tax Increase Prevention and Reconciliation Act of 2005, signed into law on May 17, 2006 (P.L. 109-455), modified the W-2 limitation with respect to S corporation shareholders. Only wages deducted in arriving at QPAI are taken into account. The amount of QPAI and wages for purposes of the 50 percent limitation are reported to shareholders on Schedule K-1 of Form 1120.

Large S Corporations

Starting with 2006 returns, S corporations with total assets of \$10 million or more will have to file new Schedule M-3, Net Income (Loss) Reconciliation for S Corporations with Total Assets of \$10 million or More, with their federal tax return, Form 1120S. The new schedule requires more detailed reconciliation between financial accounting net income and taxable income than previously was required. The increased disclosure on this schedule will enable the IRS to identify returns with potentially higher compliance risk than before.

The first draft of Schedule M-3 was released Dec. 13, 2005. A revised draft came out April 4, 2006, with revised instructions on April 25, 2006. Note that corporations filing Schedule M-3 will not have to file Schedule M-1. 

Sidney Kess has authored hundreds of books on tax-related topics. He probably is best known for lecturing to nearly every state society and more than 700,000 practitioners on tax and estate planning. In 2003 he received special recognition from AICPA and CCH for his many contributions to the tax profession. He created and moderates the annual AICPA Conference on Tax Strategies for the High-Income Individual. A graduate of Harvard Law School, Mr. Kess received his LL.M. from New York University.